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Part 2

January 28, 1998

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Recent Developments

Prepared for the Federal Open Market Committee

By the staff of the Board of Governors of the Federal Reserve System

January 28, 1998

RECENT DEVELOPMENTS

**DOMESTIC NONFINANCIAL
DEVELOPMENTS**

DOMESTIC NONFINANCIAL DEVELOPMENTS

Supply-side indicators of GDP for the fourth quarter provide evidence of continued robust growth as employment and industrial output recorded hefty increases. Spending indicators also point to above-trend growth, but not nearly so strong as those on the supply side. Household outlays decelerated and the saving rate ticked up late last year despite continued high confidence levels. At the same time, growth in real business fixed investment came to a halt after its remarkable surge in the second and third quarters. A tightening of the labor market has caused nominal wages to accelerate somewhat over the past year, but prices decelerated, restrained by falling import and energy prices.

Labor Market Developments

Labor demand expanded rapidly in the fourth quarter. Growth of nonfarm payroll employment averaged 358,000 per month--and the average workweek of production or nonsupervisory workers ticked up. The unemployment rate fell further, to an average of 4.7 percent--the lowest in more than twenty-five years.

The robust pace of hiring late last year reflected gains across all major industries. Notably, manufacturing added 125,000 jobs during the fourth quarter, bringing total growth for the year to 230,000; construction added 88,000 jobs, almost half of its net gain for the year. Employment in retail trade surged, and despite anecdotes of hiring difficulties, general merchandise and apparel outlets added almost 40,000 jobs between September and December, a much larger gain than in earlier quarters. The strong demand for retail workers also was reported to have contributed to a pickup in hiring in the help supply industry, which had shown uncharacteristically weak performance earlier in the year. The weakness in help supply had been attributed in part to a lack of qualified and available workers (perhaps for more technical jobs than seasonal retailing) rather than slackening demand. Other service industries also saw significant increases in hiring during the fourth quarter: Jobs in engineering and management, computer, and health services all rose faster than their 1997 averages.

Fluctuations in the workweek of private production or nonsupervisory workers led to a choppy monthly pattern in the growth

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

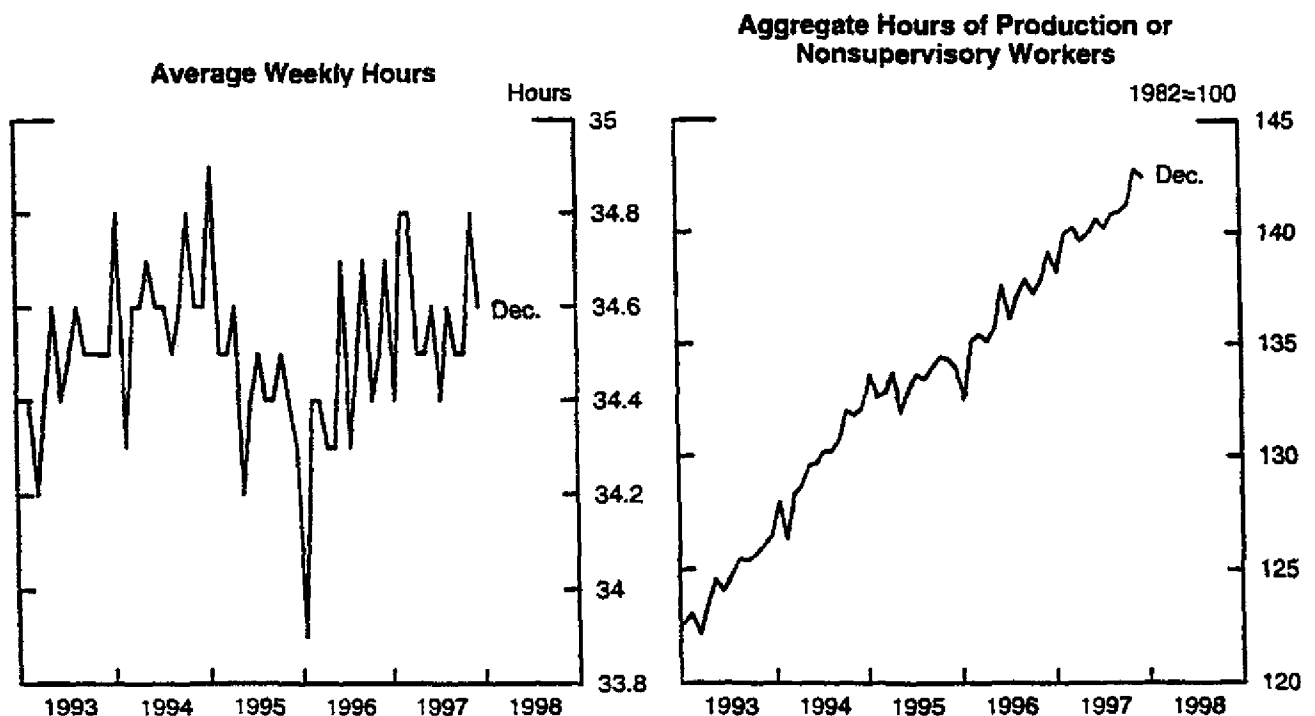
	1996	1997	1997			1997		
			Q2	Q3	Q4	Oct.	Nov.	Dec.
	---Average monthly changes---							
Nonfarm payroll employment ¹	212	267	237	245	358	291	412	370
Private	198	245	206	220	334	256	399	348
Goods Producing	19	37	15	19	70	43	77	89
Manufacturing	-5	19	10	12	42	37	49	39
Construction	24	17	4	7	29	8	30	50
Service Producing	178	208	191	201	265	213	322	259
Transportation and utilities	9	17	10	13	5	24	1	-10
Trade	60	58	52	63	89	68	133	65
Finance, insurance, real estate	11	16	14	16	24	26	24	23
Services	98	117	115	109	147	95	164	181
Help supply services	13	9	-17	5	30	4	57	29
Total government	14	23	31	25	23	35	13	22
Private nonfarm production workers ¹	168	195	163	161	262	177	340	268
Manufacturing production workers	-5	15	7	9	37	33	33	44
Total employment ²	232	240	119	123	339	149	665	202
Nonagricultural	226	243	118	112	351	244	608	201
Memo:								
Aggregate hours of private production workers (percent change) ^{1,3}	2.9	3.0	1.7	1.6	4.4	0.2	1.1	-0.2
Average workweek (hours) ¹	34.4	34.6	34.5	34.5	34.6	34.5	34.8	34.6
Manufacturing (hours)	41.5	42.0	42.0	41.8	42.1	42.0	42.1	42.3

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

1. Survey of establishments.

2. Survey of households.

3. Annual data are percent change from Q4 to Q4. Quarterly data are percent change from preceding period at an annual rate. Monthly data are percent change from preceding month.



of aggregate hours last quarter.¹ Smoothing through these wiggles and including BLS estimates for other wage and salary employees, hours for all employees rose 4.4 percent (annual rate) in the fourth quarter. However, because hours of self-employed and unpaid family workers fell at a 3.2 percent rate, we estimate that hours of all persons in the nonfarm business sector--the series used to estimate labor productivity--rose about 3-1/2 percent (annual rate). Given our expectation for growth of nonfarm business output, productivity appears to have risen at close to its trend rate of 1-1/4 percent last quarter, after two quarters of rapid increases.

The household survey also portrayed a robust labor market at year-end. Household employment growth averaged 339,000 per month last quarter, and the labor force participation rate rose to 67.2 percent in December. Although the overall participation rate changed little on net over 1997, the participation rate for adult women moved up 0.3 percentage point during the year. More than half of this increase came from a further rise in participation among women maintaining families; about 60 percent of these women have children under 18, making them an obvious group to be affected by welfare reform. However, the participation rate for these women has been rising fairly steadily throughout the current expansion, which makes it difficult to separate the effect of the recent welfare reforms from a cyclical response. The fraction of the population not in the labor force but wanting jobs continued to drop last quarter, suggesting limited room for further increases in overall participation rates.

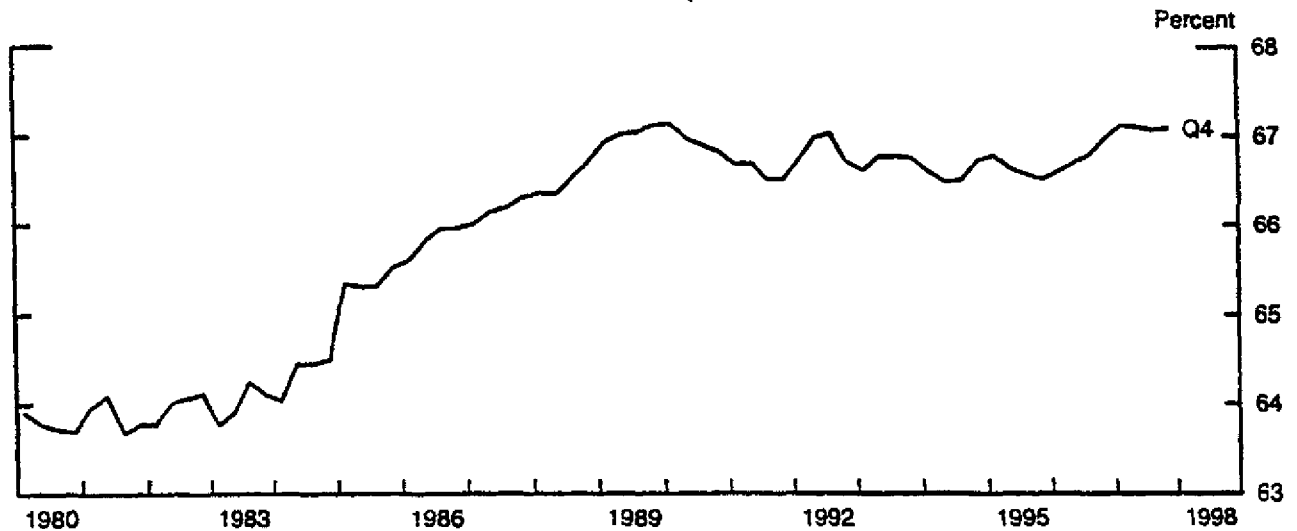
Other indicators also point to a tight labor market. The four-week moving average of state initial claims for unemployment insurance, at 329,000, has held at a level consistent with relatively strong growth of payroll employment. Surveys of businesses conducted by the National Federation of Independent Business and the Bureau of National Affairs showed that the

1. The BLS recently confirmed that the workweek data are sensitive to the number of days in the monthly pay period because of inconsistent reporting by respondents. This problem artificially boosts the change in the workweek when moving from months with more working days to months with fewer (such as from October to November) and causes a subsequent drop in the workweek when the situation is reversed (such as between November and December). The BLS has indicated that the net effect of this bias on the average workweek in the fourth quarter was probably negligible. The agency has embarked on a program to identify establishments that have been reporting incorrectly and expects to publish more consistent data at the time of its annual benchmark in June.

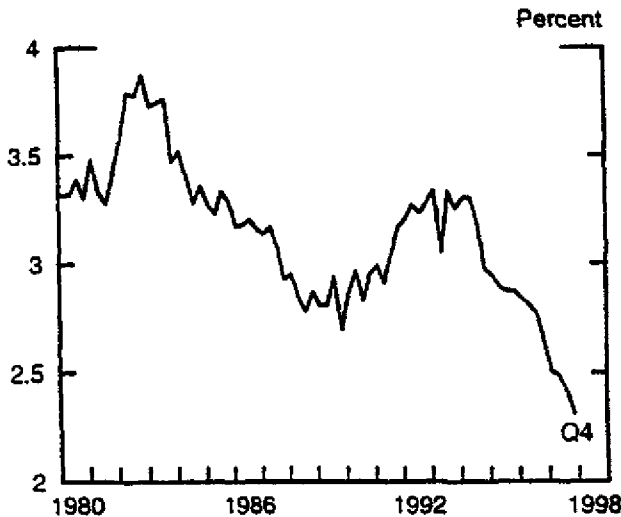
SELECTED UNEMPLOYMENT AND LABOR FORCE PARTICIPATION RATES
 (Percent; based on seasonally adjusted data)

	1996	1997	1997			1997		
			Q2	Q3	Q4	Oct.	Nov.	Dec.
Civilian unemployment rate (16 years and older)	5.4	4.9	4.9	4.9	4.7	4.8	4.6	4.7
Teenagers	16.7	16.0	15.9	16.3	15.0	15.5	15.2	14.3
Men, 20 years and older	4.6	4.2	4.1	4.1	4.0	4.1	3.9	4.1
Women, 20 years and older	4.8	4.4	4.4	4.3	4.0	4.1	4.0	4.0
Labor force participation rate	66.8	67.1	67.1	67.1	67.1	66.9	67.1	67.2
Teenagers	52.3	51.6	51.7	51.1	51.4	50.9	51.8	51.6
Men, 20 years and older	76.8	76.9	77.0	76.9	76.9	76.8	77.0	77.0
Women, 20 years and older	59.9	60.5	60.5	60.6	60.5	60.5	60.4	60.7

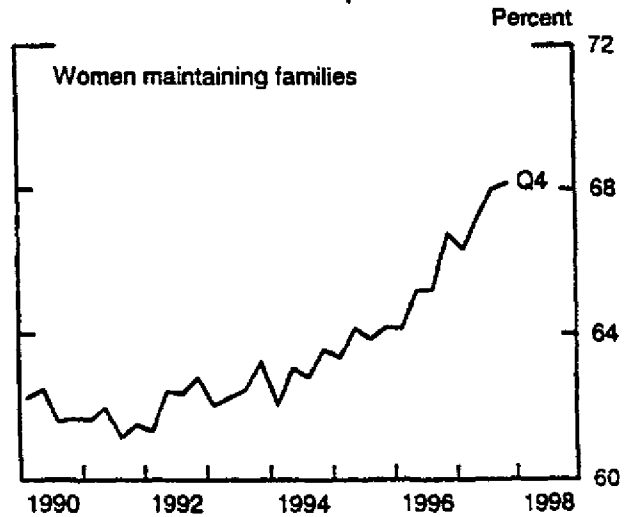
Labor Force Participation Rate



Percent of Population Not in the Labor Force Who Want Jobs



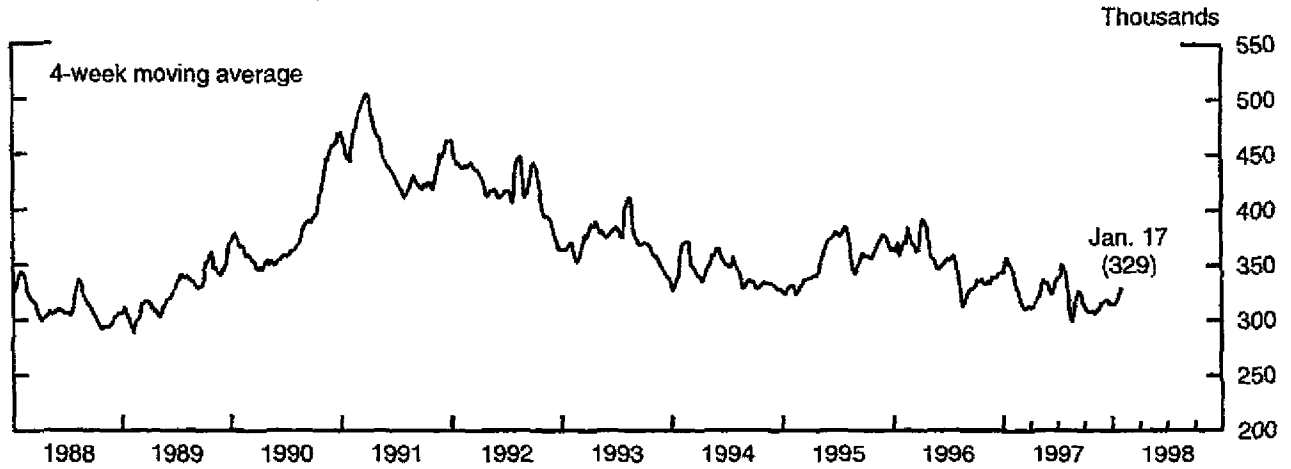
Labor Force Participation Rate



Note. Seasonally adjusted by FRB staff.

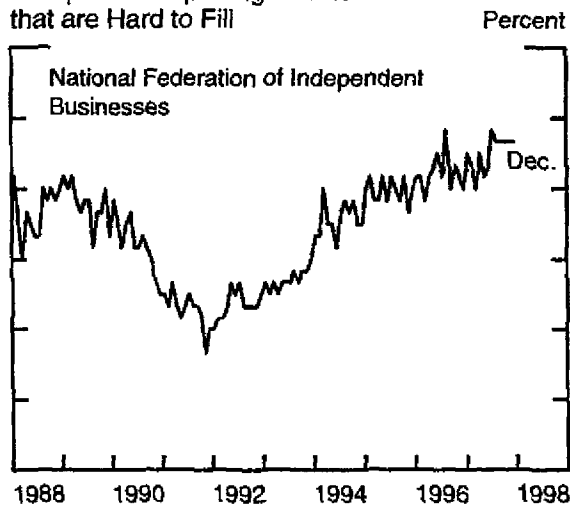
Labor Market Indicators

Initial Claims for Unemployment Insurance

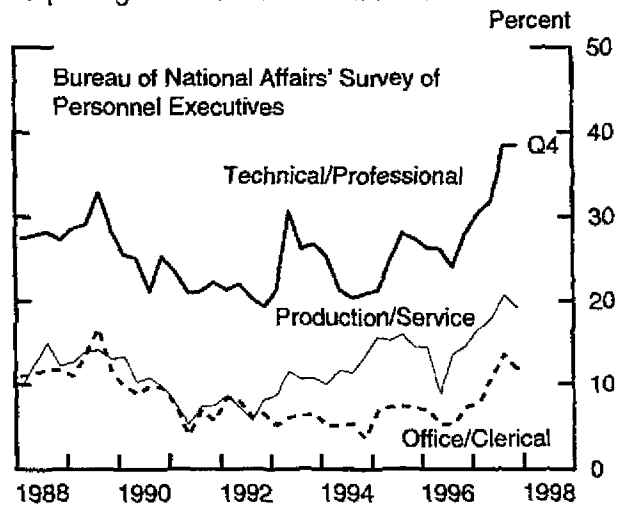


Note. State programs, includes EUC adjustment.

Companies Reporting Positions that are Hard to Fill

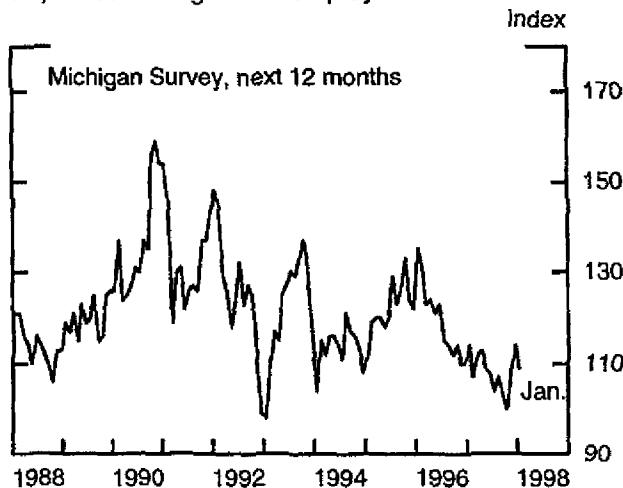


Reporting Some Jobs Difficult to Fill



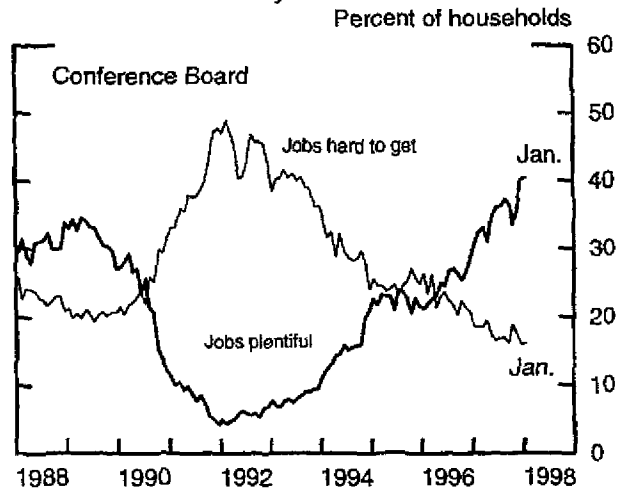
Note. Seasonally adjusted by FRB staff.

Expected Change in Unemployment



Note. Percentage expecting "more" minus percentage expecting "less" plus 100.

Current Job Availability



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

	Proportion 1997	1997 ¹	1997		1997		
			Q3	Q4	Oct.	Nov.	Dec.
			-Annual rate-		--Monthly rate--		
Total index	100.0	5.8	6.0	7.4	.7	.8	.5
Previous			6.1		.5	.8	
Manufacturing	86.2	6.4	6.1	8.3	.7	1.2	.5
Durables	46.6	9.6	10.1	10.6	.7	1.7	.6
Motor vehicles and parts	5.2	10.9	20.5	18.8	-1.1	5.3	-3.6
Aircraft and parts	2.3	18.4	20.3	20.2	.8	1.3	3.1
Nondurables	39.6	2.7	1.5	5.6	.7	.6	.4
Manufacturing excluding motor vehicles and parts	81.0	6.1	5.2	7.6	.8	.9	.8
Mining	6.2	2.3	1.8	-1.5	-.3	-.4	.3
Utilities	7.6	2.3	8.3	5.0	1.4	-1.9	.4
IP by market group							
Consumer goods	28.3	2.8	2.6	6.4	.8	.8	.3
Durables	6.0	6.2	6.6	11.6	-.6	3.8	-.1
Nondurables	22.3	1.9	1.6	5.1	1.2	.1	.4
Business equipment	13.7	10.5	13.5	9.4	.7	1.2	.4
Information processing	5.5	12.4	16.4	10.1	.8	.3	1.2
Industrial	4.5	5.6	9.0	6.7	1.6	.4	.8
Transit	2.4	15.6	21.4	17.4	-1.2	4.6	-.7
Other	1.3	9.5	3.4	1.7	1.6	.4	-1.2
Construction supplies	5.6	2.0	-2.0	3.3	.7	1.1	.6
Materials	40.3	7.6	8.4	8.7	.6	1.0	.7
Durables	22.9	11.6	12.1	13.7	1.2	1.7	.9
Semiconductors	3.7	40.2	40.3	33.0	2.3	3.7	3.1
Basic metals	3.6	5.6	4.3	11.2	1.4	1.2	.5
Nondurables	9.0	3.1	2.8	3.9	-.1	1.0	.4

1. From the final quarter of the previous period to the final quarter of the period indicated.

CAPACITY UTILIZATION
(Percent of capacity; seasonally adjusted)

	1988-89	1959-97	1996	1997		1997		
	High	Avg.	Q4	Q3	Q4	Oct.	Nov.	Dec.
Manufacturing	85.7	81.7	81.4	81.6	82.2	81.8	82.4	82.5
Primary processing	88.9	82.8	85.9	85.8	86.2	85.7	86.3	86.7
Advanced processing	84.2	81.1	79.4	79.8	80.4	80.0	80.6	80.6

proportion of companies reporting jobs difficult to fill remained at very high levels at year-end. In addition, smoothing through the monthly gyrations, the Michigan SRC and Conference Board surveys of households continue to point to very favorable perceptions of labor market conditions early in 1998.

Industrial Production

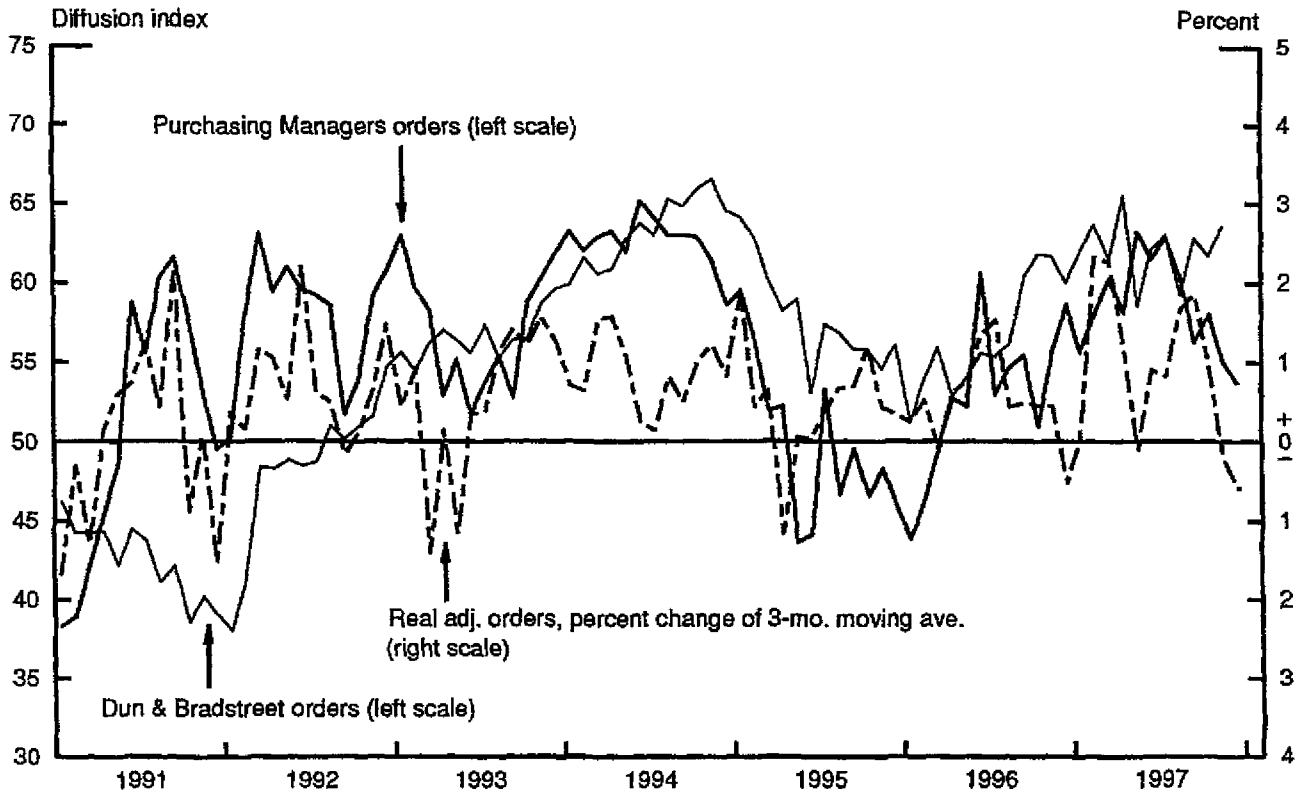
Total industrial production rose 7-1/2 percent at an annual rate in the fourth quarter, with manufacturing output soaring 8-1/4 percent, the fastest growth rate since the fourth quarter of 1994. Production of durable goods continued to advance briskly, particularly in industries producing motor vehicles and parts, aircraft and parts, and information technology goods. However, growth in the production of computing and office equipment slowed to about a 20 percent annual rate in the fourth quarter from the third-quarter's blistering 50 percent increase. Output in nondurable goods production picked up in the fourth quarter after having been sluggish earlier in the year; the advance was led by gains in food, printing and publishing, and chemical products.

The operating rate in manufacturing reached 82.5 percent in December, but was just a bit above its historical average and 1.8 percentage points below its most recent peak in January 1995. Anecdotal reports suggest few bottlenecks and continued rapid capacity growth.²

Production of motor vehicles and parts advanced almost 19 percent (annual rate) in the fourth quarter as automakers made up output lost to strikes and start-up problems in the third quarter. Production in December fell from November's high level, and industry schedules call for a further decrease in motor vehicle assemblies in the first quarter. At the end of December, the days' supply of light trucks and autos were at comfortable levels.

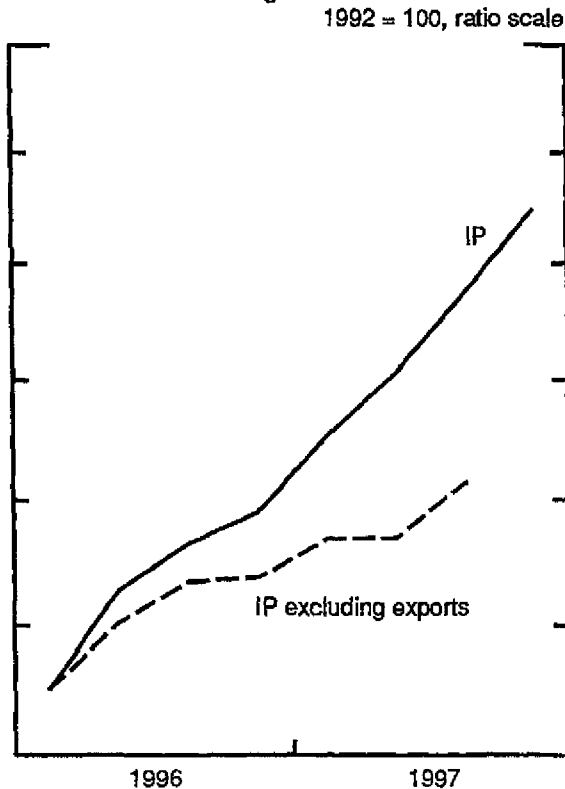
2. The most recent semiannual economic forecast from the National Association of Purchasing Managers, conducted in November and released early in December, indicated that the proportion of purchasing executives who expect capital expenditures to rise over the next year exceeds the proportion who expect capital expenditures to fall by 20 percentage points. In contrast, the margin was only 6 percentage points in December 1996. We expect to receive information from NAPM in February as to whether this optimistic forecast has been tempered by economic developments in Asia.

Indicators of Future Production

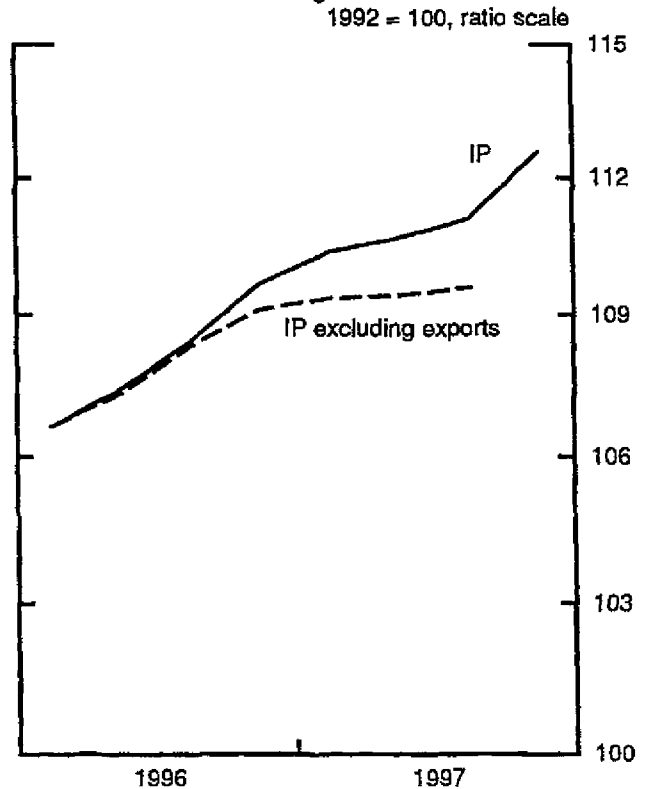


Contribution of Exports to Industrial Production

Durable Manufacturing



Nondurable Manufacturing



Note. For IP excluding exports, exports held at their value in 1996:Q1.

PRODUCTION OF DOMESTIC AUTOS AND TRUCKS
(Millions of units at an annual rate; FRB seasonal basis)

	1997		1998	1997		1998
	Nov.	Dec.	Jan.	Q3	Q4	Q1
U.S. production	13.0	12.5	Sched. 12.7	11.9	12.6	Sched. 12.1
Autos	6.1	5.8	6.0	6.0	5.9	5.6
Trucks	6.9	6.7	6.7	5.9	6.7	6.5
Days' supply						
Autos	64.0	60.0	--	56.8	60.0	--
Light trucks	68.9	73.0	--	71.9	70.6	--

Note. Components may not sum to totals because of rounding. Days' supply estimates use sales figures adjusted for shifts in reporting periods.

Several other factors also suggest that growth in industrial production is likely to moderate in the first quarter. The staff's estimate of real adjusted durable goods orders was little changed in the fourth quarter, after having increased 4.4 percent in the third quarter. In December, the new orders index from the National Association of Purchasing Managers (NAPM) fell to its lowest level in more than a year. In contrast, the monthly new orders index by Dun and Bradstreet remained more optimistic.³

Signs of slowing export demand have begun to appear. The NAPM index of new export orders fell in December to its lowest level since January 1996. Also, anecdotal reports, including the Beige Book, suggest that some manufacturers are seeing weaker demand from Asia, although the dimensions of that weakening, to date, remain unclear. Export demand has been an important contributor to the strength in output over the past two years; as shown in the accompanying chart, we estimate that the growth in exports from the first quarter of 1996 through the third quarter of 1997 contributed 6.2 percentage points to the 12.6 percent rise in durable manufacturing production over that period.⁴ Export growth was a less important source of growth in nondurable manufacturing.

3. Dun and Bradstreet also publishes a quarterly report. Manufacturers in this survey also lowered their expectations for new orders in the first quarter of this year relative to the fourth quarter of 1997; nonetheless, this index also is still at a relatively optimistic level.

4. Exports figures are converted to an IP basis by deflating nominal exports by BLS export price indexes, and multiplying the resulting real export figures by an adjustment factor based on the ratio of IP to shipments in 1992.

RETAIL SALES
(Percent change; seasonally adjusted)

	1997		1997			
	Q3	Q4	Sept.	Oct.	Nov.	Dec.
Total sales	1.8	.2	-.3	-.1	.3	.7
Previous estimate	1.8		-.3	-.2	.2	
Building materials and supplies	-.7	-.6	-.1	.6	-1.2	.2
Automotive dealers	3.6	-.2	-1.6	-1.2	1.2	2.3
Retail control ¹	1.4	.4	.1	.2	.1	.2
Previous estimate	1.4		.1	.2	.3	
GAP	1.9	.3	-1.0	.5	.3	.7
Durable goods	1.6	2.4	-.9	1.5	1.3	1.6
Furniture and appliances	1.9	1.0	-1.5	.5	1.2	1.6
Other durable goods	1.4	3.6	-.5	2.3	1.4	1.7
Nondurables	1.4	.0	.3	-.1	-.2	-.1
Apparel	2.8	-.7	-2.4	.3	.3	.8
Food	1.1	.5	.8	-.2	.4	-.4
General merchandise	1.5	.4	-.3	.5	-.1	.2
Gasoline stations	1.0	-.3	1.2	.0	-1.5	-1.1
Other nondurables	1.4	-.6	.8	-.5	-.6	.1

1. Total retail sales less building material and supply stores and automotive dealers, except auto and home supply stores.

REAL PCE SERVICES
(Percent change from the preceding period;
derived from billions of chained (1992) dollars)

	1997		1997		
	Q2	Q3	Sept.	Oct.	Nov.
	- Annual rate -		--- Monthly rate ---		
Services	3.9	3.9	.3	.6	.2
Energy	14.3	-6.6	1.1	2.3	.1
Non-energy	3.4	4.4	.3	.5	.2
Housing	2.1	2.0	.1	.2	.2
Household operation	5.4	8.3	.4	.5	.5
Transportation	3.3	6.1	.8	.2	.4
Medical	2.5	3.1	.4	.3	.4
Personal business	3.6	7.5	.8	1.5	-.2
Brokerage and investment	-3.8	28.0	3.6	9.0	-5.5
Other	6.1	5.2	-.2	.8	.0

Consumption and Personal Income

Growth in consumer outlays moderated in the fourth quarter after having surged more than 5-1/2 percent at an annual rate in the third quarter. Nevertheless, circumstances seem favorable for sizable spending gains in the near term: Real disposable income growth has been ample in recent months; consumer sentiment remains decidedly upbeat; and households have enjoyed a stunning increase in net worth.

According to the Census Bureau's advance report, total nominal retail sales increased 0.7 percent in December and 0.2 percent in the fourth quarter (not at annual rate). Spending in the retail control category, which excludes sales at automotive dealers and building material and supply stores, rose 0.2 percent in December and 0.4 percent in the quarter as a whole (not at an annual rate).

Nominal outlays at outlets for durable goods within the retail control category--furniture and appliance stores and stores selling "other durable goods"--posted strong gains in December, and these stores recorded strong sales fairly consistently throughout the fourth quarter. However, at stores selling nondurable goods, sales edged down in December and were unchanged in the fourth quarter.

The retail sales report suggests that real personal consumption expenditures (PCE) for goods excluding motor vehicles rose 0.4 percent in December and 1.1 percent at an annual rate in the fourth quarter. Building in a small anticipated decline in real motor vehicle purchases, we estimate that real PCE for all goods likely increased about 3/4 percent at an annual rate in the fourth quarter.⁵

Real expenditures for services rose 0.6 percent in October and 0.2 percent in November. In November, real outlays for energy services (natural gas and electricity) were little changed, while brokerage and investment services were pushed sharply lower by a drop in trading volume. Looking to December, temperatures were about average for the month, suggesting only a small rise in energy services. However, trading volume on major U.S. exchanges rose about 4 percent, which should boost real outlays for financial services.

The personal saving rate averaged 3.9 percent over October and November, after having dropped to 3.5 percent in the third quarter.

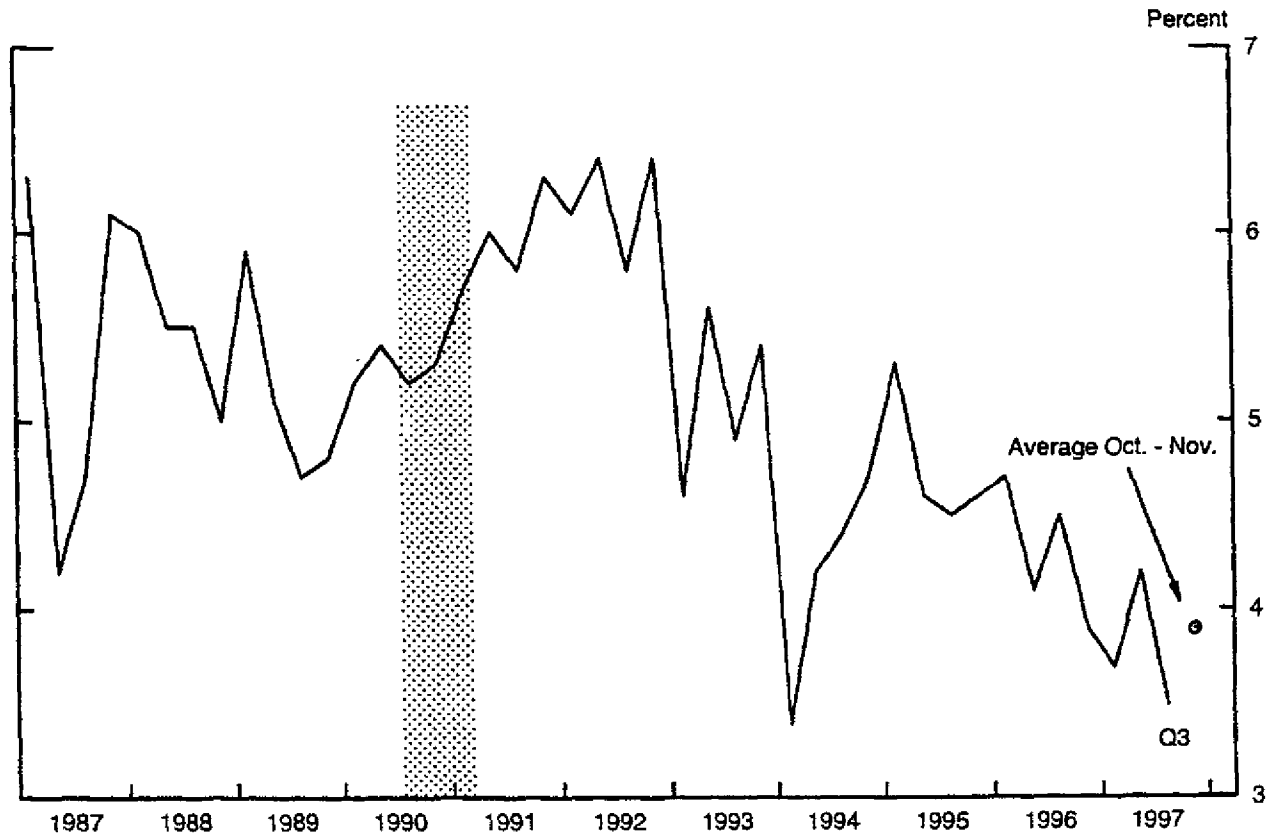
5. As described in the motor vehicle section, we expect BEA to adjust motor vehicle sales for changes in the reporting period.

PERSONAL INCOME
(Average monthly percent change)

	1996	1997			1997		
		Q1	Q2	Q3	Sept.	Oct.	Nov.
	Q4/Q4	--- Annual rate ---			--- Monthly rate ---		
Total personal income	5.8	8.0	5.0	4.6	.3	.6	.8
Wages and salaries	6.4	8.3	5.4	5.8	.4	.7	1.1
Private	7.1	8.9	6.0	6.3	.4	.8	1.3
Less: Personal tax and nontax payments	12.5	15.1	10.2	7.9	.4	.8	1.1
Equals: Disposable personal income	4.8	6.8	4.2	4.1	.3	.5	.7
Memo:							
Real disposable income ¹	2.0	4.6	3.1	2.6	.2	.4	.6
Saving rate (percent)	4.3	3.7	4.2	3.5	3.7	3.8	4.0

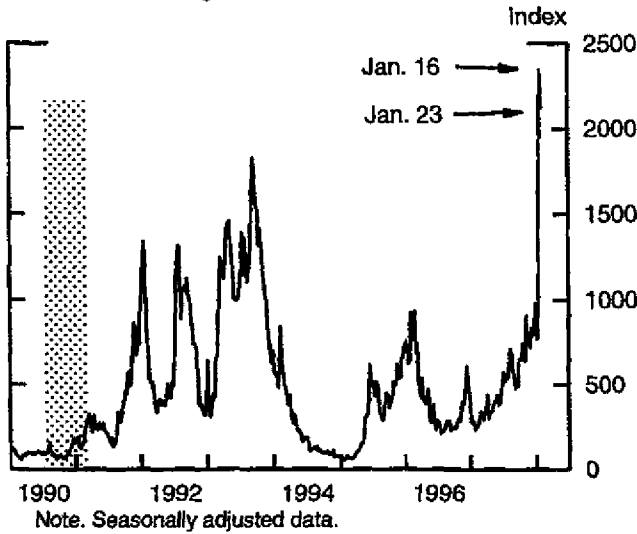
Note. Derived from BEA's advance estimates.
1. Derived from billions of chained (1992) dollars.

NIPA Personal Saving Rate

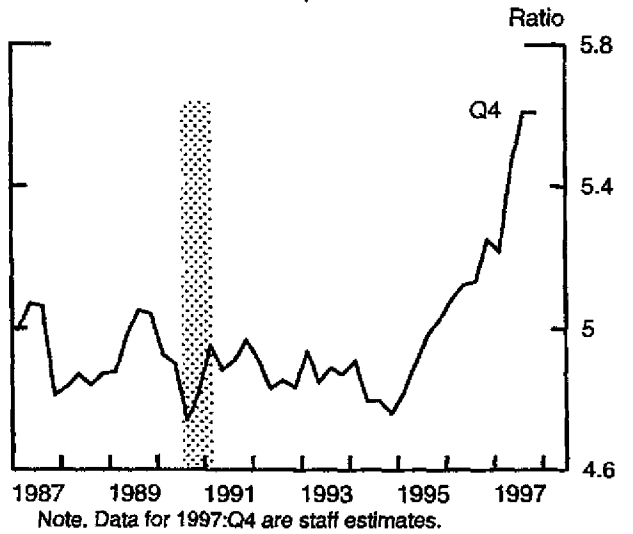


Household Indicators

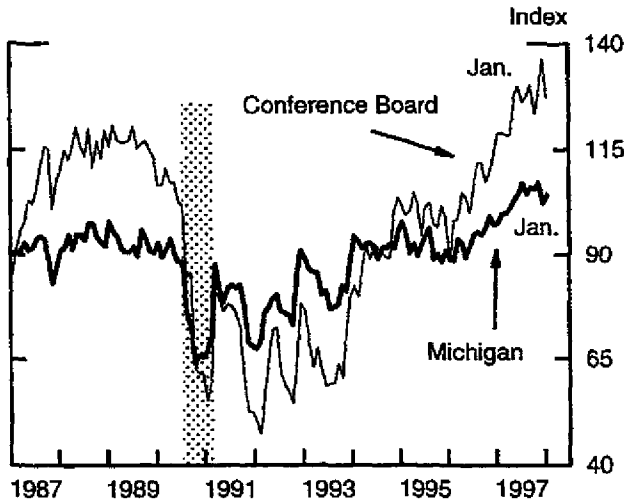
MBA Refinancing Index



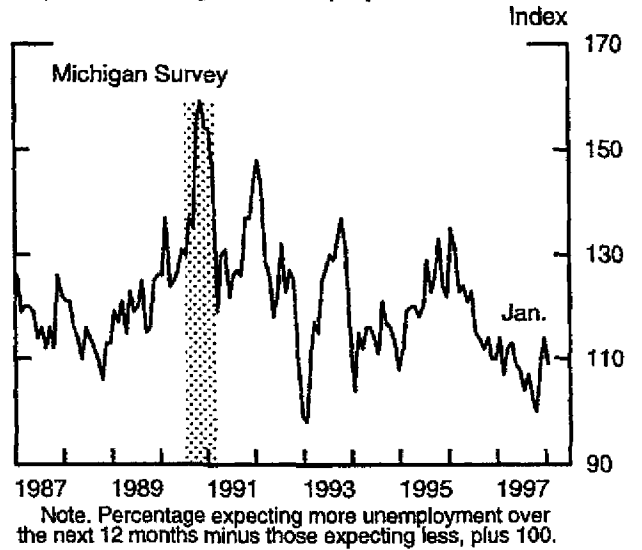
Ratio of Net Worth to Disposable Income



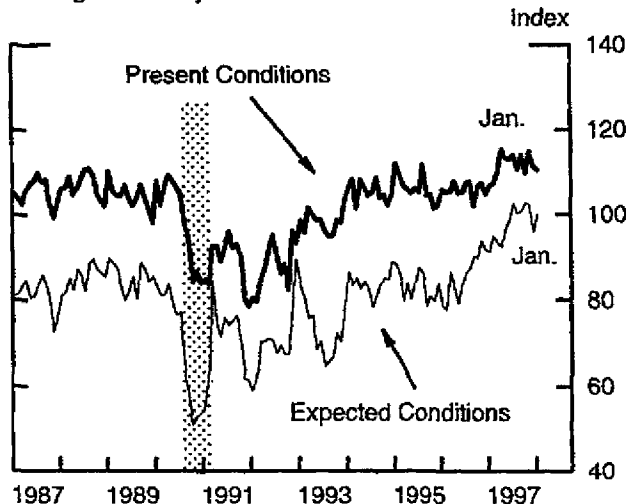
Consumer Confidence



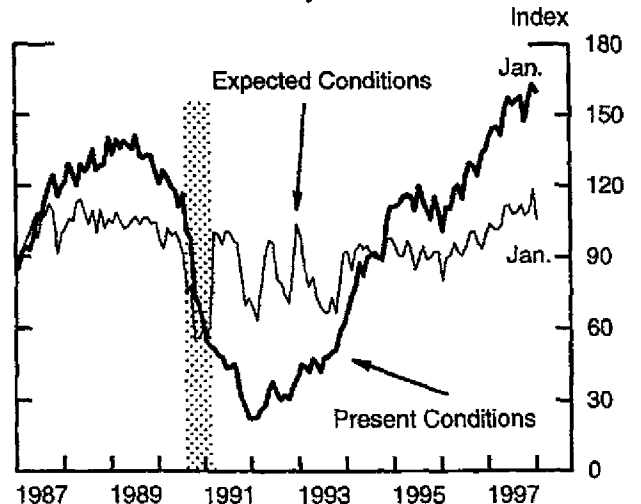
Expected Change in Unemployment



Michigan Survey



Conference Board Survey



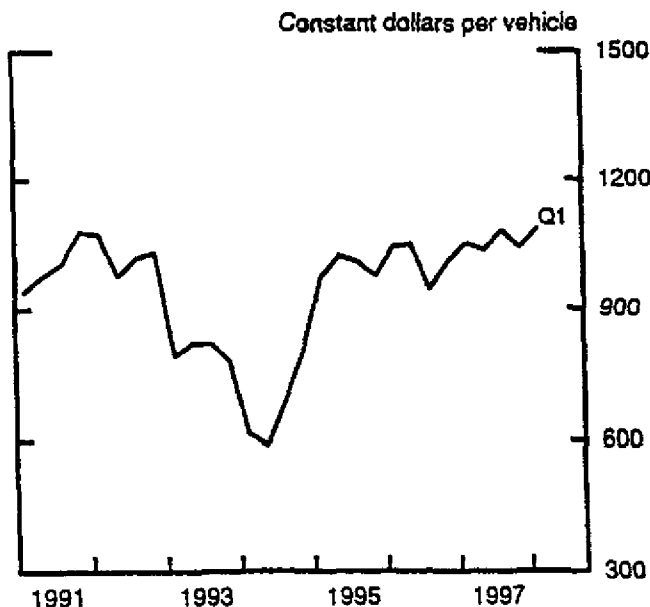
SALES OF AUTOMOBILES AND LIGHT TRUCKS
(Millions of units at an annual rate; FRB seasonals)

	1996	1997	1997			1997		
			Q2	Q3	Q4	Oct.	Nov.	Dec.
Total	15.1	15.1	14.5	15.3	15.3	14.6	15.1	16.1
Adjusted ¹	15.0	15.1	14.7	15.3	15.0	14.6	15.1	15.3
Autos	8.5	8.3	8.0	8.4	8.2	7.9	7.9	8.7
Light trucks	6.6	6.9	6.5	6.9	7.1	6.7	7.3	7.3
North American ²	13.4	13.2	12.7	13.3	13.3	12.7	13.3	13.9
Autos	7.3	6.9	6.7	7.1	6.8	6.6	6.5	7.1
Big Three	5.3	4.9	4.8	5.1	4.8	4.8	4.6	5.0
Transplants	2.0	2.0	1.9	2.0	2.0	1.8	1.9	2.1
Light trucks	6.1	6.3	5.9	6.3	6.5	6.1	6.7	6.7
Foreign produced	1.7	1.9	1.8	2.0	2.0	1.9	1.9	2.2
Autos	1.3	1.4	1.3	1.4	1.4	1.3	1.3	1.6
Light trucks	.4	.6	.6	.6	.6	.6	.5	.6

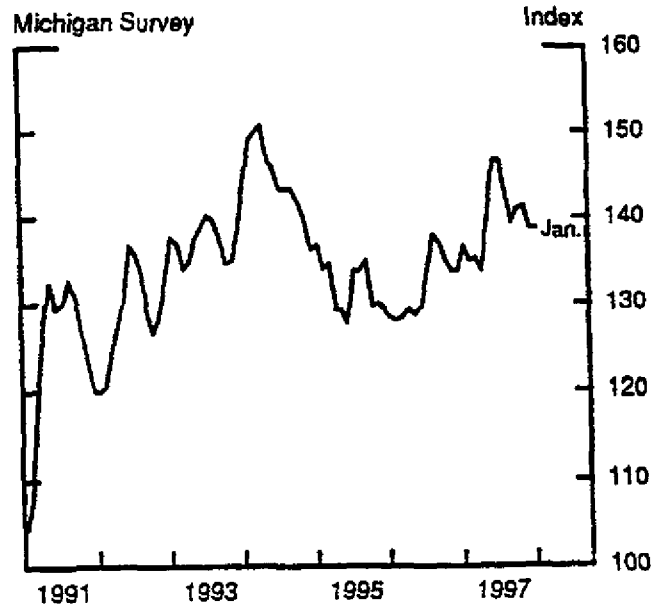
Note. Components may not sum to totals because of rounding. Data on sales of trucks and imported autos for the most recent month are preliminary.

1. Excludes the estimated effect of automakers' changes in reporting periods.
2. Excludes some vehicles produced in Canada that the industry classifies as imports

Marketing Incentives for Light Vehicles
(FRB seasonals)



Buying Attitudes for New Vehicles
(3-month moving average)



Notr.. Data from J.D. Powers, deflated by CPI for new motor vehicles.

In November, real disposable income rose a hefty 0.6 percent, led by a rapid increase in wages and salaries. Although December's labor market report suggests a much smaller increase in labor income for that month, earlier strong gains should be enough to generate a solid increase in real labor income in the fourth quarter. Looking ahead, a factor that may provide some additional impetus to consumption growth is the current wave of mortgage refinancing. However, because prevailing mortgage rates are not so far below those on the outstanding stock of loans as was the case in the last wave, the effects on spending[®] could be relatively small.

Consumer sentiment has remained at highly favorable levels. After having declined in December, the Michigan SRC index of consumer sentiment rose in early January to the middle of the reasonably high range that has prevailed since early last year. Households' appraisals of current conditions were little changed in January, but appraisals of expected conditions rebounded because of more positive expectations for their personal finances and future business conditions.

The SRC reported that one respondent in ten mentioned concern about Asian economic problems in January and that these households were more likely to expect the unemployment rate to rise. Nevertheless, the index of expected unemployment change moved down a bit in January following a sharp rise in December.

The Conference Board index of consumer confidence fell back in January after climbing to its highest level since early 1969 in December. Households in this survey were less upbeat about expected business conditions, income, and employment; however their perception that job opportunities are currently abundant kept their assessment of the present situation extraordinarily positive.

Motor Vehicles

Reported sales of new light vehicles in December jumped 1 million units, to 16.1 million units at an annual rate, in large part because many automakers extended their reporting period into early January. Adjusted for shifts in reporting periods, we estimate that sales increased about 1 percent, to 15.3 million units. Correcting for reporting-period effects, most of the increase was the result of a spurt in sales at Toyota, which reflected the company's successful effort to ensure that Camry would achieve the title of top-selling car in 1997. At this point, we expect companies to close their books at the end of this month, and,

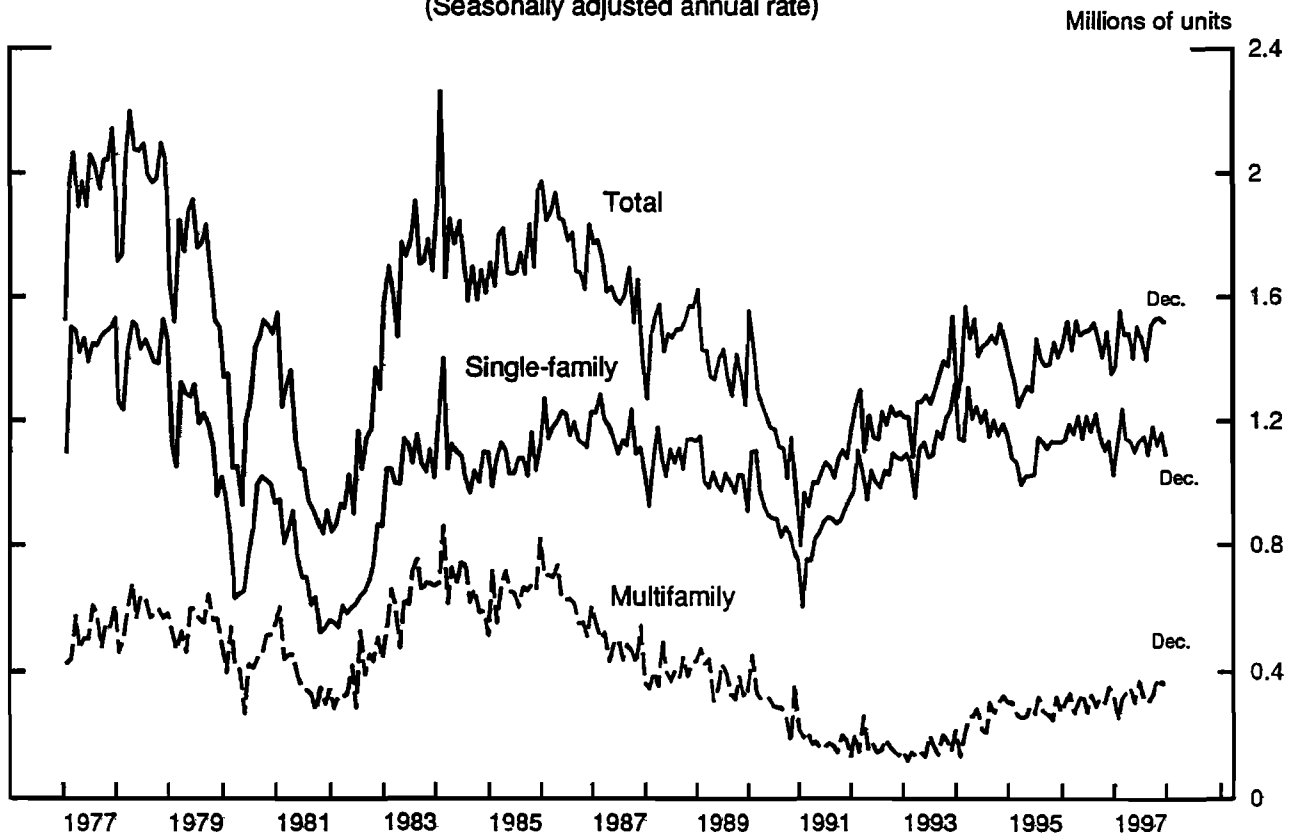
Private Housing Activity
(Millions of units; seasonally adjusted annual rate)

	1997P	1997					
		Q2	Q3	Q4P	Oct. ^r	Nov. ^r	Dec.P
<i>All units</i>							
Starts	1.48	1.46	1.46	1.53	1.53	1.53	1.52
Permits	1.44	1.43	1.42	1.47	1.49	1.44	1.49
<i>Single-family units</i>							
Starts	1.13	1.12	1.14	1.13	1.12	1.16	1.09
Permits	1.06	1.05	1.04	1.08	1.09	1.06	1.08
Adjusted permits ¹	1.13	1.12	1.11	1.15	1.19	1.13	1.14
New home sales	n.a.	.78	.81	n.a.	.79	.83	n.a.
Existing home sales	4.22	4.15	4.27	4.35	4.39	4.38	4.29
<i>Multifamily units</i>							
Starts	.34	.34	.32	.40	.41	.37	.43
Permits	.39	.37	.38	.40	.40	.38	.42
<i>Mobile homes</i>							
Shipments	n.a.	.36	.36	n.a.	.35	.35	n.a.

Note. p Preliminary. r Revised. n.a. Not available.

1. Adjusted permits equal permit issuance plus total starts outside of permit-issuing areas, and a correction for starts occurring in permit issuing places, but without a permit.

Private Housing Starts
(Seasonally adjusted annual rate)



with the shortened reporting period for January, reported sales for the month should fall sharply.

In the past, the extension of the reporting period would boost BEA's estimate of PCE and PDE spending for motor vehicles and be mostly offset by a lower estimate of inventories. The effect on GDP would reflect only the differences between the wholesale and retail margins. BEA, however, has decided to exclude an estimated effect of automakers' changes in reporting periods. Thus, the NIPA estimates for motor vehicle purchases in the fourth quarter should not be distorted by the extended reporting period.

Overall, sales of light vehicles in 1997 were 15.1 million units, little changed from the pace seen in the previous several years. However, this pace was maintained, in part, by a considerable drop in the relative price of motor vehicles. During the past year, the CPI for new cars and new trucks fell 1.0 and 0.1 percent, respectively, while the core CPI rose 2.2 percent. The industry's standard rule-of-thumb of a (negative) unitary elasticity of demand would imply that sales of light motor vehicles were 400,000 units higher in 1997 than they would have been if motor vehicle prices had moved in tandem with core CPI. (The unitary elasticity is in the middle of the range of published econometric estimates of minus 1/3 to minus 1-1/2.)

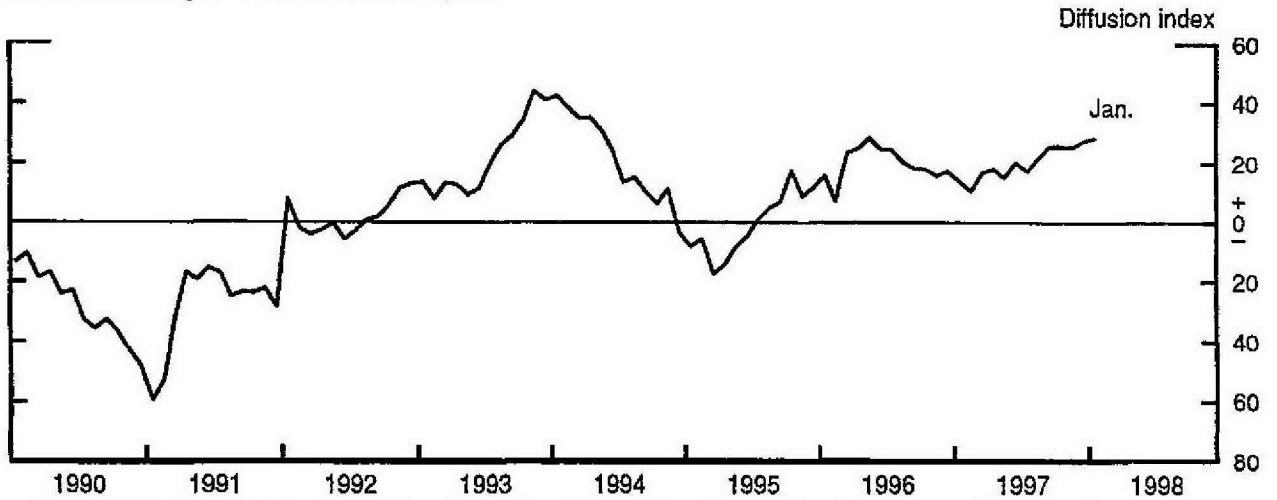
In the near term, the industry's strategy appears to be to continue pricing to keep sales in the 15-million-plus bracket. Their plans for incentives in the first quarter remain in the relatively high range that we have seen over the past several years. In turn, attractive pricing has helped sustain upbeat consumer attitudes toward buying conditions for cars. The preliminary January results from the Michigan SRC survey indicate that buying attitudes remain in the elevated range seen over the last several years.

Housing Markets

The housing sector has remained buoyant in recent months, fueled by sharp declines in fixed mortgage rates during the second half of last year and by further sizable gains in employment and personal income. To be sure, single-family starts were at a surprisingly weak 1.09 million unit annual rate in December, down 6 percent from the robust November pace and noticeably below the average reading for the year. However, adjusted permits for these units, which provide a better short-run indication of the underlying

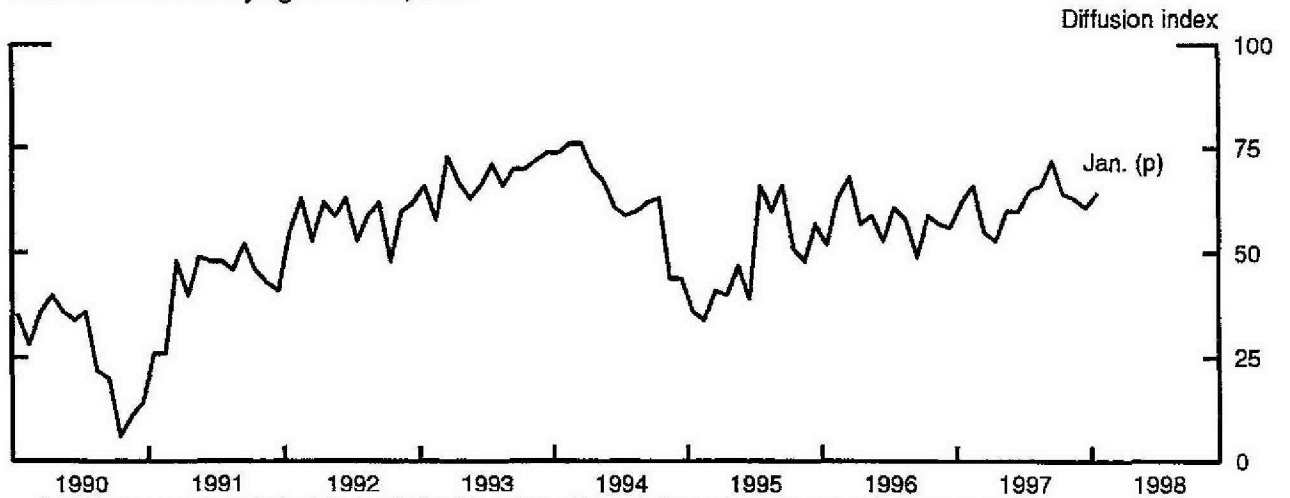
Indicators of Housing Demand

Builders' Rating of New Home Sales, SA



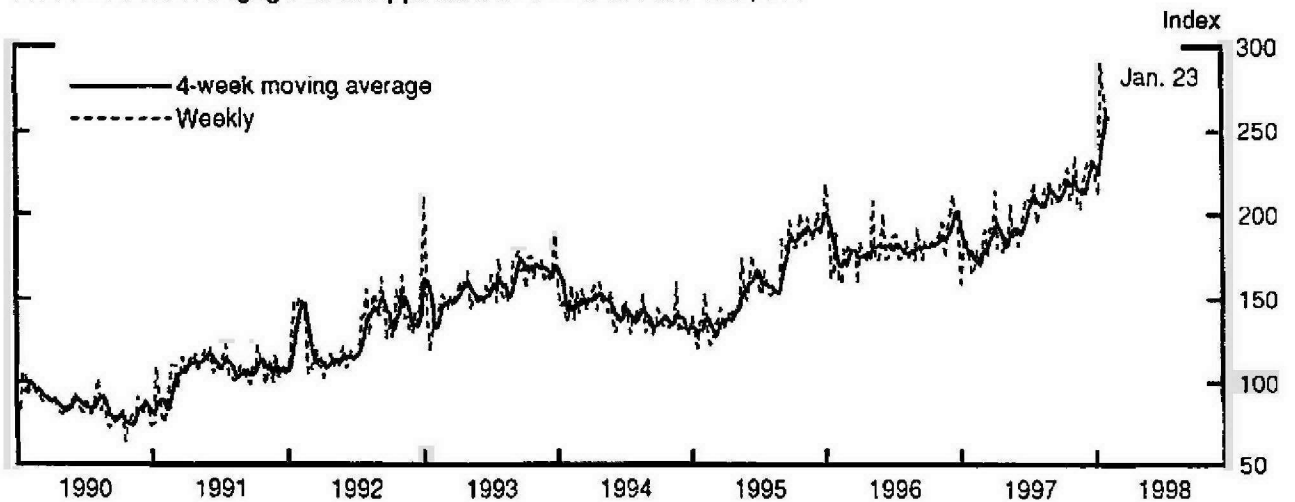
Note. The index is calculated from National Association of Homebuilders data as the proportion of respondents rating current sales as good minus the proportion rating them as poor.

Consumer Homebuying Attitudes, NSA



Note. The homebuying attitudes index is calculated from Survey Research Center data as the proportion of respondents rating current conditions as good minus the proportion rating conditions as bad.

MBA Index of Mortgage Loan Applications for Home Purchase, SA



trend, edged up 1/2 percent in December to a level a touch above the 1997 average.⁶

Other indicators of housing demand strengthened at year-end. Existing home sales were at a 4.29 million unit annual rate in December; in the fourth quarter as a whole, these sales averaged 4.35 million units, up 2 percent from the third-quarter pace. New home sales rose to an 830,000 unit annual rate in November, the highest monthly pace in more than ten years. Builders' ratings of new home sales, which have been trending up since last winter, rose a bit further in January. In addition, according to the preliminary reading from the Michigan SRC survey, consumers' assessments of homebuying conditions, which rebounded in January, have been quite positive, on net, since early last fall. Applications for mortgages to purchase homes rose to a new monthly high in December, and the average reading through January 23 was up 13 percent from the December level.⁷

Multifamily starts jumped to a 427,000 unit annual rate in December--the highest since early 1990. This followed relatively high levels of starts in both October and November. For the fourth quarter as a whole, multifamily starts averaged 401,000 units, up 26 percent from the pace seen earlier last year. Permits for these units also moved up in the fourth quarter, but not nearly so much as starts, suggesting that starts will drop back in the next few months.

Some tightening may be occurring in the multifamily market: Real rents have trended up during the past year, and the vacancy rate for rental units has edged lower, on net, since late 1995. Nevertheless, industry contacts think that the ready availability of financing may be spurring developers to undertake excessive construction.

Business Fixed Investment

Real outlays for producers' durable equipment and for nonresidential structures appeared to stall in the fourth quarter,

6. Adjusted permits include permits issued plus starts in non-permit-issuing places.

7. New home sales are recorded at the time a contract is signed, which typically is around the same time that the buyer applies for a mortgage. By contrast, existing home sales are recorded at closing, which usually is a month or two after the time that a mortgage application is submitted. As a result, mortgage applications for home purchase show a strong contemporaneous correlation with new home sales, and they tend to lead existing home sales by an average of about a month and a half.

BUSINESS CAPITAL SPENDING INDICATORS
 (Percent change from preceding comparable period;
 based on seasonally adjusted data, in current dollars)

	1997		1997		
	Q3	Q4	Oct.	Nov.	Dec.
<u>Producers' durable equipment</u>					
Shipments of nondefense capital goods	3.9	-.6	-2.7	-.4	3.2
Excluding aircraft and parts	4.0	.3	-1.3	-1.7	3.2
Office and computing	5.5	-2.1	-2.7	-4.2	8.7
Communications equipment	7.8	-1.3	.8	-4.4	3.9
All other categories	2.6	1.7	-1.4	.0	1.1
Shipments of complete aircraft ¹	9.8	n.a.	-38.5	33.4	n.a.
Sales of heavy trucks	4.7	4.9	5.6	-3.3	6.4
Orders of nondefense capital goods	6.5	7.1	2.7	17.7	-22.5
Excluding aircraft and parts	7.2	-1.5	-2.2	-2.6	.6
Office and computing	7.8	-3.3	-6.2	-2.2	9.3
Communications equipment	-.6	-5.7	-8.1	-3.2	-1.6
All other categories	9.1	.2	.8	-2.6	-1.7
<u>Nonresidential structures</u>					
Construction put in place, buildings	3.2	n.a.	1.1	-3.8	n.a.
Office	8.5	n.a.	9.0	-8.9	n.a.
Other commercial	1.8	n.a.	-3.3	3.6	n.a.
Institutional	.9	n.a.	.5	-3.3	n.a.
Industrial	3.4	n.a.	-.7	-7.3	n.a.
Lodging and miscellaneous	2.1	n.a.	2.0	-7.1	n.a.
Rotary drilling rigs in use ²	-3.5	-5.9	-3.4	-2.5	3.5
Memo:					
Business fixed investment	19.2	n.a.	n.a.	n.a.	n.a.
Producers' durable equipment	24.1	n.a.	n.a.	n.a.	n.a.
Office and computing	47.0	n.a.	n.a.	n.a.	n.a.
Communications equipment	31.3	n.a.	n.a.	n.a.	n.a.
Other equipment ³	9.9	n.a.	n.a.	n.a.	n.a.
Nonresidential structures	6.7	n.a.	n.a.	n.a.	n.a.

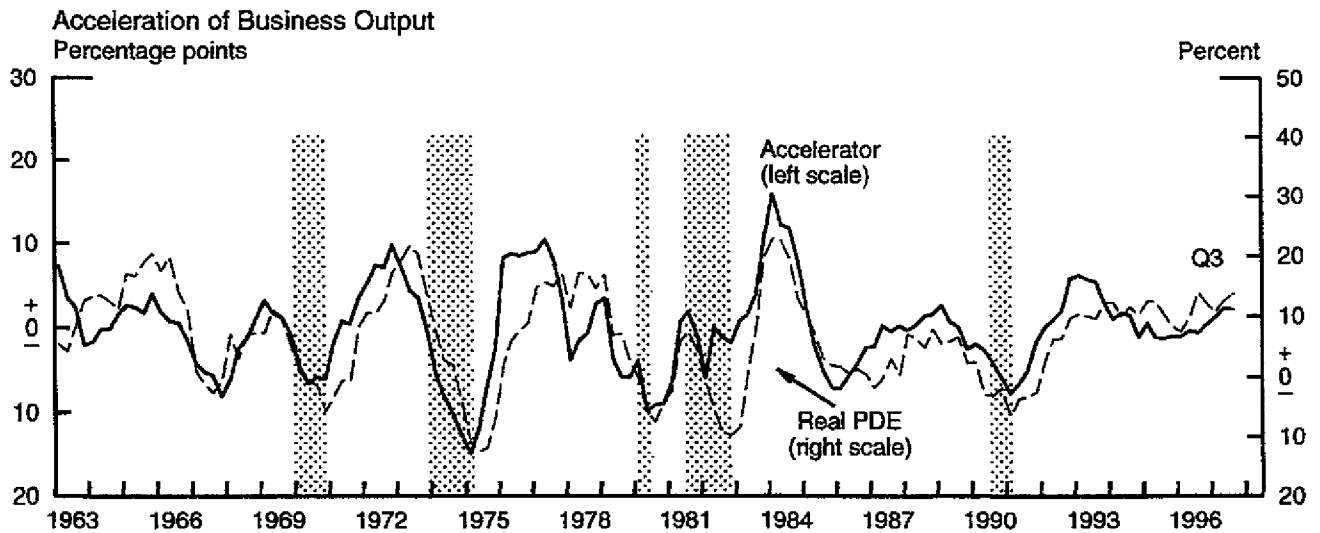
1. From the Current Industrial Report "Civil Aircraft and Aircraft Engines." Monthly data are seasonally adjusted using FRB seasonal factors constrained to BEA quarterly seasonal factors. Quarterly data are seasonally adjusted using BEA seasonal factors.

2. Percent change of number of rigs in use, seasonally adjusted.

3. Producers' durable equipment excluding office and computing, communications, motor vehicles, and aircraft and parts.

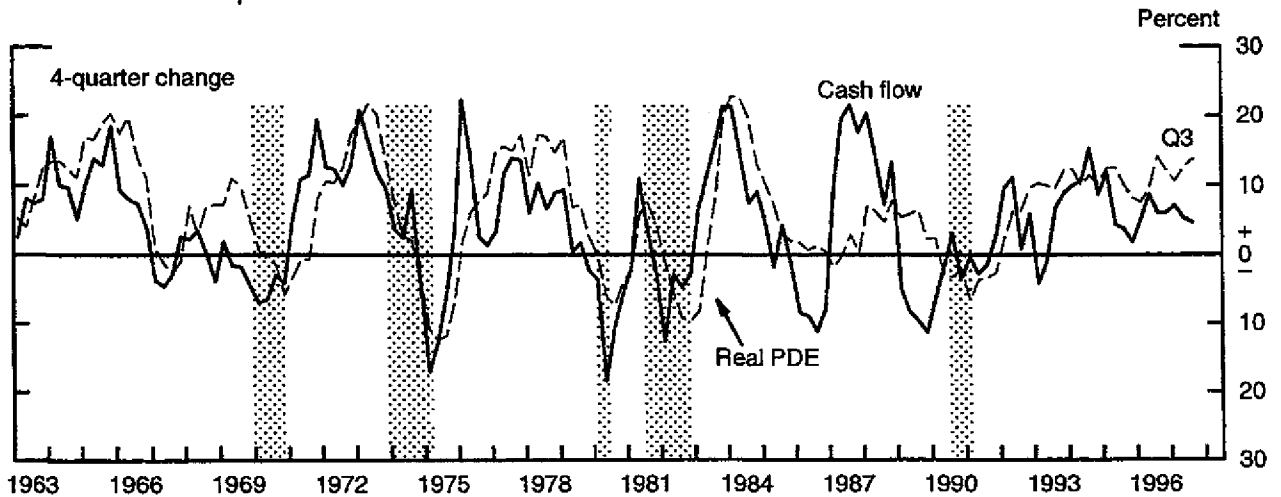
n.a. Not available.

Determinants of Equipment Spending

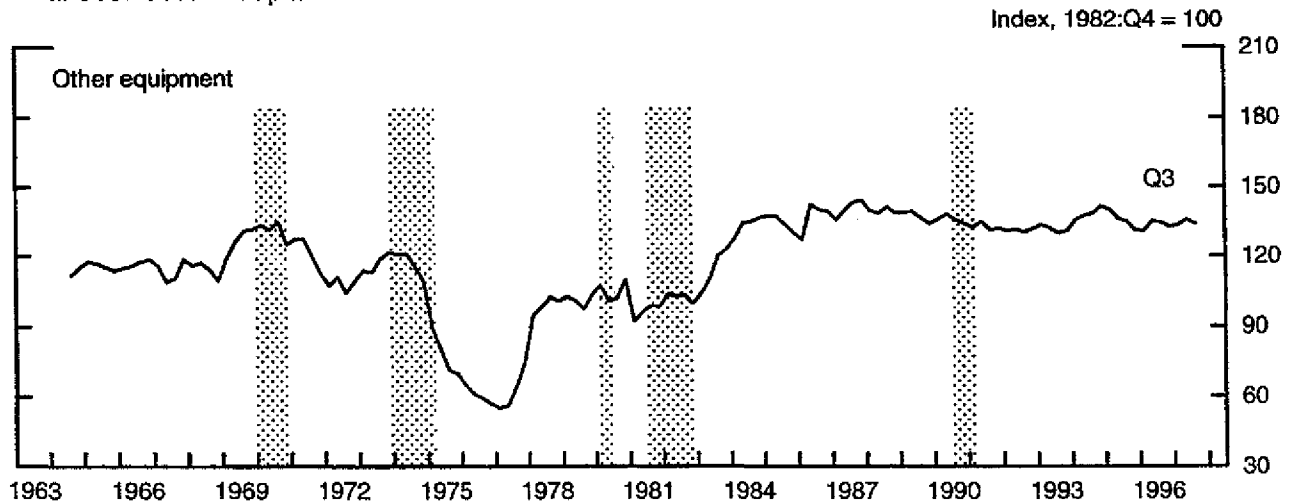


Note. The accelerator is the 8-quarter percent change in business output less the year-earlier 8-quarter percent change. Real PDE is the 4-quarter percent change.

Real Domestic Corporate Cash Flow



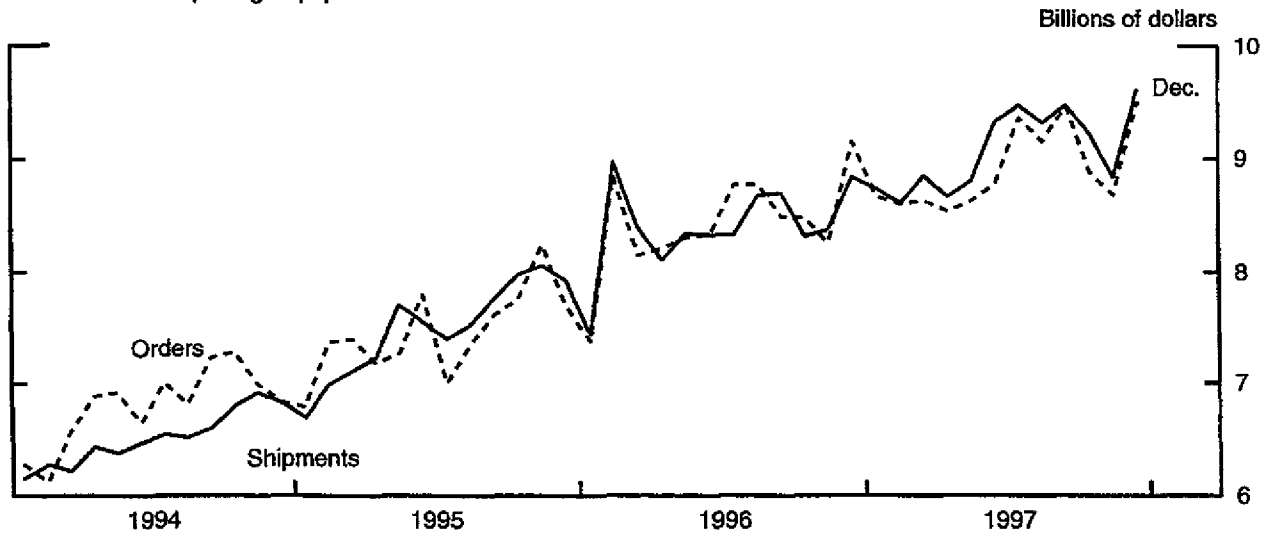
Real User Cost of Capital*



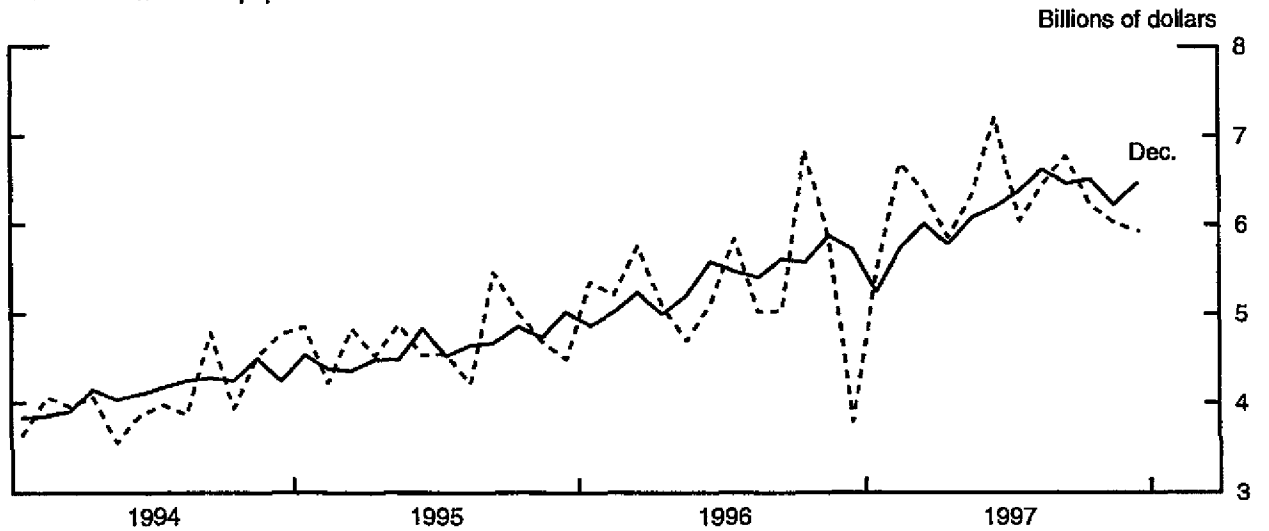
* Staff estimate.

Orders and Shipments of Nondefense Capital Goods

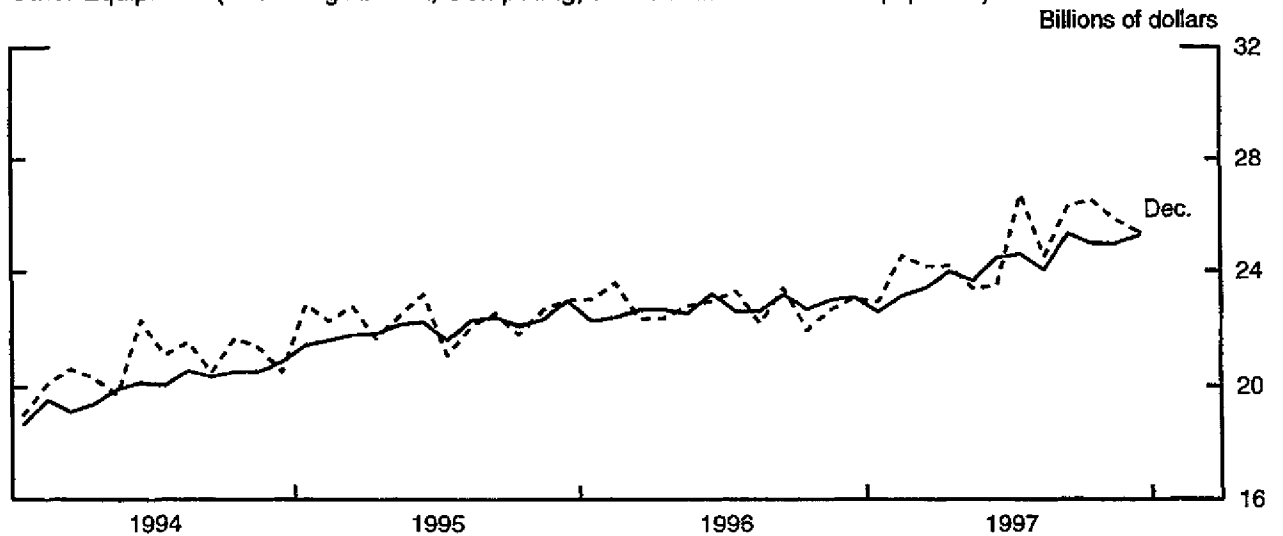
Office and Computing Equipment



Communications Equipment



Other Equipment (Excluding Aircraft, Computing, and Communications Equipment)



after having expanded at a heady pace earlier in the year. Nonetheless, the economic environment remains supportive for business investment: Business output has accelerated over the past two years, corporate cash flow is healthy, and the real user cost of capital remains low.

Led by higher shipments of office and computing equipment, shipments of nondefense capital goods excluding aircraft increased 3-1/4 percent in December. This rapid growth was not enough to offset the sizable declines in shipments registered in October and November, and for the fourth quarter as a whole shipments fell 0.3 percent.⁸

Nominal shipments of office and computing equipment subsided in the fourth quarter despite a large increase in December, which returned the level of shipments close to its trend level. After factoring in the declining prices in this sector, real office and computing expenditures likely decelerated sharply in the fourth quarter, rising perhaps 10 percent. Shipments of communications equipment fell in the fourth quarter, despite a strong performance in December, and real outlays probably posted a slight decline last quarter.

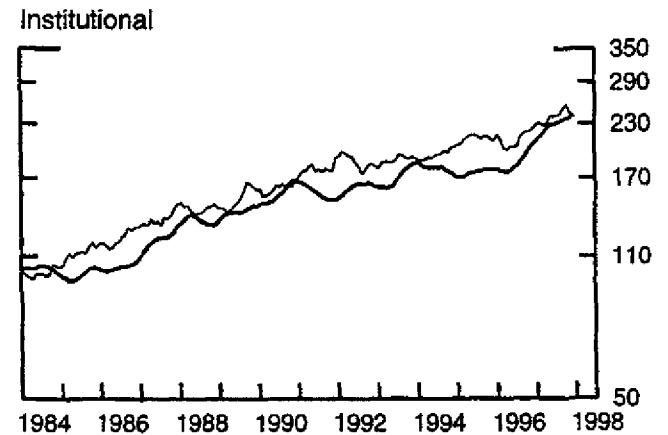
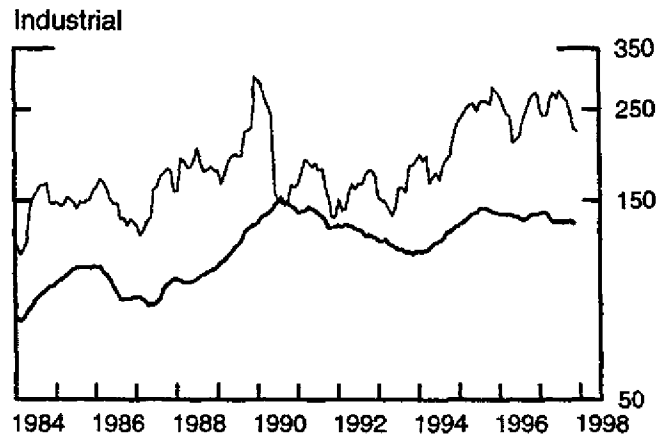
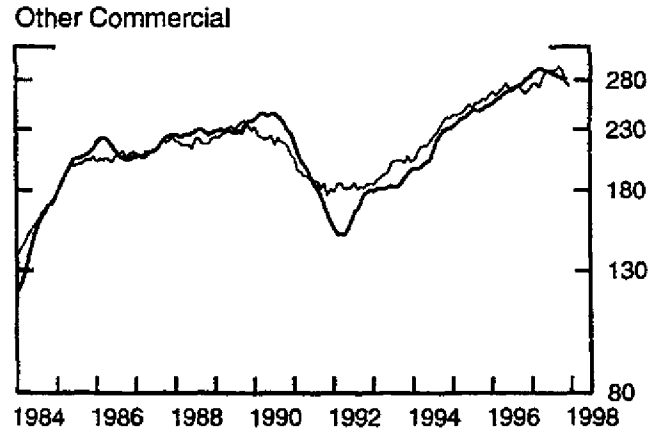
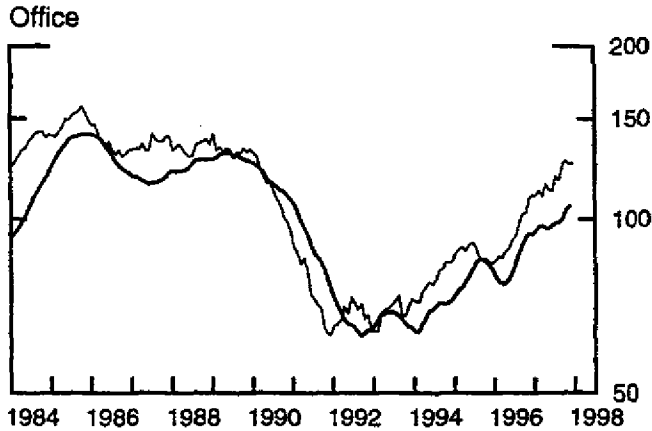
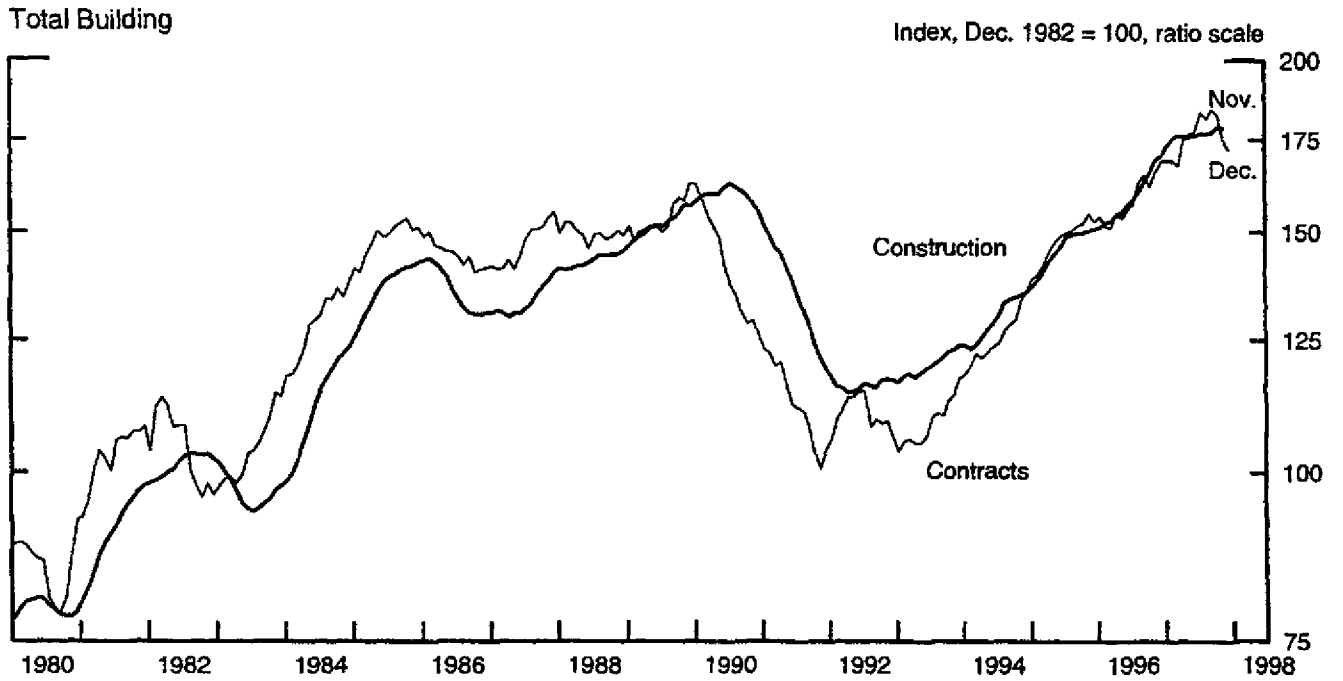
In the transportation area, sales of medium and heavy trucks remained an area of strength; sales were about 450,000 units (annual rate) last quarter, noticeably above the already high reading in the third quarter. In addition, net new orders of heavy trucks rose to the highest level in more than three years. However, real business expenditures on aircraft appear to have declined in the fourth quarter. Although deliveries by domestic manufacturers rose, net exports of aircraft are expected to more than account for the increase.

Outside of the information technology and transportation sectors, nominal shipments of capital goods rose 1.1 percent in December after having declined, on balance, over the preceding two

8. Data on shipments of capital goods are one of the basic building blocks that the BEA uses to estimate producers' durable equipment expenditures. However, the shipments data include capital goods that are exported and do not include capital goods purchased by U.S. businesses from abroad. Accordingly, to calculate equipment spending by U.S. producers, the BEA subtracts out estimates of net exports of capital goods, which are based on international trade data. The latest available data indicate a slight increase in net exports of capital goods in October and November, providing some additional weakness in FDE relative to that indicated by the shipments data in those months.

Nonresidential Construction and Contracts

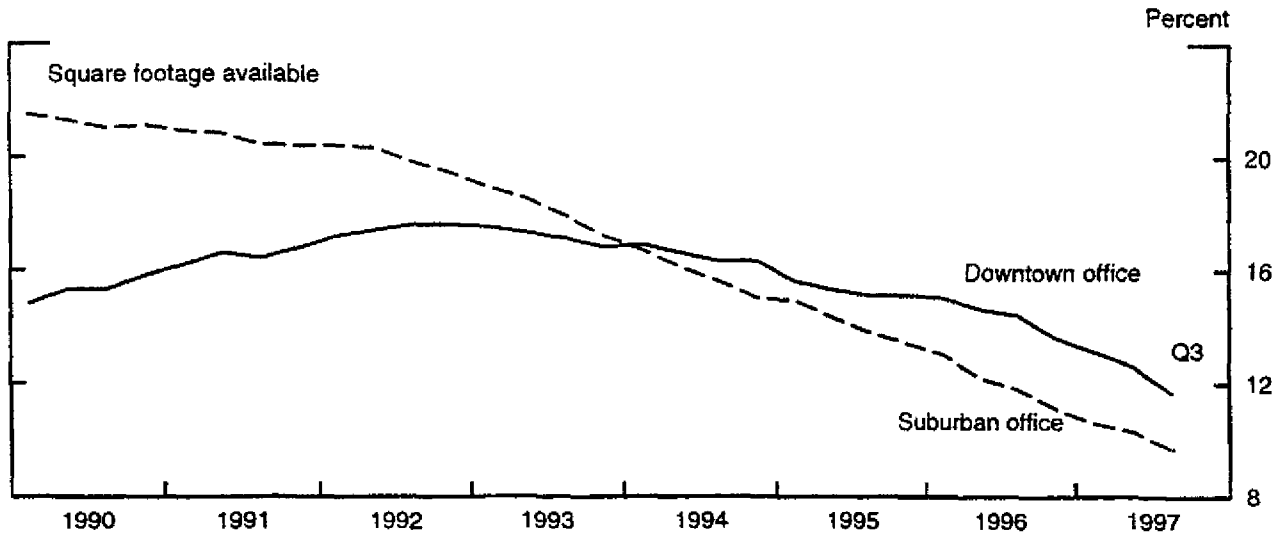
(Six-month moving average)



Note. For contracts, total includes private only; individual sectors include public and private.

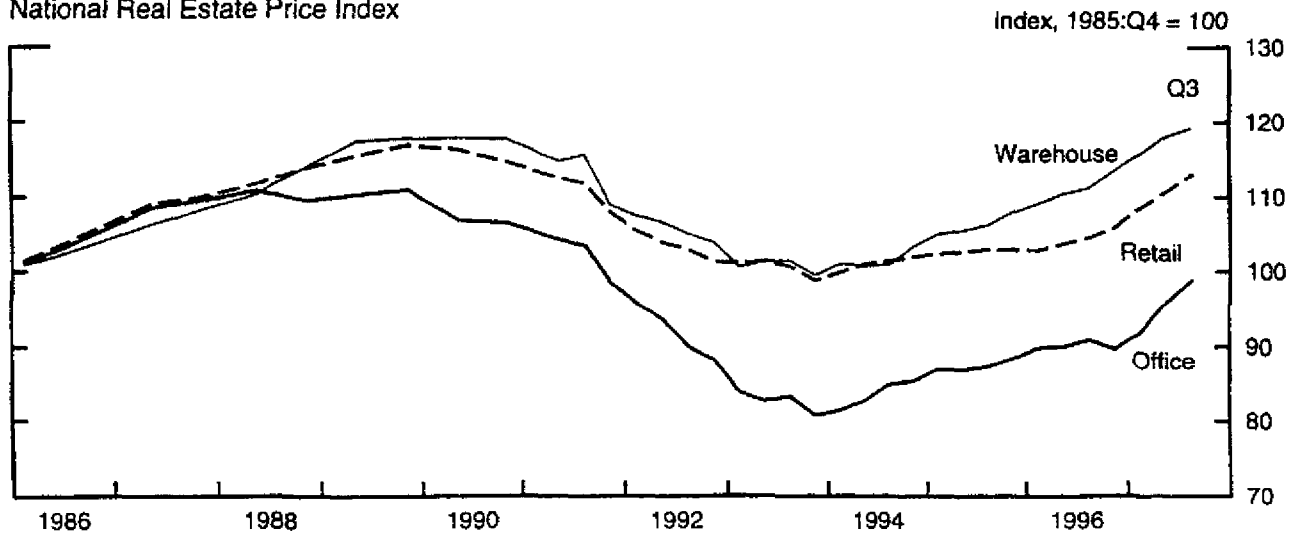
Nonresidential Construction Indicators

Vacancy Rates



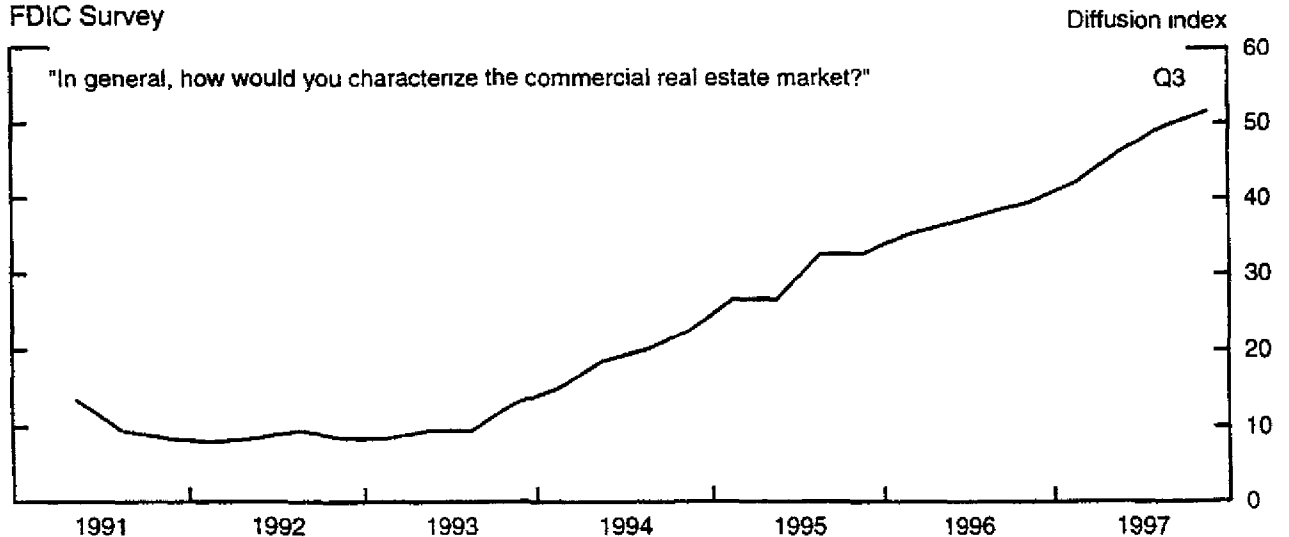
Source: CB Commercial Real Estate

National Real Estate Price Index



Note. Data are semiannual from 1986 to 1991 and quarterly from 1992 forward.

FDIC Survey



Note. Calculated as $\{(\text{Percent reporting tight supply} - \text{Percent reporting excess supply})/2\} + 50$.

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

	1997			1997		
	Q1	Q2	Q3	Sept.	Oct.	Nov.
<u>Book value basis</u>						
Total	35.8	51.5	43.7	83.1	37.1	48.6
Excluding wholesale and retail motor vehicles	30.9	48.9	36.7	71.4	37.7	51.8
Manufacturing	16.5	25.1	17.3	8.5	35.8	21.8
Excluding aircraft	9.1	19.8	13.3	11.9	20.1	17.1
Wholesale	14.3	19.1	15.8	38.6	.9	29.3
Excluding motor vehicles	11.5	14.3	14.2	34.1	6.3	29.4
Retail	5.0	7.4	10.5	36.1	.4	-2.6
Auto dealers	2.1	-2.1	5.4	7.3	4.9	-3.1
Excluding auto dealers	2.8	9.6	5.1	28.8	-4.5	.5

SELECTED INVENTORY-SALES RATIOS
(Months' supply, based on Census book-value data, seasonally adjusted)

	Cyclical reference points		Range over preceding 12 months		November 1997
	1990-91 high	1995-96 low	High	Low	
Manufacturing and trade	1.58	1.37	1.38	1.35	1.38
Less wholesale and retail motor vehicles	1.55	1.34	1.35	1.32	1.35
Manufacturing	1.75	1.36	1.37	1.34	1.37
Primary metals	2.08	1.49	1.68	1.59	1.62
Nonelectrical machinery	2.48	1.80	1.87	1.71	1.78
Electrical machinery	2.08	1.41	1.46	1.29	1.34
Transportation equipment	2.93	1.48	1.61	1.52	1.56
Motor vehicles	.97	.56	.62	.54	.55
Aircraft	5.84	4.15	4.76	4.09	4.23
Nondefense capital goods	3.09	2.31	2.39	2.21	2.34
Textile	1.71	1.44	1.52	1.47	1.48
Chemicals	1.44	1.25	1.34	1.27	1.38
Petroleum	.94	.75	.84	.76	.84
Home goods & apparel	1.96	1.67	1.74	1.65	1.69
Merchant wholesalers	1.36	1.24	1.27	1.22	1.28
Less motor vehicles	1.31	1.21	1.24	1.20	1.26
Durable goods	1.83	1.53	1.56	1.50	1.55
Nondurable goods	.96	.93	.97	.92	.99
Retail trade	1.61	1.50	1.52	1.48	1.49
Less automotive dealers	1.48	1.43	1.44	1.41	1.42
Automotive dealers	2.21	1.68	1.77	1.68	1.72
General merchandise	2.43	2.21	2.25	2.08	2.08
Apparel	2.56	2.42	2.56	2.44	2.52
GAF	2.44	2.23	2.27	2.10	2.11

months. New orders in this category dropped about 1.7 percent in December, largely erasing the backlog of unfilled orders.

Although real estate prices are up and vacancy rates are down, the available indicators suggest that real spending on nonresidential structures declined in the fourth quarter. Initial estimates indicate that construction put in place for nonresidential buildings fell 3.8 percent in November. However, this decline comes on the heels of an upward-revised 1.1 percent gain in October.⁹ The pace of construction contracts has also eased over the past six months; the weak readings in this sector are surprising given the favorable financing environment and improved market conditions.

Business Inventories

Over the first two months of the fourth quarter, businesses outside of the motor vehicle sector accumulated inventories at an average pace of around \$45 billion (annual rate) on a book-value basis, up from a \$37 billion rate in the third quarter. Manufacturers' inventories accumulated at a relatively rapid pace in both October and November. Stock-building in October was boosted by a \$16 billion accumulation of inventories of aircraft and parts, a development that was most likely a result of the production and delivery disruptions at Boeing.¹⁰ Inventories at chemical manufacturers posted large increases in both months that may have been related to rail transportation problems. With shipments declining, the inventory-shipments ratio for manufacturing increased in November but remained within the narrow range of the past year.

In wholesale trade, stocks continued to build, and the inventory-sales ratio has maintained the upward trend evident over the past year; by November, the ratio had reversed the 1996 decline. This V-shaped pattern was widespread but was especially evident in furniture, lumber, apparel, and farm products. Excluding motor vehicles, wholesale stocks rose at a \$6 billion annual rate in October and at a \$29 billion rate in November. The accumulation of

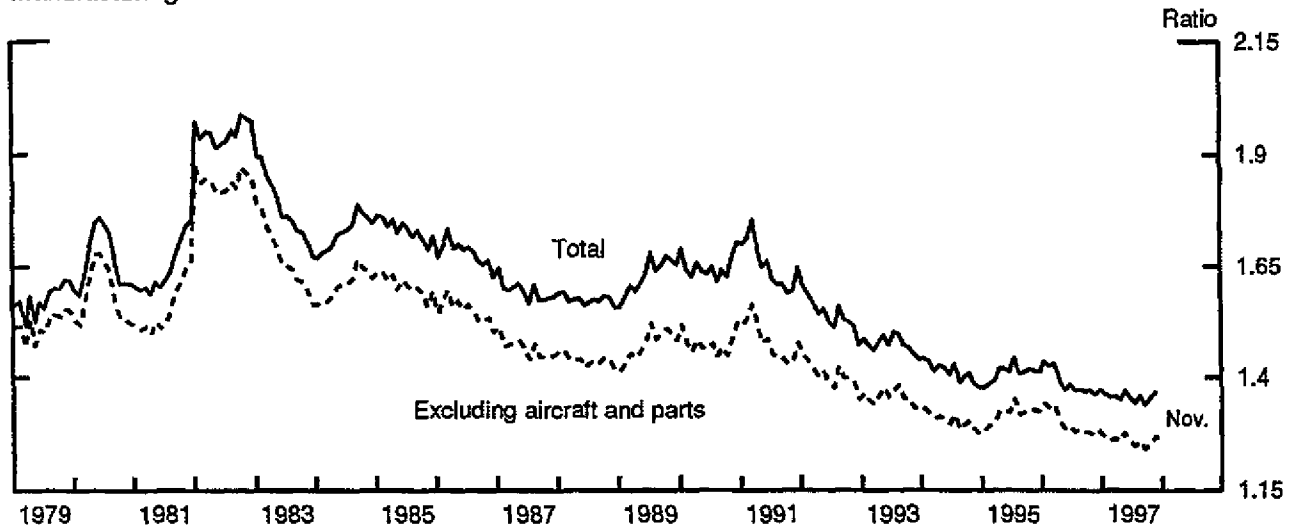
9. In each of the months since last June's comprehensive revision, the preliminary construction data for nonresidential structures have been revised up in the following month. Analysts at the Census Bureau believe that this string of positive initial revisions is purely coincidental and not due to any change in their reporting procedures. Furthermore, later downward revisions have tended to undo many of the initial upward revisions.

10. Boeing's aircraft deliveries, excluding those of McDonnell Douglas, slumped from an average of 27 planes per month in the third quarter to 17 in October and 18 in November. Although 45 planes were delivered in December, another 12 planes completed for delivery were not shipped because of payment problems.

Inventory-Sales Ratios, by Major Sector

(Book value)

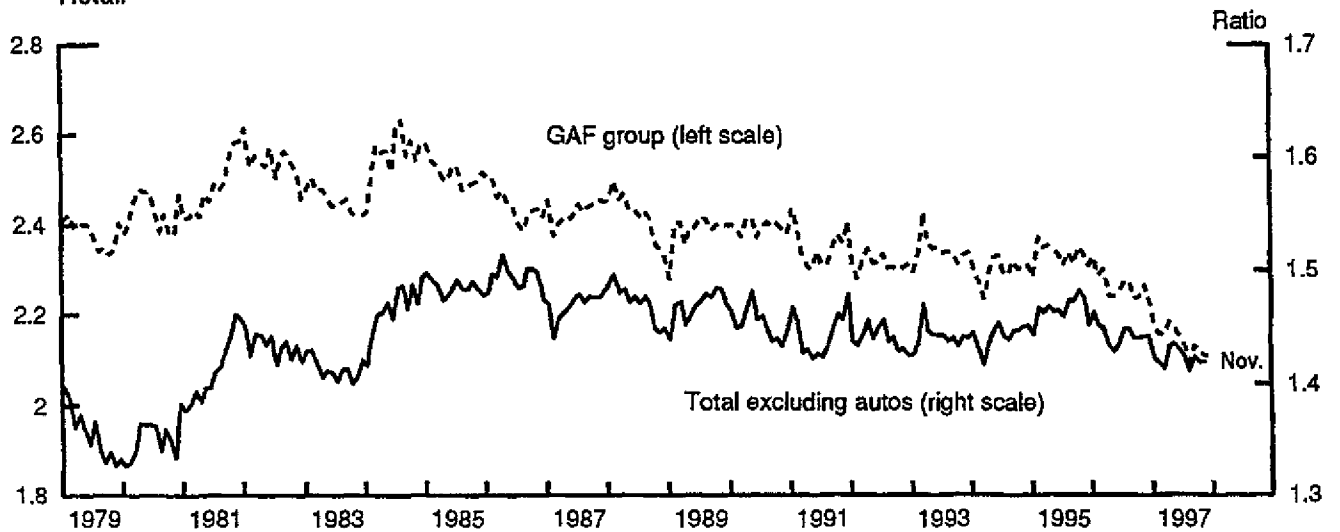
Manufacturing



Wholesale Excluding Motor Vehicles



Retail



stocks of farm products was particularly strong in October when the harvest was speeding along at a faster-than-usual pace. Wholesale inventories of groceries also surged. In the retail sector, the sluggish growth in sales in October and November did not lead to a backup in inventories. Indeed, retail inventories fell at a \$5 billion annual rate in October and were little changed in November. The inventory-sales ratio for non-auto retailers remained close to its twelve-month low.

Federal Government

Favorable numbers in the last two months of 1997 left the federal budget for the calendar year in deficit by just \$2 billion. After adjusting for payment timing shifts and excluding deposit insurance and spectrum auction proceeds, the deficit was \$19 billion in calendar 1997, \$108 billion lower than a year earlier.

Outlays grew moderately in the fourth quarter and for the year were only 2.3 percent above the 1996 level. Defense expenditures edged down further, spending growth for health programs continued to moderate, and debt service payments flattened. Declines in the number of food stamp recipients, unemployment insurance beneficiaries, and welfare cases led to a leveling-off of income security payments.¹¹ Receipts continued to grow more rapidly than nominal income; fourth-quarter receipts were 12 percent above a year earlier. December receipts included the last of the four payments by corporations on their estimated 1997 income tax liabilities; these payments were 13 percent above a year earlier. The last of the four quarterly payments by individuals on their estimated 1997 income and social insurance tax liabilities were due on January 15. Daily data indicate that these payments were well above the year-earlier level.

The Congressional Budget Office released its "Economic and Budget Outlook for Fiscal Years 1999-2008." The CBO now projects an essentially balanced federal budget over the next ten years if current policies remain unchanged.

These budget projections are more favorable than those released in September, with deficits about \$50 billion smaller than forecasted at that time. About half of the near-term improvement stems from more upbeat economic assumptions; changes in the longer-term economic outlook had a negligible effect on the deficit

11. The income security function includes retirement programs (for federal employees and others), housing programs, and most of the low-income support programs.

FEDERAL GOVERNMENT OUTLAYS AND RECEIPTS
(Unified basis; billions of dollars)

	October-December			12 months ending in Dec.		
	1996	1997	Percent change	1996	1997	Percent change
Outlays	405.2	426.1	5.1	1585.6	1621.8	2.3
Deposit insurance	-6.4	-0.9	n.a.	-12.1	-8.8	n.a.
Spectrum auction	-3.6	-0.2	n.a.	-4.0	-7.5	n.a.
Other	415.2	427.1	2.9	1601.6	1638.1	2.3
Receipts	346.0	386.4	11.7	1474.6	1619.4	9.8
Deficit (+)	59.2	39.7	n.a.	110.9	2.4	n.a.

Adjusted for payment timing shifts¹
and excluding deposit insurance and spectrum auction

Outlays	407.6	419.3	2.9	1601.3	1637.9	2.3
National defense	68.2	69.1	1.3	271.3	271.0	-0.1
Net interest	61.6	62.9	2.0	243.1	245.3	0.9
Social security	88.4	92.1	4.2	353.6	369.0	4.4
Medicare	45.9	48.8	6.2	180.3	192.8	6.9
Medicaid	23.7	25.6	8.2	93.6	97.5	4.1
Other health	7.3	7.3	-0.2	28.0	27.9	-0.4
Income security	53.0	52.8	-0.5	228.8	230.1	0.6
Other	59.5	60.7	2.0	202.6	204.3	0.8
Receipts	346.0	386.4	11.7	1474.6	1619.4	9.8
Individual income and payroll taxes	269.8	296.2	9.8	1152.1	1266.2	9.9
Withheld + FICA	261.7	287.3	9.8	1001.2	1080.1	7.9
Nonwithheld + SECA	12.5	13.6	8.9	240.2	279.9	16.5
Refunds (-)	4.5	4.7	5.2	89.3	93.8	5.0
Corporate	42.2	51.2	21.5	172.1	191.3	11.2
Other	34.1	39.0	14.4	150.5	161.8	7.5
Deficit (+)	61.6	32.9	n.a.	126.7	18.6	n.a.

Note. Components may not sum to totals because of rounding.

1. A shift in payment timing occurs when the first of the month falls on a weekend or holiday. Outlays for defense, Medicare, income security, and "other" have been adjusted to account for this shift.

n.a.--Not applicable

CBO BUDGET AND ECONOMIC PROJECTIONS

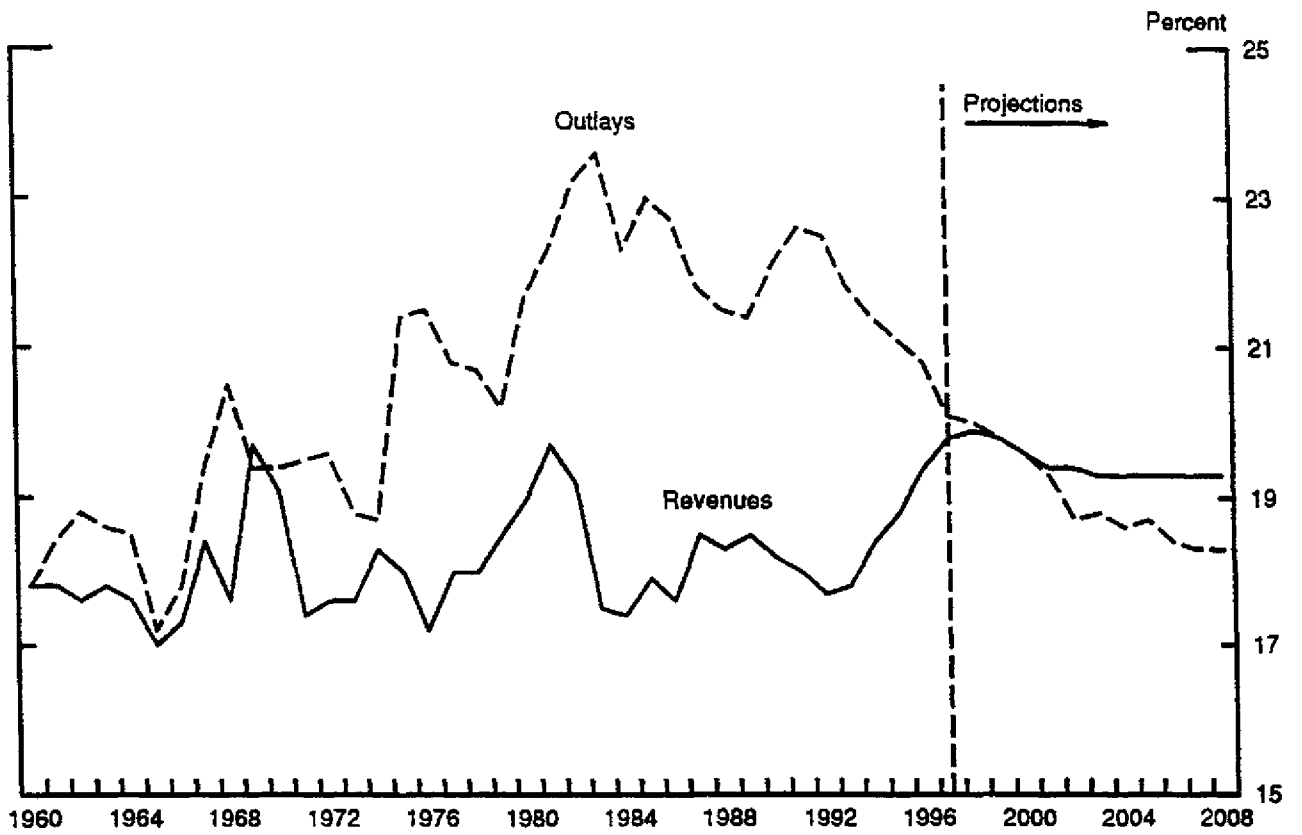
	1998	1999	2000	2001	2002	2007	2008
Budget Projections (billions of dollars; fiscal years)							
Deficit, Sept. 1997	57	52	48	36	-32	-86	n.a.
Changes							
Policy	-1	0	0	-3	3	0	n.a.
Economic	-22	-28	-18	-15	-9	-1	n.a.
Technical	-29	-22	-26	-32	-32	-42	n.a.
Deficit, Jan. 1998	5	2	3	-14	-69	-129	-138

Economic assumptions (calendar years)							
-----Percentage change, year over year-----							
Real GDP	2.7	2.0	1.9	2.0	2.1	2.2	2.1
GDP price index	2.0	2.2	2.3	2.4	2.4	2.5	2.5
CPI-U	2.2	2.5	2.7	2.8	2.8	2.8	2.8
-----Percent, annual average-----							
Unemployment rate	4.8	5.1	5.4	5.6	5.8	5.9	5.9
Yield on selected Treasuries							
Three-month	5.3	5.2	4.8	4.7	4.7	4.7	4.7
Ten-year	6.0	6.1	6.0	5.9	5.9	5.9	5.9

Note. The projections assume that revenues and mandatory outlays evolve according to laws in effect at the time the projections were made. Discretionary spending is assumed to equal the statutory caps in 1998 through 2002 and to grow at the rate of inflation in succeeding years. The projections include social security and the Postal Service, which are off-budget.

Source. Congressional Budget Office, "Economic and Budget Outlook for Fiscal Years 1999-2008," January 28, 1998.

Federal Government Revenues and Outlays (Share of GDP, unified basis, fiscal years)



Source. Congressional Budget Office.

projections. Instead, most of the improvement over the longer run reflects downward revisions to the growth in outlays because the unexpectedly slow growth in Medicaid and other mandatory programs in recent years is expected to be more persistent. In addition, the CBO boosted its estimate of income tax receipts, under an assumption that the forces behind the recent surge will fade more slowly than previously projected. By fiscal 2007, outlays in the CBO forecast drop to just 18.3 percent of GDP, well below the norm for the past thirty years, largely as a result of a continuing decline in discretionary spending as a share of GDP. Similarly, revenues are projected to remain high relative to GDP, although the share does fall between 1998 and 2003, in part because of the phase-in of last year's tax cuts.

State and Local Government

Available data suggest that spending on consumption and investment by state and local governments grew at a moderate pace in the fourth quarter. Employment edged up in the fourth quarter, suggesting a moderate gain in real consumption. (Compensation accounts for 60 percent of the state and local sector's contribution to GDP.) Among investment items, real construction outlays, which account for most of the sector's investment spending, rebounded somewhat in October after trending down from its record last February. Despite a backward slide in November, the average for the two months stands well above that for the third quarter. In particular, highway construction jumped to an unusually high level in November.

With growth in total consumption plus investment spending less than GDP growth in recent years, and revenue growth relatively strong, the sector has remained in good fiscal health. And the latest survey just published by the National Conference of State Legislators indicates that fiscal 1998 is likely to be another good year. All but one state, Alaska, reported that revenues are coming in on target or better so far this fiscal year. Likewise, spending also appears to be on target. Survey respondents report that key budget issues for legislatures this winter and spring will center on K-12 education funding, tax cuts or tax reform, and the funding of corrections programs and transportation.

CPI AND PPI INFLATION RATES
(Percent change)

	From twelve months earlier		1997		1997	
	Dec. 1996	Dec. 1997	Q3	Q4	Nov.	Dec.
			-Annual rate-		-Monthly rate-	
CPI						
All items (100.0) ¹	3.3	1.7	2.0	2.3	.1	.1
Food (15.9)	4.3	1.5	3.6	2.0	.2	-.1
Energy (7.0)	8.6	-3.4	2.5	3.3	-.2	-1.6
CPI less food and energy (77.0)	2.6	2.2	1.7	2.1	.1	.2
Commodities (23.4)	1.1	.4	-1.2	.6	.0	.1
New vehicles (5.0)	1.8	-.9	-.1	-1.8	-.2	-.2
Used cars (1.3)	-1.6	-4.9	-12.2	-3.5	-.1	.3
Apparel (4.8)	-.5	.9	-2.5	.5	.2	.1
House furnishings (3.3)	-.1	-1.4	-3.3	-.7	-.1	.0
Other Commodities (9.0)	2.2	2.1	1.1	2.7	.0	.2
Services (53.7)	3.3	3.0	2.8	2.8	.1	.4
Shelter (28.2)	2.9	3.4	2.8	3.3	.2	.4
Medical care (6.1)	3.2	2.9	2.2	2.9	.4	.5
Auto finance charges (0.6)	-2.0	-3.1	-2.4	-8.4	-1.1	-.5
Other Services (18.8)	4.0	2.6	3.2	2.2	-.1	.2
PPI						
Finished goods (100.0) ²	2.8	-1.2	.4	1.3	-.2	-.2
Finished consumer foods (23.6)	3.4	-1.0	-2.0	1.7	-.1	-.1
Finished energy (14.7)	11.7	-6.4	6.2	3.1	-.8	-.2
Finished goods less food and energy (61.6)	.6	.1	.0	.9	-.1	-.1
Consumer goods (38.1)	.8	.3	.1	1.5	-.1	-.1
Capital equipment (23.6)	.4	-.5	-.3	.0	-.1	-.2
Intermediate materials (100.0) ³	.7	-.8	.1	.4	.2	-.2
Intermediate materials less food and energy (81.3)	-.9	.3	.4	.4	.1	-.1
Crude materials (100.0) ⁴	14.7	-11.7	-3.6	16.2	1.6	-5.6
Crude food materials (38.0)	-1.0	-4.2	-13.6	-2.1	-.3	-.7
Crude energy (42.4)	51.2	-23.9	7.8	57.1	5.0	-12.6
Crude materials less food and energy (19.6)	-5.5	.1	-.3	-2.9	-.7	-1.5

1. Relative importance weight for CPI, December 1996.
2. Relative importance weight for PPI, December 1996.
3. Relative importance weight for intermediate materials, December 1996.
4. Relative importance weight for crude materials, December 1996.

Prices

The consumer price index rose just 1.7 percent during 1997, well below its 3.3 percent pace over the previous year.¹² The latest news on prices has remained quite favorable, with the CPI rising just 0.1 percent in both November and December. Continued weakness in import prices and declining energy prices have restrained consumer prices recently. At the same time, lower prices for many industrial commodities suggest no inflationary pressures at earlier stages of processing.

The CPI for energy fell 1.6 percent in December after a small decline in November. Gasoline prices moved lower for the third consecutive month; heating oil prices also retreated. In addition, electricity and natural gas prices dropped back as unseasonably warm weather eased demand. Overall, energy prices declined 3-1/2 percent last year after having surged 8-1/2 percent in 1996. All types of energy contributed to this deceleration, although the large swings in prices of gasoline and heating oil accounted for more than half of the slowing.

Retail food prices were little changed in November and December. The favorable news on food prices has been widespread across categories, and grocery prices in coming months likely will be held down by the recent declines in spot and futures prices for both crop and livestock commodities. An exception to the recent pattern in the food area is the index for food away from home, which has picked up; it rose 0.3 percent in November and 0.4 percent in December. In the last Greenbook, we noted that September's minimum wage increase appeared to have had little effect on the CPI for food away from home through October, but more recent data suggest that the effects of higher wage costs may simply have come later than expected. Even with the recent uptick in that component, the overall food CPI rose just 1-1/2 percent during 1997, nearly 3 percentage points less than its pace during the prior year.

Outside of food and energy, consumer prices rose 0.2 percent in December after having increased just 0.1 percent in November. Over last year as a whole, the core CPI was up 2.2 percent, almost

12. About every ten years, the CPI undergoes a major revision. In the next CPI release, the BLS will implement most of the changes that are part of the 1998 major revision, including updated expenditure weights, a revised item structure, and a new index for computer prices.

BROAD MEASURES OF INFLATION
(Four-quarter percent change)

	1994	1995	1996	1997
<u>Product prices</u>				
GDP chain price index ²	2.5	2.4	2.3	1.9
Nonfarm business chain-type price index ^{1 2}	2.5	1.7	1.9	1.6
<u>Expenditure prices</u>				
Gross domestic purchases chain-type price index ²	2.5	2.3	2.3	1.6
Less food and energy ²	2.6	2.4	1.9	1.6
PCE chain-type price index ²	2.6	2.2	2.7	1.9
Less food and energy ²	2.8	2.4	2.3	1.9
CPI	2.7	2.6	3.2	1.9
Less food and energy	2.8	3.0	2.6	2.2
Median CPI	2.9	3.2	2.8	2.8
Trimmed mean CPI	2.6	2.7	2.8	2.1

1. Excluding housing.
2. Value shown for 1997 is the four-quarter change through 1997:Q3.

SURVEYS OF (CPI) INFLATION EXPECTATIONS
(Percent)

	Actual inflation ¹	University of Michigan (1-year) Mean ²	University of Michigan (1-year) Median ³	Conference Board (1-year)	Professional forecasters (10-year) ⁴
1996-Q1	2.7	3.9	2.9	4.1	3.0
Q2	2.8	4.5	3.0	4.3	3.0
Q3	2.9	4.2	3.0	4.3	3.0
Q4	3.2	4.0	3.0	4.2	3.0
1997-Q1	2.9	3.8	2.9	4.2	3.0
Q2	2.3	3.6	2.9	4.0	2.9
Q3	2.2	3.4	2.7	4.0	3.0
Q4	1.9	3.3	2.8	4.1	2.7
Jul	2.2	3.4	2.7	4.0	
Aug.	2.2	3.3	2.7	3.9	
Sept.	2.2	3.5	2.8	4.1	3.0
Oct.	2.1	3.2	2.8	4.1	
Nov.	1.8	3.4	2.9	4.1	
Dec.	1.7	3.4	2.8	4.0	2.7
1998-Jan.		2.8	2.2		

1. CPI; percent change from the same period in the preceding year.
2. Average increase for responses to the question: By about what percent do you expect prices (CPI) to go up, on the average, during the next 12 months?
3. Median increase for responses to the question above.
4. Compiled by the Federal Reserve Bank of Philadelphia.

1/2 percentage point less than the pace registered during 1996.¹³ Deceleration was evident among prices of both goods and services, although it was not universal across all categories. Within goods, the deceleration was concentrated in the durables category, where falling import prices have been an especially important restraining influence. In particular, prices of new and used motor vehicles decelerated considerably in 1997 and accounted for more than half of the slowing in the core CPI last year. In contrast to durable goods, price increases for nondurable goods picked up last year, with accelerating prices for tobacco and apparel. Among services other than energy, airfares--which dropped back last year after having popped up during 1996--more than accounted for the deceleration; shelter costs accelerated somewhat over 1997.

Other broad measures of inflation have also slowed recently; as of 1997:Q3, four-quarter changes in chain price indexes for GDP and for PCE excluding food and energy were down 0.4 percentage point from their pace at the end of 1996, similar to the pattern for the core CPI.¹⁴ However, some alternative measures of the underlying trend in the CPI have not slowed as much as the published core CPI. In particular, the median CPI--calculated by the Cleveland Fed--showed no deceleration over the past year.¹⁵ The difference is due to the fact that over the past year prices decelerated substantially for a relatively small number of items in the CPI, such as motor vehicles. Large decelerations for a few important items can have a big effect on changes in the overall and core CPI but little or no effect on the median CPI. Nonetheless, movements in the median CPI should be interpreted cautiously because yet another alternative--the trimmed mean CPI--tells a story more like that of the core CPI.¹⁶

13. Technical changes to the CPI are estimated to have accounted for almost 0.1 percentage point of slowing in core CPI inflation in 1997.

14. Fourth-quarter figures for PCE and GDP prices will be released on January 30. In these figures, we anticipate that the extra holiday received by federal workers on December 26 will boost the increase in the GDP chain price index by 0.1 percentage point at an annual rate. This effect will be reversed in the first quarter.

15. The median CPI is constructed by ranking price changes of individual items in the CPI, applying relative importance weights to these changes, and selecting the price change at the 50th percentile of this weighted distribution.

16. Indeed, the Cleveland Fed's trimmed-mean CPI (which excludes the categories with the largest and smallest price increases) decelerated even more in 1997 than did the core CPI. Differences (Footnote continues on next page)

SPOT PRICES OF SELECTED COMMODITIES

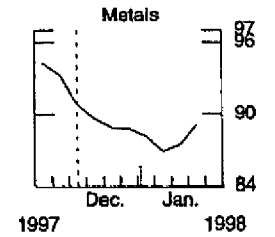
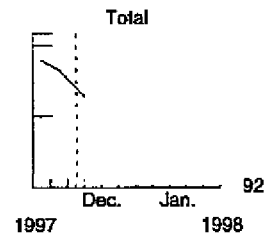
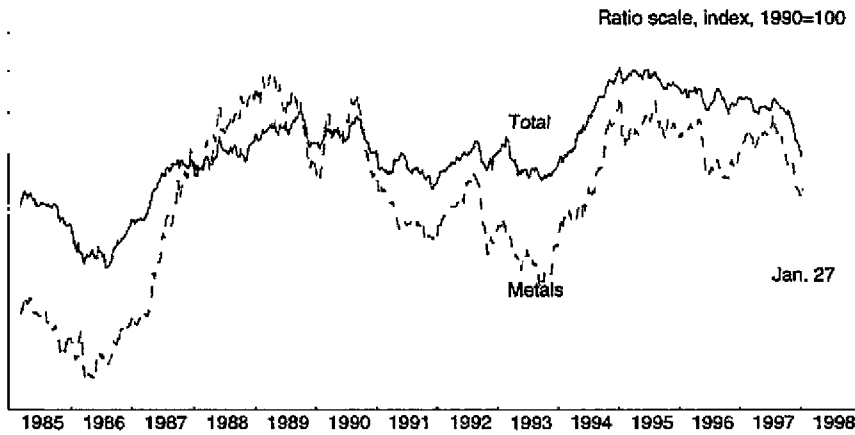
	Current price (\$)	-----Percent change ¹ -----				Memo: Year earlier to date
		1995	1996	Dec. 31 to Dec. 09 ²	Dec. 09 ² to Jan. 27	
Metals						
Copper (lb.)	.820	-3.5	-18.3	-20.6	-3.5	-29.3
Steel scrap (ton)	145.500	-6.6	-13.7	12.9	10.6	9.4
Aluminum, London (lb.)	.683	-12.9	-9.8	2.7	-3.0	-6.1
Precious metals						
Gold (oz.)	298.900	1.7	-5.1	-23.3	5.5	-15.5
Silver (oz.)	6.015	7.2	-8.8	12.3	12.2	20.9
Forest products						
Lumber (m. bdft.)	285.000	-14.4	66.0	-29.6	-2.4	-31.8
Plywood (m. sqft.)	285.000	-6.1	1.6	-6.3	-3.4	-6.6
Petroleum						
Crude oil (barrel)	15.620	16.8	25.9	-26.2	-10.5	-30.7
Gasoline (gal.)	.473	7.7	24.3	-22.8	-9.2	-28.5
Fuel oil (gal.)	.469	22.6	16.1	-25.6	-10.4	-29.7
Livestock						
Steers (cwt.)	64.000	-5.7	.0	3.0	-5.9	-1.5
Hogs (cwt.)	36.750	27.5	34.1	-19.1	-17.4	-35.5
Broilers (lb.)	.513	10.7	12.4	-22.2	5.4	-13.8
U.S. farm crops						
Corn (bu.)	2.640	57.4	-29.5	4.7	-1.1	-1.1
Wheat (bu.)	3.670	24.0	-16.6	-13.7	-6.5	-20.0
Soybeans (bu.)	6.745	29.0	-7.1	1.6	-3.5	-8.4
Cotton (lb.)	.618	-8.1	-10.9	-9.0	-4.1	-13.5
Other foodstuffs						
Coffee (lb.)	1.770	-39.1	43.2	40.4	-7.3	13.1
Memo:						
JOC Industrials	96.500	-1.7	-3.7	-6.4	-3.9	-10.8
JOC Metals	89.100	-1.8	-7.7	-2.9	-1.9	-8.8
KR-CRB Futures	233.200	3.3	-2.6	-.5	-1.6	-3.7
KR-CRB Spot	300.310	-3.5	1.0	-7.4	-3.2	-11.9

1. Changes, if not specified, are from the last week of the preceding year to the last week of the period indicated.

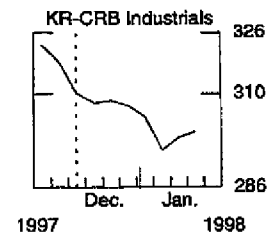
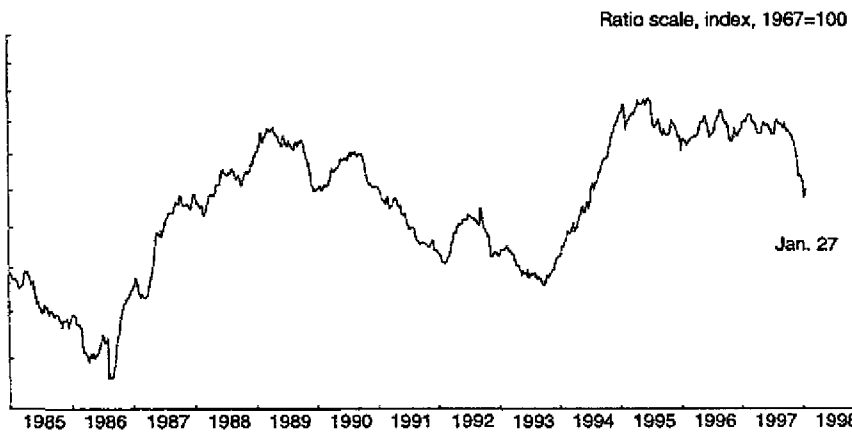
2. Week of the December Greenbook.

Commodity Price Measures

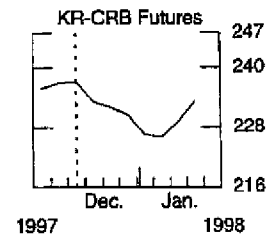
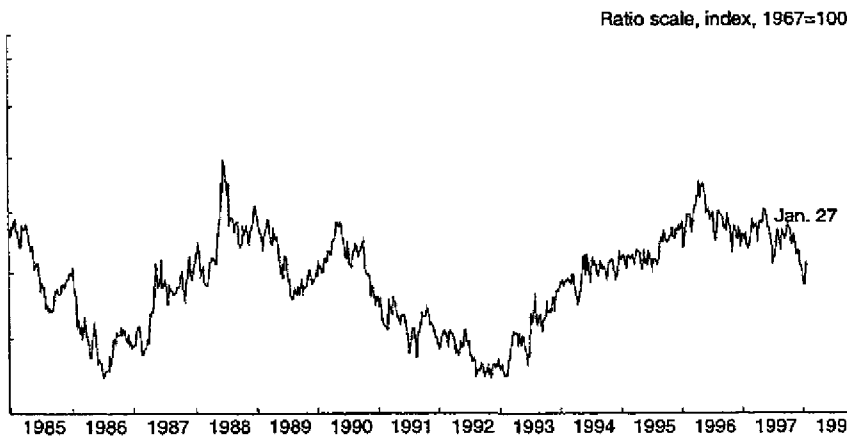
Journal of Commerce Index



KR-CRB Spot Industrials



KR-CRB Futures



Note. Weekly data, Tuesdays. Vertical lines on small panels indicate week of last Greenbook. The Journal of Commerce index is based almost entirely on industrial commodities, with a small weight given to energy commodities, and the KR-CRB spot price index consists entirely of industrial commodities, excluding energy. The KR-CRB futures index gives about a 60 percent weight to food commodities and splits the remaining weight roughly equally among energy commodities, industrial commodities, and precious metals. Copyright for Journal of Commerce data is held by CIBCR, 1994.

**EMPLOYMENT COST INDEX OF HOURLY COMPENSATION
FOR PRIVATE INDUSTRY WORKERS**

	1996	1997			
	Dec.	Mar.	June	Sept.	Dec.
	-----Quarterly percent change----- (Compound annual rate)				
Total hourly compensation ¹	2.8	2.5	3.4	3.4	4.9
Wages and salaries	3.2	3.5	3.8	3.8	5.0
Benefit costs	2.9	0.0	2.9	2.0	4.3
By industry					
Construction	3.5	2.2	3.5	2.8	1.9
Manufacturing	2.8	0.6	3.7	3.0	2.4
Transportation and public utilities	4.1	1.2	2.5	3.4	4.6
Wholesale trade	3.4	6.9	0.9	3.3	1.8
Retail trade	5.2	3.5	2.5	4.4	3.1
FIRE	-2.2	8.5	2.5	3.4	12.8
Services	3.1	2.7	3.6	3.6	5.4
By occupation					
White collar	2.8	3.4	3.0	3.3	5.7
Blue collar	3.8	1.2	3.4	2.8	2.8
Service occupations	3.8	3.5	3.4	6.9	2.4
Memo:					
State and local governments	3.1	2.1	1.8	2.1	2.7
	-----Twelve-month percent change-----				
Total hourly compensation	3.1	3.0	2.9	3.2	3.4
Excluding sales workers	2.9	2.8	2.9	3.0	3.4
Wages and salaries	3.4	3.4	3.3	3.6	3.9
Excluding sales workers	3.3	3.1	3.3	3.5	3.8
Benefit costs	2.0	2.0	2.0	2.0	2.3
By industry					
Construction	2.4	2.3	2.7	3.0	2.6
Manufacturing	3.0	2.6	2.6	2.5	2.4
Transportation and public utilities	3.0	2.7	2.6	2.8	2.9
Wholesale trade	3.1	4.2	3.5	3.6	3.2
Retail trade	3.8	3.2	3.9	3.9	3.4
FIRE	2.4	3.3	2.5	3.0	6.7
Services	3.1	3.0	3.0	3.2	3.8
By occupation					
White collar	3.2	3.2	3.2	3.1	3.8
Sales	4.0	4.2	3.0	4.3	4.2
Nonsales	3.0	2.9	3.1	3.0	3.7
Blue collar	2.7	2.4	2.5	2.8	2.6
Service occupations	3.0	3.2	3.5	4.5	4.0
Memo:					
State and local governments	2.6	2.5	2.4	2.4	2.3

1. Seasonally adjusted by the BLS.

Inflation expectations as measured by the Michigan SRC index also came down over the past year. In the fourth quarter of last year, one-year-ahead median expectations were about 1/4 percentage point lower than a year earlier, while mean expectations dropped about 3/4 percentage point. The preliminary reading for January indicates that these expectations fell substantially further, although those figures probably should be taken with a grain of salt until the final--full sample--readings are released at the end of January.

Prices of capital equipment in the PPI edged down 0.2 percent further in December, with declines for motor vehicles as well as other types of capital equipment. Just as for durable goods in the CPI, prices of capital goods in 1997 appear to have been restrained by weak import prices: The PPI for capital goods fell 1/2 percent last year, compared with an increase of about 1/2 percent registered during 1996.¹⁷

At earlier stages of processing, prices continue to be subdued. The PPI for core intermediate materials edged down in December and was up only 0.3 percent over 1997 as a whole. The index for core crude materials dropped another 1.5 percent in December after having declined 0.7 percent in November. As a result of ample supplies and softening demand on world markets, prices of many industrial commodities are, on balance, considerably below their levels in mid-December. Although the most recent weekly observations suggest that these indexes may have stopped declining, the Journal of Commerce index of industrial prices is down 4 percent, and the CRB index of spot industrials is off 3-1/4 percent.¹⁸

Labor Costs

According to the Employment Cost Index, hourly compensation of private industry workers increased at a seasonally adjusted annual

(Footnote continued from previous page)

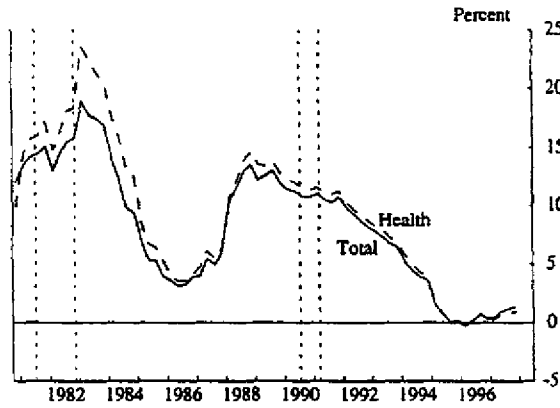
between the median, trimmed mean, and core CPI reflect subtle asymmetries in the distribution of price changes across items in the CPI, and the implications that one should draw from these differences are not obvious.

17. Because the PPI includes only domestically produced capital goods, imported capital goods affect these prices only through the competing goods effect. The BLS price measure for imported capital goods (excluding motor vehicles) fell about 7 percent in 1997.

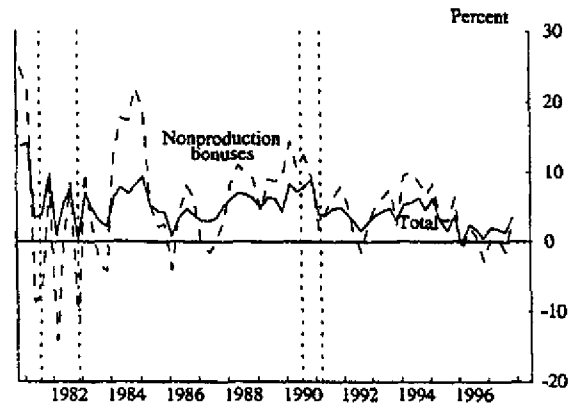
18. Price changes in the Journal of Commerce index are standardized to take account of the historical volatility of each price.

Components of ECI Benefits Costs (Private industry workers; twelve-month change)

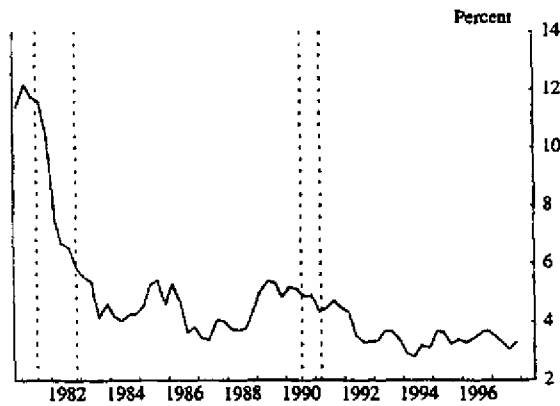
Insurance Costs



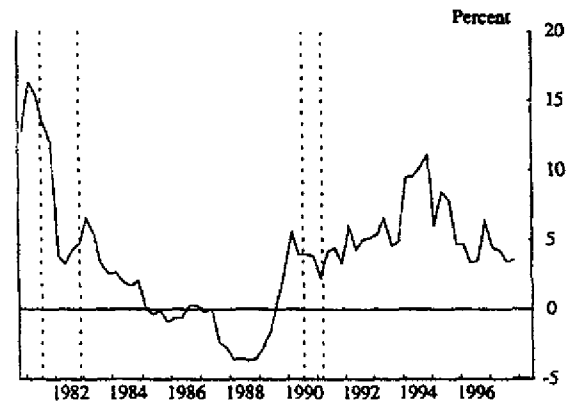
Supplemental Pay



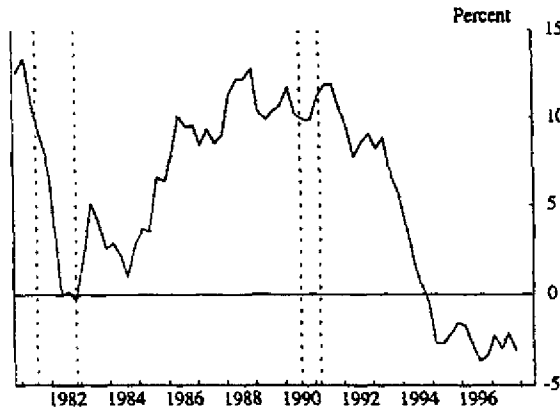
Paid Leave



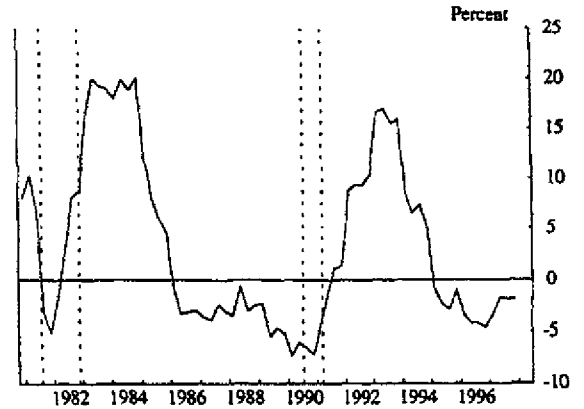
Retirement and Savings



Workers' Compensation Insurance



State Unemployment Insurance



Note. Unpublished ECI benefits detail.

rate of 4.9 percent in the three months ended in December. Over 1997 as whole, this measure of hourly compensation rose 3.4 percent, up 0.3 percentage point from its pace in the prior year.

Over the final three months of last year, the pickup in hourly compensation reflected an acceleration in wages and salaries as well as in benefit costs. Developments in the finance, insurance, and real estate (FIRE) industry contributed importantly to the pickup in both wages and benefits, adding about a percentage point to the increase in overall ECI compensation. Wages and salaries in FIRE were boosted considerably by the sizable commissions generated from the recent wave of mortgage refinancings, and nonproduction bonuses, included in benefits, also increased substantially in this industry.¹⁹

The year-end developments in FIRE largely accounted for the acceleration in hourly compensation between 1996 and 1997. Elsewhere, hourly compensation accelerated noticeably in the business services industry, where anecdotal reports of labor shortages for some occupations, such as computer specialists and skilled temporary workers, have been common. Wages also picked up in the health services industry after posting a relatively small increase in 1996. In contrast, hourly compensation in goods-producing industries and in the retail and wholesale trade sector decelerated last year.

The occupational detail suggests that the minimum wage also provided a boost to compensation gains in the past year. Of the three broad occupational categories, the services group has the highest concentration of low-wage occupations. Compensation in this category was up 4.0 percent over the past year; this compares with a 3.0 percent rise in 1996 (when the minimum wage was also increased) and a 1.9 percent rise in 1995. As for timing of the minimum wage effect within the year, the quarterly pattern of compensation in service occupations suggests that much of the impact of last September's minimum wage hike occurred in the third quarter. At annual rates, compensation for service occupations increased 6.9 percent during the three months ending in September, but only 2.4 percent over the three-month period through December.

Over the past year, benefit costs increased 2.3 percent, compared with a 2.0 percent gain in 1996. In addition to large

19. The detail on bonuses is based on unpublished and confidential information received from BLS.

bonuses in financial services, year-end bonuses were apparently sizable in a variety of other industries as well. Health insurance costs increased 0.9 percent last year, compared with an increase of 0.4 percent in the prior year.²⁰

Overall, tight labor markets appear to have sustained nominal compensation gains last year even as favorable developments in product markets led to a slowing of price inflation. Adjusted for inflation by the nonfarm business chain price index, real ECI compensation is expected to show an increase of nearly 2 percent in 1997, almost 1 percentage point more than in 1996.²¹

20. For 1998, other information suggests some acceleration in health care costs. According to a recent survey of 150 large firms conducted by Towers Perrin, health care costs faced by these companies are expected to rise 4 percent this year, compared with 3 percent last year. In addition, health care premiums for employees of the federal government increased an average of 8-1/2 percent between 1997 and 1998.

21. The figure for real ECI compensation for 1997 requires a forecast of the price measure for the nonfarm business sector for the fourth quarter. BEA will publish this number on January 30.

DOMESTIC FINANCIAL DEVELOPMENTS

III-T-1

Selected Financial Market Quotations¹
(Percent except as noted)

Instrument	1997			1998	Change to Jan. 27, from:			
	Jan. 2	Sep. 30	FOMC * Dec. 16	Jan. 27	Jan. 2	Sep. 30	FOMC * Dec. 16	
Short-term rates								
Federal funds ²	5.79	5.57	5.50	5.53	-.26	-.04	.03	
Treasury bills ³								
3-month	5.05	4.93	5.10	5.10	.05	.17	.00	
6-month	5.14	5.08	5.18	5.09	-.05	.01	-.09	
1-year	5.28	5.18	5.18	5.05	-.23	-.13	-.13	
Commercial paper ⁴								
1-month	5.48	5.51	5.79	5.46	-.02	-.05	-.33	
3-month	5.47	5.48	5.70	5.40	-.07	-.08	-.30	
Large negotiable CDs ³								
1-month	5.39	5.59	5.87	5.53	.14	-.06	-.34	
3-month	5.42	5.67	5.79	5.54	.12	-.13	-.25	
6-month	5.50	5.72	5.79	5.54	.04	-.18	-.25	
Eurodollar deposits ⁵								
1-month	5.38	5.56	5.81	5.50	.12	-.06	-.31	
3-month	5.44	5.63	5.75	5.50	.06	-.13	-.25	
Bank prime rate	8.25	8.50	8.50	8.50	.25	.00	.00	
Intermediate- and long-term rates								
U.S. Treasury (constant maturity)								
3-year	6.13	5.88	5.70	5.50	-.63	-.38	-.20	
10-year	6.54	6.12	5.78	5.70	-.84	-.42	-.08	
30-year	6.75	6.41	5.97	5.95	-.80	-.46	-.02	
U.S. Treasury 10-year indexed note	n.a.	3.61	3.57	3.66	n.a.	.05	.09	
Municipal revenue (Bond Buyer) ⁶	5.96	5.63	5.45	5.30	-.66	-.33	-.15	
Corporate-A utility, recently offered	7.64	7.44	7.30	7.09	-.55	-.35	-.21	
High-yield corporate ⁷	9.72	9.02	9.04	8.94	-.78	-.08	-.10	
Home mortgages ⁸								
FHLMC 30-yr fixed rate	7.64	7.28	7.17	6.99	-.65	-.29	-.18	
FHLMC 1-yr adjustable rate	5.57	5.51	5.53	5.53	-.04	.02	.00	
Stock exchange index	Record high		1997		1998	Percentage change to Jan. 27, from:		
	Level	Date	Jan. 2	FOMC * Dec. 16	Jan. 27	Record high	Jan. 2	FOMC * Dec. 16
Dow-Jones Industrial	8259.31	8/6/97	6441.49	7922.59	7815.08	-5.38	21.32	-1.36
S&P 500 Composite	983.79	12/5/97	736.01	963.39	969.02	-1.50	31.66	.58
NASDAQ (OTC)	1745.85	10/9/97	1279.70	1536.56	1578.90	-9.56	23.38	2.76
Russell 2000	465.21	10/13/97	357.96	420.76	422.53	-9.17	18.04	.42
Wilshire	9486.69	10/7/97	7146.80	9162.76	9215.96	-2.85	28.95	.58

1. One-day quotes except as noted.

2. Average for two-week reserve maintenance period closest to date shown. Last observation is the average to date for maintenance period ending January 28, 1998.

3. Secondary market.

4. As of September 2, 1997, commercial paper rates are those collected by the Depository Trust Company; prior rates are averages of offering rates at several large dealers.

5. Bid rates for Eurodollar deposits at 11 a.m. London time.

6. Most recent observation based on one-day Thursday quote and futures market index changes.

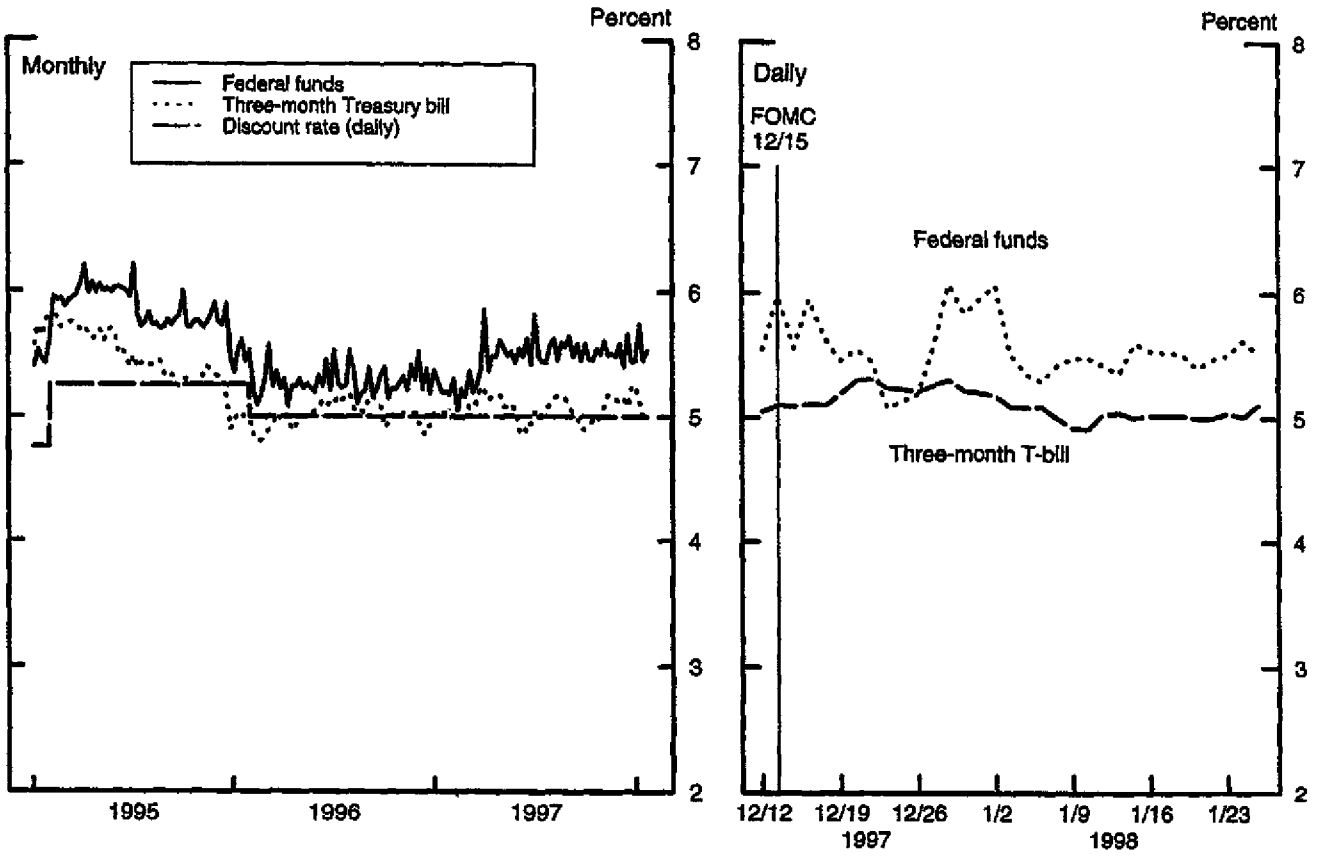
7. Merrill Lynch Master II high-yield bond index composite.

8. Quotes for week ending Friday previous to date shown.

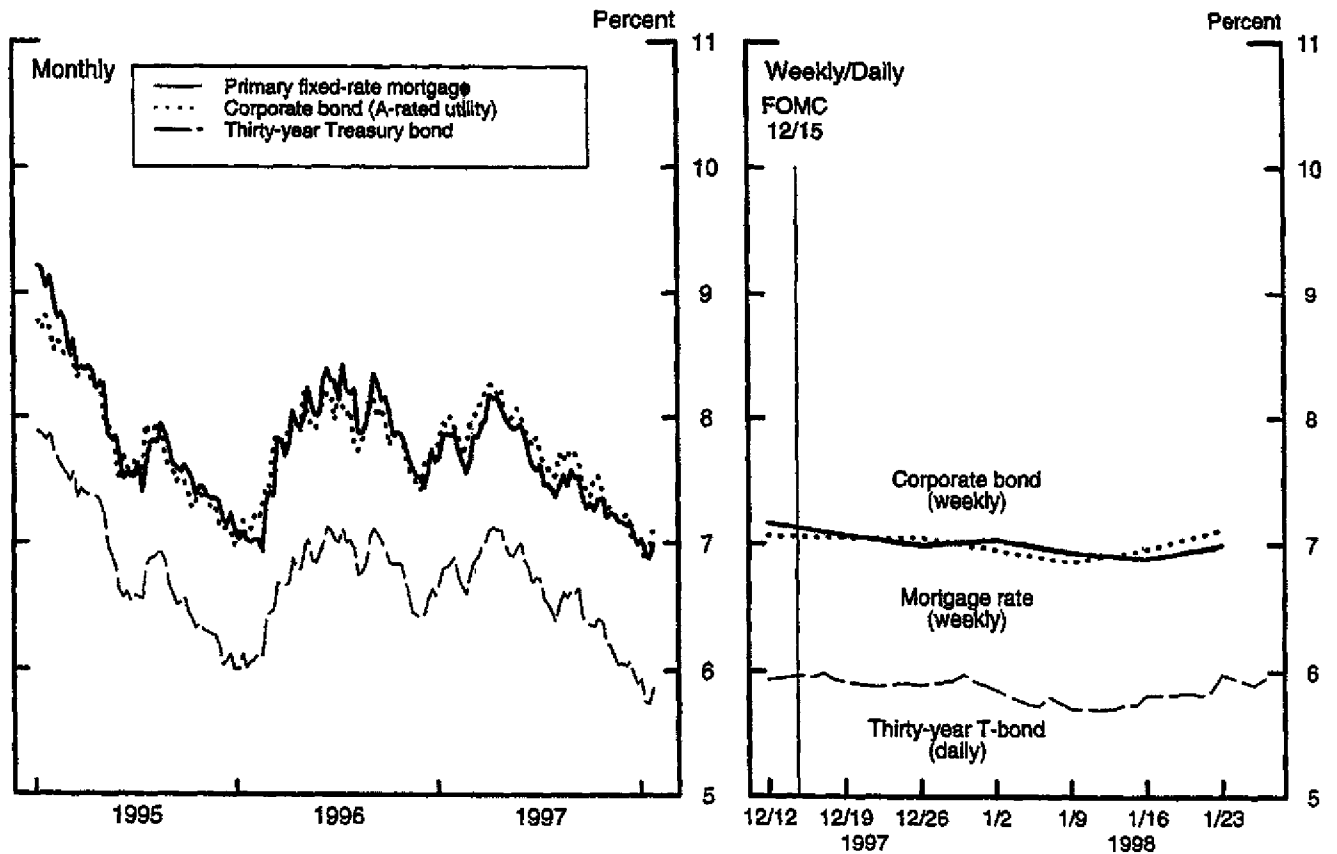
* Figures cited are as of the close on December 15, 1997.

Selected Interest Rates

Short-Term



Long-Term



DOMESTIC FINANCIAL DEVELOPMENTS

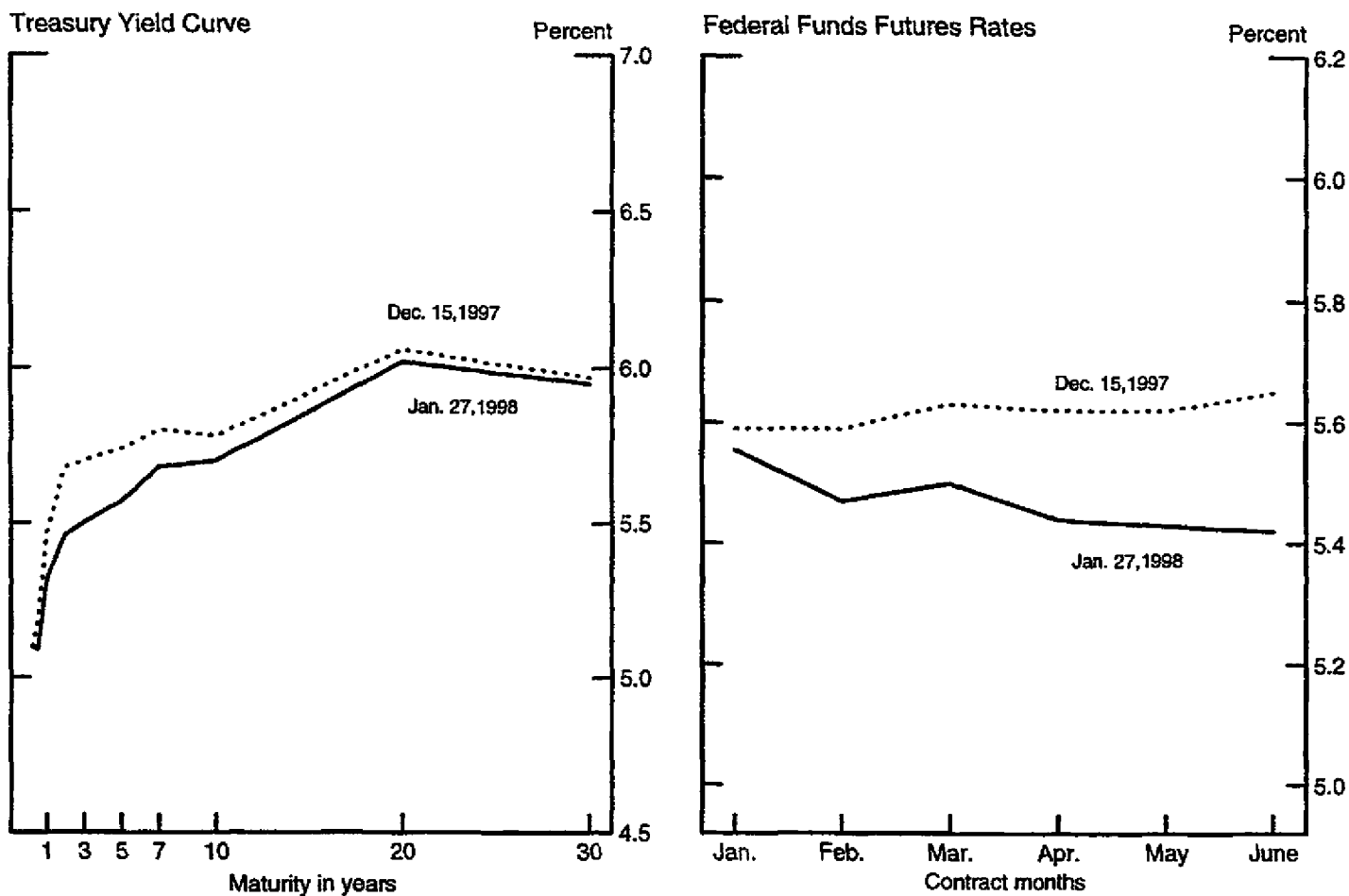
The decision by the FOMC to keep policy on hold at the December meeting had been anticipated and thus market yields were unaffected. But, in subsequent weeks, more bad news from Asia and more good news on U.S. inflation caused nominal interest rates to fall 10 to 40 basis points, the largest declines being posted at intermediate maturities (chart). The slide in rates was attributed in part to a flight to the relative safety and liquidity of dollar assets, particularly nominal Treasury securities. More recently, that rate decline was largely reversed, as some Asian economies were perceived to be stabilizing. Uncertainty associated with the President's legal problems also appeared to be a factor.

Federal funds futures rates, which were flat at the time of the December FOMC meeting, now slope downward (chart). With the contract for June currently about 8 basis points below the intended rate of 5-1/2 percent, market participants apparently see a significant chance of policy easing before midyear.

Since the last FOMC meeting, major equity indexes have registered mixed changes, amid considerable volatility that has been closely associated with frequent, large swings in prices on Asian markets and mixed signals on earnings growth prospects. On balance, the Dow Jones Index was little changed, while the NASDAQ rose 2-3/4 percent, reversing some of its relative underperformance during the fall.

The decline in interest rates created an inviting market for bond issuance, and this has tilted heavy business credit demands toward the bond market. Bank C&I loans also have been rising rapidly of late, reportedly fueled by inventory growth and brisk merger activity. In contrast, the shakier stock market environment has trimmed new equity offerings. Borrowing by households in recent months appears to have stayed around its moderate third-quarter pace; with the decline in rates, this portends a slight easing of the burden of debt payments. Net borrowing by the Treasury remains minimal. Lower rates on tax-exempt bonds have boosted bond issuance--and overall borrowing--by the state and local sector. Growth in the broader monetary aggregates has been robust in recent months.

Treasury Yield Curve and Federal Funds Futures Rates



Business Finance

Gross bond issuance by nonfinancial corporations maintained a moderate \$12 billion monthly pace in December, with some potential issuers apparently staying on the sidelines anticipating still lower yields (table). In early January, when corporate bond yields in fact touched their lowest levels in more than two decades, issuance surged. Based on proceeds raised through January 26, issuance in January will easily top \$20 billion, well ahead of the brisk \$16-1/2 billion pace in the fourth quarter. Issuance has been particularly heavy in the investment-grade sector, where a significant chunk of the proceeds apparently has been used to pay down commercial paper. Speculative-grade bond offerings slowed to \$5-1/2 billion in December--a healthy pace, but one that pales by

comparison with last year's record monthly average of almost \$8 billion.

Over the intermeeting period, interest rates on high-yield debt fell only about 10 basis points, resulting in a slight increase in quality spreads. The widening in spreads did not appear to reflect greater concern about default risk but, rather, the marked preferences of those fleeing emerging markets for the liquidity of Treasuries and top-quality corporates. Indeed, the spread of junk over Treasury rates was a great deal wider in early January, before Treasury yields retraced some of their recent declines.

The effects of the Asian crisis on corporate fortunes have become a major focus for equity investors. Although U.S. stock price indexes show small mixed changes over the intermeeting period, this masks some sizable weekly swings (chart, top panel). Because money center banks and technology firms have relatively large exposures to Asia, their stock prices have been especially volatile, with the money center banks registering large declines since mid-December. Equities in the energy and basic materials sectors were roiled by the declines in oil and other commodity prices--both related at least in part to Asian developments.

With about half of the S&P 500 firms thus far reporting fourth-quarter earnings, it appears that, on balance, corporate earnings once again have come in above analysts' downward-revised projections. Positive surprises have outnumbered negative surprises by a margin of about five to three, a bit less favorable balance than in the last several quarters. Some of the biggest positive surprises have come from the airline industry; firm prices and declining fuel costs have produced big profits in this sector. In the computer-related technology sector, earnings have mostly run a bit above the most recent consensus projections. Perhaps more important for share prices, though, several major companies in this sector have indicated that declining demand in Asia or the strong U.S. dollar will have a significant negative effect on first-half performance.

If earnings reports continue the pattern seen to date, the four-quarter growth in S&P 500 earnings per share is estimated to have slowed to around 8 or 9 percent, from 12 percent in the third quarter (middle left panel). This might be consistent with a small quarter-over-quarter gain in economic profits on a seasonally adjusted basis.

GROSS ISSUANCE OF SECURITIES BY U.S. CORPORATIONS
(Billions of dollars; monthly rates, not seasonally adjusted)

Type of security	1996	1997	1997				1998
			Q3	Q4	Nov.	Dec.	Jan. ^e
All U.S. corporations	58.4	69.6	76.7	71.5	65.4	68.6	63.1
Stocks ¹	10.2	9.7	8.6	11.4	12.4	7.7	5.5
Bonds	48.2	59.8	68.0	60.1	52.9	60.8	57.6
Nonfinancial corporations							
Stocks ¹	6.7	4.9	5.0	5.4	6.9	2.4	2.0
Initial public offerings	2.9	1.8	1.8	2.4	3.6	.8	.5
Seasoned offerings	3.8	3.1	3.3	3.0	3.3	1.6	1.5
Bonds	12.5	17.2	21.5	16.6	13.2	11.9	23.2
By rating, sold in U.S. ²							
Investment grade	6.3	7.4	9.9	6.8	5.5	5.8	15.6
Speculative grade	4.8	7.9	9.1	7.3	7.4	5.4	5.6
Public	2.3	1.5	1.0	.8	1.0	.7	1.4
Rule 144A	2.5	6.4	8.1	6.5	6.4	4.7	4.2
Financial corporations							
Stocks ¹	3.5	4.8	3.6	6.0	5.6	5.3	3.5
Bonds	35.8	42.6	46.5	43.6	39.7	48.9	34.4
MEMO:							
Net issuance of nonfinancial commercial paper (end-of-period basis)	-.1	8.0	.8	1.13	5.8	-4.9	n.a.
Change in C&I loans at commercial banks (end-of-period basis)	5.6	6.5	7.8	7.2	10.8	10.9	n.a.

Note. Components may not sum to totals because of rounding. These data include speculative-grade bonds issued privately under Rule 144A. All other private placements are excluded. Total reflects gross proceeds rather than par value of original discount bonds.

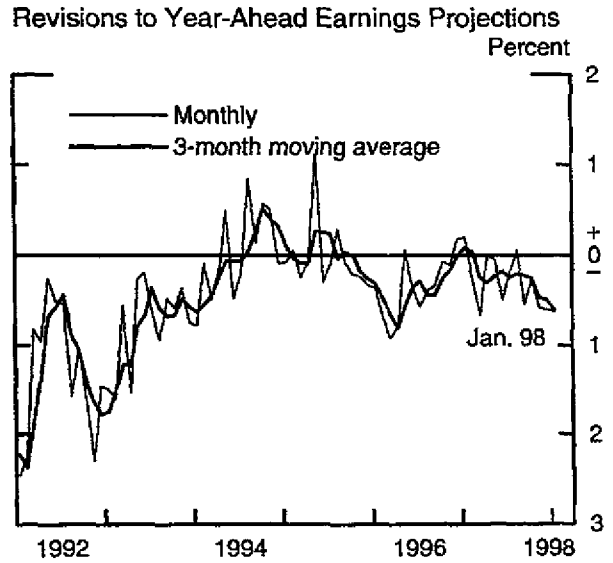
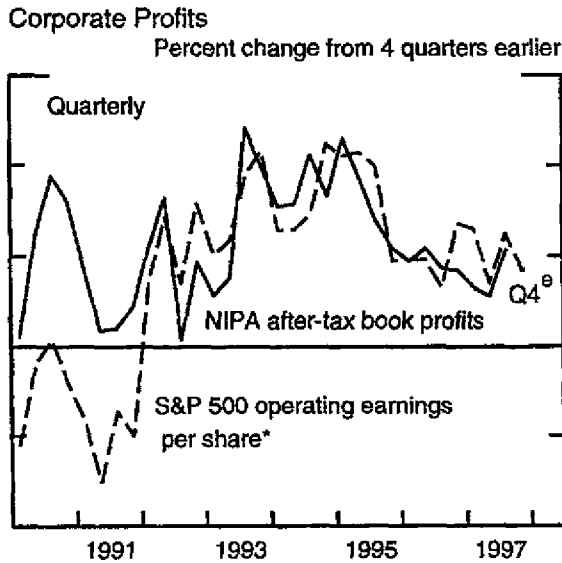
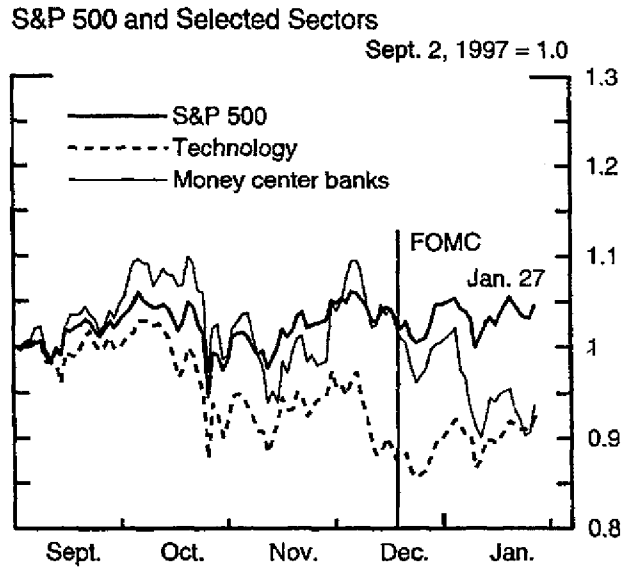
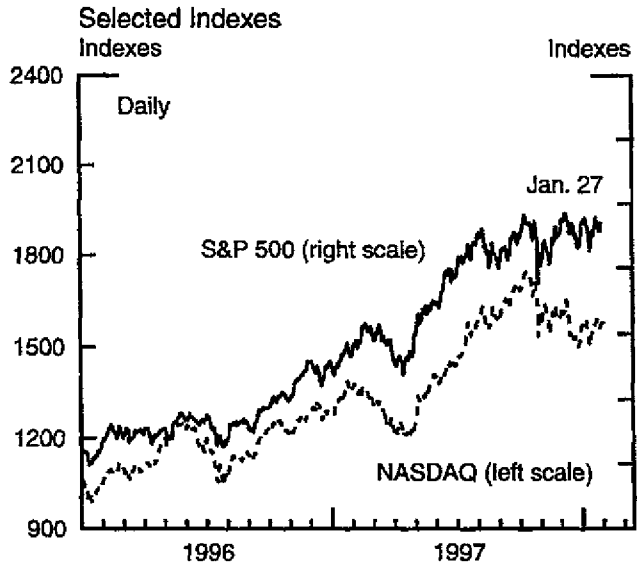
1. Excludes equity issues associated with equity-for-equity swaps that have occurred in restructurings.

2. Bonds categorized according to Moody's bond ratings, or to Standard & Poor's if unrated by Moody's. Excludes mortgage-backed and asset-backed bonds.

e Staff estimate based on data through January 26, 1998.

n.a. Not available.

Stock Market Prices and Corporate Earnings

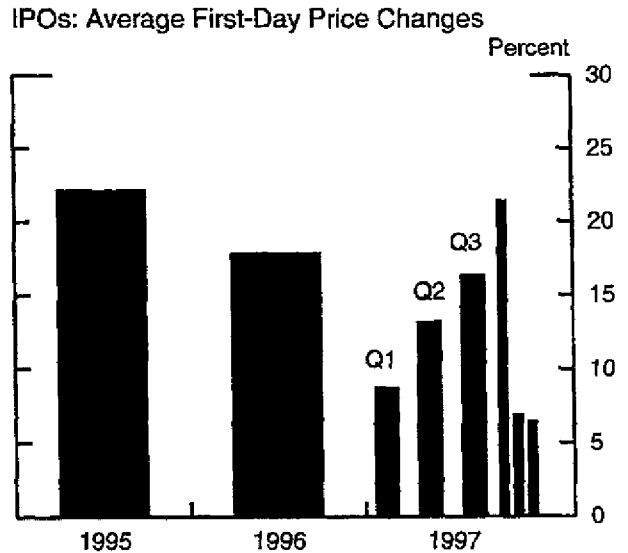


*Source: Goldman Sachs.

Source: I/B/E/S.



Source: I/B/E/S.



Despite the market's preoccupation with Asian problems, equity analysts have not yet marked down longer-term earnings prospects much. Since mid-October, average year-ahead earnings projections for S&P 500 firms have been lowered only about 1/2 percent per month (middle right panel). Nearly all of the recent downward adjustments are accounted for by revisions to technology sector projections. Currently, company-analyst ("bottom-up") projections for S&P 500 earnings in 1998 still imply an expectation that earnings will grow 13-1/2 percent (not shown). While analysts' long-term growth projections have stopped rising, they remain at record high levels (lower left panel).

The increase in stock market volatility in late October had little immediate effect on the pace of equity issuance, as November saw a near-record number of IPOs by nonfinancial companies, resulting in \$3.6 billion in new issues. But IPO price performance deteriorated significantly in late November and December: average one-day returns on IPOs dropped to around 7 percent, from more than 20 percent in October (lower right panel). Partly as a result, nonfinancial IPOs raised a paltry \$0.8 billion in December and failed to pick up in January after the normal seasonal lull early in the month.

Meanwhile, equity retirements have remained very strong. Companies continue to announce stock repurchase plans at a near-record pace, and merger activity involved about \$30 billion in equity retirements during the fourth quarter. Only \$8 billion of this came from megamergers, while the number of minimergers (combinations of companies under \$1 billion in capitalization) was the largest for any quarter during the current merger wave. The \$22 billion of equity retired from these minimergers likely boosted bank loan growth late in the year, because many of the acquirers have limited access to securities markets for debt financing.

The fourth quarter saw very few ratings changes for U.S. corporations. Over the course of the year, upgrades were balanced by downgrades in the nonfinancial sector. Although a large amount of nonfinancial debt was recently put on Moody's watchlist for downgrades, much of it was related to recent and prospective mergers. None of the additions appeared to be the result of Asia-related or general economic concerns.

Household Sector

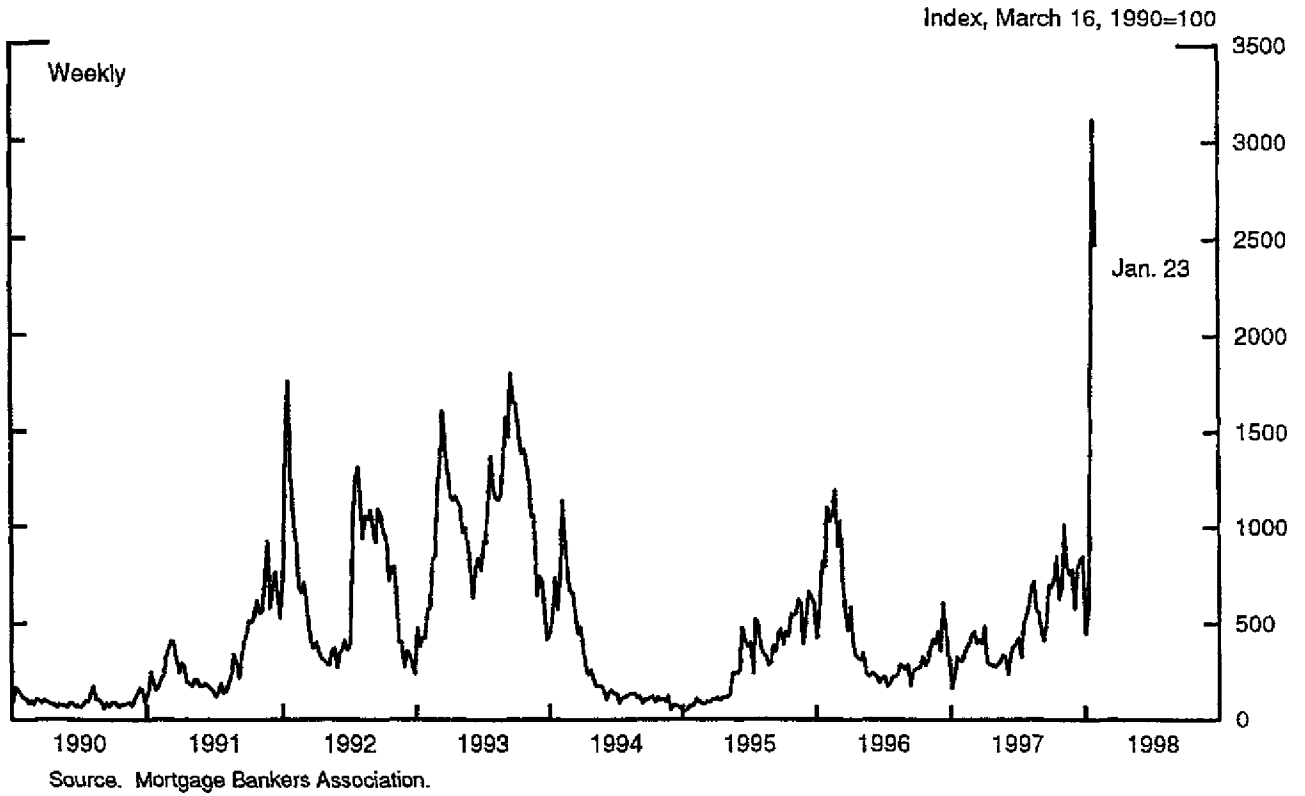
After interest rates on new fixed-rate home mortgages dropped below 7 percent, homeowners scrambled to refinance their mortgage loans. Indeed, the Mortgage Bankers Association's refinancing application index surged to a record high in early January (chart). While this signals an extraordinary level of refinancing activity, some of that increase probably reflects heavy multiple application filing by customers fearful that backed-up mortgage bankers will not be able to process their forms promptly.

The volume of refinancing had already been rising for several months, as borrowers--including many holding ARMs--sought to lock in lower long-term rates. In total, prepayment activity for all of 1997 is estimated to have reduced interest costs about \$5-1/2 billion, only a fraction of the \$33 billion in estimated savings from the major refinancing wave in 1993, when rates last broke below 7 percent. The staff estimates that, if mortgage rates were to settle in near 7 percent during the months ahead, then refinancing could reduce annualized mortgage payments about \$16 to \$24 billion in 1998, all else the same.

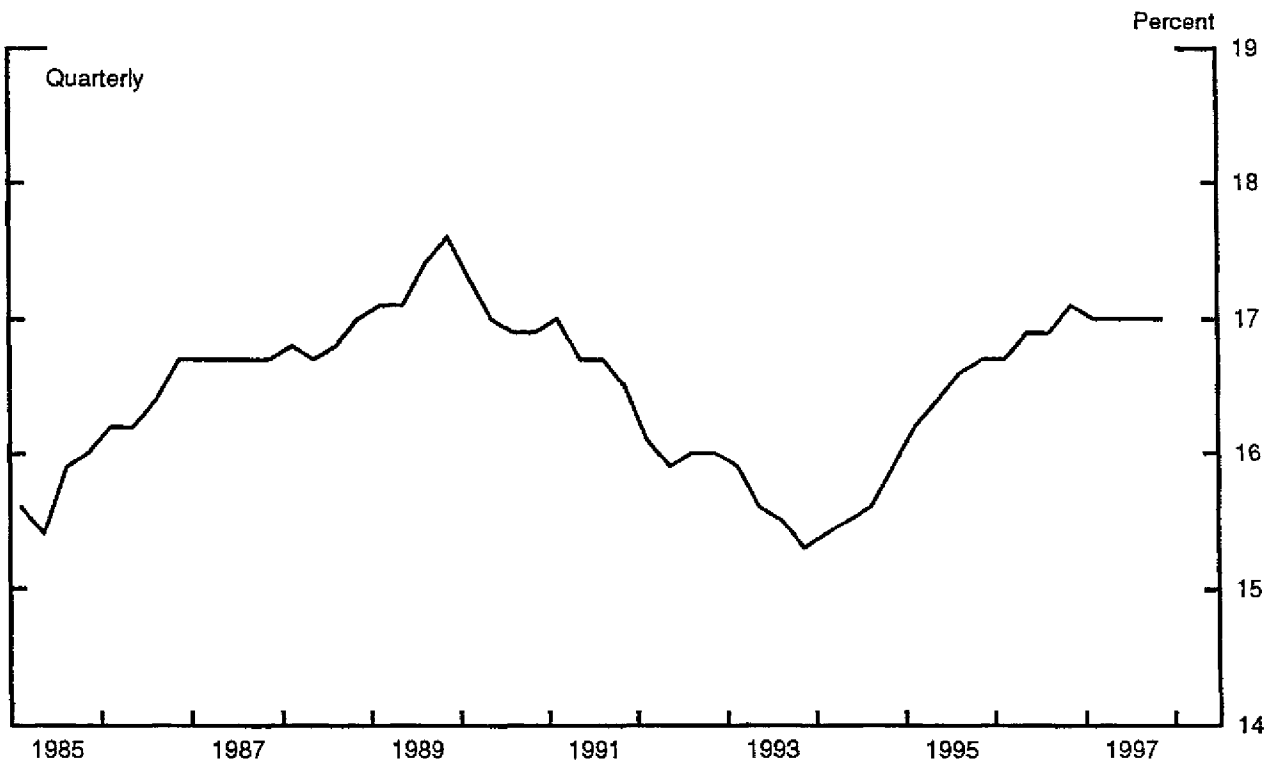
Overall, growth in household debt appeared moderate during the fourth quarter. Various indicators point to a pickup in mortgage debt growth last quarter from the sluggish third-quarter pace, but only a smattering of hard data is yet available to confirm this. Smoothing through month-to-month volatility, growth in nonmortgage consumer credit continued on its path of gradual deceleration. An outsized gain in October was followed in November by a contraction of 4 percent (annualized): for the two months combined, consumer credit grew at a 3-1/2 percent annual rate, a bit slower than in the second and third quarters. December and January figures on banks' consumer loans suggest consumer credit growth remains subdued. The Senior Loan Officer Opinion Survey results suggest continued selective tightening of standards on credit card and other consumer loans.

Given growth in household debt that only slightly outpaced that of income last year and the downward drift in average interest rates on the stock of debt, the ratio of debt-service payments to disposable income is estimated to have stabilized at 17 percent in 1997, a bit below the highs recorded in 1989 (lower panel). If the interest savings from possible mortgage refinancings noted above

Applications for Mortgage Refinancing
 (Seasonally adjusted by Federal Reserve Board staff)



Household Debt Service Burden



Note. Staff estimate of scheduled payments of interest and principal on mortgage and consumer loans, as percent of disposable personal income.

should materialize, then, all else the same, the debt-service burden ratio would be reduced about 1/3 percentage point.

Evidence on loan payment performance for the fourth quarter is scant, limited mainly to monthly reports from the major domestic auto finance companies. A drop in the delinquency rate on auto loans at these firms in September pulled the third-quarter average below the previous quarter's reading. Company reports for October and November indicate that delinquencies remain near their September level, and down from their average level in the third quarter.

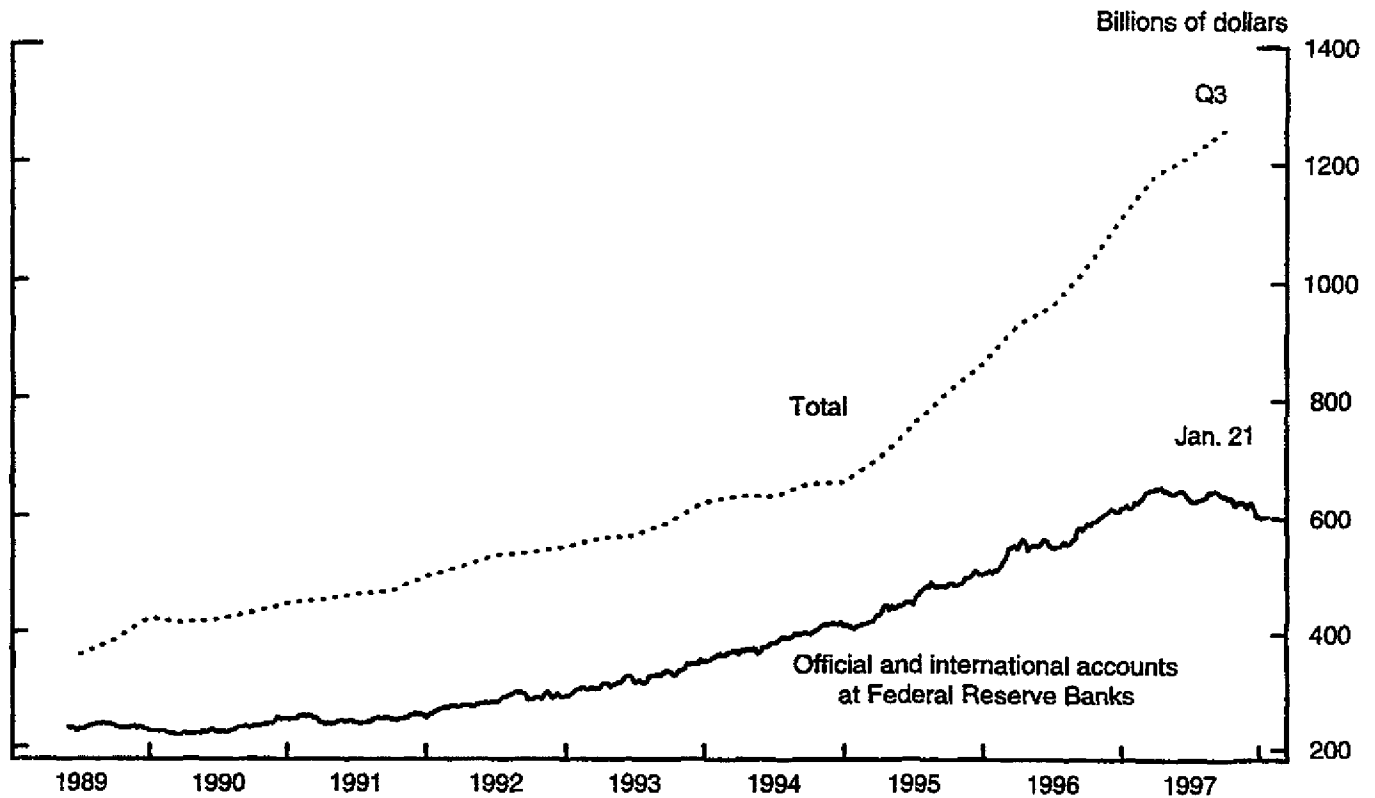
Government Finance

Treasury borrowing has remained subdued, held down by favorable budget developments and a drawdown of cash balances that had been boosted by unusually strong tax inflows. In January, the Treasury held its third auction of ten-year, price-index-linked securities. The \$8 billion sale of securities--at a yield of 3-5/8 percent--brought the total outstanding stock of indexed securities to \$41 billion, about 1 percent of total U.S. marketable debt. The auction drew about three times as many bids as there were securities available for sale, comparable to typical demand for nominal securities. Yields on Treasury index-linked securities had actually inched up in December and early January, while nominal Treasury bond yields were declining, perhaps reflecting the oncoming supply and the preference for more liquid securities amid volatile financial markets; but, since the day preceding the auction, index-linked Treasury yields have edged down, even as nominal yields backed up.

While flight to quality has at times clearly boosted demands for Treasury securities, also purportedly weighing on the market have been concerns that the troubled economies of Asia and the associated speculative attacks in Latin America and Eastern Europe might lead foreign holders--both private and public--to sell some of their Treasury securities in large volume. As yet, no massive sales have materialized. However, foreign official holdings of U.S. Treasury securities in custody at the New York Federal Reserve Bank have fallen about \$40 billion from their September peak (chart). The most notable official sales in the fourth quarter were by Russia, Indonesia, Taiwan, Korea, and Japan.

Spreads between agency-issued securities and Treasuries have held steady over the intermeeting period, even as government-sponsored enterprises resumed issuance in global markets after a lull late last year. Recent issuers include Fannie Mae (\$4 billion)

Foreign Holdings of Marketable U.S. Treasury Securities



Source: Flow of funds accounts and Federal Reserve Bank of New York.

GROSS OFFERINGS OF MUNICIPAL SECURITIES (Billions of dollars; monthly rates, not seasonally adjusted)

	1995	1996	1997	1997				1998
				Q3	Q4	Nov.	Dec.	Jan. ^e
Total tax-exempt	15.4	17.9	20.8	24.1	24.6	24.1	24.3	17.7
Long-term	12.1	14.3	17.1	18.3	21.1	20.2	21.3	16.5
Refundings ¹	3.6	4.9	6.4	8.8	8.0	7.2	7.9	5.5
New capital	8.5	9.4	10.7	9.5	13.1	13.0	13.5	11.1
Short-term	3.3	3.6	3.7	5.8	3.5	3.9	2.9	1.2
Total taxable	0.7	0.8	1.0	0.8	0.9	0.9	0.8	0.8

Note. Includes issues for public and private purposes.

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

e Staff estimate based on data through January 26, 1998.

and Freddie Mac (\$1 billion). The bulk of the issuance was denominated in U.S. dollars. On the domestic scene, the Tennessee Valley Authority refinanced a portion of its debt by issuing \$1 billion in the forty-year sector.

Gross offerings of long-term municipal securities increased in December to \$21-1/4 billion for the month, about equal to the fourth-quarter pace (table). Both new capital issues and refundings were strong in December, as yields on long-term tax-exempts declined to their lowest levels since 1993. Although preliminary data show issuance in January slowing a bit, it is still quite strong.

Money and Bank Credit

Bank credit expanded at about a 10 percent annual rate in December, maintaining the robust pace observed earlier in the fourth quarter. Also following the pattern in recent months, the increase in bank credit was heavily weighted toward securities holdings, a somewhat puzzling development given that loan demand has continued solid; adjusted for mark-to-market accounting rules, securities in December expanded at about a 25 percent pace.

Total loans increased at a 5-1/2 percent rate in December, driven by strong business lending, which rose at a 14 percent pace that month. In addition, there were substantial sales of loans to pools in the form of issuance of collateralized loan obligations (CLOs); including these loans in net business loan originations would boost bank business lending in December substantially further. The strength in business lending likely reflected borrowing related to mergers and acquisitions and inventory accumulation, as well as perhaps some substitution of bank loans for commercial paper issuance at year-end. Results from the latest Senior Loan Officer survey suggest a continued accommodative stance toward business lending, although less easing of standards than in other recent surveys. Aside from some Japanese respondents, whose lending apparently has been crimped by their capital positions, the survey found no evidence of a tightening in credit standards.

To fund strong bank credit expansion, the broader aggregates have continued to grow briskly in December and January. M2 expanded at an annual rate near 6-1/2 percent last month, pulling up its growth for 1997 (Q4 to Q4) as a whole to 5-1/4 percent, slightly

MONETARY AGGREGATES
(Based on seasonally adjusted data)

Aggregate or component	1997		1997		1998	1997:Q4	Level	
	1997	Q3	Q4	Nov.	Dec.	Jan. (pe)	to Jan. 98 (pe)	(bil. \$) Dec. 97
<u>Aggregate</u>	Percentage change (annual rate) ¹							
1. M1	-1.5	0.3	-0.3	6.3	5.2	-3	1%	1071.0
2. M2 ²	5.2	5.0	6.2	6.5	6.4	7	6%	4023.1
3. M3	8.3	7.8	9.2	10.7	10.1	10	10%	5352.6
<u>Selected components</u>								
4. Currency	7.5	7.0	8.7	10.3	10.5	5	7%	425.6
5. Demand deposits	-2.6	0.2	-6.3	10.8	2.1	-10	-2%	392.9
6. Other checkable deposits	-12.4	-9.9	-5.6	-6.8	0.5	-4	-3	244.3
7. M2 minus M1 ³	7.8	6.7	8.5	6.6	6.8	11	8%	2952.1
8. Savings deposits	9.8	7.1	11.9	8.2	12.4	12	11%	1397.5
9. Small time deposits	1.9	2.6	0.7	0.4	0.7	3	2	965.3
10. Retail money market funds	13.6	12.9	13.8	13.0	3.7	19	12%	589.4
11. M3 minus M2 ⁴	19.4	16.9	18.7	23.6	21.6	20	21%	1329.5
12. Large time deposits, net ⁵	18.0	16.0	12.2	20.7	15.5	6	12	579.2
13. Institution-only money market mutual funds	21.0	19.6	22.0	7.6	34.5	19	22%	376.2
14. RPs	17.2	13.5	39.3	79.5	10.8	52	43	235.6
15. Eurodollars	24.9	19.3	4.7	-12.3	32.9	24	21	138.6
<u>Memo</u>								
16. Sweep-adjusted M1 ⁶	5.9	6.1	6.1	7.8	7.6	2	5	1322.8
17. Monetary base	6.0	6.1	8.5	11.4	11.8	-2	4%	481.2
18. Household M2 ⁷	6.1	5.8	7.0	6.2	5.8	9	7%	3625.9
<u>Average monthly change (billions of dollars)⁸</u>								
<u>Memo</u>								
<u>Selected managed liabilities at commercial banks:</u>								
18. Large time deposits, gross	11.2	12.0	8.4	9.4	7.6	3	. . .	682.1
19. Net due to related foreign institutions	-3.4	-4.0	-5.5	0.7	9.6	14	. . .	203.3
20. U.S. government deposits at commercial banks	0.2	-2.3	0.8	-1.6	-0.2	-1	. . .	20.3

1. For the years shown, fourth quarter-to-fourth quarter percent change. For the quarters shown, based on quarterly averages.

2. Sum of seasonally adjusted M1, retail money market funds, savings deposits, and small time deposits.

3. Sum of retail money funds, savings deposits, and small time deposits, each seasonally adjusted separately.

4. Sum of large time deposits, institutional money funds, RP liabilities of depository institutions, and Eurodollars held by U.S. addressees, each seasonally adjusted separately.

5. Net of holdings of depository institutions, money market mutual funds, U.S. government, and foreign banks and official institutions.

6. Sweep figures used to adjust these series are the estimated national total of transaction account balances initially swept into MMDAs owing to the introduction of new sweep programs, on the basis of monthly averages of daily data.

7. M2 less demand deposits

8. For the years shown, "average monthly change" is the fourth quarter-to-fourth quarter dollar change, divided by 12. For the quarters shown, it is the quarter-to-quarter dollar change, divided by 3.

pe-Preliminary estimate.

Note: Data incorporate revisions from the annual benchmark and seasonal review. These data are scheduled to be published in early February and until that time are strictly confidential.

Commercial Bank Credit
(Percent change; seasonally adjusted annual rate)

Type of credit	1997		1997			Level, Dec 1997 (billions of \$)	
	1997	Q3	Q4	Oct	Nov		Dec
1. Bank credit: Reported	8.8	6.9	9.7	10.3	13.2	9.9	4,108.0
2. Adjusted ¹	8.3	6.0	9.7	10.2	11.2	10.1	4,013.3
3. Securities: Reported	9.9	4.2	18.2	16.4	40.9	22.4	1,101.4
4. Adjusted ¹	8.2	0.3	19.1	16.5	34.9	24.4	1,006.7
5. U.S. government	5.6	-0.5	11.7	12.4	23.3	9.7	752.0
6. Other ²	20.9	15.6	33.5	25.8	82.2	50.5	349.4
7. Loans ³	8.4	7.9	6.7	8.1	3.5	5.4	3,006.6
8. Business	9.6	9.0	11.0	9.6	3.8	13.9	856.9
9. Real estate	9.0	9.2	5.7	5.1	5.8	0.3	1,225.4
10. Home equity	16.1	16.8	12.7	11.3	11.2	11.1	98.2
11. Other	8.4	8.6	5.1	4.6	5.3	-0.6	1,127.2
12. Consumer: Reported	-2.1	0.6	-6.2	-14.2	0.9	-1.4	508.9
13. Adjusted ⁴	3.6	3.4	5.8	4.9	6.3	4.0	713.9
14. Other ⁵	19.5	11.4	17.4	43.2	-0.6	12.0	415.5

Note. Adjusted for breaks caused by reclassifications. Monthly levels are pro rata averages of weekly (Wednesday) levels. Quarterly levels (not shown) are simple averages of monthly levels. Annual levels (not shown) are levels for the fourth quarter. Growth rates shown are percentage changes in consecutive levels, annualized but not compounded.

1. Adjusted to remove effects of mark-to-market accounting rules (FIN 39 and FASB 115).

2. Includes securities of corporations, state and local governments, and foreign governments and any trading account assets that are not U.S. government securities.

3. Excludes interbank loans.

4. Includes an estimate of outstanding loans securitized by commercial banks.

5. Includes security loans, loans to farmers, state and local governments, and all others not elsewhere classified. Also includes lease financing receivables.

Net Sales of Long-Term Mutual Funds

(Billions of dollars excluding reinvested distributions; quarterly and annual data at a monthly rate)

	1997							Memo:
	1995	1996	Q2	Q3	Oct.	Nov.	Dec. ^a	Nov. assets
Stock funds	10.7	18.5	18.7	22.2	18.5	18.1	18.0	2358
Domestic equity ¹	9.7	14.7	13.9	18.7	18.5	18.9	n.a.	2014
Aggressive Growth	3.1	4.7	2.4	4.8	4.0	3.1	n.a.	366
Growth	3.1	3.9	3.2	5.9	5.8	7.0	n.a.	665
Growth & income	3.7	6.2	8.3	7.9	8.9	8.9	n.a.	981
International	1.0	3.9	4.8	3.5	0.1	-0.9	n.a.	344
Bond funds	-0.4	1.3	3.0	5.1	3.7	10.4	8.5	1015
High-yield	0.7	1.0	1.7	1.6	0.9	1.9	n.a.	102
Balanced	0.5	0.9	1.8	1.8	1.2	2.4	n.a.	309
Other	-1.6	-0.7	-0.5	1.7	1.6	6.0	n.a.	604

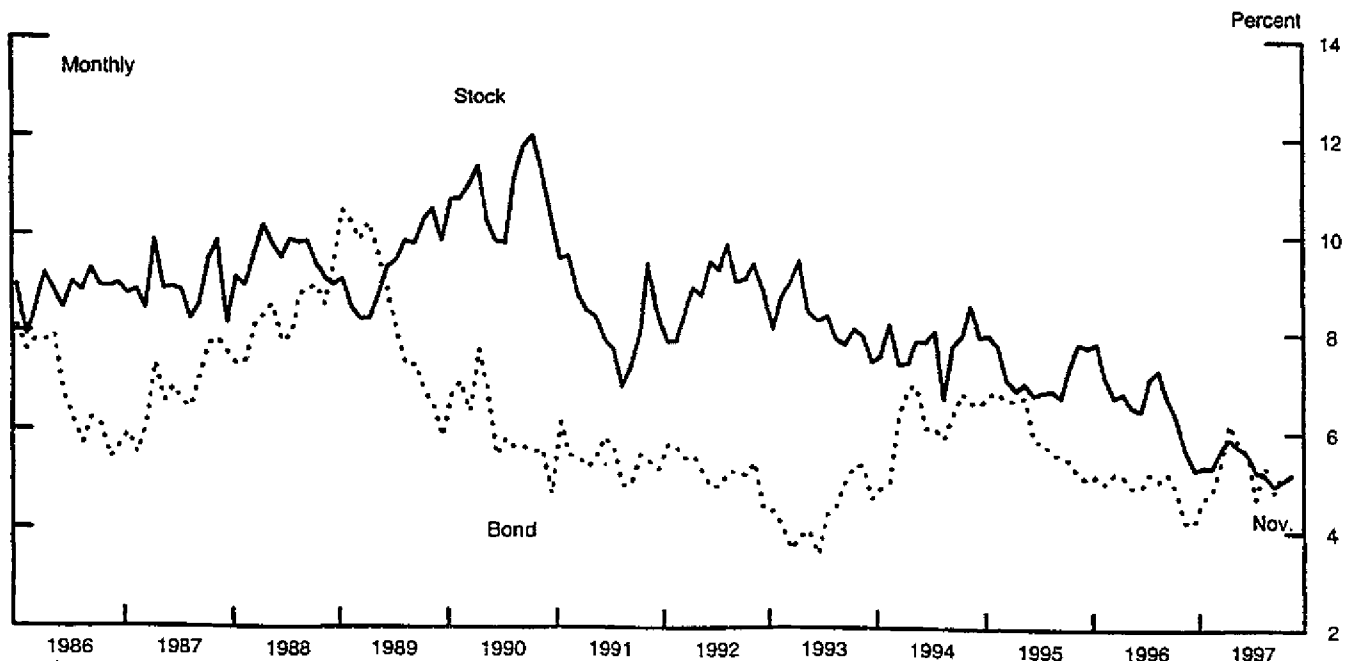
1. Includes precious metals funds not shown elsewhere.

^a Staff estimates, based on weekly ICI totals.

n.a. Not available.

Source. Investment Company Institute (ICI)

Liquidity Ratios for Domestic Long-Term Mutual Funds



Note. Liquidity ratio is cash and short-term securities as a percent of total assets.

Source. Investment Company Institute.

above its annual range.¹ Rapid M2 growth has persisted into January, when it likely has been boosted by robust increases in income and perhaps by a greater preference for safe assets as financial markets remained more turbulent. M3 expanded 10 percent in December, bringing its growth last year to 8-1/4 percent, far above its 2 to 6 percent annual range; this aggregate too has continued to expand briskly in January. Banks continued to raise large amounts of funds through issuance of managed liabilities. In addition, Eurodollar deposits and institution-only money market mutual funds grew at a stunning pace in December.

Mutual Funds

Preliminary monthly estimates from the ICI indicate that net sales of mutual funds continued strong in December. Net sales of equity funds are estimated at \$18 billion for the month, roughly matching the pace of the two prior months and the first half of 1997 but below the \$22 billion monthly pace of the third quarter. Estimates for individual fund types are not yet available owing to complications in measuring the levels of reinvestment of year-end fund distributions; however, preliminary results suggest flows to international funds continued to be weak in December.² Net sales of bond funds for December are estimated at \$8.5 billion, the second highest monthly total for 1997, off from \$10.4 billion in November.

Available information about January flows presents somewhat contradictory patterns. Representatives of some major fund families suggest very strong flows in early January, particularly in 401(k) plans and IRAs. By contrast, data from commercial surveys depict sluggish flows in the first half of January, with some indications of a pickup more recently. Sources generally agree that early January figures continued to show that demands for international funds remained off their earlier peaks, while flows to bond funds were strong.

1. The monetary aggregates data incorporate revisions from the annual benchmark and seasonal review. These data are scheduled to be published in early February and until that time are strictly confidential.

2. In December, flows to mutual funds generally contain large automatic reinvestments of dividends and capital gains distributions. Before receiving fund-level data, the ICI employs complicated algorithms to quantify and remove reinvestments so that the reported flows (net sales) more accurately depict new, discretionary cash flowing from investors to mutual funds. The results for this December were particularly problematic.

Liquidity ratios of equity funds ticked up from 5.5 percent in October to 5.7 percent in November--the latest data available--but remain well below the average level of recent years. Liquidity ratios for bond funds held at around the average level of the 1990s. Mutual funds report that they continue to rely on lines of credit to supplement holdings of liquid assets in their management of liquidity.

APPENDIX

THE JANUARY SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING PRACTICES

The January 1998 Senior Loan Officer Opinion Survey on Bank Lending Practices (covering, for the most part, changes over the past three months) posed the usual questions bearing on the supply of and demand for bank loans to businesses and households. Additional questions targeted changes in the sensitivity of respondents' loan quality to an economic slowdown, changes in standards and terms on home equity loans, and lending to affiliate or subsidiaries of East Asian firms.

The domestic respondents indicated little change in standards on loans to businesses, although a fairly large percentage narrowed yield spreads. By contrast, foreign respondents (especially the branches and agencies of Japanese banks) appear to be pulling back from business lending, with many reporting tighter standards and terms. Both domestic and foreign respondents took steps to restrict lending to U.S. affiliates of non-Japanese East Asian firms. At the same time, demand from U.S. affiliates of Japanese firms increased.

Many banks are still tightening standards on consumer loans, but few said that their willingness to make these loans had changed. Standards for residential mortgage loans were about unchanged, but demand for such loans increased at a large percentage of respondents. Several banks eased terms and standards on home equity loans.

Special questions elicited broadly different opinions among respondents as to the change in their customers' ability to meet their debt obligations during a period of economic weakness. A few more banks said that, overall, their loan portfolio had become more vulnerable to a downturn than said it had become less vulnerable.

Lending to Businesses

The survey results suggest somewhat less easing of business loan standards and terms than did last year's surveys. For domestic respondents, one bank, on net, tightened standards both on C&I loans to small and to larger businesses. Recent surveys had found small fractions of banks easing business lending standards. Also for both size categories, about 25 percent of the domestic respondents reported some narrowing of yield spreads; for loans to large borrowers, this was a somewhat smaller percentage than in recent surveys. Less than 10 percent eased other terms such as the size and cost of credit lines, loan covenants, and collateralization requirements; in general, these percentages have also fallen a bit.

Many branches and agencies--primarily those of Japanese banks--reported curtailing their lending, likely reflecting in part the economic turmoil in Asia. More than one-third of the branches and agencies reported tighter standards on C&I loans, and nearly two-thirds widened spreads. Significant fractions also decreased the size and increased the cost of credit lines. The respondents attributed the tightening to a weakening of their parents' current or expected capital position.

On net, about 25 percent of the domestic banks experienced increased demand for business loans from larger firms, and 15 percent reported stronger demand from small firms. Most frequently, the increased demand was attributed to merger and acquisition funding needs, but the need for plant and equipment and inventory financing was also cited. The importance accorded to inventory financing needs was about the same as that reported in the November survey and a little less than that in the August survey. Few branches and agencies reported a change in business loan demand.

Less than 10 percent of the domestic respondents, on net, eased standards on commercial real estate loans, about the same as in November. By contrast, a net 15 percent of the foreign respondents tightened standards on these loans. Large net fractions of the participants--two-fifths of the domestic and one-third of the foreign respondents--experienced increased demand for these loans, larger fractions than reported a pickup in demand in November.

Lending to Households

The responses concerning consumer loans resembled those on recent surveys. On net, one bank expressed greater willingness to make consumer installment loans, 20 percent tightened standards on credit card loans, and 15 percent tightened standards on other consumer loans. While the current survey is the ninth in a row to find significant net percentages of banks tightening standards on consumer loans, the percentages have tailed off over the past year. The survey revealed little evidence of any change in consumer loan terms.

Standards applied to mortgage applications were about unchanged. Many banks--three-fifths--reported increased demand for these loans. Even though this question specifically refers to mortgages to purchase homes, the large number of respondents indicating increased demand may reflect, in part, the spike in refinancing in January.

Special questions found modest evidence of eased standards and terms for home equity loans. Between 15 percent and 20 percent of the respondents, on net, eased standards on these loans over the past year. Similar percentages reduced fees and raised maximum loan-to-value ratios; somewhat smaller percentages narrowed spreads and lengthened maturities. The responses suggest a degree of easing similar to that found by the January 1997 survey.

Lending to Affiliates and Subsidiaries of East Asian Firms

The recent financial difficulties of many East Asian firms have raised the possibility that lenders may be approaching the U.S. affiliates of such firms with greater caution. In fact, the survey found a widespread tightening of standards and terms on loans to nonbank U.S. affiliates of Asian firms, excluding Japanese firms. Two-thirds of the domestic respondents and all of the branches and agencies had tightened their standards on loans to nonbank affiliates or subsidiaries of Korean firms. Only slightly fewer tightened standards on loans to non-Korean (and non-Japanese) firms. All or nearly all of the survey participants had tightened terms on these loans, including the size and cost of credit lines, yield spreads, loan covenants, and collateralization requirements.

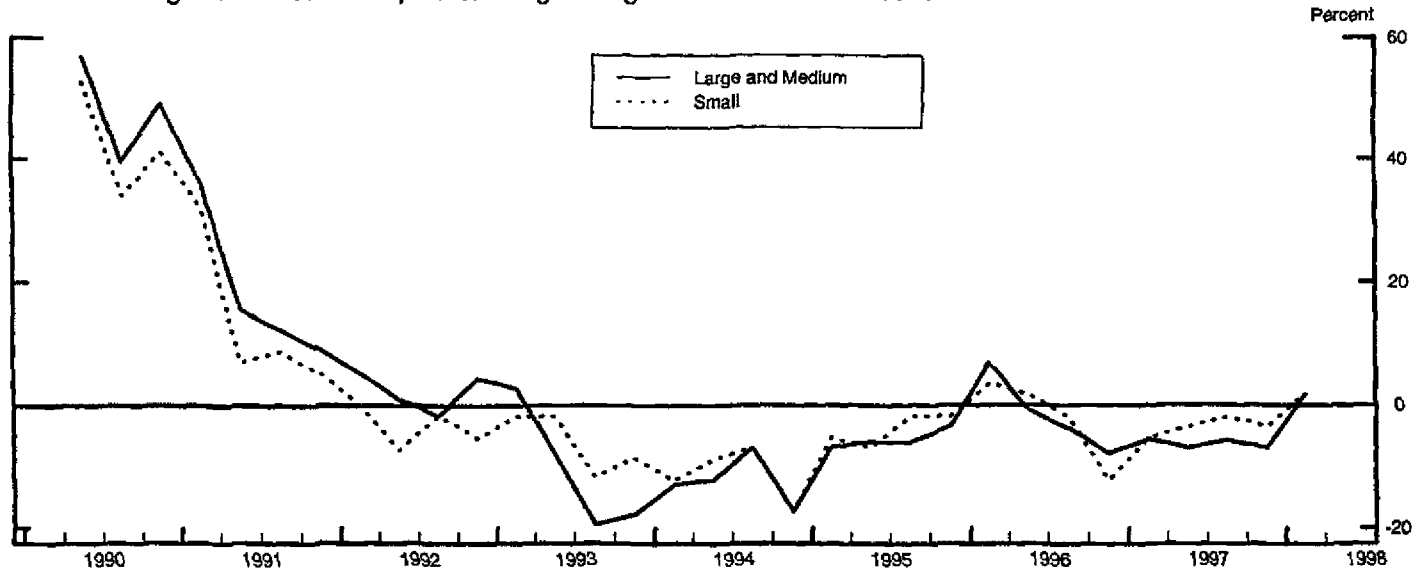
In the last few months, Japanese banks have been under pressure to increase loan-loss reserves while maintaining capital ratios. These requirements may have reduced the supply of credit in Japan, possibly leading to a reduction in funding by Japanese parents to their nonbank U.S. affiliates or subsidiaries. The survey did find that about one-quarter of the domestic respondents, on net, and one-half of the branches and agencies had experienced increased loan demand from these firms. However, most of those institutions experiencing increased demand attributed it to reduced attractiveness of other sources of funds. Reduced funding from parent firms was cited much less often, although still widely, as a reason for the increased demand. Nevertheless, when increased loan demand is the result of substitution away from alternative sources of funds, it may be difficult for respondents to know the alternative source.

Sensitivity of Loan Performance to a Recession

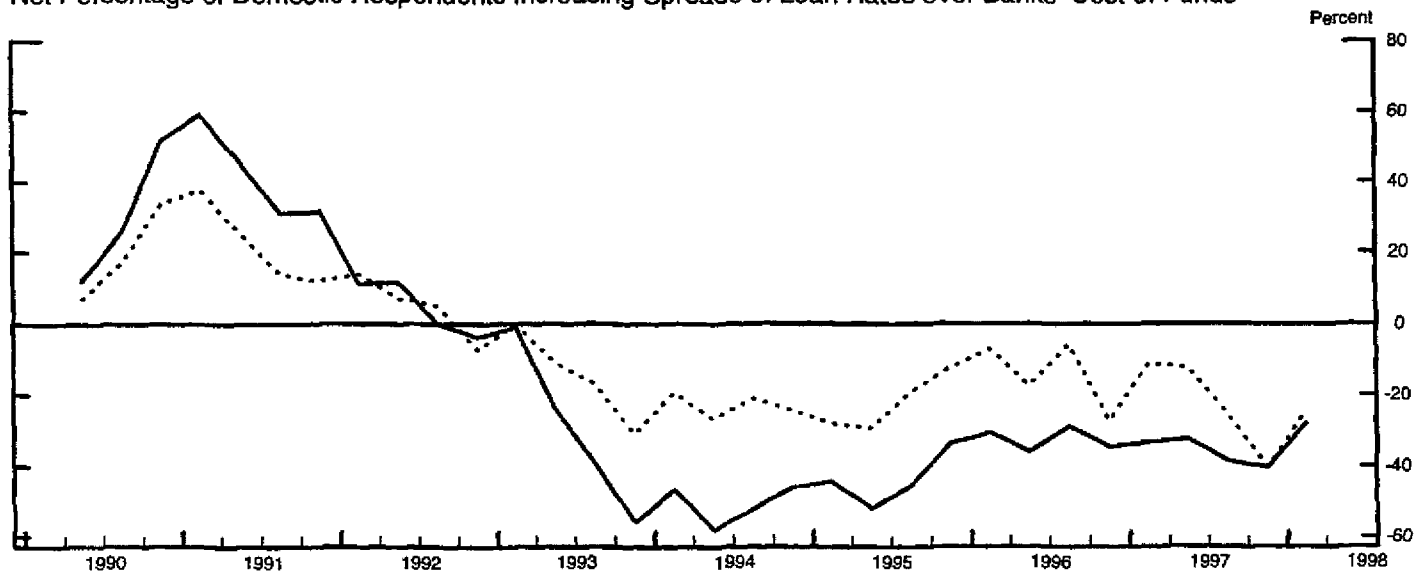
For the past couple of years, this survey and other sources have reported an easing by banks of standards and terms for business credit and a tightening for consumer credit. Special questions in the current survey asked respondents to evaluate the effect that these changes have had on the ability of their various customer groups to meet debt obligations during a period of economic weakness. Banks' responses differed fairly widely. About one-quarter of the respondents, on net, felt that their commercial real estate borrowers' ability to weather a downturn had improved over the past two years. By contrast, on net about 20 percent felt that their credit card customers, and about 10 percent their other consumer loan borrowers, were in worse shape. It may be that the tightening of standards on consumer loans has not offset the deteriorating condition of some existing customers at these institutions. Regarding commercial and industrial and residential real estate borrowers, responses were quite dispersed, with fairly large percentages of banks assessing their borrowers to be in better condition and roughly equal percentages seeing deterioration. Looking at their loan portfolios overall, about 25 percent of the loan officers judged their banks' aggregate charge-off and delinquency rates to be more sensitive to a downturn than they were two years ago, and about 15 percent felt this sensitivity had declined.

Measures of Supply and Demand for C&I Loans, by Size of Firm Seeking Loans

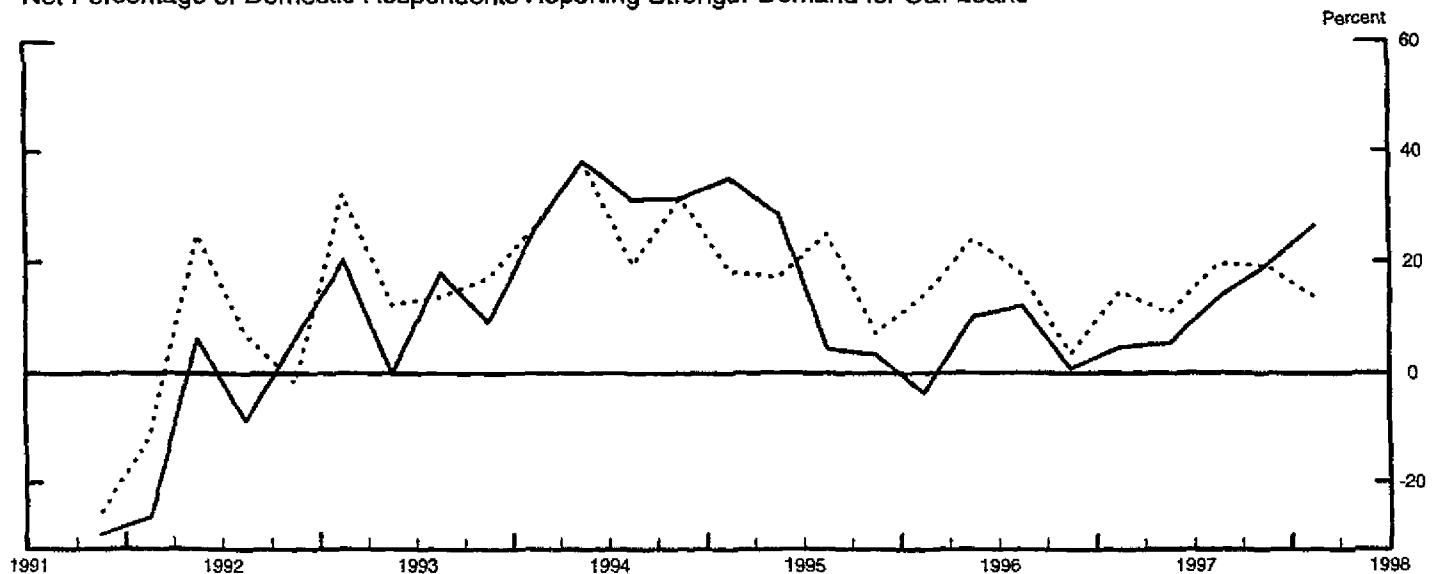
Net Percentage of Domestic Respondents Tightening Standards for C&I Loans



Net Percentage of Domestic Respondents Increasing Spreads of Loan Rates over Banks' Cost of Funds

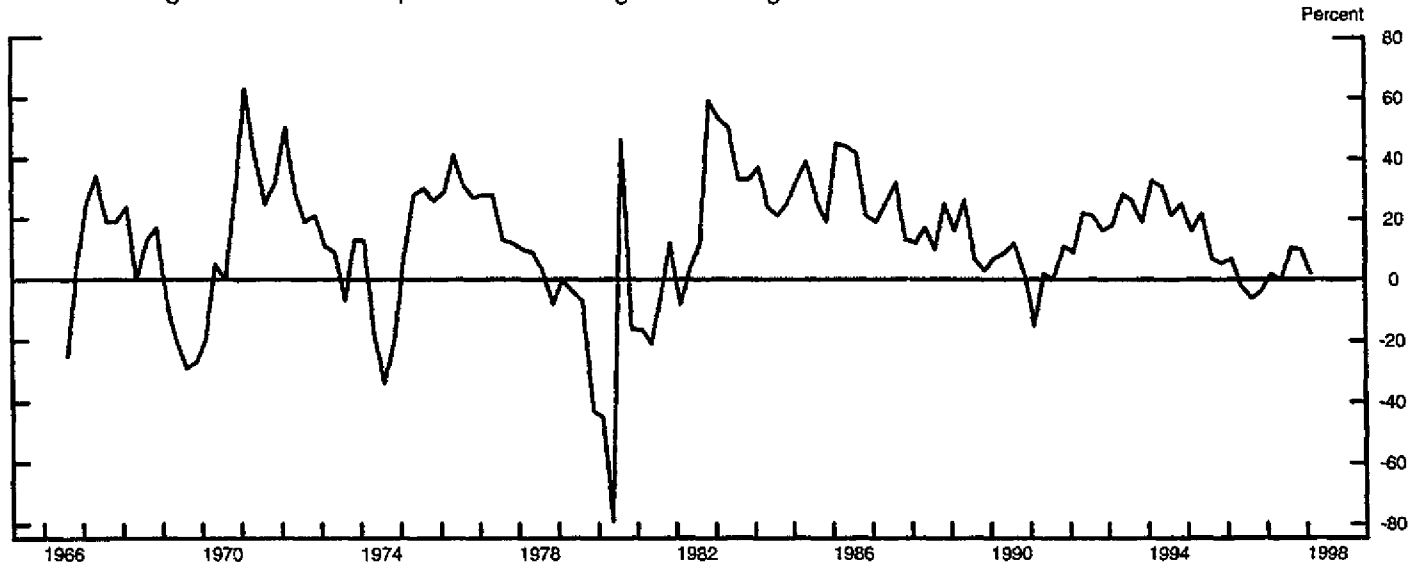


Net Percentage of Domestic Respondents Reporting Stronger Demand for C&I Loans

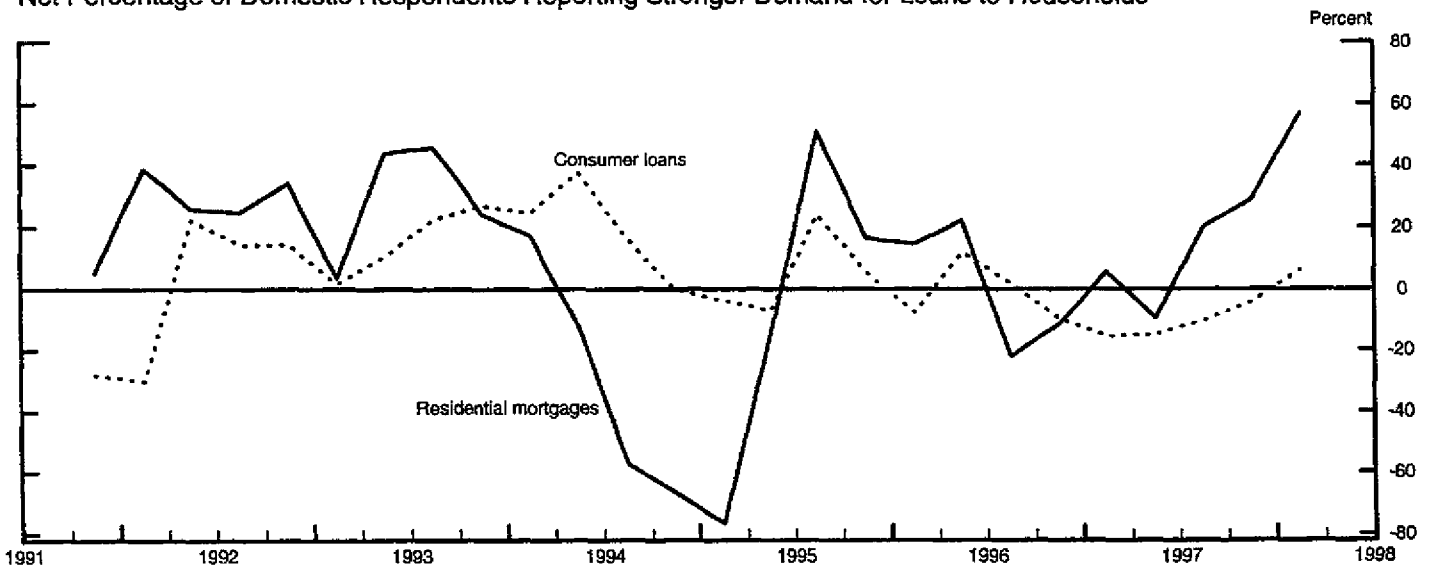


Measures of Supply and Demand for Loans to Households

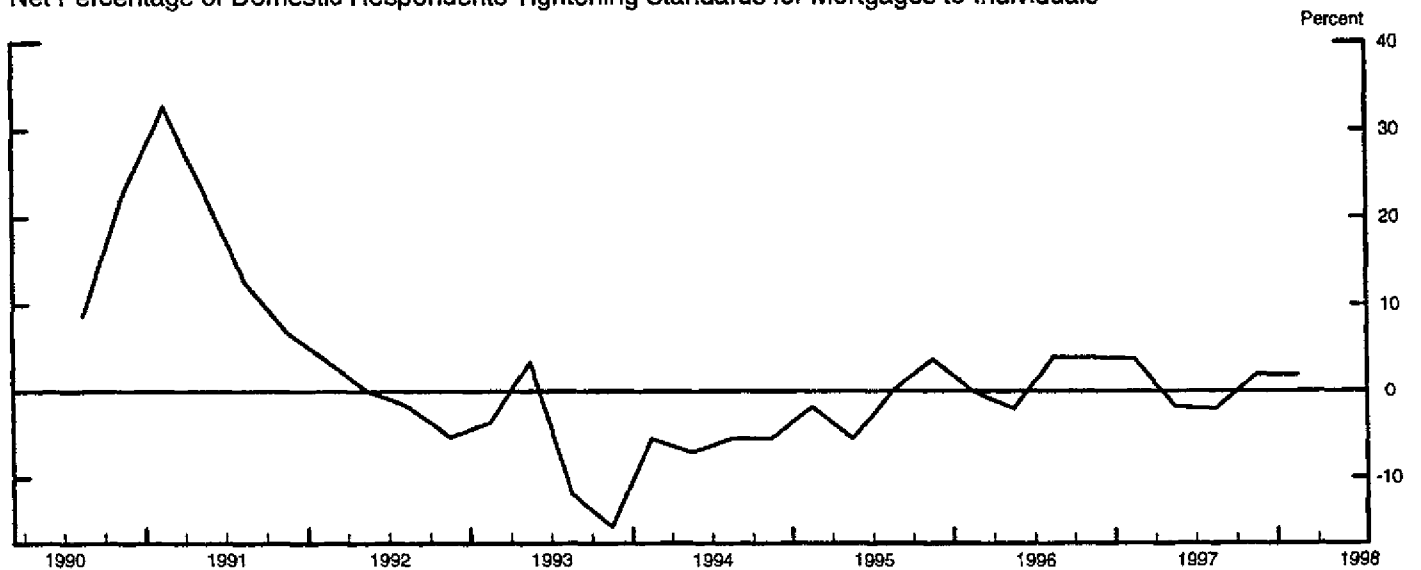
Net Percentage of Domestic Respondents Indicating More Willingness to Make Consumer Installment Loans



Net Percentage of Domestic Respondents Reporting Stronger Demand for Loans to Households



Net Percentage of Domestic Respondents Tightening Standards for Mortgages to Individuals



INTERNATIONAL DEVELOPMENTS

INTERNATIONAL DEVELOPMENTS

U.S. International Trade in Goods and Services

In November, the U.S. trade deficit in goods and services narrowed to \$8.0 billion as imports dropped more than exports. The deficit in October-November combined was much smaller at an annual rate than in the third quarter and about equal to the deficit in the second quarter. Trade data for December will be released on February 19.

NET TRADE IN GOODS & SERVICES
(Billions of dollars, seasonally adjusted)

	1996	Annual rates			Monthly rates		
		1997			1997		
		Q2	Q3	Q4e/	Sep	Oct	Nov
<u>Real NIPA 1/</u>							
Net exports of G&S	-114.4	-136.6	-164.1	...	...	...	...
<u>Nominal BOP</u>							
Net exports of G&S	-111.0	-102.6	-120.1	-102.8	-11.2	-9.1	-8.0
Goods, net	-191.2	-188.5	-207.8	-189.5	-18.5	-16.5	-15.1
Services, net	80.1	86.0	87.7	86.7	7.3	7.4	7.1

1. In billions of chained (1992) dollars.

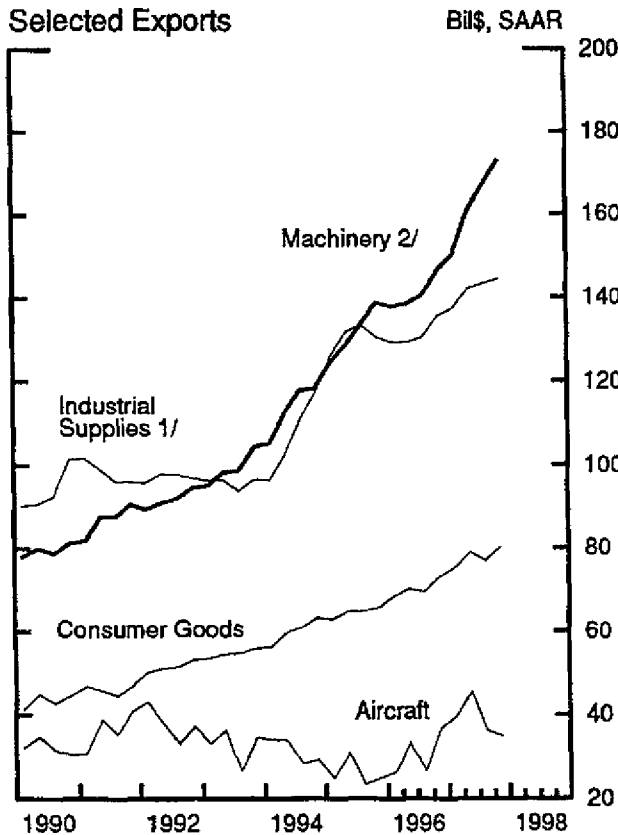
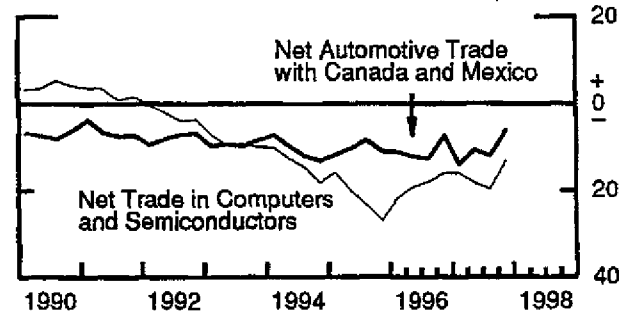
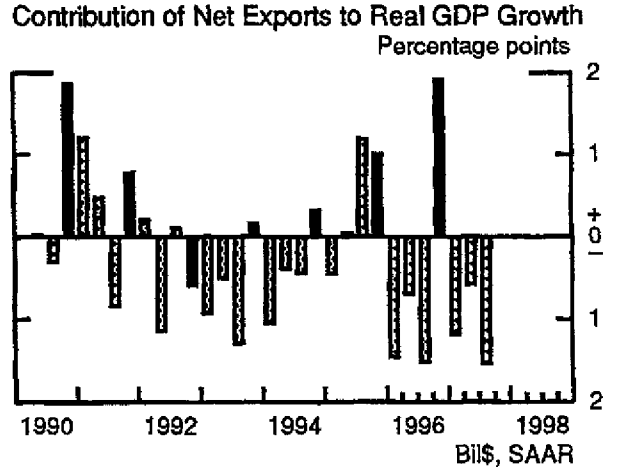
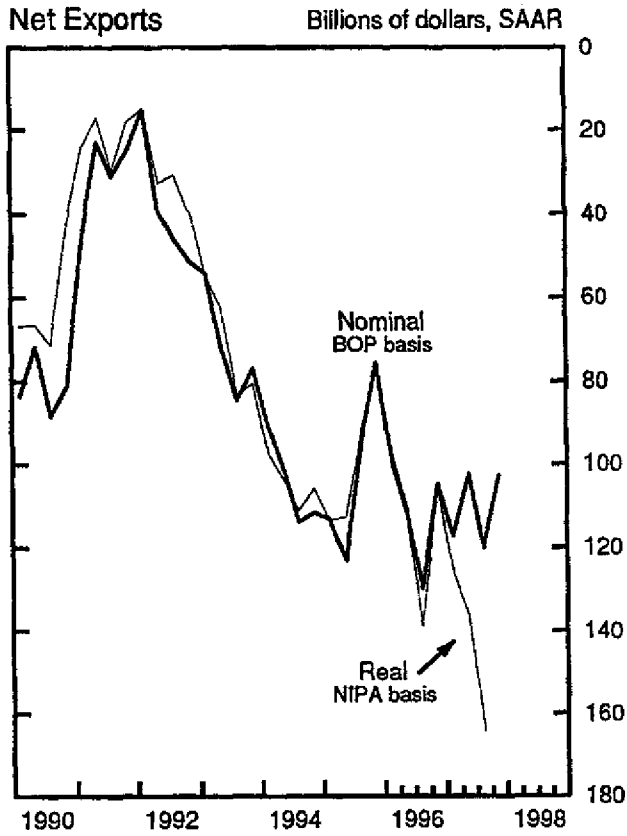
e. BOP data are two months at an annual rate.

Source. U.S. Dept. of Commerce, Bureaus of Economic Analysis and Census.

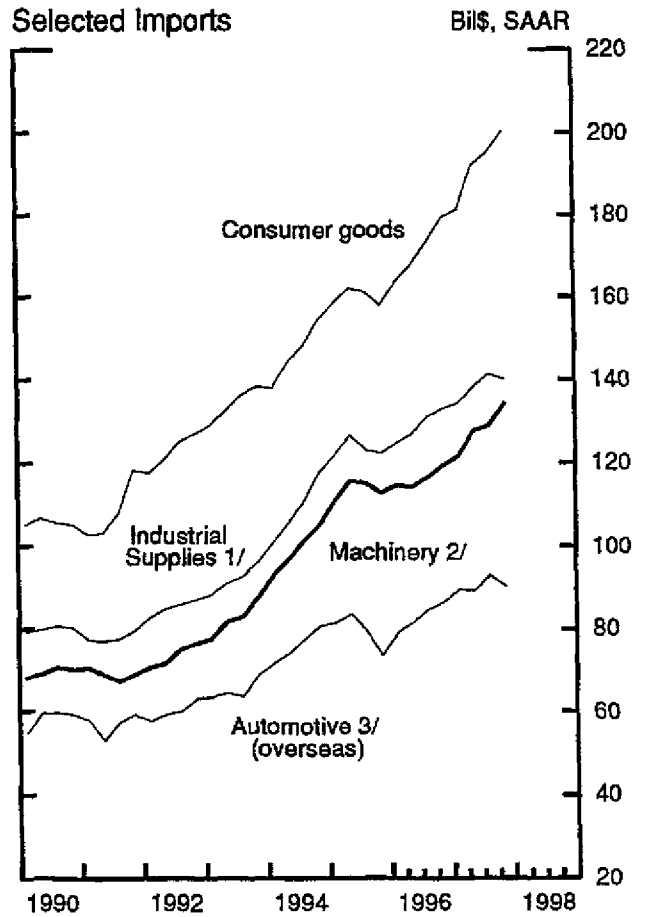
Exports declined slightly in November after jumping up in October. Exports in October-November on average were 1.8 percent higher than the third-quarter average. The sharpest increases were in automotive and agricultural products, with strong increases also recorded for exported consumer goods and machinery (other than computers and semiconductors, which both declined). [Note: There is little evidence in U.S. data through November of a significant drop in exports to developing countries in Asia, other than perhaps the decline in the value of computers and semiconductors, and a moderate decrease in exports to Korea.]

Imports dropped 2.3 percent in November with most of the decline in oil (primarily quantity) and capital goods. The value of imports in October-November on average were about the same as the third-quarter average. Most of the change reflected increases in imported consumer goods and machinery (other than computers and semiconductors) that were about offset by declines in imported automotive products, computers, and, to a lesser extent a wide range of other products. For imported oil in October-November on average, a decline in quantity was about offset by an increase in price.

U.S. International Trade in Goods and Services



1/ Excludes agriculture and gold.
2/ Excludes computers and semiconductors.



1/ Excludes oil and gold.
2/ Excludes computers and semiconductors.
3/ Excludes Canada and Mexico.

U.S. EXPORTS AND IMPORTS OF GOODS AND SERVICES
(Billions of dollars, SAAR, BOP basis)

	Levels				Amount Change 1/			
	1997		1997		1997		1997	
	Q3	Q4e/	Oct	Nov	Q3	Q4e/	Oct	Nov
<u>Exports of G&S</u>	939.4	956.6	962.8	950.4	0.4	17.2	25.4	-12.4
Goods exports	681.8	697.4	701.4	693.4	-3.9	15.6	25.0	-8.0
Agricultural	58.1	62.6	63.4	61.9	1.7	4.5	3.1	-1.5
Gold	3.4	3.1	3.4	2.8	-5.8	-0.3	-0.2	-0.6
Other goods	620.2	631.6	634.6	628.7	0.3	11.4	22.1	-5.9
Aircraft & pts	36.3	35.1	34.0	36.1	-9.2	-1.2	-1.3	2.1
Computers	52.6	50.5	51.9	49.0	2.5	-2.1	-0.4	-2.9
Semiconductors	40.3	38.7	40.8	36.6	2.0	-1.7	-0.4	-4.2
Other cap gds	169.2	175.7	177.4	174.0	6.2	6.6	8.9	-3.4
Automotive	73.1	80.2	77.5	82.9	-0.3	7.1	7.4	5.4
to Canada	38.8	41.6	41.0	42.2	0.3	2.8	4.1	1.1
to Mexico	11.3	14.7	14.4	14.9	-0.0	3.4	1.9	0.5
to ROW	23.0	23.9	22.0	25.8	-0.6	0.9	1.4	3.8
Ind supplies	143.4	144.4	144.4	144.5	1.3	1.0	2.2	0.1
Consumer goods	77.0	80.1	81.0	79.2	-1.9	3.1	4.2	-1.9
All other	28.4	26.9	27.5	26.3	-0.3	-1.4	2.7	-1.2
Services exports	257.6	259.2	261.4	257.0	4.3	1.5	0.4	-4.4
<u>Imports of G&S</u>	1059.5	1059.3	1071.9	1046.8	18.0	-0.2	-0.3	-25.0
Goods imports	889.5	886.8	899.1	874.5	15.4	-2.7	0.3	-24.6
Petroleum	70.4	69.9	76.2	63.6	-0.6	-0.5	2.9	-12.6
Gold	3.0	3.0	2.6	3.4	-8.0	0.0	-0.6	0.7
Other goods	816.2	813.9	820.3	807.6	24.0	-2.2	-2.1	-12.7
Aircraft & pts	19.0	17.3	19.0	15.7	3.5	-1.7	0.0	-3.3
Computers	73.6	70.7	72.8	68.5	3.1	-2.9	-1.1	-4.3
Semiconductors	39.0	38.3	39.6	37.0	2.9	-0.7	0.3	-2.6
Other cap gds	130.9	136.2	137.2	135.2	1.3	5.4	5.6	-2.0
Automotive	143.7	138.2	135.0	141.5	5.4	-5.5	-6.8	6.4
from Canada	50.8	47.8	46.8	48.7	1.7	-3.0	-1.1	1.9
from Mexico	25.6	29.4	30.8	27.9	-0.4	3.8	3.6	-2.9
from ROW	67.3	61.1	57.3	64.8	4.1	-6.2	-9.3	7.5
Ind supplies	141.1	140.0	141.5	138.6	3.0	-1.1	-1.4	-2.9
Consumer goods	195.1	200.4	199.7	201.0	3.0	5.3	-0.1	1.3
Foods	40.6	39.0	39.7	38.3	0.6	-1.6	-1.1	-1.4
All other	33.3	33.7	35.8	31.7	1.2	0.5	2.6	-4.1
Services imports	170.0	172.5	172.7	172.3	2.6	2.5	-0.5	-0.4
Memo:								
Oil qty (mb/d)	10.96	10.57	11.41	9.72	0.16	-0.40	0.08	-1.69
Oil price (\$/bbl)	17.57	18.10	18.29	17.91	-0.44	0.53	0.59	-0.38

1. Change from previous quarter or month. e. Average of two months.
Source. U.S. Dept. of Commerce, Bureaus of Economic Analysis and Census.

Oil Imports and Prices

The quantity of imported oil declined sharply in November following several months of moderate increases. As a result, for October-November on average the quantity of imports was a bit less than in the third quarter. This decline followed two consecutive quarters of strong increases in oil imports, driven by extremely robust consumption in the second and third quarters. Preliminary department of Energy statistics indicate that oil imports declined again in December due to a substantial drawdown in stocks.

The price of imported oil declined in November and December following increases in the previous three months. Nonetheless, prices for the fourth quarter were 5 percent higher than the average for the third quarter. The run-up in prices from late summer through early fall reflected production disruptions in Colombia and the lagged effect of Iraq not exporting for two months. Spot WTI prices declined sharply in December as the market anticipated increased production from Saudi Arabia, Kuwait, and the UAE. Spot prices declined further in January because of weak demand in Asia, relatively warm weather in the northeastern United States, and the resumption of oil production for export by Iraq.

Prices of Non-oil Imports and Exports

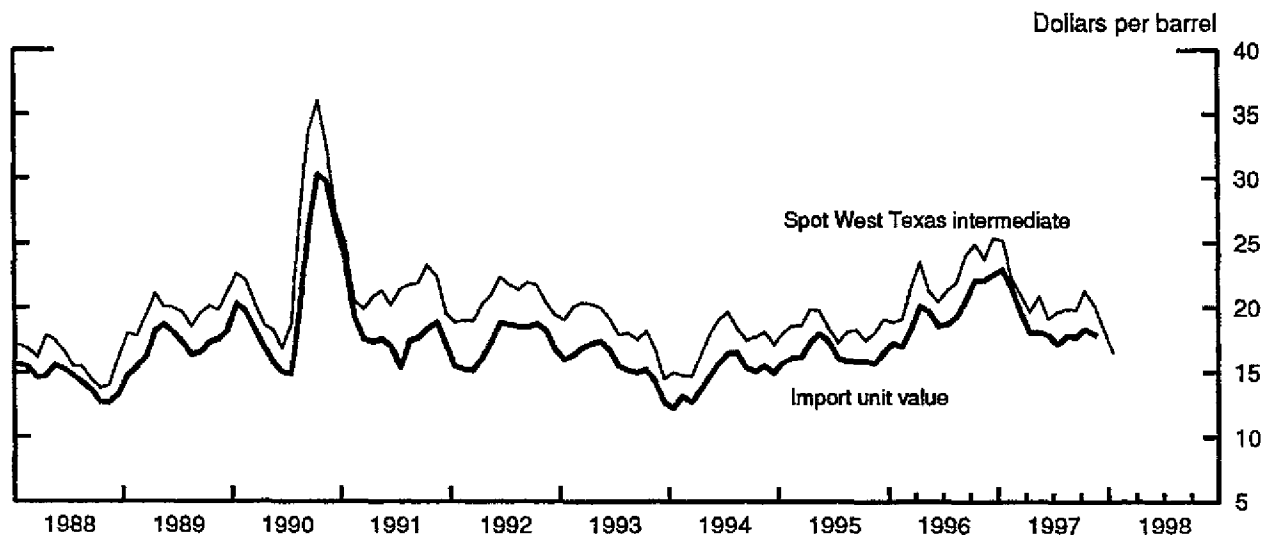
Prices of U.S. non-oil imports decreased slightly in December for the third consecutive month. This decline was attributable to decreases in all major trade categories with the exception of foods and consumer goods. For the fourth quarter, non-oil import prices decreased 2-1/4 percent at an annual rate, continuing a downward trend that began in late 1995. There were price declines in all major trade categories with the exception of automotive products.

Prices of exports declined slightly in December after remaining unchanged in November. The decline was attributable to lower prices for agricultural products and, to a lesser degree, other industrial supplies, computers, semiconductors, and other capital goods. For the fourth quarter, export prices decreased moderately for the third consecutive quarter. Prices of agricultural products declined significantly. Prices of nonagricultural exports decreased 2-1/4 percent at an annual rate with declines spread among all major trade categories with the exception of automotive products and consumer goods.

PRICES OF U.S. IMPORTS AND EXPORTS
(Percentage change from previous period)

	Annual rates			Monthly rates		
	1997			1997		
	Q2	Q3	Q4	Oct	Nov	Dec
	-----BLS prices (1995=100)-----					
<u>Merchandise imports</u>	-8.8	-1.5	-1.8	0.2	-0.5	-0.6
Oil	-48.5	-2.8	4.7	5.6	-5.0	-5.4
Non-oil	-3.4	-1.5	-2.2	-0.3	-0.1	-0.2
Foods, feeds, bev.	7.9	-5.3	-3.8	-0.8	-0.9	0.7
Ind supp ex oil	-6.0	1.6	-0.1	-0.5	0.6	-0.5
Computers	-17.6	-14.5	-18.0	-2.9	-0.5	-0.4
Semiconductors	-2.2	-5.3	-11.9	-0.8	-1.9	-1.4
Cap. goods ex comp & semi	-3.8	-1.1	-2.1	-0.2	0.0	-0.1
Automotive products	-0.7	1.9	1.3	0.2	0.0	-0.1
Consumer goods	-1.3	-0.8	-0.8	0.1	-0.2	0.1
<u>Merchandise exports</u>	-0.4	-1.1	-2.9	-0.4	0.0	-0.4
Agricultural	-0.8	-10.8	-6.4	-1.8	0.7	-0.8
Nonagricultural	-0.1	-0.1	-2.3	-0.2	-0.1	-0.3
Ind supp ex ag	1.3	0.7	-4.9	-0.4	-0.3	-0.6
Computers	-10.4	-7.9	-7.6	-0.9	-0.5	-1.4
Semiconductors	-2.7	-8.7	-13.9	-0.8	-0.2	-1.0
Cap. goods ex comp & semi	1.0	0.5	-0.4	0.0	0.2	-0.2
Automotive products	1.4	0.4	0.1	0.1	0.1	0.0
Consumer goods	0.1	1.7	1.3	0.1	-0.1	0.1
	---Prices in the NIPA accounts (1992=100)---					
<u>Chain-weight</u>						
Imports of gds & serv.	-7.6	-3.0	n.a	...	...	...
Non-oil merchandise	-3.9	-2.3	n.a	...	...	...
Exports of gds & serv.	-0.7	-2.0	n.a	...	...	...
Nonag merchandise	-2.4	-2.3	n.a	...	...	...

Oil Prices



U.S. International Financial Transactions

The flight to quality apparent in the very large October net purchases of U.S. securities by private foreigners was moderated considerably in November (line 4 of the Summary of U.S. International Transactions table). Private net purchases of U.S. Treasury securities were still strong in November, but far below the record pace of October (line 4a). The net was more than accounted for by the Netherlands Antilles and the United Kingdom. Large purchases of Treasury securities in October by residents of Japan were reversed in November, probably because of the large increase in the Japan premium during the month of November. Moreover, purchases of Treasuries by Mexican residents fell by over \$2.5 billion to nearly zero in November. On the other hand, moderately large purchases continued in Hong Kong.

Net purchases of corporate and other bonds by private foreigners were unusually low in November (line 4b). New issues of Eurobonds by U.S. corporations had been very strong in September and October, but fell sharply in November and continued very weak in December. The pace of corporate stock purchases by private foreigners was moderate compared with that of the second and third quarters (line 4c).

U.S. residents had quite modest net purchases of foreign securities in November (line 5). The total included \$3.2 billion of net sales of foreign stocks; almost two-thirds of this total was accounted for by net sales of Japanese stocks. U.S. residents also had net stock sales in the \$500 million range to residents of Brazil and Mexico. In Asia, there were net stock purchases in Hong Kong and Korea and net sales in the Philippines, Singapore, and Malaysia.

Foreign official assets held in the United States fell about \$7 billion in November (line 1); over half the fall was attributable to Russia, with smaller decreases for Korea and Thailand. Preliminary data from the FRBNY indicate a further overall decrease in the \$15 billion range for December, with a large part of this decline due to Japan.

Banks in the United States reported small net inflows in November (line 3). Monthly average data reported on the International Banking Data table indicate a continuation of inflows from own foreign offices and IBFs in December (line 1).

SUMMARY OF U.S. INTERNATIONAL TRANSACTIONS
(Billions of dollars, not seasonally adjusted except as noted)

	1995	1996	1996		1997			
			Q4	Q1	Q2	Q3	Oct	Nov
<u>Official capital</u>								
1. Change in foreign official reserve assets in U.S. (increase, +)	110.0	127.7	38.9	27.5	-4.9	22.4	-5.0	-7.4
a. G-10 countries	33.1	36.6	3.2	7.7	4.6	2.0	-1.8	.2
b. OPEC countries	4.3	15.4	5.5	7.0	2.6	3.5	-3.2	3.0
c. All other countries	72.6	75.7	30.2	12.7	-12.1	16.8	-.2	-10.6
2. Change in U.S. official reserve assets (decrease, +)	-9.7	6.7	-.3	4.5	-.2	-.7	-.1	-.7
<u>Private capital</u>								
<u>Banks</u>								
3. Change in net foreign positions of banking offices in the U.S. ¹	-30.9	-50.1	-7.9	-26.1	15.5	-3.9	-8.8	8.2
<u>Securities²</u>								
4. Foreign net purchases of U.S. securities (+)	190.8	287.2	106.4	79.0	97.8	97.3	46.8	21.5
a. Treasury securities ³	99.9	155.6	71.4	33.1	43.1	36.5	30.9	13.7
b. Corporate and other bonds ⁴	82.6	118.9	33.3	33.7	33.2	37.1	12.9	3.2
c. Corporate stocks	8.2	12.7	1.7	12.2	21.5	23.7	3.0	4.6
5. U.S. net purchases (-) of foreign securities	-98.7	-110.6	-30.7	-17.0	-22.3	-39.7	-2.4	-1.5
a. Bonds	-48.4	-51.4	-20.3	-5.2	-8.7	-24.2	-.6	-4.7
b. Stocks	-50.3	-59.3	-10.5	-11.8	-13.6	-15.6	-1.8	3.2
<u>Other flows (quarterly data, s.a.)</u>								
6. U.S. direct investment (-) abroad	-86.7	-87.8	-30.9	-26.4	-36.7	-24.7	n.a	n.a
7. Foreign direct investment in U.S.	67.5	77.0	17.7	30.6	26.6	21.1	n.a	n.a
8. Foreign holdings of U.S. currency	12.3	17.3	7.8	3.5	4.8	6.6	n.a	n.a
9. Other (inflow, +) ⁵	-10.6	-72.3	-60.8	-21.1	-28.5	-10.4	n.a	n.a
<u>U.S. current account balance (s.a.)</u>	-129.1	-148.2	-36.9	-40.0	-37.9	-42.2	n.a	n.a
<u>Statistical discrepancy (s.a.)</u>	-14.9	-46.9	-3.3	-14.3	-14.2	-25.8	n.a	n.a

Note. The sum of official capital, private capital, the current account balance, and the statistical discrepancy is zero. Details may not sum to totals because of rounding.

1. Changes in dollar-denominated positions of all depository institutions and bank holding companies plus certain transactions between broker-dealers and unaffiliated foreigners (particularly borrowing and lending under repurchase agreements). Includes changes in custody liabilities other than U.S. Treasury bills.

2. Includes commissions on securities transactions and therefore does not match exactly the data on U.S. international transactions published by the Department of Commerce.

3. Includes Treasury bills.

4. Includes U.S. government agency bonds.

5. Transactions by nonbanking concerns and other banking and official transactions not shown elsewhere plus amounts resulting from adjustments made by the Department of Commerce and revisions in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.

n.a. Not available. * Less than \$50 million.

INTERNATIONAL BANKING DATA¹
(Billions of dollars)

	1994	1995	1996	1997				
	Dec.	Dec.	Dec.	Jun.	Sep.	Oct.	Nov.	Dec.
1. Net claims of U.S. banking offices (excluding IBFs) on own foreign offices and IBFs	-224.0	-260.0	-231.2	-225.7	-211.6	-189.3	-189.1	-195.7
a. U.S.-chartered banks	-70.1	-86.1	-66.4	-79.9	-77.9	-69.7	-69.4	-69.7
b. Foreign-chartered banks	-153.9	-173.9	-164.8	-146.0	-133.7	-119.6	-119.7	-126.0
2. Credit extended to U.S. nonbank residents								
a. By foreign branches of U.S. banks	23.1	26.5	31.9	33.4	34.0	34.1	34.5	34.4
b. By Caribbean offices of foreign-chartered banks	78.4	86.3	79.4	74.8	84.7	n.a.	n.a.	n.a.
3. Eurodollar holdings of U.S. nonbank residents								
a. At all U.S.-chartered banks and foreign-chartered banks in Canada and the United Kingdom	86.3	94.6	119.5	134.0	142.6	140.4	139.3	149.0
b. At the Caribbean offices of foreign-chartered banks	86.0	92.3	122.2	130.6	130.3	n.a.	n.a.	n.a.
MEMO: Data as recorded in the U.S. international transactions accounts								
4. Credit extended to U.S. nonbank residents	178.1	212.8	239.0	244.7	252.3	n.a.	n.a.	n.a.
5. Eurodeposits of U.S. nonbank residents	242.0	275.8	336.7	371.2	387.1	n.a.	n.a.	n.a.

1. Data on lines 1 through 3 are from Federal Reserve sources and sometimes differ in timing from the banking data incorporated in the U.S. international transactions accounts.

Lines 1a, 1b, and 2a are averages of daily data reported on the FR 2950 and FR2951.

Lines 2b and 3b are end-of-period data reported quarterly on the FFIEC 002s. Line 3a is an average of daily data (FR 2050) supplemented by the FR 2502 and end-of-quarter data supplied by the Bank of Canada and the Bank of England. There is a break in the series in April 1994.

Lines 4 and 5 are end-of-period data estimated by BEA on the basis of data provided by the BIS, the Bank of England, and the FR 2502 and FFIEC 002s. They include some foreign-currency denominated deposits and loans. Source: SCB

Foreign Exchange Markets

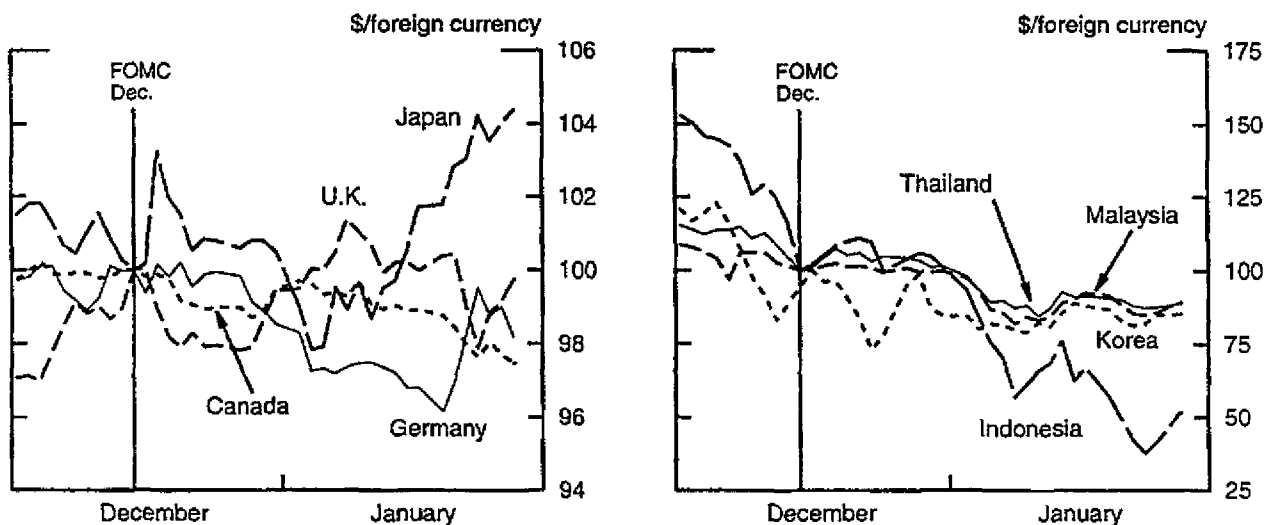
Since the December FOMC meeting, the dollar has continued to appreciate against most of the currencies of the Asian developing economies. Against a weighted average of ten developing economy currencies (eight of which are Asian currencies), the dollar has appreciated almost 5 percent over the intermeeting period. Against the currencies of the G-10 countries, the dollar peaked in early January before declining late in the month. On balance, the dollar has firmed slightly against these currencies, up 1 percent on a trade-weighted basis.

Financial markets in Korea and Indonesia were particularly volatile over the intermeeting period. In mid-December, after Korean authorities abandoned the daily, ten-percent limit on fluctuations in the won and Kim Dae-jung won the presidential election, the value of the won and Korean share prices fell sharply as the total of short-term, foreign currency obligations of Korean borrowers became apparent. Markets stabilized in late December when foreign banks agreed to a rollover of short-term obligations of Korean financial institutions and disbursements from the IMF and other international financial institutions were accelerated. On balance, since the December FOMC meeting, the won has fallen more than 6-1/2 percent against the dollar; nevertheless, share prices in Korea were up more than 34 percent.

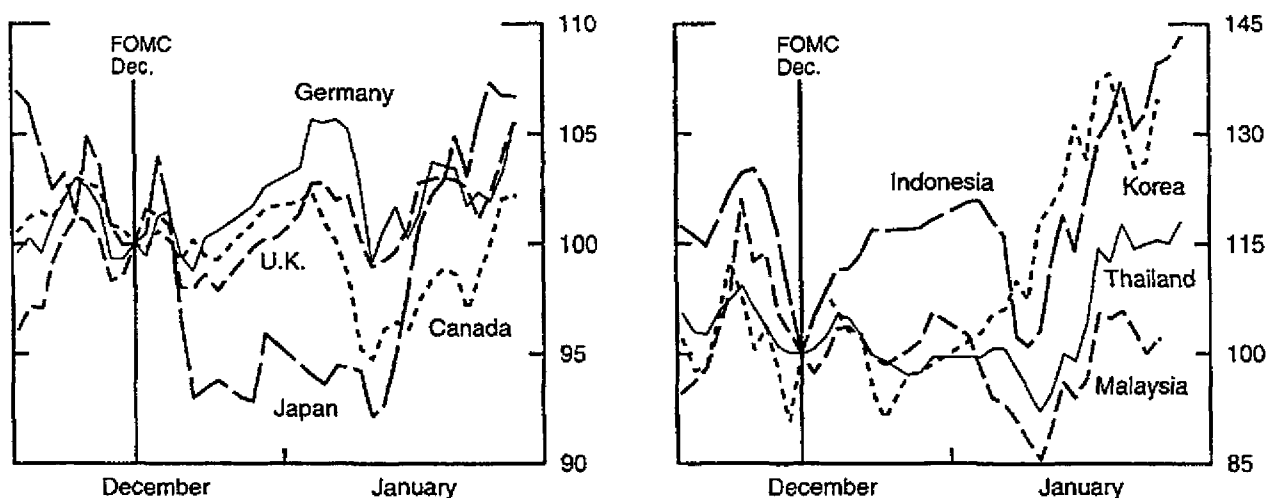
While relatively tranquil in December, Indonesian markets have fluctuated wildly in the new year. The rupiah fell sharply in early January on the release of a budget for 1998 that was viewed as unrealistic and inconsistent with Indonesia's program with the IMF. The rupiah continued to plunge until mid-January when a series of meetings involving Indonesian, IMF, and U.S. officials took place. The meetings culminated with the announcement of a new program that accelerates reforms intended to restructure the Indonesian economy. Nevertheless, over the following week the rupiah continued to fall, with President Suharto's decision to seek reelection providing little calm to Indonesian markets. In the past two days, the rupiah has firmed on the announcement of a debt renegotiation framework and further banking sector reforms. Over the intermeeting period as a whole, the rupiah has lost 48 percent of its value against the

Exchange Rates

(Daily Indices, Dec. 16, 1997 = 100)

**Stock Market Indices**

(Daily Indices, Dec. 16, 1997 = 100)

**Interest Rates in Major Industrial Countries**

	Three-month rates			Ten-year bond yields		
	Dec. 15	Jan. 28	Change	Dec. 15	Jan. 28	Change
Germany	3.68	3.48	-0.20	5.28	5.08	-0.20
Japan	0.85	0.75	-0.10	1.68	1.86	0.18
United Kingdom	7.66	7.50	-0.16	6.25	6.08	-0.17
Canada	4.53	4.55	0.02	5.68	5.38	-0.30
France	3.56	3.47	-0.09	5.28	5.08	-0.20
Italy	6.13	6.19	0.06	5.66	5.38	-0.28
Belgium	3.59	3.43	-0.16	5.42	5.21	-0.21
Netherlands	3.65	3.37	-0.28	5.25	5.04	-0.21
Switzerland	1.44	1.13	-0.31	3.12	2.92	-0.20
Sweden	4.65	4.49	-0.16	5.96	5.61	-0.35
Weighted-average foreign	3.98	3.85	-0.13	4.92	4.76	-0.16
United States	5.79	5.54 ^P	-0.25	5.78	5.66 ^P	-0.12

Note. Change is in percentage points.

^P Preliminary.

dollar. Over the same period, Indonesian equity prices have risen almost 43 percent.

Other Asian financial markets have been less volatile. The currencies of most of these economies have depreciated against the dollar, with the largest declines registered by the ringgit (11 percent) and baht (11 percent). Equity markets surged 18 percent in Thailand, although they were up only 2 percent in Malaysia and down 21 percent in Singapore. Share prices have fallen 11 percent in Hong Kong, with the largest declines coming on the news that Peregrine Investments had filed for liquidation.

The dollar has depreciated more than 4 percent against the yen. Over the first three weeks of the intermeeting period, the dollar strengthened against the yen. Against a background of weak economic news, the mid-December Japanese government proposal to promote financial stability and economic recovery had little impact on financial markets. Sizeable sales of dollars by Japanese authorities around the time of the unveiling of the proposal also had little lasting impact on the yen. The dollar peaked near ¥134 in early January and has fallen since then on three factors: 1) talk of additional fiscal stimulus (beyond that contained in the December proposal), 2) a period of relative stability and recovery in some Asian developing economies, and 3) concerns over the fall-out of the allegations involving President Clinton. Over the intermeeting period as a whole, the interest differential between ten-year bellwether bonds in Japan and the United States has increased 30 basis points in favor of Japanese assets.

The dollar has appreciated a bit less than 2 percent against the mark over the intermeeting period. The dollar appreciated through early January as concerns began to emerge over the ramifications of the crisis in Asia and amid comments by Bundesbank officials that the dollar's rise was not troubling. Over the past week, the mark has recouped some of these losses against the dollar in response to a positive Ifo survey of the business climate and the allegations against President Clinton. The German ten-year interest rate has fallen 20 basis points since the December FOMC, 8 basis points more than the decline in the comparable U.S. rate. Italian long rates have fallen a bit further, in part reflecting the late-December, 75 basis-point cut in official Italian rates.

The dollar has gained more than 2-1/2 percent against the Canadian dollar,

. The Canadian dollar reached historical lows against the U.S. dollar late this month following a favorable CPI release and indications that the Bank of Canada is content with the current level of monetary conditions. The ten-year interest rate in Canada has declined 18 basis points more than the comparable rate in the United States. At the three-month horizon, the Canadian interest rate is little changed, while the U.S. three-month interest rate has fallen 25 basis points.

. The Desk did not intervene in the foreign exchange market during the period.

Developments in Foreign Industrial Countries

Economic activity in major foreign industrialized countries appears to have continued to expand on average at a healthy clip in the last quarter of 1997, with recent data indicating moderate to robust growth in all countries except Japan. Although apparently slowing somewhat from the third quarter, the pace of economic expansion continued to be fairly strong in Canada, France, Germany and the United Kingdom. Growth in Italy likely was weaker, but still only slightly off the moderate pace recorded in the first nine months of 1997. By contrast, indicators in Japan suggest persistent weakness in economic activity. Despite some preliminary signs that the southeast Asian crisis has begun to show up in forward-looking indicators, the eventual impact of the crisis on the foreign industrial economies remains uncertain.

Inflationary pressures have been subdued to nearly nonexistent in all foreign G-7 countries except the United Kingdom. CPI inflation is near or under 1-1/2 percent in France, Germany and Italy, and under one percent in Canada. It is close to zero in Japan, after netting out the effects of tax increases. In the United Kingdom, however, consumer price inflation remains slightly above the government's 2-1/2 percent target.

Individual country notes. In Japan, economic indicators for the fourth quarter suggest continued weakness. Industrial

production declined sharply in November, and industrial inventories surged. Housing starts during October and November remained near ten-year lows, and labor market conditions deteriorated. Household expenditures during October and November were down from their third-quarter level, but December auto registrations rebounded somewhat. Inflation, net of the effects of fiscal measures, remains virtually nonexistent.

The trade balance increased sharply during the fourth quarter, with export volumes expanding and import volumes contracting. Fourth-quarter trade data, however, provide the first glimpse of the effects of the Asia crisis on Japanese trade, as exports to Thailand and Korea registered sizable year-over-year declines. In addition, foreign orders for machinery fell sharply in October and November.

JAPANESE ECONOMIC INDICATORS
(Percent change from previous period except where noted, SA)

	1997						
	Q2	Q3	Q4	Sep	Oct	Nov	Dec
Industrial Production	-0.1	-0.3	n.a.	2.4	0.1	-5.0	n.a.
Housing Starts	-5.2	-10.6	n.a.	1.7	2.6	-5.4	n.a.
Machinery Orders	6.0	1.3	n.a.	1.1	-9.7	-4.9	n.a.
New Car Registrations	-23.9	4.8	3.9	10.8	-1.4	-8.5	19.2
Unemployment Rate (%)	3.4	3.4	n.a.	3.4	3.5	3.5	n.a.
Job Offers Ratio ¹	0.73	0.72	n.a.	0.71	0.70	0.69	n.a.
Business Sentiment ²	7	3	-11	...	...	...	...
CPI (Tokyo area) ³	1.5	1.7	2.0	2.2	2.4	2.0	1.7
Wholesale Prices ³	2.6	2.0	n.a.	2.0	1.6	1.5	n.a.

1. Level of indicator.

2. Percent of large manufacturing firms having a favorable view of business conditions less those with an unfavorable view (Tankan survey).

3. Percent change from previous year, NSA.

In late December, the Japanese Cabinet approved a supplementary budget for FY1997 and the regular budget for FY1998, which begins in April. The supplementary budget includes a ¥2 trillion temporary income tax cut, as well as ¥1 trillion of new spending for disaster relief and public works. The FY1998 budget calls for ¥5 trillion of expenditure reductions, offset by about ¥1

trillion of tax changes, including cuts in the corporate income tax, the securities transactions tax, and real estate taxes. Taken together, these measures, which are expected to gain rapid Diet approval, suggest that fiscal policy would exert about a ¼ percent drag on GDP growth during calendar year 1998.

The Cabinet also approved the provision of ¥30 trillion (about \$230 billion) of public funds to the Deposit Insurance Corporation (DIC) to address the banking system's difficulties. These funds include ¥10 trillion of capital contribution bonds, which the DIC may "cash" as resources are needed, and ¥20 trillion of government guarantees for DIC borrowing from the Bank of Japan. Government officials have indicated that ¥7 trillion of the capital contribution bonds plus ¥10 trillion of BOJ lending are available, if necessary, to protect depositors at failed banks. The remaining funds may be used to recapitalize weak institutions or provide capital to "rescue banks."

Also in late December, the government announced measures intended to promote provision of credit. First, new lending programs for small- and medium-sized firms will be established at government-owned financial institutions. Second, banks that are active only in the domestic market will not be subject to more stringent capital-asset standards scheduled to take effect on April 1. Third, Japanese banks will have the option of valuing their equity holdings at historical cost, rather than at the minimum of historical cost and market cost.

Japanese Finance Minister Mitsuzuka resigned on January 28, after two senior Ministry of Finance bank examiners were arrested on charges that they had accepted bribes from major banks in exchange for information on inspection schedules. Mitsuzuka stated, "The Ministry of Finance needs to be reborn. Major reforms are needed." The banks involved in the scandal (Asahi Bank, Dai-Ichi Kangyo Bank, Sanwa Bank, and failed Hokkaido Takushoku Bank) issued statements of regret.

Incoming data point to a continuation of the economic expansion in Germany during the fourth quarter, but there are tentative signs that the crisis in Asia has begun to affect the outlook for exports. Industrial production rose 0.7 percent in October-November from its level in the third quarter. Manufacturing

orders remain at a high level despite declines in October-November. However, the decline in October-November owed to a sharp drop in orders from foreign firms, as domestic orders rose, and points to diminished export prospects over the near term. Business confidence also dropped back slightly in October and November but remained near its highest level in almost three years. Conditions in the labor market remain stagnant, however, with the all-German unemployment rate edging up to 11.9 percent in December. To some extent, the rise in unemployment in 1997 resulted from the termination of government subsidized work programs in the eastern states (the unemployment rate in eastern Germany rose from 16 percent in the fourth quarter of 1996 to 19.8 percent in December). Price pressures remain modest, with preliminary CPI inflation for January at 1.2 percent on a 12-month basis.

GERMAN ECONOMIC INDICATORS
(Percent change from previous period except where noted, SA)

	1997						1998
	Q2	Q3	Q4	Oct	Nov	Dec	Jan
Industrial Production	1.0	1.8	n.a.	2.6	0.3	n.a.	n.a.
Orders	3.8	2.4	n.a.	-0.5	-0.8	n.a.	n.a.
Unemployment Rate (%)	11.3	11.6	11.8	11.8	11.8	11.9	n.a.
Western Germany	9.8	9.9	9.9	9.9	9.9	9.9	n.a.
Eastern Germany	17.7	18.8	19.6	19.4	19.6	19.8	n.a.
Capacity Utilization ¹	85.1	86.0	n.a.	...	...	...	...
Business Climate ^{1,2}	6.7	16.0	n.a.	17.0	16.0	n.a.	n.a.
Consumer Prices ³							
All-Germany	1.6	1.9	1.8	1.8	1.9	1.8	n.a.
Western Germany	1.5	1.9	1.7	1.7	1.8	1.7	1.2

1. Western Germany.

2. Percent of firms (in manufacturing, construction, wholesale, and retail) citing an improvement in business conditions (current and expected over the next six months) less those citing a deterioration in conditions.

3. Percent change from previous year.

In France, economic activity in the fourth quarter is estimated to have expanded at a solid pace slowing somewhat from its rapid third-quarter rate. Domestic demand underpinned third-quarter GDP, and fourth-quarter data support a continued broadening of

growth beyond the export sector. In October-November, industrial production was 2.0 percent above its third-quarter average. The composition of increased manufacturing output was consistent with strong foreign and domestic demand. Business surveys suggested that manufacturing output accelerated in each month during the fourth quarter. These surveys did not indicate that the slowing in Asian economic activity or trucker's strike in November had impacted production. The IP data, however, suggested that firms had increased production in October in advance of the strike. Consumption of manufactured products increased sharply in October (owing to some special factors) and remained virtually flat in November and December. Stores reported buoyant holiday spending in December, and consumer sentiment remained at a high level. Although the unemployment rate edged down in November to 12.4 percent (the first decline in the rate of unemployment since September 1996), it still was only slightly below its post-war high. Meanwhile, inflationary pressures remain contained as consumer prices in December were 1.1 percent above their year-earlier level.

FRENCH ECONOMIC INDICATORS
(Percent change from previous period except where noted, SA)

	1997						
	Q2	Q3	Q4	Sep	Oct	Nov	Dec
Consumption of Manufactured Products	-0.4	2.5	1.1	-1.8	2.8	0.4	0.0
Industrial Production	2.5	1.6	n.a.	-1.0	3.5	-1.9	n.a.
Capacity Utilization	83.8	84.5	n.a.	...	...	...	...
Unemployment Rate (%)	12.5	12.5	n.a.	12.5	12.5	12.4	n.a.
Business Confidence ¹	8.3	13.0	15.0	19.0	13.0	16.0	16.0
Consumer Prices ²	0.9	1.3	1.2	1.3	1.0	1.3	1.1

1. Percent balance of manufacturing firms citing an improvement in the outlook versus those citing a worsening; no August survey conducted.
2. Percent change from previous year.

The pace of economic activity in the **United Kingdom** slowed somewhat in the fourth quarter of last year. The preliminary GDP release showed growth of 2.1 percent (SAAR). Output of production industries was estimated to have declined in the quarter, reflecting weak manufacturing production and lower output of utilities

industries owing to unseasonably warm weather. However, consumer expenditure appears to have remained strong on average in the quarter, despite a slight decline in the average volume of retail sales in November and December. Total service sector output increased about 4 percent (SAAR). Since November, business sentiment has remained well below the average level earlier this year, reflecting increased concern over both domestic and export demand.

UNITED KINGDOM ECONOMIC INDICATORS
(Percent change from previous period except where noted, SA)

	1997						1998
	Q2	Q3	Q4	Oct	Nov	Dec	Jan
Real GDP (AR)	4.3	3.4	2.1	...	...	...	...
Non-oil GDP (AR)	4.0	3.3	2.5	...	...	...	...
Industrial Production	0.7	1.2	n.a.	-0.3	-0.5	n.a.	n.a.
Retail Sales	1.9	1.0	1.3	2.9	-0.5	-0.1	n.a.
Unemployment Rate (%)	5.8	5.3	5.1	5.2	5.1	5.0	n.a.
Business Confidence ¹	17.7	18.0	13.0	20.0	9.0	10.0	9.0
Consumer Prices ²	2.6	2.8	2.8	2.8	2.8	2.7	n.a.
Producer Input Prices ³	-9.6	-8.4	-9.0	-9.0	-8.5	-9.5	n.a.
Average Earnings ³	4.3	4.4	n.a.	4.5	4.8	n.a.	n.a.

1. Percent of firms expecting output to increase in the next four months minus those expecting output to decrease.
2. Retail prices excluding mortgage interest payments. Percent change from previous year.
3. Percent change from previous year.

Conditions in the labor market appear to have tightened further in the fourth quarter. The claimant unemployment rate fell to 5 percent in December. Based on the quarterly Labour Force Survey, the LFS unemployment rate declined 0.5 percentage points to 6.6 percent over the September-November period, and LFS unemployment fell to its lowest level since the series was introduced in 1984. Average earnings growth picked up in both October and November, primarily reflecting increased overtime and annual bonuses. Retail prices excluding mortgage interest payments rose 2.7 percent over the year to December, remaining above the government's inflation target of 2½ percent for underlying inflation.

In Italy, GDP rose 1.8 percent (SAAR) in the third quarter. Final domestic demand was relatively strong with both household consumption and business investment contributing positively. Net exports also contributed to third-quarter growth. Inventory accumulation, which contributed over 7 percent to second-quarter growth, slowed. Passthrough effects of the government's highly successful auto-tax incentives continued to provide stimulus to household consumption.

ITALIAN REAL GDP
(percent change from previous period, SAAR)

	1995	1996	1996	1997		
	Q4/Q4	Q4/Q4	Q4	Q1	Q2	Q3
GDP	2.4	0.2	-0.1	-0.8	7.6	1.8
Private Consumption	1.7	1.0	2.7	3.0	1.8	1.8
Investment	8.2	-2.0	-2.1	-1.1	5.1	2.8
Government Consumption	-0.7	0.8	0.2	-0.9	0.6	-0.0
Exports	5.3	3.4	-0.1	-15.0	41.3	31.7
Imports	5.7	-0.8	16.5	-11.5	62.2	25.9
Total Domestic Demand	2.4	-0.8	3.3	0.6	10.1	-0.1
Net Exports (contribution)	0.1	1.0	-3.2	-1.4	-2.0	1.9

Available fourth-quarter indicators point to modest but continuing growth. Industrial production rose in October and November. Consumer confidence declined slightly below its third-quarter average, but remained higher than its level in the second quarter.

Italian inflation, which reached record low levels last year, remains modest. In 1997, inflation was 1.8 percent on a year-over-year basis, sharply below the 3.9 percent consumer price inflation in 1996, and well below the official target of 2.5 percent. In January, data from eleven Italian cities, which carry a cumulative 76 percent weight in the national index, point to a 1.5 percent year-over-year increase in consumer prices.

ITALIAN ECONOMIC INDICATORS
(Percent change from previous period except where noted, SA)

	1997						1998
	Q2	Q3	Q4	Oct	Nov	Dec	Jan
Industrial Production	2.2	0.5	n.a.	1.2	0.6	n.a.	n.a.
Cap. Utilization (%)	77.7	77.7	n.a.	...	...	...	...
Unemployment Rate (%)	12.4	12.1	n.a.	...	...	...	...
Consumer Confidence ¹	108.8	117.2	115.3	116.1	116.7	113.2	n.a.
Bus. Sentiment ² (%)	13.7	18.0	n.a.	12.0	13.0	n.a.	n.a.
Consumer Prices ³	1.6	1.6	1.6	1.6	1.6	1.5	1.5
Wholesale Prices ³	-0.4	0.4	n.a.	n.a.	n.a.	n.a.	n.a.

1. Level of index, NSA.

2. Percent of manufacturing firms having a favorable view of business conditions minus those with an unfavorable outlook.

3. Percent change from previous year.

On December 24, the Bank of Italy cut its official discount and Lombard rates by 75 basis points each. Currently, the discount rate stands at 5-1/2 percent and the Lombard rate at 7 percent. Since July 1996, both the discount and the Lombard rates have been lowered five times for a cumulative 350 basis points. The latest cuts--widely expected by market participants--were announced a day after preliminary data indicated lower-than-expected consumer price inflation in December and on the day the government's 1998 budget proposal passed through parliament.

On January 2, the Treasury Ministry announced that the 1997 public sector borrowing requirement (PSBR) was slightly below \$30 billion equivalent, compared with a PSBR of \$70 billion equivalent a year ago. As a result, the 1997 budget deficit as a share of GDP is now expected to be below the 3 percent Maastricht reference value--less than half the 6.7 percent deficit in 1996.

Real GDP in Canada rose 4.1 percent (SAAR) in the third quarter, following revised growth of 5.4 percent in the second quarter. Consumption expenditures rose 5.3 percent, near the average of the previous three quarters. Fixed investment surged, led by investment in machinery and equipment. Government expenditures rose slightly. Exports grew a solid 10.1 percent, but imports increased a rapid 19.9 percent, due to strong domestic

demand growth for goods with high import content, such as machinery and equipment, industrial goods, and automotive products.

CANADIAN REAL GDP (Percent change from previous period, SAAR) ¹						
	1995	1996	1996	1997		
			Q4	Q1	Q2	Q3
GDP	0.8	2.0	2.4	4.1	5.4	4.1
Total Domestic Demand	-0.4	4.1	11.0	1.0	7.5	6.4
Consumption	1.2	3.0	5.6	3.9	4.5	5.3
Investment	-6.4	13.8	21.7	10.3	8.5	13.8
Government Consumption	-1.1	-0.8	0.3	-1.2	0.6	0.8
Inventories (contribution)	0.3	0.1	3.4	-2.8	3.0	0.5
Exports	5.2	2.6	-8.7	26.9	2.7	10.1
Imports	3.0	7.8	15.5	19.3	8.1	19.9
Net Exports (contribution)	0.8	-1.6	-8.2	2.5	-1.9	-3.1

1. Annual changes are Q4/Q4.

Canada recently has enjoyed declining unemployment and low inflation. Unemployment--though still high--dropped from 9.0 percent in November to 8.6 percent in December, the first time below 9 percent since September 1990. Employment showed strong gains, led by an expansion of full-time employment. Canadian consumer price inflation (on a twelve-month basis) decelerated to 0.7 percent in December, below the Bank of Canada's 1 to 3 percent target range. Contributing factors were moderation in auto price increases and a decline in gasoline prices.

The Bank of Canada increased its key Bank Rate 50 basis points, to 4.5 percent, on December 12, the fourth increase in the Bank Rate since June but the first move of 50 basis points in more than two years. The move was explicitly aimed at defending the Canadian dollar, which had continued to weaken to near all-time lows despite a previous rate hike on November 25. The Canadian currency remained under pressure due to Canada's worsening external balances and the belief that low inflation and relatively high unemployment would keep the Bank of Canada from raising rates aggressively in the near future. The Canadian dollar fell to an all-time low (below 69

US cents) on January 22 following indications by Bank of Canada officials that the Bank was not uncomfortable with the current level of monetary conditions.

CANADIAN ECONOMIC INDICATORS
(Percent change from previous period except where noted, SA)

	1997						
	Q2	Q3	Q4	Sep	Oct	Nov	Dec
GDP at Factor Cost	1.2	1.2	n.a.	0.2	0.2	n.a.	n.a.
Industrial Production	1.7	1.7	n.a.	-0.3	0.8	n.a.	n.a.
Manufacturing Survey: Shipments	0.9	2.6	n.a.	0.1	1.5	-0.3	n.a.
New Orders	1.4	2.1	n.a.	0.5	2.3	-0.1	n.a.
Retail Sales	1.7	1.8	n.a.	0.5	0.3	-1.2	n.a.
Housing Starts	-6.3	2.4	n.a.	-1.7	3.5	-0.5	n.a.
Employment	0.9	0.8	0.4	0.0	0.0	0.3	0.3
Unemployment Rate (%)	9.3	9.0	8.9	9.0	9.1	9.0	8.6
Consumer Prices ¹	1.6	1.7	1.0	1.6	1.5	0.9	0.7
Consumer Attitudes ²	116.7	119.3	n.a.	...	...	...	...
Business Confidence ³	165.0	164.9	n.a.	...	...	...	...

1. Percent change from year earlier.

2. Level of index, 1991 = 100.

3. Level of index, 1977 = 100.

Canada's trade surplus fell to \$0.3 billion in October (the lowest level since December 1993) but rebounded a bit to \$0.7 billion in November. Fallout from the Asian crisis showed through in the weakness of Canadian exports, whose decline partly reflected lower commodity prices (especially for primary metals and energy). In addition, a decline in lumber exports was due largely to reduced demand from Japan. The surge in Canadian imports was led by investment goods (machinery and equipment, computer equipment, aircraft), as Canadian firms continued their investment boom.

EXTERNAL BALANCES
(Billions of U.S. dollars, seasonally adjusted)

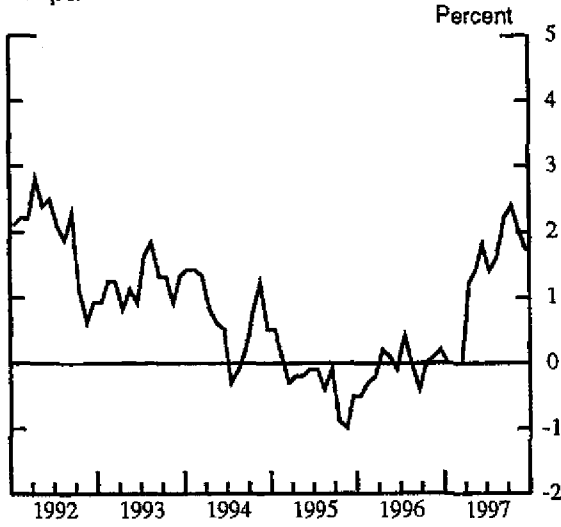
	1996	1997	1997					
			Q3	Q4	Sep	Oct.	Nov	Dec
Japan: trade	61.4	83.4	21.7	25.6	6.2	10.2	9.1	6.2
current account	65.9	n.a.	24.9	n.a.	6.6	11.1.	10.2	n.a.
Germany: trade ¹	65.4	n.a.	20.4	n.a.	8.5	6.5	7.6	n.a.
current account ¹	-13.1	n.a.	-1.3	n.a.	2.2	-2.5	1.5	n.a.
France: trade	17.0	n.a.	8.3	n.a.	3.1	3.1	n.a.	n.a.
current account	21.9	n.a.	8.5	n.a.	2.9	5.2	n.a.	n.a.
U.K.: trade	-19.6	n.a.	-4.1	n.a.	-2.0	-2.1	-2.5	n.a.
current account	-0.6	n.a.	0.8	n.a.	...	...	...	...
Italy: trade	44.4	n.a.	7.2	n.a.	2.0	3.0	n.a.	n.a.
current account ¹	41.1	n.a.	11.3	n.a.	1.2	n.a.	n.a.	n.a.
Canada: trade	30.0	n.a.	3.1	n.a.	1.0	0.3	n.a.	n.a.
current account	-1.2	n.a.	-4.6	n.a.

1. Not seasonally adjusted.

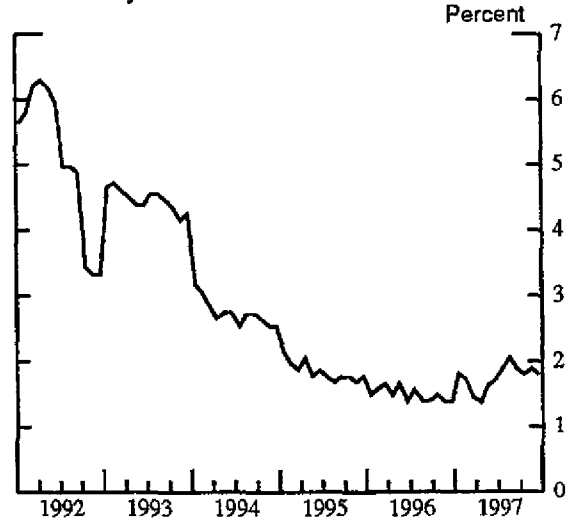
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Consumer Price Inflation in Selected Industrial Countries (12-month change)

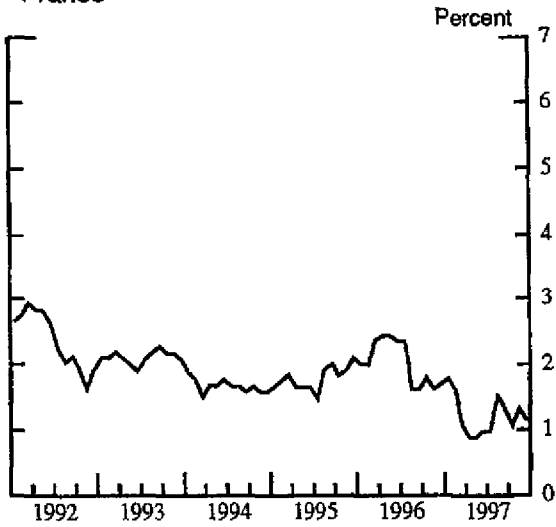
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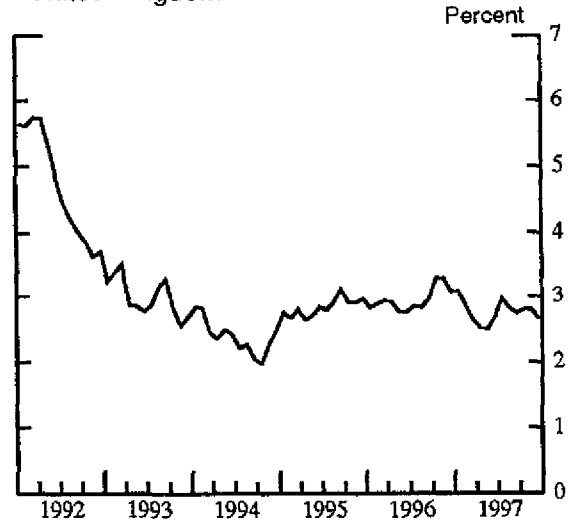
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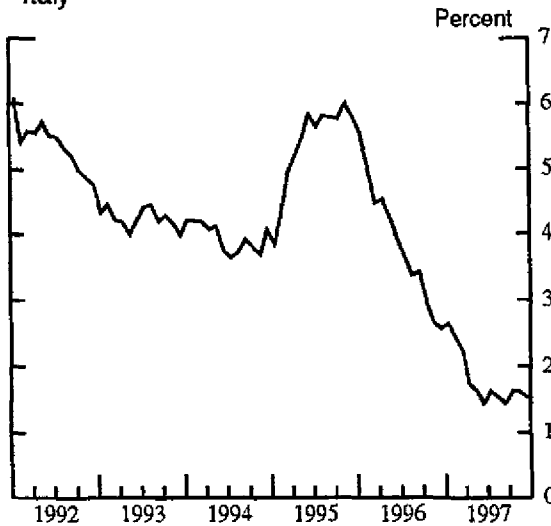
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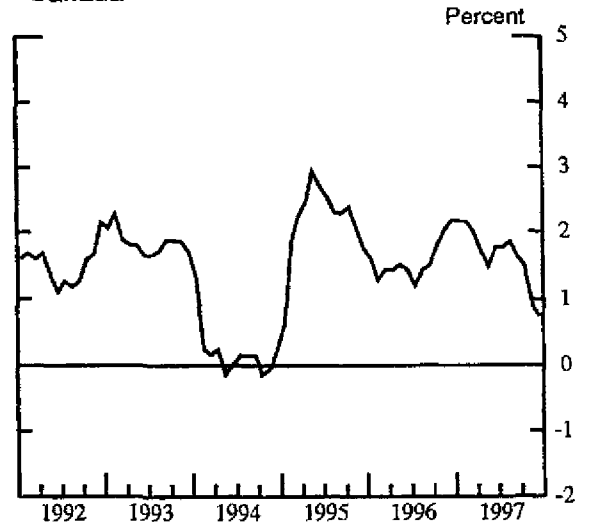
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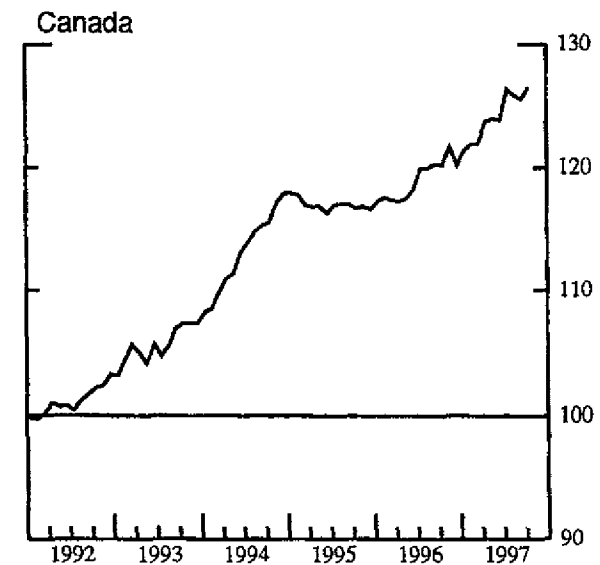
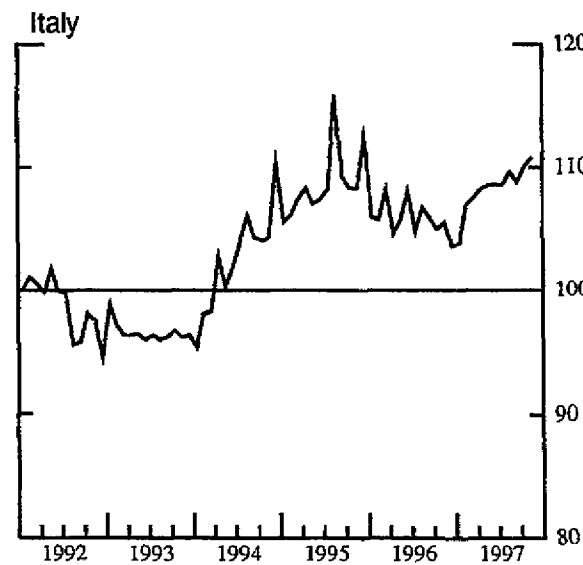
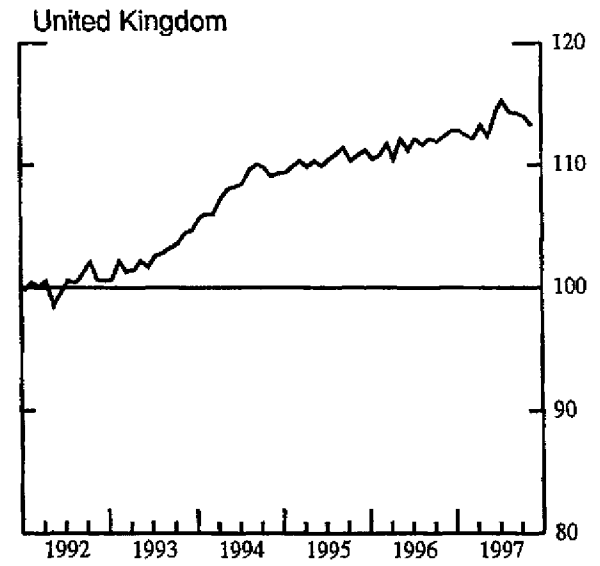
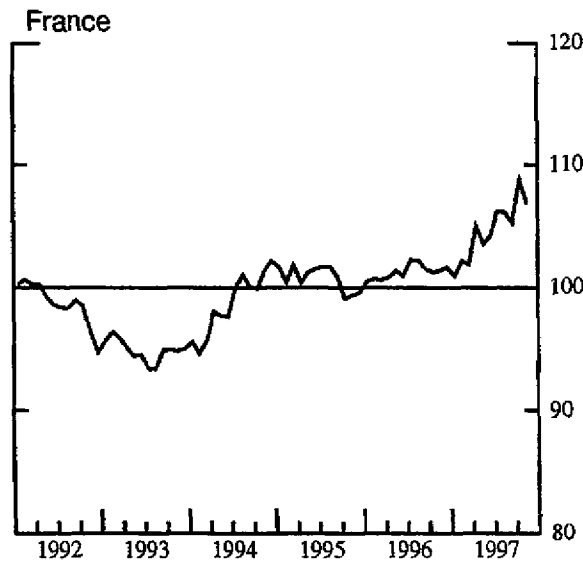
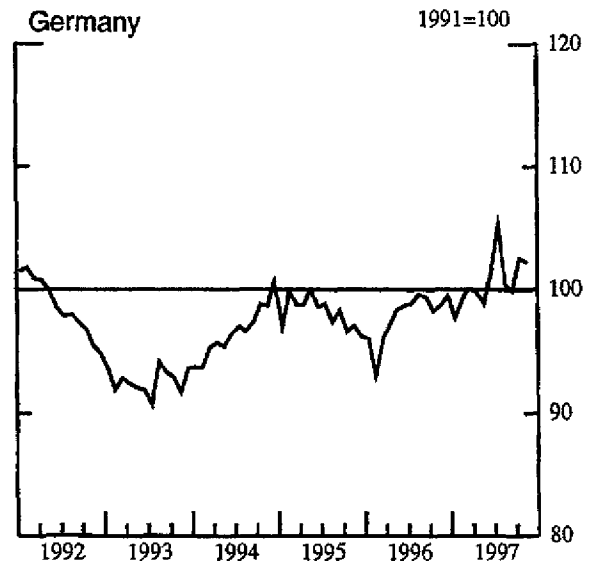
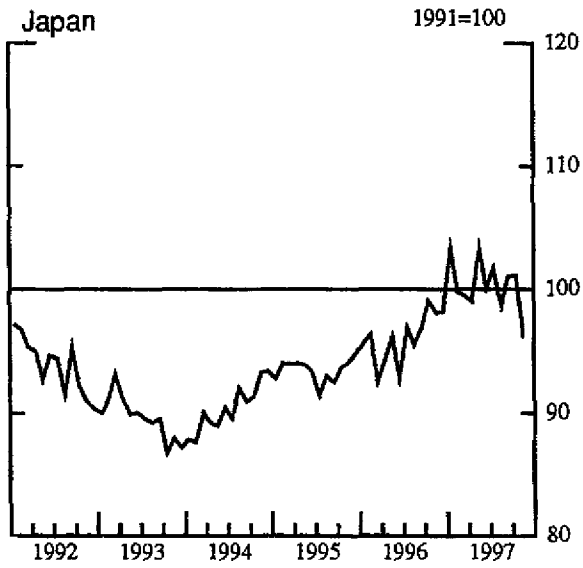
Italy



Canada



Industrial Production in Selected Industrial Countries



Economic Situation in Other Countries

Financial turmoil has shown few signs of abating in the ASEAN region and is reaching dangerous levels in Indonesia. In Korea, major commercial bank creditors agreed in late December to a voluntary arrangement to roll over claims on Korean banks, which appears to have succeeded, at least temporarily, in halting a run on Korea's banks. Negotiations on a debt-restructuring agreement began on January 21.

Financial turmoil has led to a significant slowdown in growth in Asia, with the exception of Taiwan. The slowdown is particularly pronounced in the major ASEAN countries, but it appears that growth began slowing in Korea in the fourth quarter, and also moderated in China in the second half of the year. Growth performance was good in major Latin American countries in the second half of 1997, with the exception of Brazil.

External imbalances in the ASEAN region and Korea have narrowed as a result of the fall in domestic demand and currency depreciations. In China, surging exports contributed to the largest trade surplus in its history in 1997.

Individual country and ASEAN notes. In Korea, there are already signs of substantial macroeconomic adjustment. Real activity appears to have decelerated markedly in November and December, due to a severe credit squeeze and high degree of economic uncertainty. The Bank of Korea (BOK) estimated on a preliminary basis that the growth rate of industrial production slowed to under four percent in December on a year-over-year basis.

Korea's current account appears to have achieved a rapid turnaround into surplus, following substantial deficits during the past two years. The recent improvement in the current account reflects in part a large depreciation of the Korean won, reduced credit availability, and slowing growth. The depreciation of the won has translated into a sharp rise in import prices (which rose by 36 percent in December from their year-earlier level), and substantial upward pressure on consumer prices.

The IMF program announced in early December failed initially to restore market confidence. The international run on Korea's banks continued to drain the BOK's reserves through the first three weeks of December, and the won declined substantially. Following

efforts by the IMF and U.S. authorities to "tighten" the original program in late December, the major commercial bank creditors of Korea agreed to a voluntary arrangement to roll over claims on Korean banks. The rollover arrangement effectively imposed a temporary standstill on payments to creditor banks while a long-term solution to managing Korea's external obligations was formulated.

KOREAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1997		1997		
			Q3	Q4	Oct	Nov	Dec
Real GDP	6.8	n.a.	6.3	n.a.	...	...	...
Industrial Production	8.4	n.a.	8.9	n.a.	12.2	6.2	n.a.
Consumer Prices	4.9	4.5	4.0	5.1	4.3	4.4	6.6
Trade Balance ¹	-15.3	-2.7	0.0	3.3	-0.0	0.7	2.7
Current Account ¹	-23.7	-9.0	-2.3	3.5	-0.7	0.5	3.6

1. Billions of U.S. dollars, NSA

The arrangement has been broadly supported by the major creditor banks of Korea, including banks in the United States, Japan, Germany, and France. It appears to have succeeded in halting the run on Korea's banks (at least temporarily). The BOK's reserves stood at \$11 billion on January 22, up from \$4 billion at their low on December 18.

On Wednesday January 21, a Korean delegation met in New York with the major creditor commercial banks to begin negotiations on a debt-restructuring agreement. The Koreans proposed to restructure a substantial fraction of the short-term liabilities of Korean banks into longer-term obligations that would be accompanied by a sovereign guarantee.

Korea's President-Elect Kim Dae Jung has indicated strong support for the IMF program since his election on December 18. Despite his reputation as a populist, Kim supports legislation to increase labor market flexibility, including provisions that would make it easier for employers to lay off workers.

Korean authorities have moved swiftly to implement several key reforms mandated in their IMF program. In particular, Korea's National Assembly passed a financial sector reform bill on December 29 that grants independence to the BOK effective April 1;

consolidates authority for regulating the financial sector into a single regulatory agency; and requires corporations to file consolidated accounting statements. The National Assembly also passed legislation that will facilitate the effort to clean up the banking sector by allowing the government to write down shareholder equity when injecting capital into banks. The Korean authorities also took important steps in December towards opening the capital account by allowing foreign investors much greater access to Korean stock and bond markets and by giving domestic corporations greater ability to borrow funds abroad.

In the ASEAN region, the substantial increases in interest rates since the onset of the crisis, along with the effects of the currency depreciations and associated declines in investor confidence, have slowed domestic demand growth considerably. In Thailand, industrial production in October 1997 was 12 percent below its year-earlier level. In Indonesia and the Philippines, anecdotal reports suggest a substantial slowdown in economic activity in the second half of 1997 from the pace in the first half of the year.

ASEAN ECONOMIC INDICATORS: GROWTH

	1996	1997			1997		
		Q1	Q2	Q3	Sep	Oct	Nov
Real GDP, s.a.a.r.							
Indonesia	7.8	n.a.	n.a.	n.a.	...	...	...
Malaysia	8.6	6.9	9.1	3.9	...	...	...
Philippines	5.7	6.0	10.3	2.2	...	...	...
Singapore	6.7	4.8	15.6	6.5	...	...	...
Thailand	6.4	n.a.	n.a.	n.a.	...	...	...
Industrial Production ¹							
Malaysia	11.0	11.6	11.8	9.3	7.5	9.8	11.4
Thailand	7.2	6.0	5.8	-2.7	-6.7	-12.3	n.a.

1. Year-over-Year

Inflation has been rising in some economies in the region, driven in large part by the sharp depreciation of their currencies. In Indonesia, inflation rose to over 11 percent by end-1997; a long drought has exacerbated the inflationary pressure. Inflation also picked up a bit in the Philippines and Thailand, but remains at low levels in Malaysia and Singapore.

ASEAN ECONOMIC INDICATORS: INFLATION
(Percent change from year earlier)

	1996	1997			1997		
		Q1	Q2	Q3	Oct	Nov	Dec
Consumer Prices							
Indonesia	8.0	5.2	4.9	6.0	8.5	9.9	11.3
Malaysia	3.5	3.2	2.5	2.3	2.7	2.8	2.9
Philippines	8.4	4.7	4.5	4.9	5.7	6.5	6.1
Singapore	1.4	1.6	1.8	2.3	2.5	2.3	n.a.
Thailand	5.8	4.4	4.4	6.2	7.6	7.6	7.7

Trade balances continued to improve in most economies in the region as a result of the real depreciation of their currencies, the slowdown in their growth, and strong industrial country growth. Thailand reported a trade surplus in October, in contrast to a decade of trade deficits.

ASEAN ECONOMIC INDICATORS: TRADE BALANCE

	1996	1997			1997		
		Q1	Q2	Q3	Oct	Nov	Dec
Trade Balance ¹							
Indonesia	6.9	1.4	3.4	1.5	1.0	n.a.	n.a.
Malaysia	-0.2	0.8	-1.9	0.5	0.0	0.2	n.a.
Philippines	-11.4	-2.9	-2.6	-2.6	-1.0	n.a.	n.a.
Singapore	2.3	-0.0	0.9	0.2	0.3	0.3	0.3
Thailand	-9.5	-3.2	-3.2	-1.4	0.6	n.a.	n.a.

1. Billions of U.S. dollars

On January 15, Indonesian authorities announced that they have reached agreement with the IMF on a "much strengthened and reinforced" economic program. The major improvement over the previous program--which had been announced on November 5--is that President Suharto has promised "to take personal responsibility for the quick and full implementation of the program." The four major elements of the program are: (1) a tight monetary policy; (2) fiscal measures; (3) structural reforms; and (4) bank and corporate sector restructuring.

The Indonesian authorities renewed their commitment to a tight monetary policy until confidence in the currency is restored. Under the new program, Bank Indonesia will be given greater autonomy to conduct monetary policy and determine interest rates. On January 27, Bank Indonesia raised the rates on its central bank certificates for all maturities. The Indonesian authorities will improve fiscal

performance by (i) phasing out most subsidies on energy; (ii) improving fiscal transparency by bringing several off-budget funds on to the budget; and (iii) limiting spending on infrastructure projects and eliminating tax and credit breaks granted to the national airplane projects and the national car project. Additionally, distribution cartels will be broken up, trade in agricultural products will be deregulated, and barriers to foreign investment in palm oil plantations will be removed.

Despite these steps, the renewal of the market's confidence is likely to depend heavily on the crucial fourth element of the program, the plans to restore the health of the banking and corporate sectors. On January 26, Indonesian authorities announced reforms of the banking sector and a framework to handle the renegotiation of corporate debt. The banking sector reforms consist of two components: (1) a government guarantee to depositors and creditors of locally incorporated banks, and (2) the creation of a restructuring agency to handle problem institutions. The guarantee is valid for both rupiah and foreign currency denominated loans (the latter are payable in rupiah at current exchange rates), is to last for about two years, and is to be followed by the introduction of a deposit insurance scheme. Shareholders and subordinated debt are excluded from the guarantee. The financial restructuring agency will supervise and manage the restructuring process of problem banks, and will also serve as the management agency for assets that it acquires in the course of restructuring. The Indonesian government will issue bonds to cover the costs of the restructuring.

The corporate debt framework includes a temporary freeze on financial, non-trade debt servicing, during which time depositors and creditors will be encouraged to arrange workouts. A steering committee consisting of senior international bankers from the main creditor countries is being set up, as is a contact committee of borrowers. The framework will be set up and managed by the private sector based on voluntary agreements between borrowers and lenders. The scheme does not involve any government guarantee or financing.

In Thailand, authorities have continued to take steps to improve the health of the financial sector. On January 24, the central bank took control of a failing mid-sized commercial bank, thereby increasing the pressure on other struggling banks to raise

capital quickly. In the Philippines, the authorities announced their intention to seek further assistance from multilateral sources in their efforts to defuse the crisis.

In Hong Kong, concerns about the currency peg remain. As of late January, the yield spread between Hong Kong government debt and U.S. Treasuries remained 350 to 550 basis points at maturities up to 10 years (the longest maturity available), comparable to the spread between Hong Kong interbank rates and LIBOR U.S. dollar rates. Hong Kong's stock market, which fell 20 percent during 1997, has fallen another 14 percent this year. Much of that decline occurred following the failure of Peregrine, Hong Kong's largest independent investment bank; press reports suggest concern about other, generally small, securities companies as well.

Hong Kong authorities, as well as Chinese officials, continue to stress Hong Kong's commitment to the fixed peg against the dollar. Foreign exchange reserves were \$93 billion at the end of December, down about \$4 billion from November. Hong Kong authorities estimate that GDP grew about 5.0 in the third quarter of 1997 from the year-earlier period, compared with growth of 6.5 percent in the first half of 1997.

In China, output growth was about 8 percent in the second half of 1997 from the year-earlier period, and the 8.8 percent growth rate (year over year) for all of 1997 was the lowest rate of growth since 1991. Inflation remained close to zero. Exports surged 20 percent in 1997 from a year earlier, contributing to the widest trade surplus in China's history; imports rose about 3 percent.

So far, China has remained relatively unaffected by the current financial crisis in Asia. China's exchange rate has remained stable against the U.S. dollar, and the price of domestic shares (which comprise 95 percent of China's stock market, and which foreigners cannot purchase) remain 30 percent higher than they were last July. Foreign-exchange reserves have risen steadily, reaching \$140 billion at the end of 1997, up \$33 billion for the year.

China's currency is not convertible on the capital account, making a speculative attack difficult. Chinese authorities had previously expressed a goal of moving towards capital account convertibility, but in mid-January announced that, in response to events in Asia, they were postponing any such plans.

CHINESE ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1997		1997		
			Q3	Q4	Oct	Nov	Dec
Real GDP	9.7	8.8	8.0	8.2	...	...	...
Industrial Production	15.6	n.a.	12.1	n.a.	14.1	13.8	n.a.
Consumer Prices ¹	7.0	0.4	1.8	0.4	1.5	1.1	0.4
Trade Balance ²	12.2	40.3	12.8	9.7	5.0	4.7	0.0

1. End of period

2. Billions of U.S. dollars, NSA

In addition, China announced plans to accelerate reforms of the financial system, including a reorganization of the People's Bank of China, the central bank, to make its structure more similar to that of the Federal Reserve system. In particular, in order to reduce interference by local authorities, the reforms would eliminate many of the local and provincial branches, creating 10 regional headquarters that cut across provincial lines. Other reforms include increased efforts to improve the quality of bank assets by closing unprofitable branches of the state-owned commercial banks, and substantially increasing state allocations to write off non-performing loans. According to Chinese officials, more than 20 percent of bank loans are non-performing, although only 5 to 6 percent of loans are unrecoverable. However, western bankers often estimate that the proportion of non-performing and unrecoverable loans may be much higher.

In **Taiwan**, industrial production surged in the fourth quarter, while consumer prices have remained relatively flat. Very preliminary government statistics suggest that in the fourth quarter, GDP growth was about 6.7 percent. If these statistics are accurate, the staff estimates that at a seasonally-adjusted annual rate, growth was around 8 percent in the third and fourth quarters. Taiwan's trade surplus narrowed substantially in 1997, as exports rose 5 percent from 1996 and imports rose 12 percent.

The Taiwan dollar depreciated about 5 percent against the U.S. dollar in early January, following declines in other Asian currencies. The stock market ended 1997 up 18 percent for the year, although it was 20 percent below its mid-summer peak. As of January 28, the market was down 1 percent for the year. At the end of November, international reserves were \$83 billion, essentially

unchanged from a month earlier, and down \$7 billion from their recent peak in June.

TAIWAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted, NSA)

	1996	1997	1997		1997		
			Q3	Q4	Oct	Nov	Dec
Real GDP	5.7	n.a.	6.9	n.a.	...	...	...
Industrial Production	1.6	7.0	7.4	8.2	10.8	5.8	8.1
Consumer Prices ¹	2.5	0.2	0.6	0.2	-0.3	-0.5	0.2
Trade Balance ²	14.3	7.7	2.0	2.2	1.0	1.3	-0.1
Current Account ²	10.5	n.a.	2.1	n.a.	...	...	...

1. End of period

2. Billions of U.S. dollars, NSA

In Brazil, economic activity has weakened considerably. Industrial production plunged in November in the wake of the doubling of interest rates at the end of October from 20 to 40 percent. Inflation ended the year at 4.3 percent (December-over-December), Brazil's lowest inflation rate since the 1950s.

BRAZILIAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1997		1997		
			Q3	Q4	Oct	Nov	Dec
Real GDP, s.a.a.r. ¹	2.9	n.a.	4.1	n.a.	...	...	...
Industrial Production (SA) ²	2.3	n.a.	1.4	n.a.	0.4	-3.2	n.a.
Open Unemployment Rate (%)	5.4	n.a.	5.8	n.a.	5.7	5.4	n.a.
Consumer Prices ³	9.4	4.3	0.4	1.1	0.3	0.2	0.6
Trade Balance ⁴	-5.5	-8.4	-2.2	-2.9	-0.8	-1.3	-0.8
Current Account ⁴	-24.3	-33.8	-7.9	-11.2	-4.0	-3.3	-3.9

1. Percent-change from previous period.

2. Annual data are from national income accounts.

3. INPC, Percentage change from previous period. Annual data are Dec/Dec.

4. Billions of U.S. dollars, NSA

The sharp decline in demand contributed to a narrowing in the trade deficit in December to \$0.8 billion, down considerably from the deficit of \$1.8 billion in the year-earlier period. The current account deficit for 1997 stood at \$33.8 billion, about 4 percent of GDP. International reserves totalled about \$52 billion (liquidity concept), down \$8 billion from a year ago. In the capital account, direct foreign investment rose from \$10 billion in 1996 to \$17 billion in 1997, owing in part to privatizations at the federal and

state levels. Other net capital inflows declined from \$22 billion in 1996 to \$8 billion in 1997, largely reflecting an outflow of short-term capital.

So far, Brazilian authorities have maintained that they will not succumb to pressures to devalue the "real" and will keep interest rates high. The "real"/dollar exchange rate has continued to depreciate slowly within a narrow crawling band (the so-called "mini-band") that is realigned about 0.6 percent each month. This narrow band moves within a wider band (the so-called "maxi-band") that has been realigned about once a year. On January 21, about a month before markets expected, the central bank realigned the "maxi" band, but the implied maximum-allowable depreciation over the next year is in keeping with the current policy of a 7 percent annual depreciation of the "real"/dollar exchange rate. Therefore, financial markets interpreted the move as a continuation of the existing policy.

The Cardoso administration has also continued its efforts at tackling Brazil's serious fiscal problems. In January, Congress convened an emergency session to consider constitutional reforms that are thought to be crucial for fiscal stability.

In Argentina, economic activity continues to be quite strong. Compared with the year-earlier period, industrial production rose almost 9 percent in November while real GDP grew more than 8 ½ percent in the third quarter of 1997. Moreover, the unemployment rate fell to 13.7 percent in the October 1997 survey, down almost 5 percentage points from its peak in mid-1995. Despite the decline in unemployment, inflation remains virtually non-existent. Strong growth led to a trade deficit of \$2.5 billion through November of 1997, compared with a surplus of over \$2 billion over the same period in 1996.

To date, the turmoil in Asia has not created any undue pressures on either convertibility or the banking sector, although the blue-chip Merval stock index has declined roughly 25 percent since the Asian crisis intensified in late October. The real interest rate (measured using observed monthly inflation) on 30-day peso-denominated deposits rose over 500 basis points to almost 12 percent in November, but has been declining since then.

ARGENTINE ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1997		1997		
			Q3	Q4	Oct	Nov	Dec
Real GDP	4.3	n.a.	8.6	n.a.	...	...	...
Industrial Production (SA)	3.1	n.a.	11.8	n.a.	13.0	8.7	n.a.
Unemployment Rate (%) ²	17.2	14.9	...	13.7	...	...	...
Consumer Prices ¹	0.1	0.4	0.4	-0.2	-0.2	-0.2	0.2
Trade Balance ³	1.6	n.a.	-1.0	n.a.	-0.4	-0.7	n.a.
Current Account ³	-4.0	n.a.	n.a.	n.a.	...	...	...

1. Percentage change from previous period; annual and quarterly numbers use end-of-period figures.

2. Unemployment figures available only in May and October of each year. The annual figure is the average of the two surveys.

3. Billions of U.S. dollars, NSA

International reserves (excluding gold) stood at over \$21 billion at the end of December, up roughly 7 percent from November. Deposits, which currently stand at nearly \$70 billion and have more than doubled since the end of the banking crisis in 1995, have not shown any substantial declines following the Asian crisis. The fiscal deficit (excluding privatization revenues) declined from \$4.9 billion in 1996 (1.6 percent of GDP) to \$2.9 billion in 1997 (1 percent of GDP), meeting the 1997 IMF target of \$3 billion.

In Mexico, economic activity remains strong, and unemployment has continued to decline. Industrial production remains robust, and unemployment declined to 2.8 percent at the end of 1997. Consumer price inflation has remained subdued. In the twelve months to December 1997, consumer prices rose 16 percent, well below the inflation rate of 28 percent registered in 1996. In December, the trade deficit was \$0.7 billion; for all of 1997, Mexico had a small trade surplus of \$0.6 billion, down from a surplus of \$6.5 billion in 1996. The recovery of the economy and the real appreciation of the peso have contributed to faster growth of imports than exports.

On December 15, Finance Minister Guillermo Ortiz was nominated by President Zedillo, and approved by the senate, to head the Bank of Mexico. Ortiz replaces Miguel Mancera, whose 15-year tenure ended last month with his retirement. On January 5, Foreign Minister Jose Angel Gurría was named as the new Finance Minister; prior to being Foreign Minister, Gurría held various high-ranking

economics posts. Economic policies under this new team are expected to remain essentially unchanged.

MEXICAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1997		1997		
			Q3	Q4	Oct	Nov	Dec
Real GDP	5.1	n.a.	8.1	n.a.	...	...	...
Industrial Production	10.4	n.a.	10.2	n.a.	10.4	8.6	n.a.
Unemployment Rate (%)	5.5	3.7	3.7	3.1	3.2	3.3	2.8
Consumer Prices ¹	27.7	15.7	3.0	3.4	0.8	1.1	1.4
Trade Balance ²	6.3	0.6	-0.3	-1.3	-0.2	-0.3	-0.7
Imports ²	89.6	109.8	28.5	31.0	10.5	9.9	10.6
Exports ²	95.9	110.4	28.2	29.7	10.2	9.6	9.9
Current Account ²	-1.9	n.a.	-2.5	n.a.	...	...	...

1. Percentage change from previous period.

2. Billions of U.S. dollars, NSA

In mid-December, the Mexican congress passed the budget, ending a stalemate that had threatened to shut down the government. This budget does not include the main tax cuts the opposition wanted, including a reduction of Mexico's value-added tax to 12 percent from 15 percent, and is unlikely to raise the fiscal deficit by much above the administration's initial target of 1.25 percent of GDP. In January, the Mexican authorities announced additional spending cuts to offset an expected decline in revenues of 0.4 percentage points of GDP; the cuts are expected to come in both current spending and investment. The authorities expect that the estimated budget deficit of 1.25 percent of GDP for 1998 fiscal year will remain unchanged.

Mexican financial markets continue to be affected by the Asian crisis. The peso value of the dollar, which opened the year at 8.1, fell to the 8.2-8.3 range in the second week of January, and has remained volatile. At the most recent Treasury auction 28-day interest rates were 17.4 percent, below their mid-December rates but above their mid-October level.

In Venezuela, the recent pick-up in economic activity continues. The unemployment rate fell to 11.1 percent in the fourth

quarter of 1997, compared with 12.4 percent in the same period of 1996. The recovery has led to a widening of external balances; the non-oil trade deficit moved to roughly \$6 billion in the period from January to October last year compared with around \$4 billion in the same months of 1996. Inflation picked up last year: December/December consumer price inflation for 1997 was 38 percent, compared with the original target of 25 percent agreed upon with the IMF.

VENEZUELAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1997		1997		
			Q3	Q4	Oct	Nov	Dec
Real GDP	-1.6	n.a.	...	...	...	...	...
Unemployment Rate (NSA, %)	11.8	11.8	11.5	11.1	...	...	...
Consumer Prices ¹	103.3	37.8	9.7	9.6	3.8	2.9	2.6
Non-oil Trade Balance ²	-4.8	n.a.	-2.2	n.a.	-0.8	n.a.	n.a.
Trade Balance ²	13.8	n.a.	2.4	n.a.	0.9	n.a.	n.a.
Current Account ²	8.8	n.a.	...	...	...	...	...

1. Percentage change from previous period, NSA; annual and quarterly numbers are end-of-period figures.

2. Billions of U.S. dollars, NSA.

The recent decline in oil prices is likely to create fiscal problems for the government this year, and has led to a fall in international reserves which, excluding gold, stood at just under \$14 billion at the end of December, down 10 percent from November. The stock market has suffered due to the decline in oil prices coupled with the effects of the Asian crisis.

Responding to concerns that the Venezuelan currency is overvalued, Venezuela's Central Bank in January reset the central rate of its currency band system and accelerated the rate at which the bands depreciate from 1.16 to 1.28 percent per month. In an attempt to tighten monetary policy to curb inflation, the central bank also increased the discount rate to 60 percent from 45 percent, effective immediately.

In Russia, recent data confirm the favorable macroeconomic trends of 1997. Real GDP showed a 12-month increase of 1.2 percent in December, and for 1997 as a whole edged up 0.4 percent, its first yearly rise since 1990. Industrial production was up 4.2 percent in the 12 months to December. The 12-month consumer price inflation

rate continued to edge down in December, and at 11.1 percent was substantially below the 21.8 percent rate of the previous December. Consistent with an environment of less inflation, the government introduced a redenominated ruble at the start of the year, equal to 1,000 old rubles; the introduction of the new ruble appears to have gone smoothly. The government's draft budget calls for real GDP growth of 2 percent and inflation of below 6 percent in 1998.

RUSSIAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1997		1997		
			Q3	Q4	Oct	Nov	Dec
Real GDP	-6.3	0.4	1.1	0.9	0.5	1.0	1.2
Industrial Production	-5.2	1.9	2.2	3.4	2.3	3.7	4.2
Consumer Prices	52.8	14.8	14.5	11.8	12.9	11.5	11.1
Ruble Depreciation	12.5	12.7	10.3	7.8	8.2	7.9	7.3
Trade Balance ¹	16.4	n.a.	n.a.	n.a.	...	...	...
Current Account ¹	2.2	n.a.	n.a.	n.a.	...	...	...

1. Billions of U.S. dollars.

The severe downward pressure on the ruble which had developed in November eased in December after the central bank signaled its willingness to raise interest rates substantially to defend the currency. Foreign exchange reserves showed no net decline during December, remaining at \$18 billion, following a \$5 billion decline in November. Russian financial markets have continued, however, to remain vulnerable to occasional bouts of pressure resulting from spillovers from the Asian financial crisis or adverse reports about President Yeltsin's health.

On January 8, the IMF approved the release of \$800 million to Russia that had been held up since September because of concerns over the government's ability to collect taxes and meet its promised budget targets.