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## **Part 2**

September 23, 1998

# **CURRENT ECONOMIC AND FINANCIAL CONDITIONS**

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## **Recent Developments**

Prepared for the Federal Open Market Committee  
by the staff of the Board of Governors of the Federal Reserve System

September 23, 1998

## **RECENT DEVELOPMENTS**

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# **DOMESTIC NONFINANCIAL DEVELOPMENTS**

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## Domestic Nonfinancial Developments

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### Overview

As the third quarter draws to a close, the U.S. economy appears to be expanding moderately. As a result of reduced export demand and rising import competition, activity in the industrial sector has stagnated and the pace of factory job losses has quickened. But domestic final demand to date has remained strong, sustaining hefty employment gains in the construction and service sectors. The unemployment rate has remained low, and anecdotal reports of sizable wage increases are heard with some frequency. However, the available aggregate data on pay inflation suggest at most a modest upcreep, and readings on price trends remain mixed.

### Labor Market Developments

Many of the labor market indicators were distorted in July and August by the effects of the General Motors shutdown. But combining the two months to filter out that noise, growth in overall labor demand appears to have weakened a bit from its robust pace over the first half of the year. Private nonfarm payrolls expanded an average of 181,000 per month in July and August, down from an average pace of 222,000 per month in the first half of the year. The unemployment rate held steady at 4.5 percent in August, a tad above the low registered in the spring.

**Change in Employment**  
(Monthly average, thousands)

Category	1998:H1	July-August average
<b>Total private nonfarm payrolls</b>	<b>222</b>	<b>181</b>
Manufacturing	-2	-53
Nonmanufacturing	223	234
Construction	23	19
Transportation and utilities	15	21
Trade	49	64
Finance, insurance, real estate	23	24
Services	117	111

Manufacturing payrolls fell about 53,000 per month on average in July and August after having posted a smaller decline in the second quarter and a small gain in

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

	1996	1997	1998				
			Q1	Q2	June	July	Aug.
	-Average monthly changes-						
Nonfarm payroll employment <sup>1</sup>	233	282	208	279	189	68	365
Private	224	263	192	251	204	54	308
Manufacturing	3	21	13	-16	-25	-200	95
Nonmanufacturing	222	241	180	267	229	254	213
Construction	28	20	17	29	29	21	16
Transportation and utilities	8	14	18	11	4	18	24
Trade	54	48	22	76	31	101	27
Finance, insurance, real estate	14	17	21	25	22	35	13
Services	117	142	104	129	144	86	135
Total government	9	20	16	28	-15	14	57
Private nonfarm production workers <sup>1</sup>	190	212	136	195	172	49	151
Manufacturing production workers	0	16	4	-23	-28	-190	77
Total employment <sup>2</sup>	232	240	72	72	-244	-142	101
Nonagricultural	226	243	157	2	-251	-241	14
<b>Memo:</b>							
Aggregate hours of private production workers (percent change) <sup>1,3</sup>	3.2	3.4	3.2	0.8	-0.1	0.3	0.1
Average workweek (hours) <sup>1</sup>	34.4	34.6	34.7	34.6	34.6	34.6	34.6
Manufacturing (hours)	41.6	42.0	42.0	41.7	41.8	41.7	41.7

n.s. Not available.

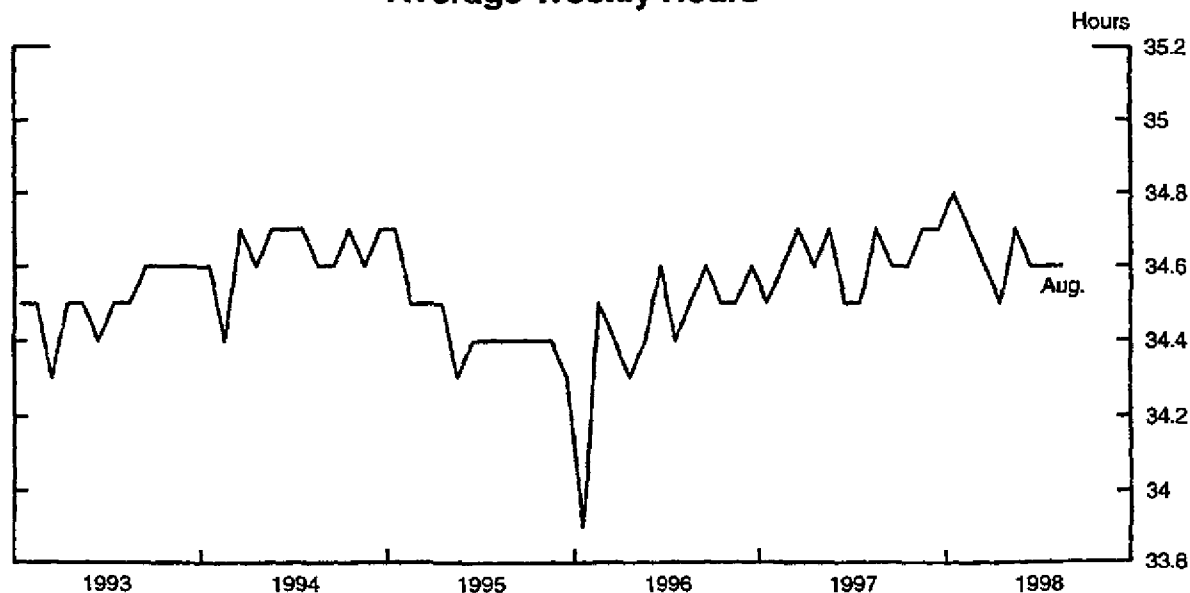
Note. Average change from final month of preceding period to final month of period indicated.

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.

### Average Weekly Hours



the first quarter. Job losses were greatest in the electronic components and apparel industries, in which the Asian crisis is taking a toll. Outside of manufacturing, construction employment continued to record healthy gains despite ongoing anecdotal reports of shortages of skilled workers. Job gains remained strong in the service-producing sector.<sup>1</sup>

Aggregate hours of production or nonsupervisory workers on nonagricultural payrolls increased 0.1 percent in August after having risen 0.3 percent in July. The level in August, which was unaffected by the GM strikes, was 0.5 percent above the second-quarter average. The workweek held steady at 34.6 hours in August for the third straight month; the workweek has fluctuated around this level since early 1997, with a modest drop-off in manufacturing being offset by a rise elsewhere in the economy.

The household survey continues to point to tight labor markets, albeit with a slight hint of easing pressures. As noted above, the unemployment rate, at 4.5 percent, was a little above the second-quarter average, and total employment has shown little growth over the past two months. The labor force participation rate remained at 66.9 percent last month--a touch below the 67.0 percent level that prevailed in the second quarter, and still farther below the all-time high of this past winter. The sum of those who would accept a job but have not been searching and those reporting themselves as unemployed--which represents a measure of the supply of available workers--has been moving up since May, which is consistent with a marginal relaxation of labor market pressures.

Other indicators of overall labor market activity remain strong. The four-week average of initial claims for unemployment insurance has remained below its pre-GM strike level and is consistent with robust employment growth in September. Manpower Inc.'s survey of hiring strength for the fourth quarter points to considerable strength in labor demand, although this survey is a better indicator of conditions in the quarter in which it is administered (in this case the third quarter) than of the conditions in the survey's reference quarter (the fourth). The adjusted index of help-

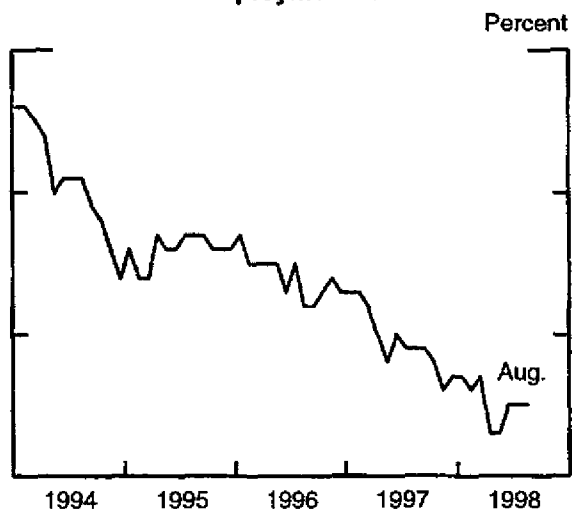
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1. Employment in retail trade surged in July but posted only a small gain in August, as strong early summer demand pulled some normal August hiring into July. Conversely, the increase in employment in the service industry was relatively small in July and considerably stronger in August, reflecting a large swing in hiring in the help-supply industry--some of which was an indirect effect of the GM strikes.

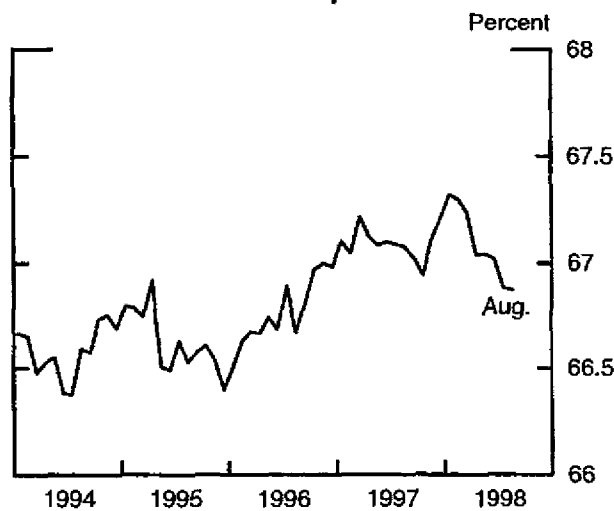
**SELECTED UNEMPLOYMENT AND LABOR FORCE PARTICIPATION RATES**  
 (Percent; based on seasonally adjusted data, as published)

	1996	1997	1997 Q4	1998		1998		
				Q1	Q2	June	July	Aug.
<b>Civilian unemployment rate</b> (16 years and older)	5.4	4.9	4.7	4.7	4.4	4.5	4.5	4.5
<b>Teenagers</b>	16.7	16.0	15.0	14.6	14.0	14.6	13.7	15.0
<b>Men, 20 years and older</b>	4.6	4.2	4.0	3.8	3.6	3.7	3.9	3.7
<b>Women, 20 years and older</b>	4.8	4.4	4.0	4.3	4.0	4.1	4.0	4.1
<b>Labor force participation rate</b>	66.8	67.1	67.1	67.3	67.0	67.0	66.9	66.9
<b>Teenagers</b>	52.3	51.6	51.4	53.3	52.4	53.0	51.9	52.3
<b>Men, 20 years and older</b>	76.8	76.9	76.9	76.9	76.8	76.7	76.9	76.5
<b>Women, 20 years and older</b>	59.9	60.5	60.5	60.6	60.4	60.4	60.1	60.4
<b>Women maintaining families</b>	65.3	67.4	68.2	67.9	67.5	67.4	68.4	68.1

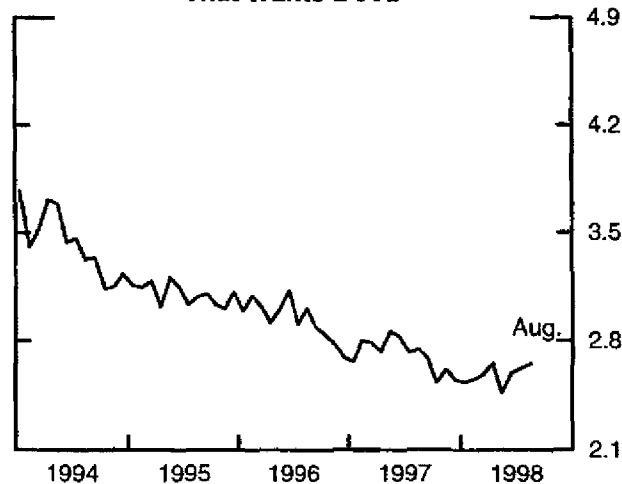
**Unemployment Rate**



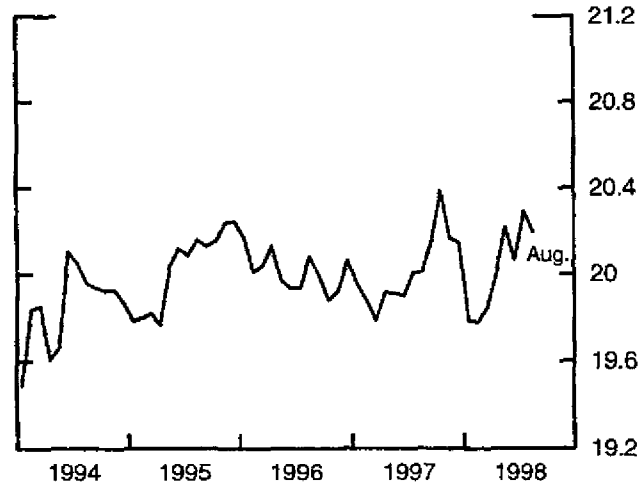
**Labor Force Participation Rate**



**Percent of Population (age 16 to 64)  
That Wants a Job\***



**Percent of Population (age 16 to 64)  
That Does Not Want a Job\***



\*Seasonally adjusted by FRB staff.



wanted advertising remained at a high level in July.<sup>2</sup> The demand for new hires still appears to be straining the available supply: Surveys of hiring conditions by the National Federation of Independent Businesses and the Bureau of National Affairs suggest that companies continued to have difficulty hiring new workers in August, though less so than in July.

Reflecting a dramatic slowdown in output growth last quarter and a more modest slowing in the hours worked by all persons, labor productivity in the nonfarm business sector increased 0.1 percent at an annual rate in the second quarter, down from the 3.5 percent rise in the first quarter. The productivity figures were held down by the lost production resulting from the GM strikes because the hours data were collected before the strikes began. Without the strikes, second-quarter productivity growth would likely have been roughly 1/2 percentage point greater. Productivity in the nonfinancial corporate sector rose 2.8 percent at an annual rate in the second quarter, little changed from the 2.6 percent increase recorded in the first quarter. The substantial difference between productivity in the nonfarm business sector and the nonfinancial corporate sector reflects some of the same factors that resulted in a widening of the statistical discrepancy in the second quarter: The output of the nonfinancial corporate sector, which is estimated from the income side of the national accounts, has been growing faster than nonfarm business output, which is measured from the product side.

Turning to the most recent data on labor costs, average hourly earnings of production or nonsupervisory workers on private nonagricultural payrolls rose at an average monthly rate of about 1/3 percent in July and August.<sup>3</sup> Over the past twelve months, average hourly earnings rose 4.2 percent, up a couple of tenths from the increase in the year-earlier period. The three-month change in August dropped below the corresponding change in May, but given the noise in the monthly figures, it is too soon to tell whether this reflects a topping out of wage gains.

With respect to benefits costs, information from public-sector employers points to a step-up in health insurance premium increases in 1999. The Office of Personnel Management recently announced that total premiums (including both government and employee shares) for FEHBP health insurance will rise about 10-1/4 percent next year,

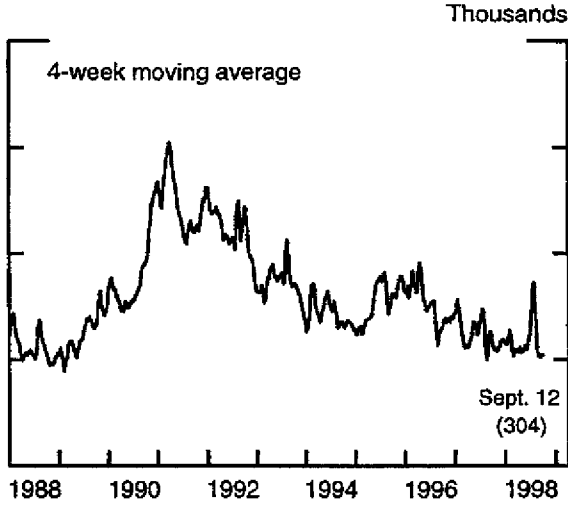
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2. The Board staff makes rough adjustments to the Conference Board's Index of Help-Wanted Advertising to account for consolidation in the newspaper industry and the increase in temporary help employment--which can replace newspaper advertising as a method of posting and filling open positions.

3. As published, average hourly earnings rose 0.2 percent in July and 0.5 percent in August. BLS estimates, however, that the effects of the GM strikes held down the July increase by 0.1 percentage point and boosted the August increase by the same amount.

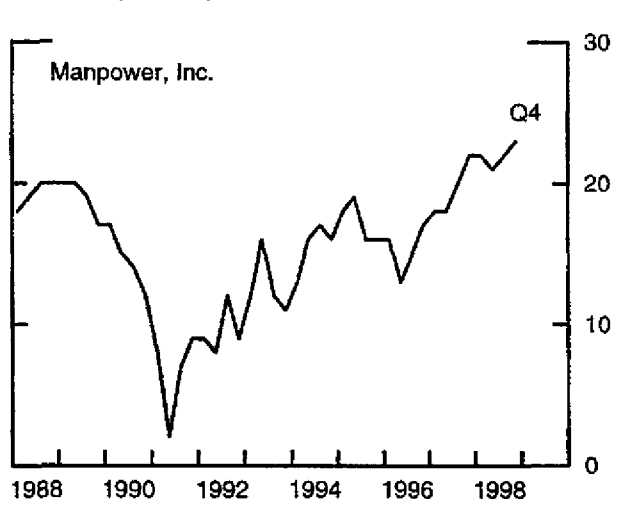
## Labor Market Indicators

Initial Claims for Unemployment Insurance



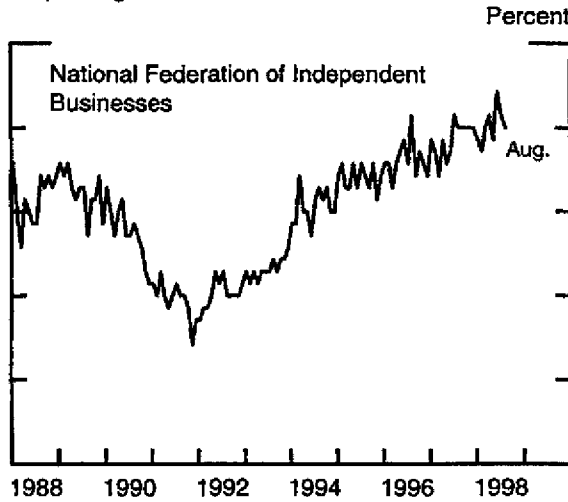
Note. State programs, includes EUC adjustment.

Net Hiring Strength

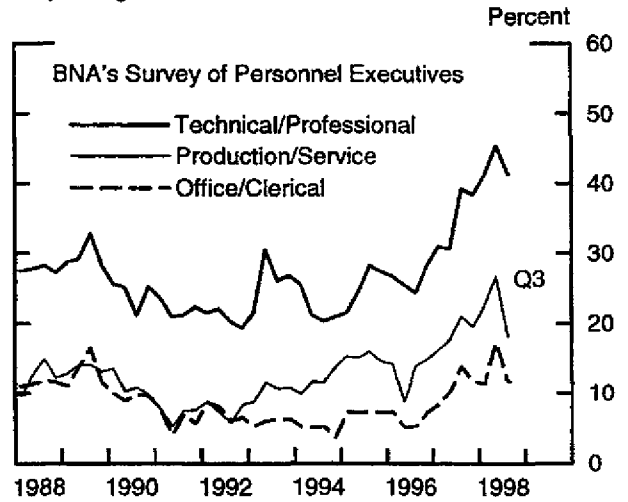


Note. Percent planning an increase in employment minus percent planning a reduction.

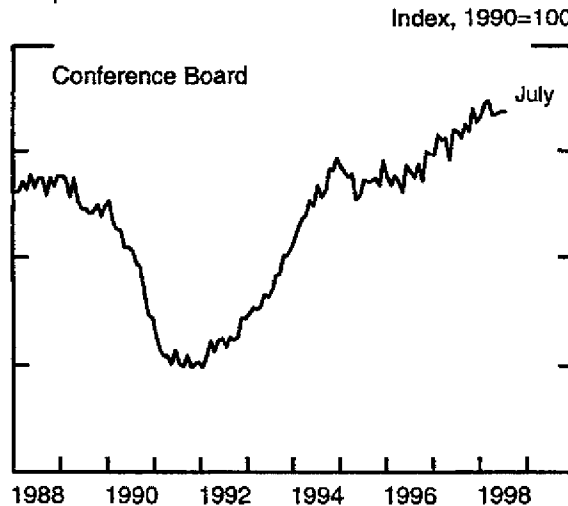
Reporting Positions Hard to Fill



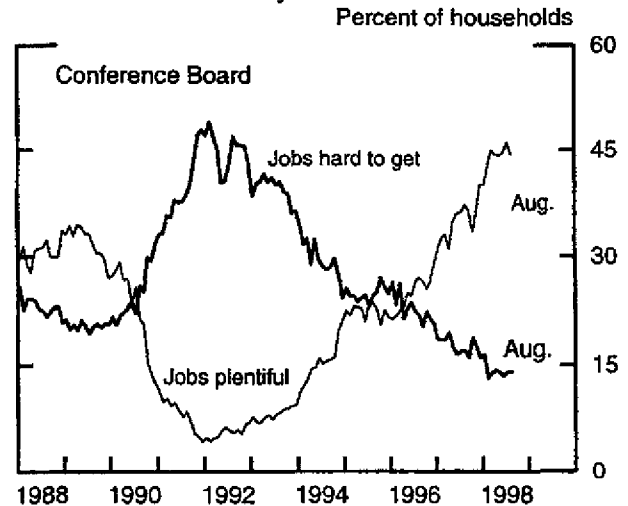
Reporting Positions Hard to Fill



Help Wanted Index



Current Job Availability



Note. Series has been adjusted to take account of structural and institutional changes, including consolidation of newspaper industry and tendency to increase hiring through personnel supply agencies.

**AVERAGE HOURLY EARNINGS**  
(Percentage change; based on seasonally adjusted data)

	Twelve-month percent change			Three-month percent change		1998	
	Aug. 1996	Aug. 1997	Aug. 1998	May 1998	Aug. 1998	July	Aug.
	- - - - - Annual rate - - - - -					- Monthly rate -	
Total private nonfarm	3.4	4.0	4.2	4.5	4.1	.2	.5
Manufacturing	3.4	2.8	2.6	1.5	2.1	-.2	.8
Construction	2.5	3.5	3.9	3.0	5.7	.8	.3
Transportation and public utilities	2.3	3.7	2.1	1.6	.8	.5	-.1
Finance, insurance, and real estate	3.6	5.1	5.0	5.9	4.6	.1	.7
Retail trade	3.8	4.4	5.4	6.2	4.7	.6	.5
Wholesale trade	3.5	4.9	4.4	5.6	4.4	.6	.6
Services	3.7	4.2	4.9	6.8	4.8	.2	.5

**LABOR PRODUCTIVITY AND COSTS**  
(Percent change from preceding period at compound annual rate;  
based on seasonally adjusted data)

	1996 <sup>1</sup>	1997 <sup>1</sup>	1997		1998		1997:Q2 to 1998:Q2
			Q3	Q4	Q1	Q2	
<u>Output per hour</u>							
Total business	2.4	1.9	3.7	0.9	4.1	-0.2	2.1
Nonfarm business	2.1	1.7	3.6	0.9	3.5	0.1	2.0
Manufacturing	4.6	4.5	7.3	4.9	1.4	2.5	4.0
Nonfinancial corporations <sup>2</sup>	2.4	2.6	5.6	1.0	2.6	2.8	3.0
<u>Compensation per hour</u>							
Total business	3.9	4.0	4.1	5.3	4.9	4.1	4.6
Nonfarm business	3.7	3.9	3.9	4.9	4.6	4.0	4.4
Manufacturing	2.4	5.3	5.6	8.0	4.1	2.6	5.0
Nonfinancial corporations <sup>2</sup>	3.4	3.9	4.2	5.0	3.6	4.6	4.3
<u>Unit labor costs</u>							
Total business	1.5	2.0	0.4	4.4	0.8	4.3	2.4
Nonfarm business	1.6	2.1	0.3	4.0	1.1	3.9	2.3
Manufacturing	-2.1	0.7	-1.6	3.0	2.7	0.1	1.0
Nonfinancial corporations <sup>2</sup>	0.9	1.2	-1.3	4.0	0.9	1.8	1.3

1. Changes are from fourth quarter of preceding year to fourth quarter of year shown.

2. Nonfinancial corporate sector includes all corporations doing business in the United States except banks, stock and commodity brokers, and finance and insurance companies; the sector accounts for about two-thirds of business employment.

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

	Proportion 1997	1997 <sup>1</sup>	1998		1998		
			Q1	Q2	June	July	Aug.
			-Annual rate-		--Monthly rate--		
Total index	100.0	5.8	1.2	1.7	-1.1	-.4	1.7
Previous		5.8	1.2	1.9	-1.1	-.6	
Manufacturing	86.2	6.3	2.3	.8	-1.3	-.4	2.0
Durables	46.6	9.5	2.6	2.6	-1.7	-.9	3.8
Motor vehicles and parts	5.2	11.9	-17.7	-11.9	-14.3	-12.3	39.7
Aircraft and parts	2.3	18.5	10.8	.0	-.4	1.3	.6
Nondurables	39.6	2.6	1.8	-1.4	-.9	.2	-.1
Manufacturing excluding motor vehicles and parts	81.0	6.0	3.7	1.6	-.5	.3	.1
Mining	6.2	2.1	9.9	-4.0	-2.2	.3	-.6
Utilities	7.6	2.4	-16.5	18.8	2.7	-.9	.4
IP by market group excluding motor vehicles and parts							
Consumer goods	26.3	2.3	.0	1.6	-.3	.1	-.2
Durables	4.0	4.2	10.6	4.6	-1.4	.2	-.5
Nondurables	22.3	2.0	-1.8	1.1	-.1	.0	-.1
Business equipment	12.3	10.8	2.9	9.8	1.5	.7	-.4
Information processing	5.5	12.2	6.3	15.9	.9	-.2	1.2
Computer and office eq.	1.8	36.3	56.6	59.7	4.1	2.4	2.5
Industrial	4.5	5.6	-2.0	6.0	2.7	1.0	-.9
Transit	1.1	27.3	19.4	4.1	-.2	1.7	1.5
Other	1.3	9.5	-8.8	5.8	1.2	2.5	-7.0
Construction supplies	5.6	2.2	8.5	2.5	-.3	.4	-.7
Materials	38.5	6.9	3.2	2.0	-.8	.2	.6
Durables	21.1	10.8	6.0	2.4	-.9	.0	1.3
Semiconductors	3.7	39.8	30.8	10.6	.1	1.4	1.1
Basic metals	3.6	4.8	1.8	-10.4	-2.2	-.8	3.7
Nondurables	9.0	3.5	-.8	-3.1	-.2	.4	-.5

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	1997	1998		1998		
	High	Avg.	Q4	Q1	Q2	June	July	Aug.
Manufacturing	85.7	81.7	82.2	81.6	80.7	79.7	79.1	80.4
Primary processing	88.9	82.8	86.0	85.6	84.8	84.0	83.9	83.9
Advanced processing	84.2	81.1	80.4	79.8	79.0	77.8	77.0	78.8

up from an 8-1/2 percent increase this year--the largest increase in ten years.<sup>4</sup> The California Public Employees' Retirement System, the second largest purchaser of employee health benefits behind the federal government, announced earlier this year that overall premiums would increase about 6 percent in 1999 after rising about 3 percent in 1998 and declining in the previous three years. The 1998 increases in public-sector health insurance costs do not appear to have carried over into the private-sector premiums that are included in the employment cost index and the hourly compensation figures. However, the same factors leading to the rise in public-sector health insurance costs in 1999--mainly rising prescription drug prices and a need to replenish financial reserves--could contribute to rising private-sector premiums as well.<sup>5</sup>

### **Industrial Production**

Industrial output grew 1.7 percent in August, almost entirely because of GM's post-strike production ramp-up. Outside of the motor vehicles and parts industries, manufacturing edged up 0.1 percent, remaining nearly unchanged from its level in May. The rise in production for all of manufacturing in August pushed the factory operating rate up to 80.4 percent; nevertheless, this rate is more than 1 percentage point below the long-term average and about 2 percentage points below the level late last year.

Motor vehicle assemblies shot up to 13.2 million units at a seasonally adjusted annual rate in August from 8.2 million units in July. Even with the increased pace of assemblies at GM, inventories of autos and light trucks remained extremely lean in August. GM's scheduled production through the fourth quarter remains strong, as it will likely take several months to rebuild dealer stocks.

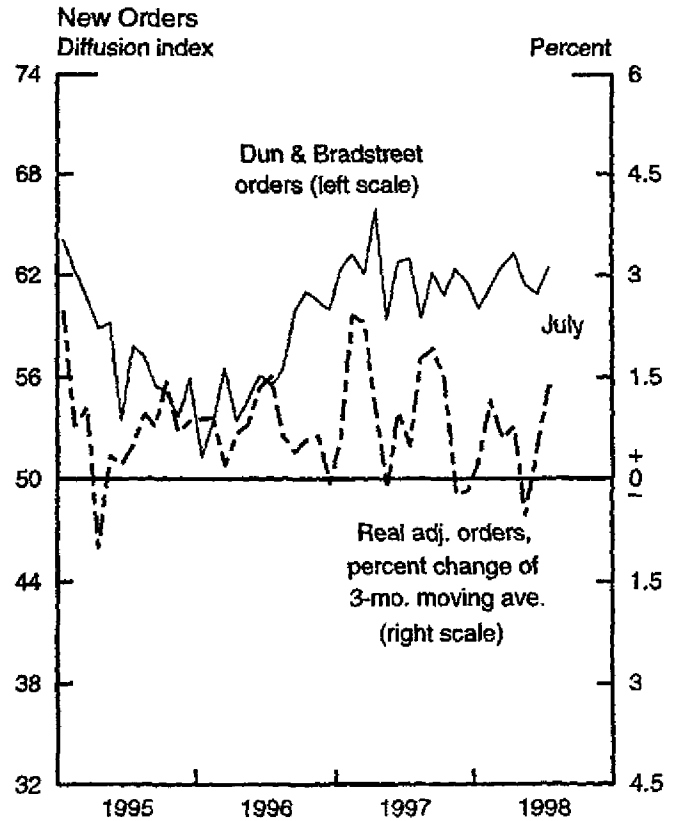
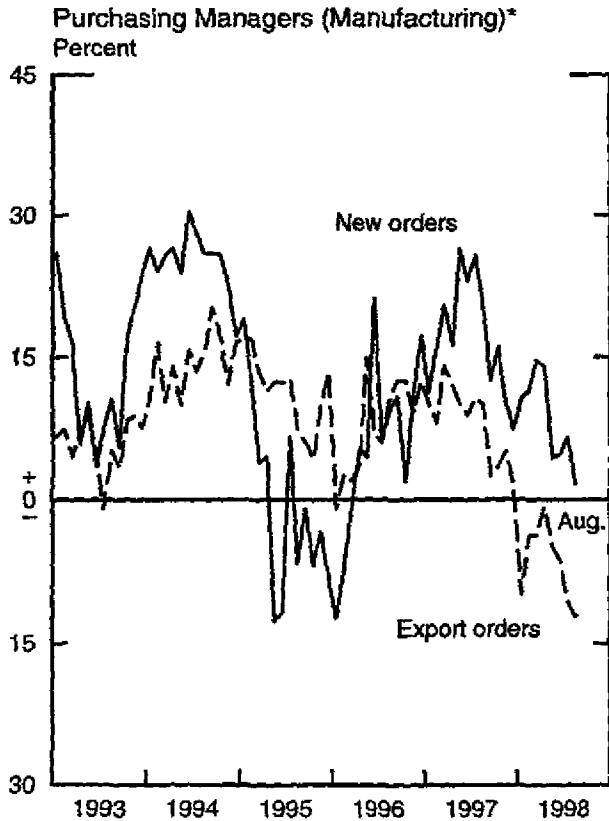
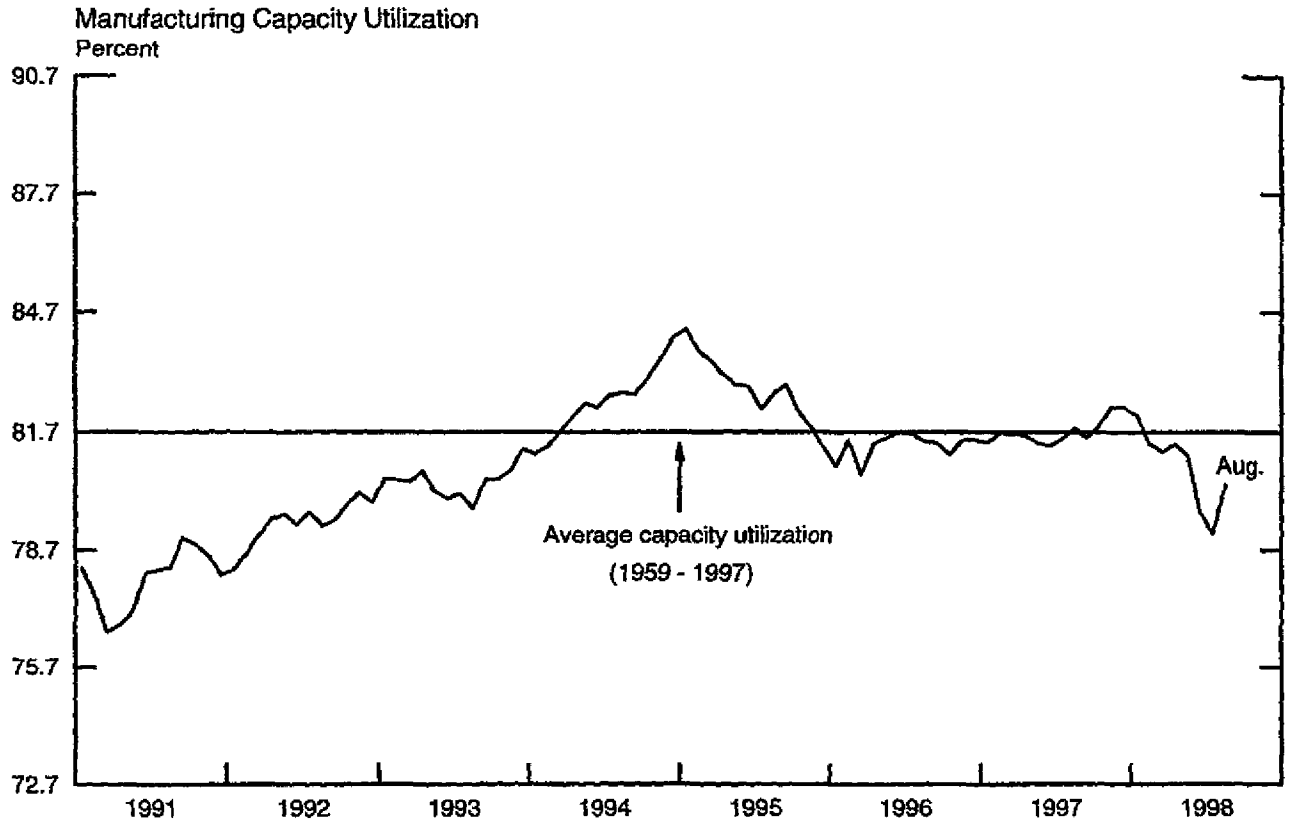
Outside of motor vehicles and parts, the deterioration in net exports clearly has contributed to this year's lackluster growth in industrial production. Indeed, most

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4. These figures are calculated assuming that enrollment patterns are unchanged from the previous year. OPM estimates that when changes in enrollment are taken into account, the increase for 1998 will be 7 percent, rather than 8-1/2 percent.

5. OPM also cited rising costs associated with the aging of the federal workforce in its recent announcement.

### Industrial Production Indicators



\*Percent reporting increases minus percent reporting decreases.

industries (including steel; chemicals; miscellaneous manufacturing; and stone, clay, and glass) experienced negative swings in net exports in the first half of the year.<sup>6</sup>

**Production of Domestic Autos and Trucks**  
(Millions of units at an annual rate; FRB seasonal basis)

Item	1998					
	July	Aug. <sup>1</sup>	Sept. <sup>2</sup>	Q2	Q3 <sup>2</sup>	Q4 <sup>2</sup>
U.S. production	8.2	13.2	12.6	11.6	11.4	12.6
Autos	3.9	6.3	6.3	5.3	5.5	5.7
Trucks	4.3	6.9	6.3	6.4	5.9	7.0
Domestic stocks <sup>3</sup>						
Autos	1.1	1.2	n.a.	1.1	n.a.	n.a.
Light trucks	1.3	1.3	n.a.	1.4	n.a.	n.a.

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

1. Production rates are latest estimates from Ward's Automotive Communications.

2. Production rates are manufacturers' schedules.

3. Quarterly data are for last month of quarter.

n.a. Not available.

Since the first quarter, producers have largely been able to avoid inventory imbalances, despite the softening demand, by slowing production accordingly.<sup>7</sup>

The production of non-auto durable consumer goods slid in August, held down by a reduction in appliance production, and the output of nondurable consumer goods, which has been weak all year, pulled back a bit further. The production of business equipment also fell, as strength in information processing and aircraft production was outweighed by lower output of industrial and other equipment. Within industrial equipment, mining and oil and gas machinery continued to recede in response to soft oil prices, and special industrial machinery--which includes semiconductor manufacturing equipment--declined further. The output of farm machinery fell in August as well, because of weakening farm income. One bright spot has been

6. The Beige Book and staff discussions with industry contacts continue to point to reduced exports to Asia and increased foreign competition for a variety of industries. In addition, National Association of Purchasing Management surveys indicate that the percentage of manufacturers reporting declines in export orders minus the percentage reporting increases has been positive and increasing all year.

7. One noteworthy exception is the troubled chemical industry, for which inventory-sales ratios have risen substantially; domestic output of chemicals has dropped only modestly despite a loss of market share to a flood of imports. In contrast, producers in the electrical machinery industry have liquidated inventories since April, as output has not kept pace with thriving demand.

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

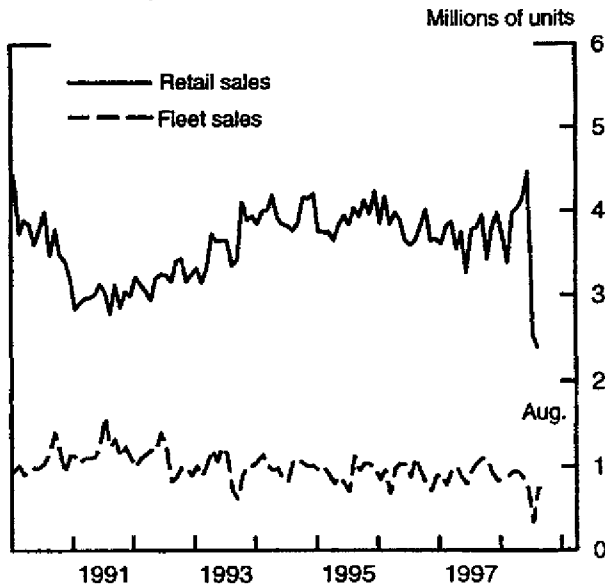
	1996	1997	1997	1998		1998		
			Q4	Q1	Q2	June	July	Aug.
Total	15.0	15.1	15.1	15.1	16.1	16.9	13.8	14.4
Adjusted <sup>1</sup>	15.1	15.0	14.8	15.3	16.0	17.0	13.6	14.6
Autos	8.5	8.3	8.1	8.0	8.4	8.8	7.2	7.8
Light trucks	6.5	6.8	7.0	7.0	7.6	8.1	6.6	6.6
North American <sup>2</sup>	13.3	13.1	13.1	13.1	14.1	14.9	11.7	12.4
Autos	7.3	6.9	6.7	6.6	7.1	7.4	5.8	6.4
Big Three	5.3	4.9	4.7	4.7	5.0	5.3	3.5	4.1
Transplants	2.0	2.0	1.9	1.9	2.0	2.1	2.3	2.4
Light trucks	6.1	6.2	6.5	6.5	7.0	7.5	5.9	6.0
Foreign Produced	1.7	1.9	1.9	1.9	2.0	2.0	2.1	2.0
Autos	1.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Light trucks	.4	.6	.6	.6	.6	.6	.7	.6

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

1. Excludes the estimated effect of automakers' changes in reporting periods.

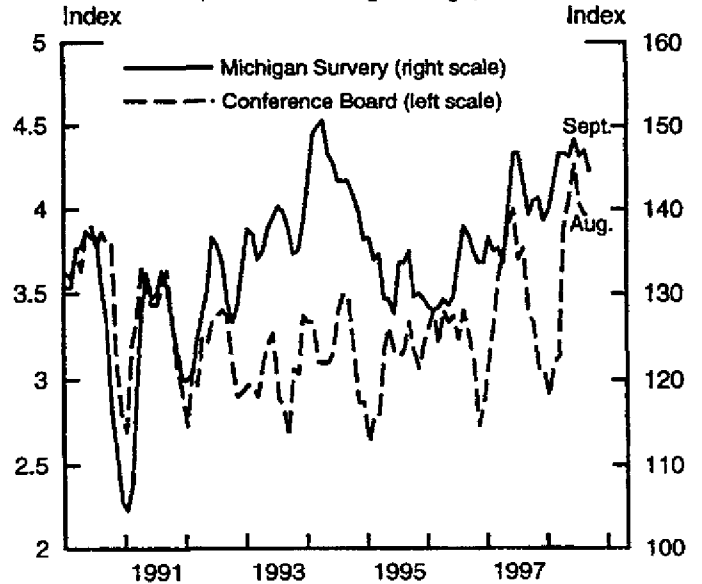
2. Excludes some vehicles produced in Canada that are classified as imports by the industry.

**General Motors' Fleet & Retail Sales**  
(FRB seasonals; annual rate)



Note. Data are confidential. Retail includes consumer leasing.

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





construction equipment, where production has grown sharply this summer, reflecting the strong pace of construction activity.

Within materials, steel production increased in August after declining for five straight months. Nonetheless, steel output remains well below its level earlier this year, and output appears to be weakening substantially in early September. Low-priced imports are now flooding the market, and domestic producers have been forced to slash prices and idle some mills. Semiconductor output increased again, but recent gains lag the pace set last year.<sup>8</sup>

Leading indicators of industrial production are mixed. In August, the index of new orders from the National Association of Purchasing Management survey registered its lowest level in more than two years, with the proportion of companies reporting increased orders barely exceeding the proportion reporting decreased orders. In contrast, the staff's estimate of real adjusted durable goods orders has rebounded recently, advancing more than 4 percent from May to July, and the new orders index from Dun & Bradstreet remains at a high level.

### **Consumption and Personal Income**

The available data suggest that consumer spending has increased considerably this quarter, despite a drop-back in vehicle sales from the elevated level of the spring. We estimate that the level of real personal consumption expenditures in August was about a percentage point above its second-quarter average, not at an annual rate.

Sales of light vehicles were 14.4 million units (annual rate) in August and 13.8 million units in July, well below the elevated pace of about 16 million units in the second quarter. The drop in sales reflects the effects of the expiration of the "coupon" incentive programs offered by the Big Three as well as the recent crippling strikes at General Motors. Despite a quick ramp-up of production following the settlement of the strikes in late July, total retail vehicle sales slipped a bit further in August, as the share of light vehicles going to fleets edged back up toward its recent average and the sparse stocks at GM dealerships limited retail supply. Sales at Ford and the major Japanese firms moved up in August, likely benefiting from GM's woes. Supply constraints at GM are likely to limit sales somewhat for another month or so.

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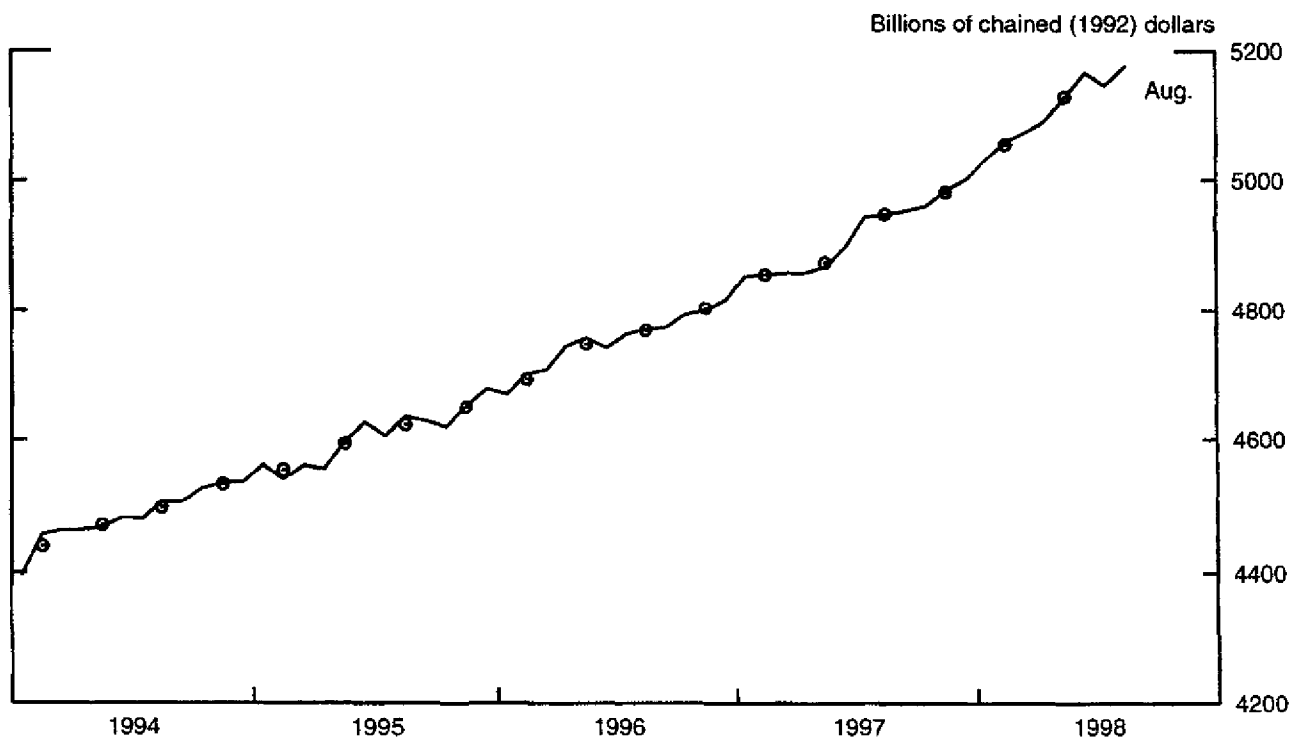
8. Recent news on the semiconductor industry has been mixed. Two Japanese firms recently announced that they were closing semiconductor plants in the United States, and Motorola has halted construction of a plant to be built in Richmond. In contrast, Intel and National Semiconductor announced that orders have picked up lately.

**RETAIL SALES**  
(Percent change from preceding period)

	1998		1998		
	Q1	Q2	June	July	Aug.
Total sales	2.0	1.9	.1	-.6	.2
Previous estimate		1.9	.1	-.4	
Building materials and supplies	5.8	2.3	-1.5	1.3	-.5
Automotive dealers	2.3	3.6	.1	-4.1	-.2
Retail control <sup>1</sup>	1.6	1.3	.3	.6	.4
Previous estimate		1.3	1.0	.4	
GAF <sup>2</sup>	3.6	1.1	.0	.4	.7
Durable goods	3.8	.0	.9	.5	.6
Furniture and appliances	4.7	-.6	1.0	1.2	1.0
Other durable goods	3.1	.6	.8	.0	.3
- Nondurable goods	1.1	1.6	.1	.6	.3
Apparel	4.1	1.1	-.7	1.3	1.2
Food	.2	1.7	.3	.4	.4
General merchandise	3.0	1.8	-.2	-.3	.3
Gasoline stations	-4.7	-.4	-.1	1.7	-.9
Drug stores	2.4	2.3	.4	.7	1.1
Eating and drinking	2.3	1.0	.6	-.3	-.2
Other nondurable goods	.6	4.0	.2	2.6	1.1

1. Total retail sales less sales at building material and supply stores and automotive dealers, except auto and home supply stores.
2. General merchandise, apparel, furniture, and appliance stores.

## Personal Consumption Expenditures



Note. The June, July, August and Q2 numbers are staff estimates.

Looking ahead, the factors affecting near-term sales are more mixed than they were earlier in the year but still, on balance, appear favorable. Although concerns about the economic outlook and the loss of stock market wealth may temper future demand, auto company sources have indicated that September sales got off to a good start, and car-buying attitudes in the preliminary Michigan SRC survey for the month were only a little below their average in the first eight months of the year. Automakers continue to offer attractive pricing: The announced prices of 1999 models are little changed from the 1998 models, and incentives in the fourth quarter are expected to at least match those in the third quarter, as GM's concern about market share has prompted the first significant wave of incentives on 1999 models as well as revised and extended incentives on 1998 models.

Outside of motor vehicles, household spending on goods has advanced at a solid clip so far this quarter. Nominal retail sales in the "control" category, which excludes spending at automotive dealers and building material and supply stores, rose 0.4 percent in August after gaining an upward-revised 0.6 percent in July. Most components of the control total were up in August, with especially large increases at apparel outlets and furniture and appliance stores.

Growth in spending on services likely will considerably outpace that for goods this quarter. Real outlays for services moved up 0.3 percent in July after having risen at a robust 5.2 percent annual rate in the second quarter. Spending on most types of non-energy services posted gains in July, led by another large advance in the recreation category, for which expenditures have been climbing rapidly since the beginning of the year. At the same time, spending on energy services moved down in July: Although the weather was unseasonably warm, it was less so than in June.<sup>9</sup> Looking beyond July, the very high temperatures in August point to a pickup in energy services in that month. In addition, the sharp rise in stock market volume at the end of last month implies at least a modest gain in spending on personal business services in August, to be followed by a more substantial increase in September.<sup>10</sup>

Real disposable income appears to be rising swiftly this quarter. The most recent figures on personal income show a 0.6 percent rise in wages and salaries in July, and the labor market data for August suggest another large increase in that

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9. For consumer spending on energy services, BEA constructs its initial estimates for a given month by comparing the number of heating and cooling degree days with their seasonal norms. The energy estimates are typically revised in the third release of a given month to incorporate data from the Energy Information Administration on actual utility billings.

10. BEA's estimates of the brokerage and investment counseling component of personal business services are based in part on stock market volume.

**REAL PCE SERVICES**  
(Percent change from the preceding period)

	1997	1998		1998		
		Q1	Q2	May	June	July
	Q4/Q4	- Annual rate -		--- Monthly rate ---		
PCE Services	3.8	3.5	5.2	.2	.7	.3
Energy	1.1	-24.2	24.2	1.7	2.6	-1.1
Non-energy	3.9	4.9	4.5	.1	.6	.4
Housing	2.4	2.7	2.2	.2	.3	.2
Household operation	8.7	6.5	5.9	.5	.7	.4
Transportation	5.1	3.7	8.7	-.1	.6	.0
Medical	2.3	3.1	3.3	.3	.2	.2
Recreation	4.8	10.7	8.3	.4	1.5	1.5
Personal business	4.7	6.5	5.7	-.7	.9	.2
Other	6.8	8.2	6.0	.7	1.4	1.1

Note. Derived from billions of chained (1992) dollars.

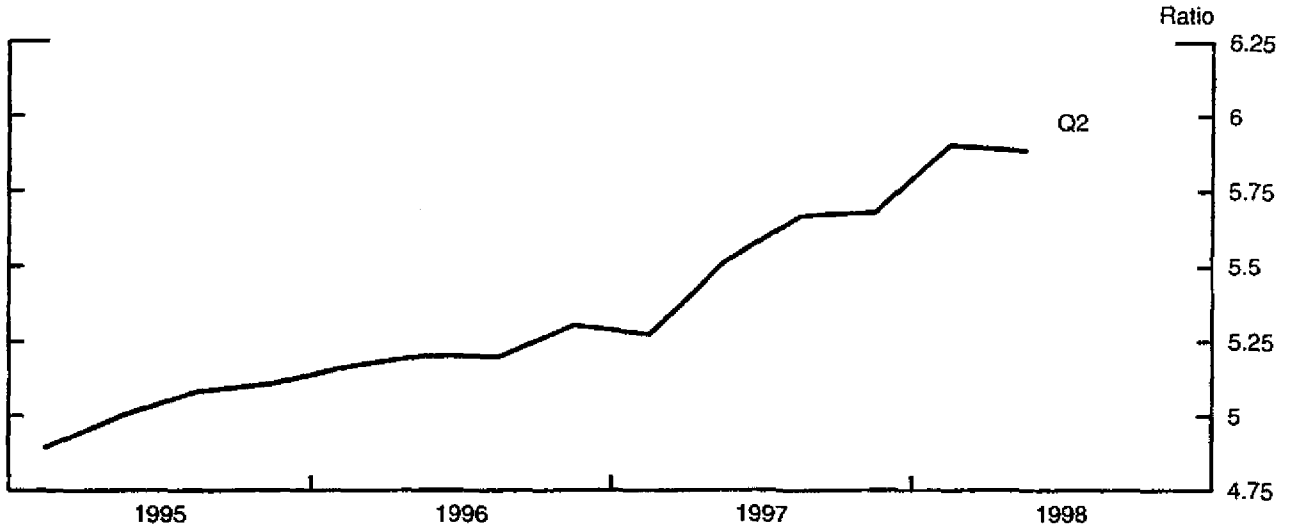
**PERSONAL INCOME**  
(Average monthly percent change)

	1997	1998		1998		
		Q1	Q2	May	June	July
	Q4/Q4	Annual rate		--- Monthly rate ---		
Total personal income	5.4	5.9	4.5	.4	.3	.5
Wages and salaries	7.2	7.4	5.6	.7	.2	.6
Private	7.9	7.9	6.0	.7	.1	.7
Other labor income	2.8	5.9	2.9	.2	.2	.2
Less: Personal tax and nontax payments	11.5	17.1	7.9	1.1	.6	.6
Equals: Disposable personal income	4.4	4.0	3.8	.3	.2	.5
Memo:						
Real disposable income <sup>1</sup>	2.9	4.0	2.9	.1	.2	.3
Saving rate (percent)	2.1	1.2	.6	.5	.1	.8

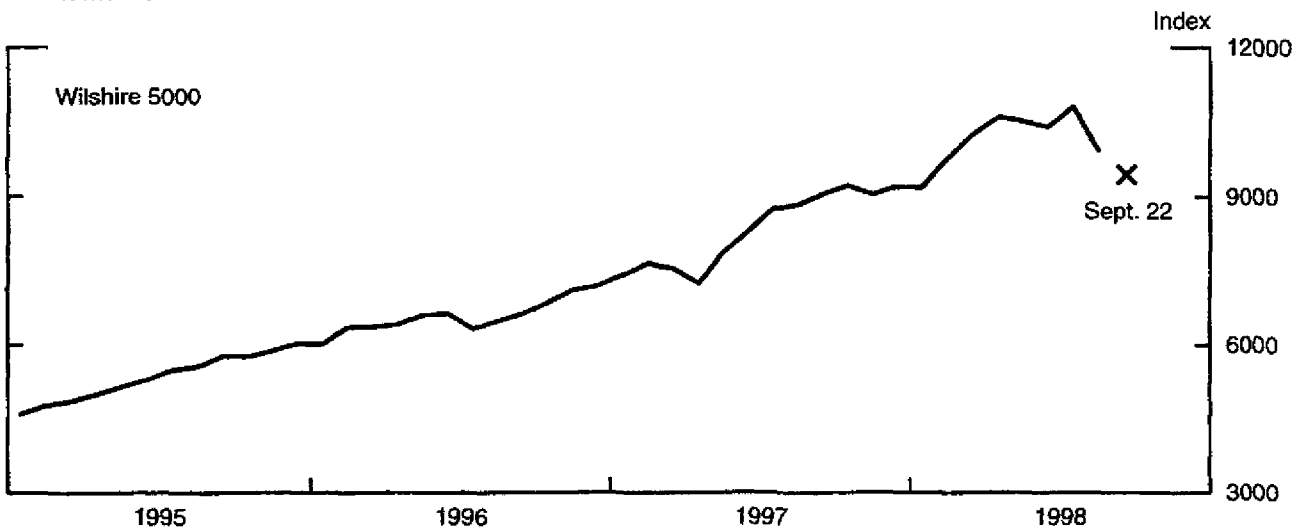
1. Derived from billions of chained (1992) dollars.

## Wealth and Consumer Spending

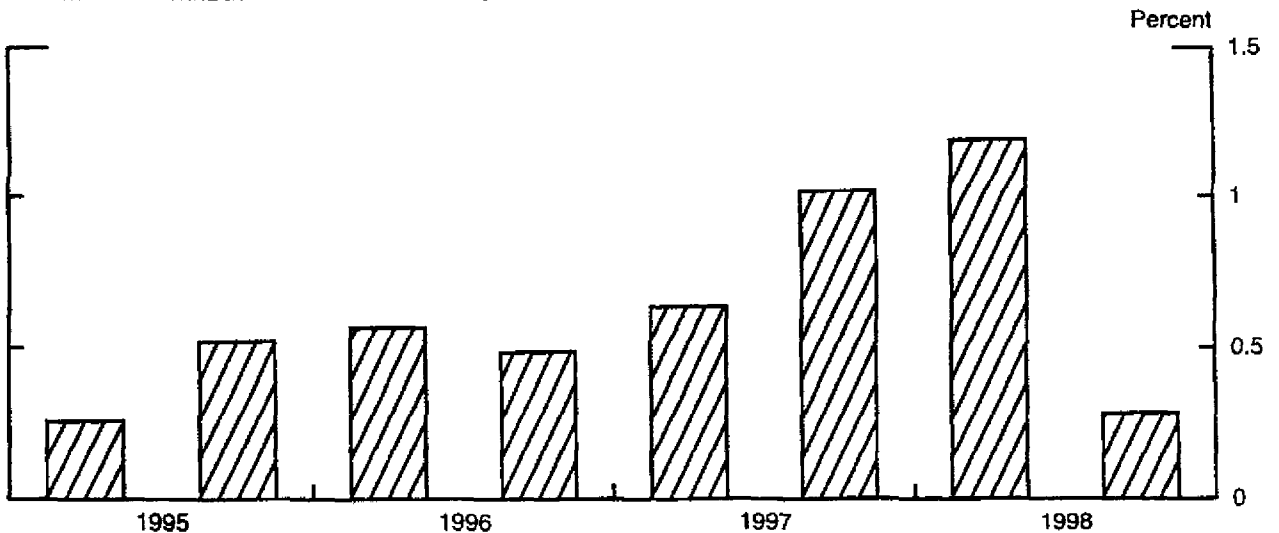
Ratio of Net Worth to Disposable Income



Stock Market



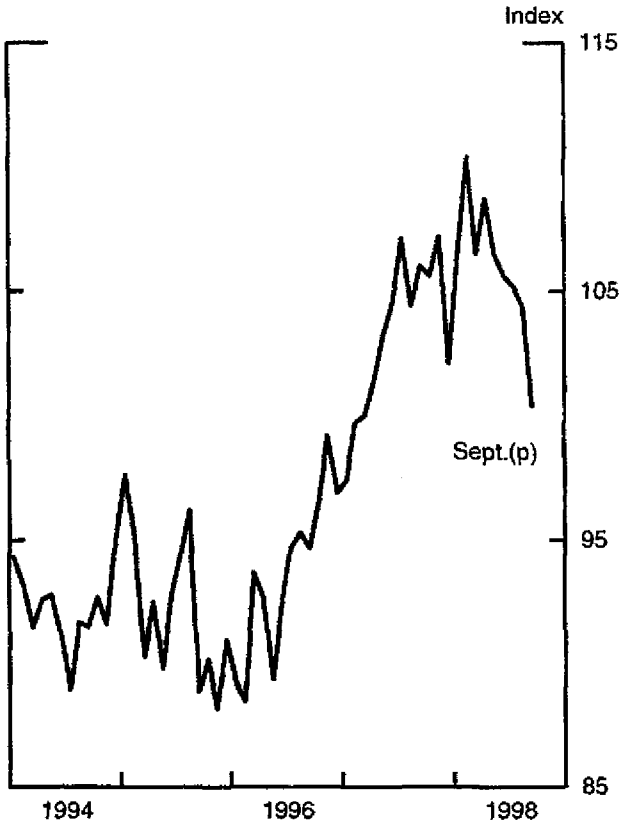
Estimated Contribution of Wealth Effect to PCE Growth



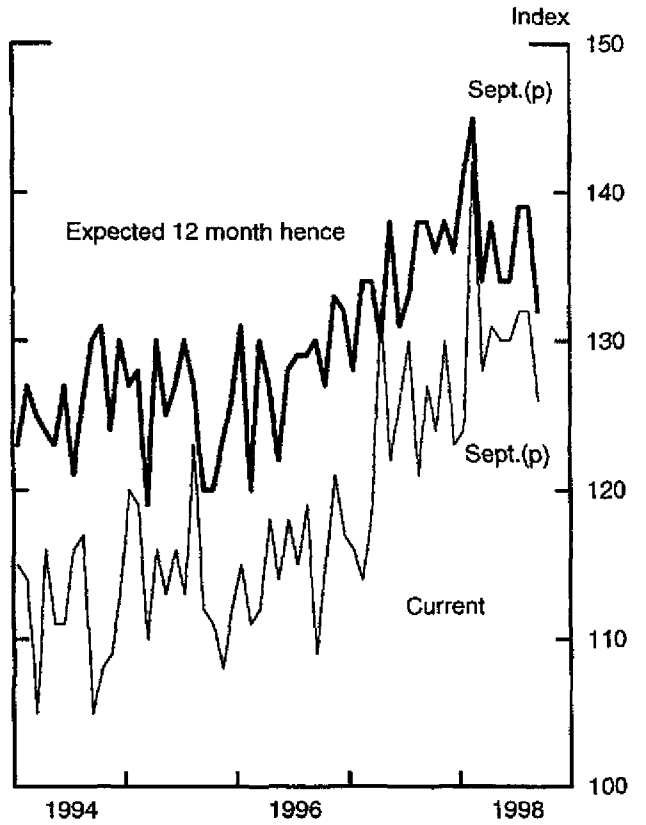
Note. Calculations show the effect on PCE growth relative to baseline in which the wealth-to-income ratio is held constant at its 1994:Q4 value. Calculations also assume that the stock market stays at its current level through the end of the year.

# Michigan Survey

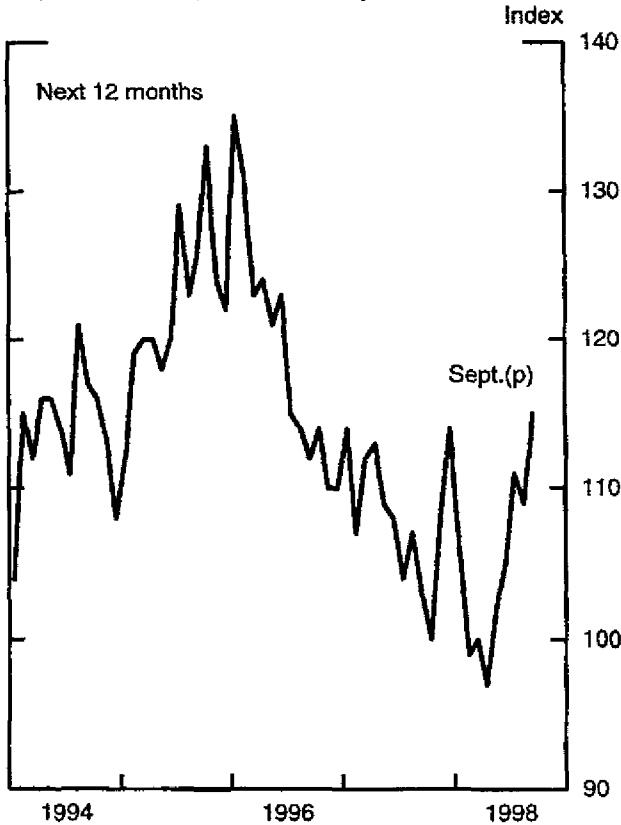
Consumer Sentiment



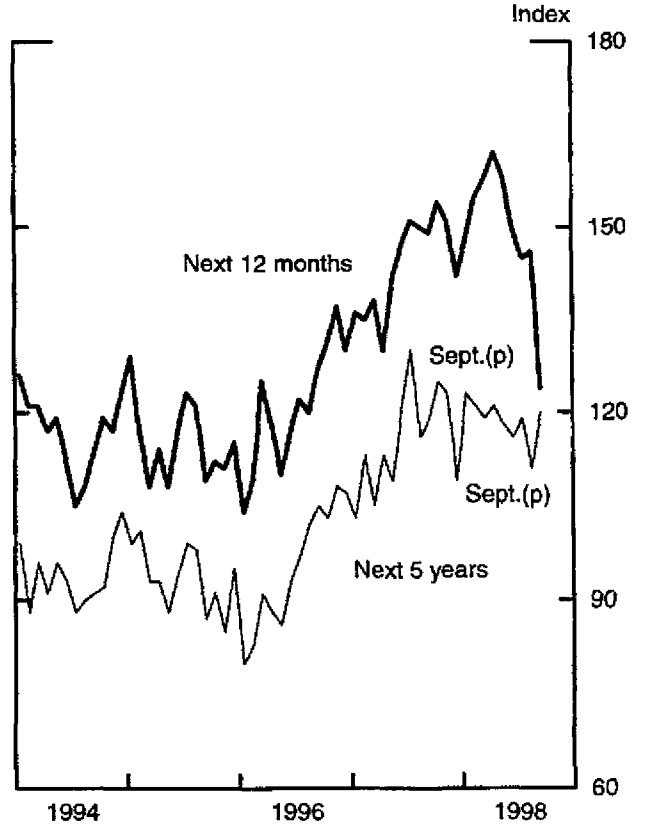
Household Financial Conditions



Expected Change in Unemployment



Expected Business Conditions



month. Outside of labor income, July changes in most components of personal income were in line with those of recent months. With personal income up more than outlays in July, the personal saving rate jumped 0.7 percentage point from June, although at 0.8 percent, it remained extraordinarily low.

During the past few years, the saving rate has dropped roughly 3 percentage points. Over this period, household wealth has soared relative to disposable income. The drop in the stock market since July undoubtedly will cause a noticeable decline in the wealth-income ratio this quarter, but a back-of-the-envelope calculation suggests that--even if the market had stabilized at its record high--the so-called "wealth effect" alone would have caused consumption growth to have fallen roughly 1/4 percentage point in the second half of this year as the lagged effect of past stock price increases dissipated.<sup>11</sup> The recent drop in equity prices will likely result in a more pronounced slowing in consumption growth. Assuming that the stock market stays at its current level (roughly 9500 on the Wilshire 5000), the recent decline in equity values should trim an additional 1/2 percentage point or so off of consumption growth in the second half of 1998, bringing the total decline in the contribution of the wealth effect to consumption growth to a little less than a percentage point.

Households' reactions to recent financial market developments appear to be reflected in Michigan SRC data on consumer sentiment. The overall Michigan index fell noticeably in early September after slipping in August, although the current reading is still at the top of the range that prevailed before the beginning of last year. The decline in the overall index was attributable to markedly less favorable views by households of their current and expected personal financial situations as well as substantially less optimistic expectations of business conditions over the next year. In addition, the index of the expected change in unemployment over the next twelve months moved up sharply. When asked about unfavorable economic news they had heard, survey respondents cited both stock price declines and the widening trade deficit.

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11. The calculation assumes that an additional dollar of stock market wealth leads to a permanent rise in the level of consumption of three cents, with about 60 percent of the adjustment occurring in the first year. Most econometric models produce a marginal propensity to consume out of wealth of between zero and six cents, with the adjustment occurring over several years. The bulk of the estimates fall in the middle of this range, though most are not very precise.

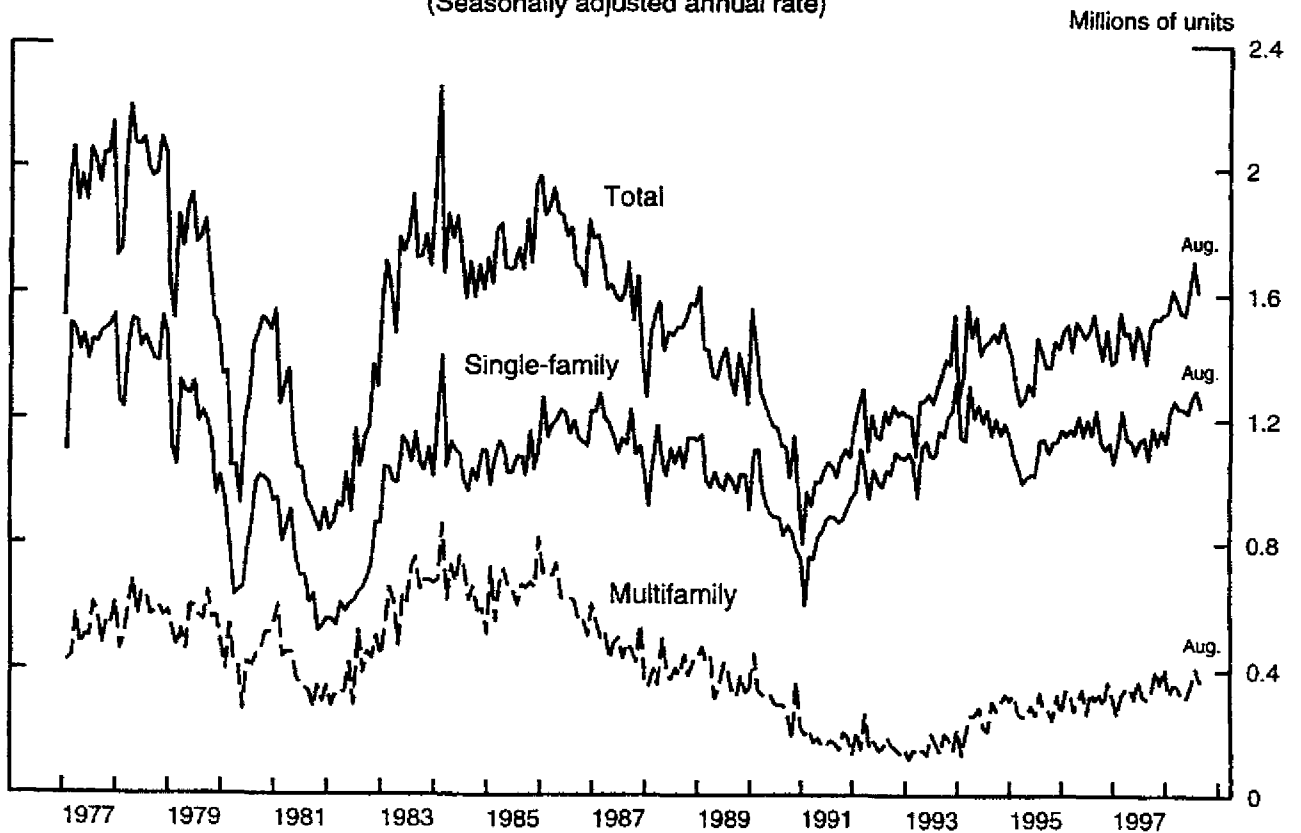
**Private Housing Activity**  
(Millions of units; seasonally adjusted annual rate)

	1997		1998				
	1997	Q4	Q1	Q2 <sup>r</sup>	June <sup>r</sup>	July <sup>r</sup>	Aug. <sup>p</sup>
<i>All units</i>							
Starts	1.47	1.53	1.58	1.57	1.62	1.71	1.61
Permits	1.44	1.48	1.59	1.53	1.52	1.58	1.62
<i>Single-family units</i>							
Starts	1.13	1.14	1.24	1.24	1.27	1.30	1.25
Permits	1.06	1.10	1.15	1.14	1.13	1.17	1.17
Adjusted permits <sup>1</sup>	1.14	1.18	1.24	1.23	1.23	1.26	1.25
New home sales	.80	.83	.86	.89	.90	.89	n.a.
Existing home sales	4.22	4.38	4.68	4.78	4.74	4.93	n.a.
<i>Multifamily units</i>							
Starts	.34	.39	.34	.33	.35	.41	.37
Permits	.39	.38	.44	.38	.39	.41	.44
<i>Mobile homes</i>							
Shipments	.35	.35	.37	.37	.36	.36	n.a.

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

1. Adjusted permits equals permit issuance plus total starts outside of permit-issuing areas, minus a correction for those starts in permit-issuing places that lack a permit.

**Private Housing Starts**  
(Seasonally adjusted annual rate)





### Housing Markets

Demand for single-family homes has been robust so far this year, and the most recent data indicate that activity has stayed at a high level. Starts of single-family homes were at a 1.25 million unit annual rate in August, similar to the average posted during the first seven months of the year. In July, sales of new single-family homes were at an 886,000 unit pace, slightly higher than in the first half. Sales of existing homes--which are a lagging indicator of housing demand because they are recorded mainly at closings--came in at a 4.93 million unit rate in July, more than 4 percent above the first-half pace.

Indicators of near-term housing demand continue to be quite favorable: The thirty-year, fixed mortgage rate, which has been under 7 percent since last spring, has edged down further in recent weeks. Builders' assessments of current sales conditions, which reached a record high in July, have eased only slightly during the past two months. Mortgage applications for home purchase have been strong all year, and the MBA index of loan applications set another new high in mid-September. Consumers' assessments of home-buying conditions, which posted an all-time high in April, have receded in recent months but remain at a very favorable level by historical standards.

Affordability for existing homes, as measured by an index calculated by the National Association of Realtors, increased sharply in the latter part of 1997 and during the first two months of this year, owing mainly to a decline in the thirty-year, fixed mortgage rate. Although it remains at an historically high level, this affordability index has slipped during the past six months. Rates drifted a bit lower during that period, but price increases for existing homes outpaced gains in median household income. By contrast, new home affordability, a measure constructed by the staff, has continued to improve in recent months, primarily reflecting the more moderate rate of increase in the median price of new homes.<sup>12</sup>

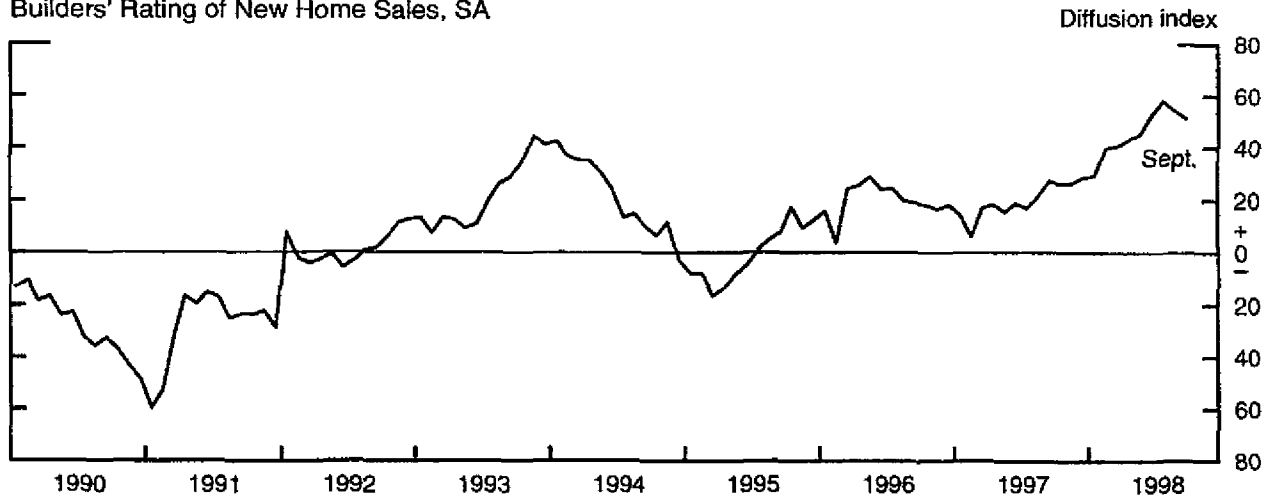
Multifamily starts, which are highly volatile on a monthly basis, jumped to 407,000 units at an annual rate in July but fell back to 368,000 units in August. The July-August average for these starts was almost 17 percent above the first-half average. Multifamily permits rose 8-1/2 percent last month, and the permit backlog edged up. Other indicators of market conditions in the multifamily sector are mixed. The vacancy rate for these units, a highly volatile measure, rose to 9.4 percent in the second quarter, about 1/4 percentage point above its year-earlier reading and the highest rate since mid-1996. Still, real rents for apartments have been rising at about

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12. This index is based on the same formula as the NAR index for the affordability of existing homes.

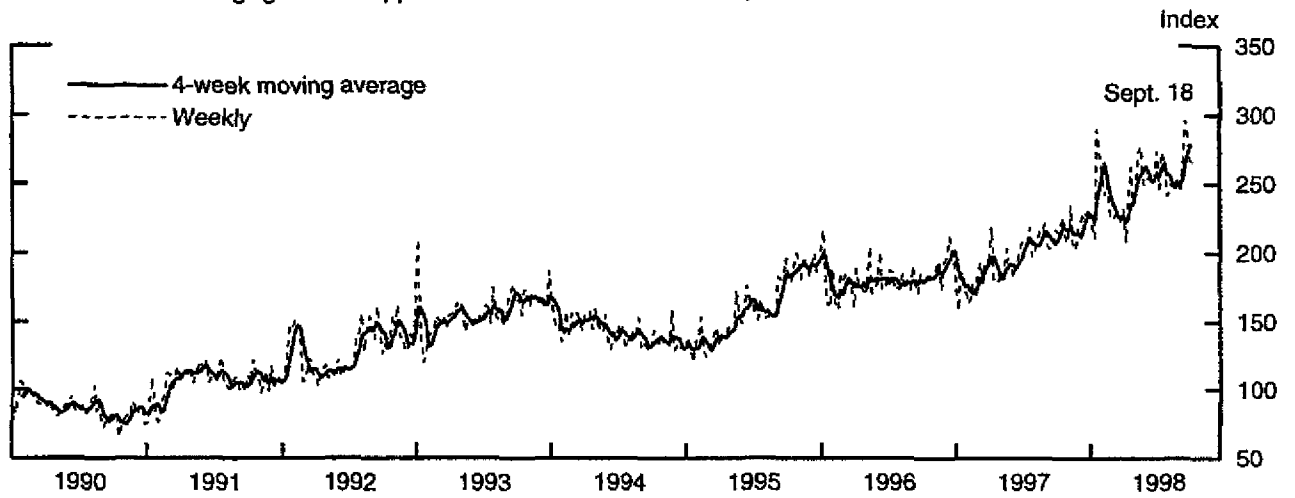
## Indicators of Housing Demand

Builders' Rating of New Home Sales, SA

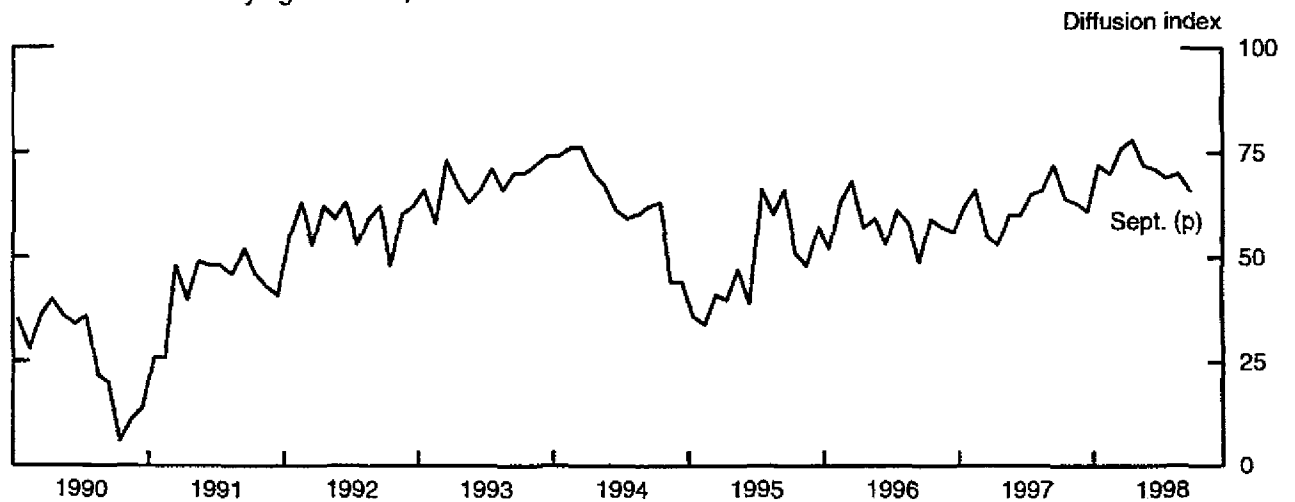


Note. The index is calculated from National Association of Homebuilders data as the proportion of respondents rating current sales as good minus the proportion rating them as poor.

MBA Index of Mortgage Loan Applications for Home Purchase, SA



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.

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

	1998		1998		
	Q1	Q2	May	June	July
<u>Producers' durable equipment</u>					
Shipments of nondefense capital goods	4.6	1.4	.1	3.6	-2.5
Excluding aircraft and parts	3.7	1.6	-.1	4.7	-2.5
Office and computing	9.5	4.7	-3.7	7.4	.1
Communications equipment	4.4	.8	4.3	4.8	-11.3
All other categories	1.4	.6	.4	3.6	-1.3
Shipments of complete aircraft	37.1	-12.6	24.6	-10.6	40.9
Sales of heavy trucks	3.1	4.7	1.1	-6.7	9.2
Orders for nondefense capital goods	-1.9	-.1	-.8	.4	-.8
Excluding aircraft and parts	4.2	-.9	1.2	3.2	-1.8
Office and computing	12.1	4.3	-2.5	7.3	-.6
Communications equipment	21.8	-4.9	19.2	-5.7	-14.8
All other categories	-2.5	-1.8	-1.8	4.1	1.2
<u>Nonresidential structures</u>					
Construction put in place, buildings	.8	.8	-1.8	1.1	-1.2
Office	2.5	7.0	1.3	7.1	-7.9
Other commercial	.5	.1	-.3	-.8	5.5
Institutional	.8	-3.3	-3.9	-4.3	-1.4
Industrial	3.0	-3.0	-5.8	.3	-4.0
Lodging and miscellaneous	-4.2	3.2	-1.6	3.6	-.1
Rotary drilling rigs in use <sup>1</sup>	8.1	-11.9	-4.6	-3.2	-5.1
Memo (1992 Chained dollars):					
Business fixed investment	22.2	12.6	n.a.	n.a.	n.a.
Producers' durable equipment	34.3	18.1	n.a.	n.a.	n.a.
Office and computing	101.5	58.9	n.a.	n.a.	n.a.
Communications equipment	35.9	9.5	n.a.	n.a.	n.a.
Other equipment <sup>2</sup>	13.2	7.8	n.a.	n.a.	n.a.
Nonresidential structures	-4.9	-1.6	n.a.	n.a.	n.a.

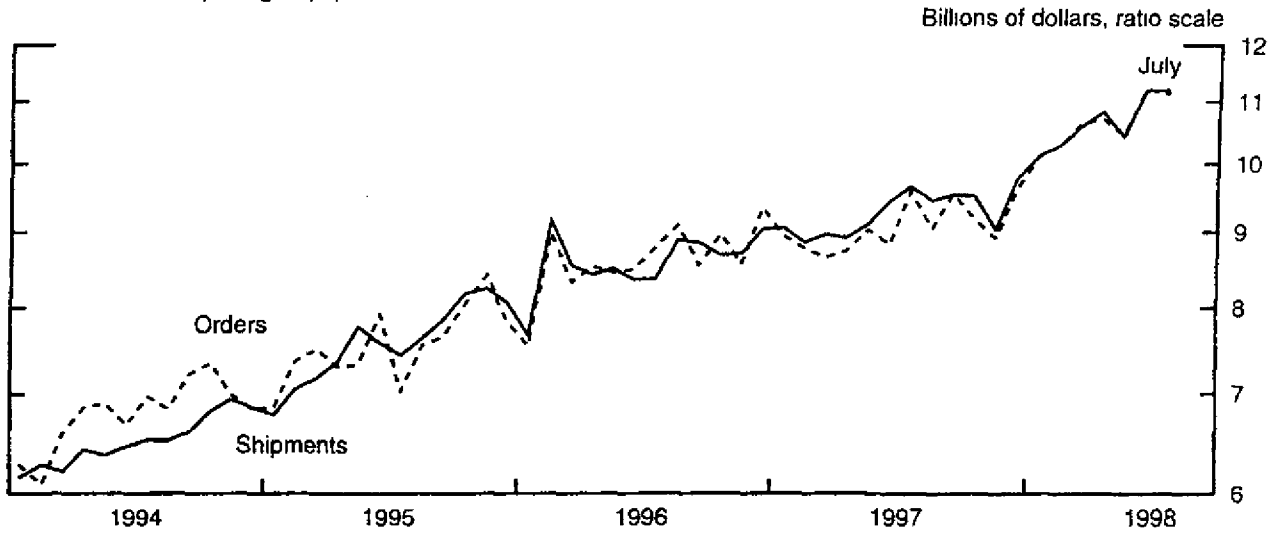
1. Percent change of number of rigs in use, seasonally adjusted.

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

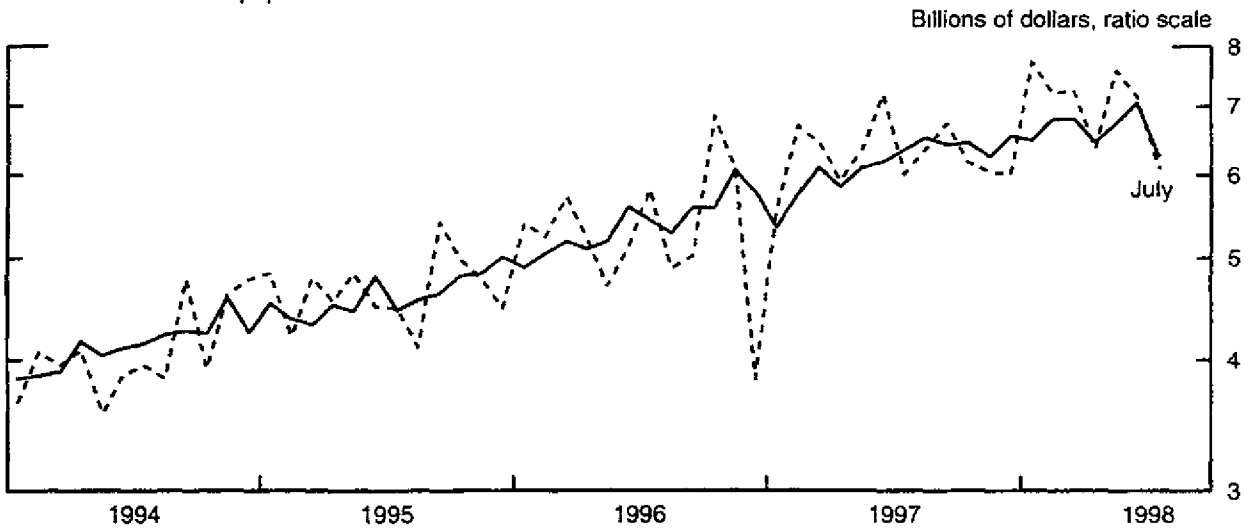
n.a. Not available.

## Orders and Shipments of Nondefense Capital Goods

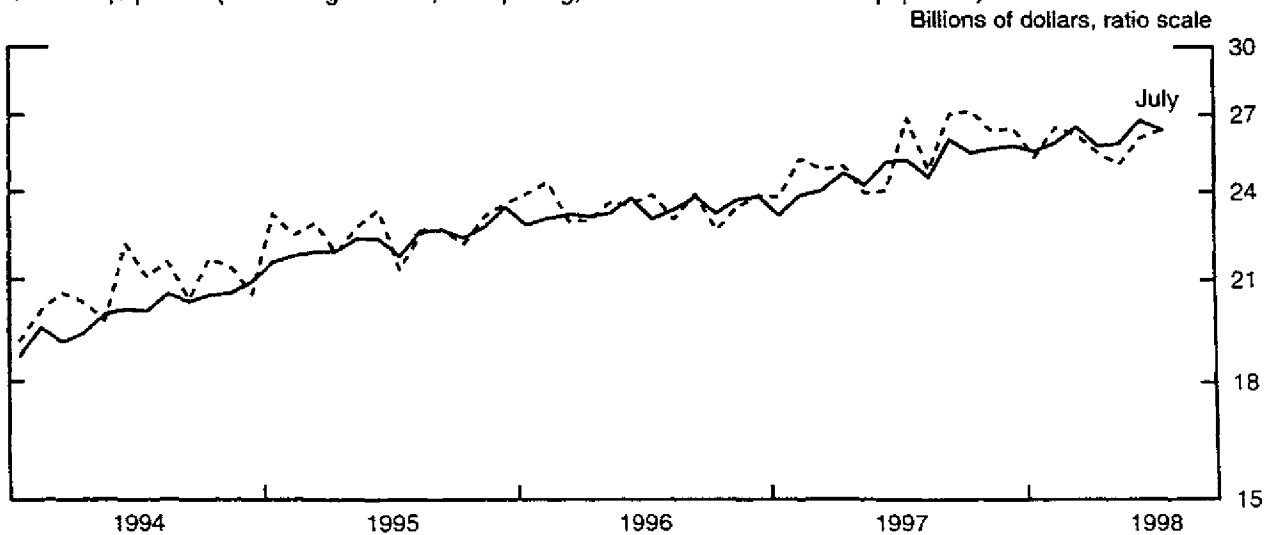
Office and Computing Equipment



Communications Equipment



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



a 1-1/2 percent annual rate recently, in contrast to the average annual decline of 1/2 percent from 1990 to 1996.<sup>13</sup>

### **Business Fixed Investment**

After a blistering first half, growth in real business fixed investment appears set for a pause in the current quarter. The slowing in large measure reflects the effects of the GM strikes: Supply shortages created by the strikes led to a substantial reduction in fleet sales over the summer and curtailed consumer leasing, which is counted as spending on producers' durable equipment in the national accounts. Outside of light motor vehicles, however, business spending on equipment likely has continued to rise.

In the high-tech sector, computer prices have continued to fall rapidly: Although the inventory adjustment that drove price-cutting over the first half of the year appears to be over, technological change and falling prices of components have fueled further large price declines. The PPI for computing equipment, which is hedonically adjusted to account for product improvements, fell 4-1/2 percent in August alone, driven by a record 13 percent drop in the price of personal computers. Despite these ongoing price declines, nominal shipments of computing equipment have held up well; they were unchanged in July following a 7-1/2 percent increase in June. Thus, real expenditures on office and computing equipment appear poised for another huge gain in the current quarter.

Orders and shipments of communications equipment, which have been increasingly erratic in the past two years, plummeted in July. However, a number of factors suggest that shipments for this category may bounce back at least somewhat in the coming months. These factors include a sizable backlog of unfilled orders, further expansion of the Internet, and fiber optic upgrades for cable systems.

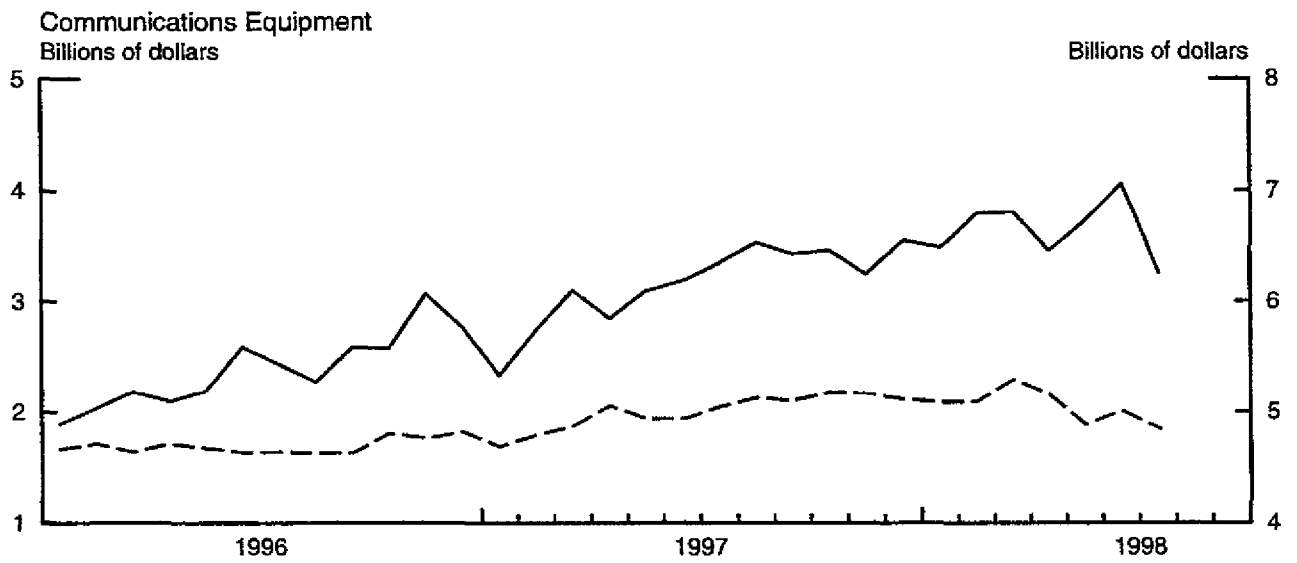
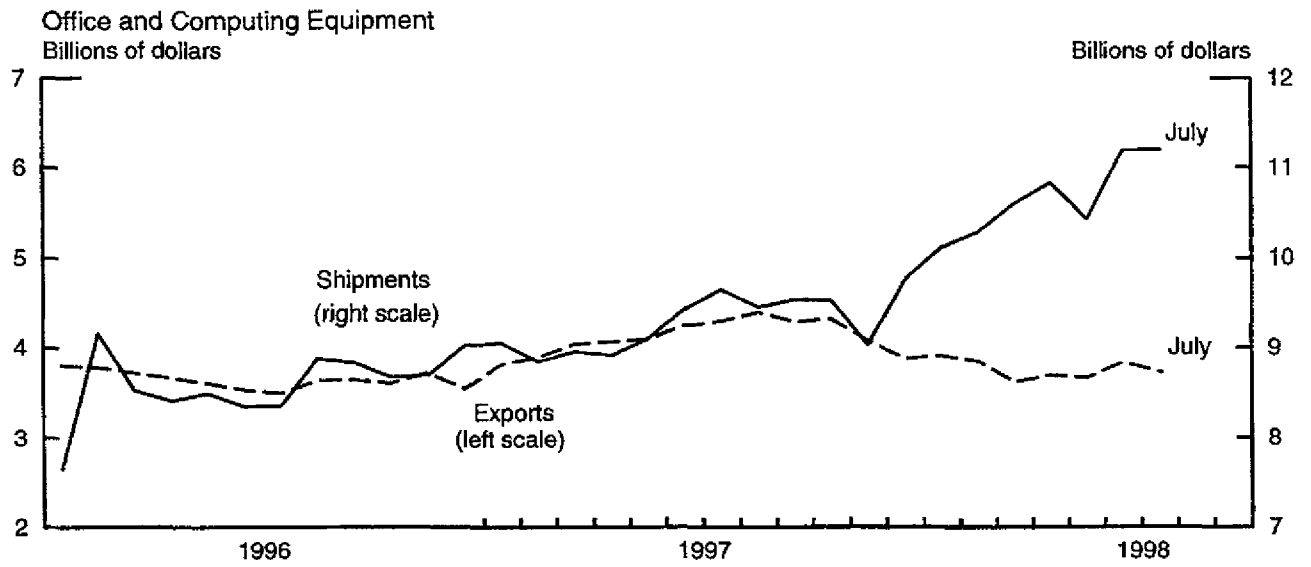
Sales of medium and heavy trucks rose sharply further in August, reaching an annual rate of 546,000 units. So far this quarter, sales are running substantially above the second-quarter pace. Even so, backlogs moved higher last month, suggesting that the near-term outlook is still favorable.

Excluding transportation and high-tech equipment, orders and shipments have picked up in recent months. After having fallen earlier in the year, orders posted strong gains in June and July. Moreover, the July level of shipments in this category, though off somewhat from June's, still stood 1.2 percent above the second-quarter average.

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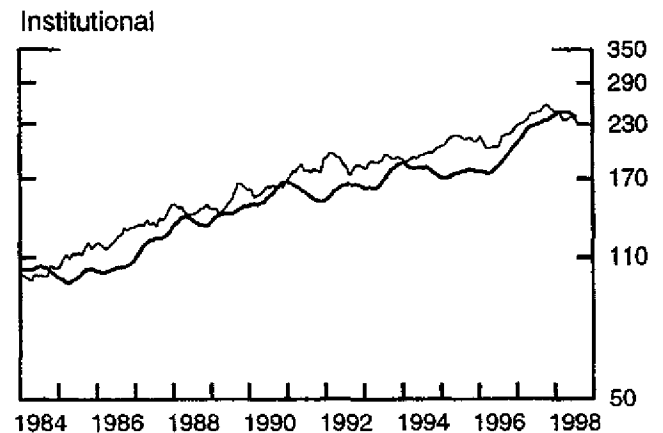
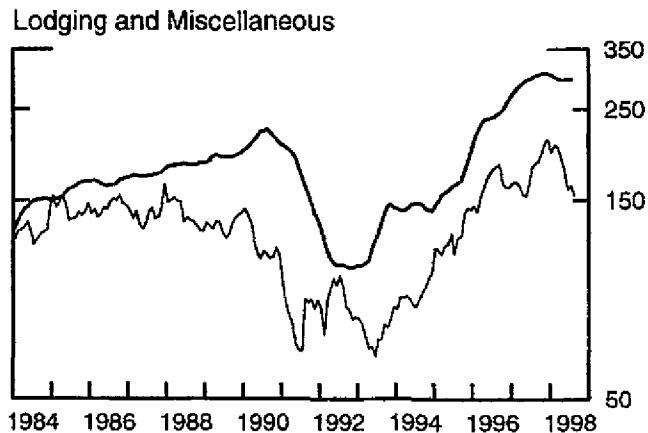
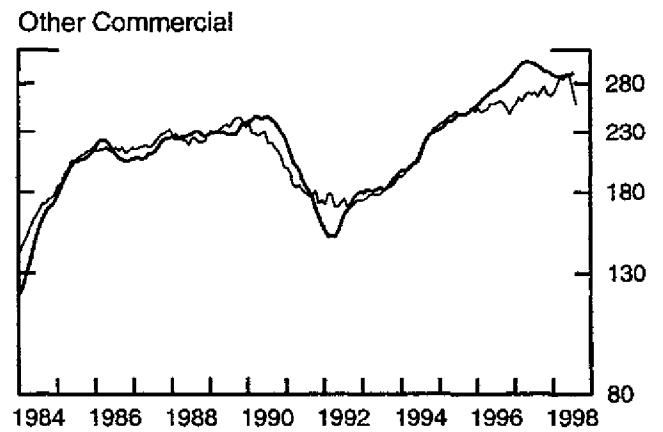
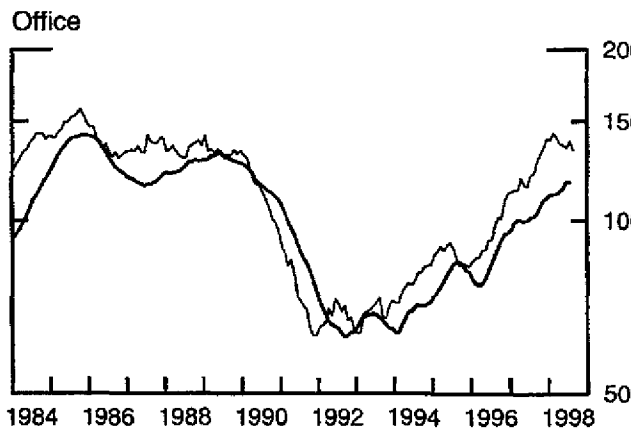
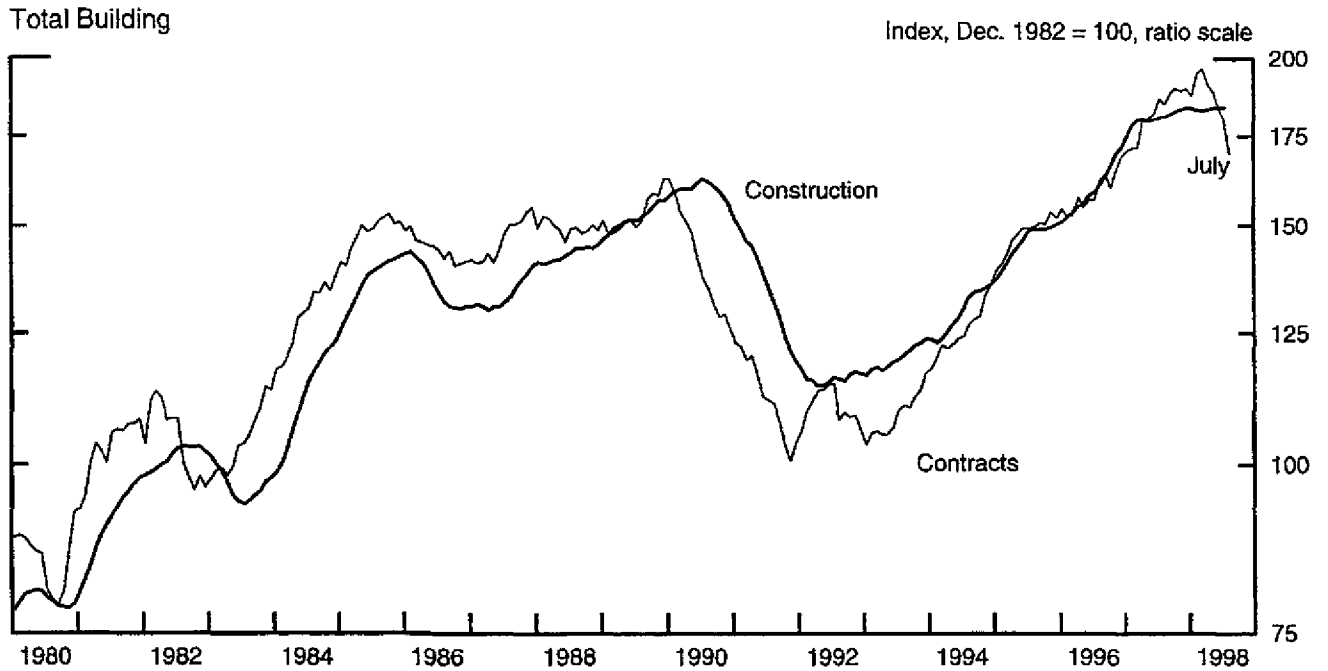
13. Real rents are computed by dividing the CPI for rent of shelter by the total CPI.

## Exports and Shipments of Nondefense Capital Goods



## Nonresidential Construction and Contracts

(Six-month moving average)



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

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

	1997	1998		1998		
	Q4	Q1	Q2	May	June	July
<u>Book value basis</u>						
Total	39.8	62.7	7.0	-6.4	5.9	2.2
Excluding wholesale and retail motor vehicles	40.2	55.3	35.0	23.9	44.3	23.4
Manufacturing	15.6	23.3	19.0	12.7	11.7	16.3
Excluding aircraft	15.0	19.2	6.9	6.9	1.9	9.9
Wholesale	18.1	17.3	-.4	21.2	-2.2	-7.4
Excluding motor vehicles	19.5	11.5	10.9	28.9	6.3	.1
Retail	6.0	22.1	-11.5	-40.3	-3.6	-6.7
Auto dealers	.9	1.6	-16.6	-22.6	-29.9	-13.7
Excluding auto dealers	5.1	20.5	5.0	-17.7	26.3	7.0

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

	Cyclical reference points		Range over preceding 12 months		July 1998
	1990-91 high	1995-96 low	High	Low	
Manufacturing and trade	1.58	1.38	1.39	1.37	1.38
Less wholesale and retail motor vehicles	1.55	1.35	1.36	1.34	1.37
Manufacturing	1.75	1.38	1.40	1.36	1.40
Primary metals	2.08	1.49	1.64	1.53	1.65
Nonelectrical machinery	2.48	1.77	1.75	1.61	1.61
Electrical machinery	2.08	1.41	1.39	1.30	1.31
Transportation equipment	2.93	1.51	1.83	1.57	1.88
Motor vehicles	.97	.56	.64	.54	.64
Aircraft	5.84	4.44	5.12	4.34	4.97
Nondefense capital goods	3.09	2.27	2.33	2.12	2.20
Textiles	1.71	1.42	1.54	1.40	1.49
Chemicals	1.44	1.25	1.41	1.30	1.41
Petroleum	.94	.80	.89	.83	.90
Home goods & apparel	1.96	1.63	1.69	1.59	1.62
Merchant wholesalers	1.36	1.26	1.30	1.26	1.29
Less motor vehicles	1.31	1.22	1.28	1.23	1.28
Durable goods	1.83	1.55	1.62	1.56	1.58
Nondurable goods	.95	.91	.96	.92	.96
Retail trade	1.61	1.50	1.50	1.45	1.45
Less automotive dealers	1.48	1.43	1.42	1.40	1.40
Automotive dealers	2.22	1.69	1.77	1.56	1.60
General merchandise	2.42	2.20	2.11	2.00	2.03
Apparel	2.53	2.27	2.45	2.32	2.42
GAF	2.42	2.23	2.15	2.06	2.08



Domestic demand for capital equipment has been considerably stronger this year than might be suggested by a literal reading of the data on orders and shipments alone. Trade flows loom large in the capital goods sector, and weak demand from abroad has appreciably held down shipments by U.S. producers in recent quarters. Between October 1997 and July 1998, exports of computing equipment declined 14 percent, exports of communications equipment declined 15 percent, and exports of capital goods excluding high-tech and transportation equipment fell 7 percent. Over the same period, computer shipments rose 18 percent, shipments excluding high-tech and transportation equipment rose 3-1/2 percent, and shipments of communications equipment fell only 3 percent, despite the sharp decline in July.<sup>14</sup> That total shipments have continued to grow despite the substantial negative external shock from abroad is an indication of robust domestic demand.

Nonresidential construction activity has remained sluggish overall. Ample capacity in the factory sector has put construction of industrial buildings on a downward trend since early 1997. Construction of retail and lodging buildings has been flat so far this year. The one bright spot has been the office sector, in which outlays have been on a strong uptrend for the past two years or so. Contracts for construction, an important leading indicator, have weakened significantly this year, even for the office sector. Furthermore, available financing for commercial real estate, such as real estate investment trusts and commercial mortgage-backed securities, has tightened considerably recently. These indicators suggest that a pickup from the sluggish growth in nonresidential building activity remains unlikely in the near future.

### **Business Inventories**

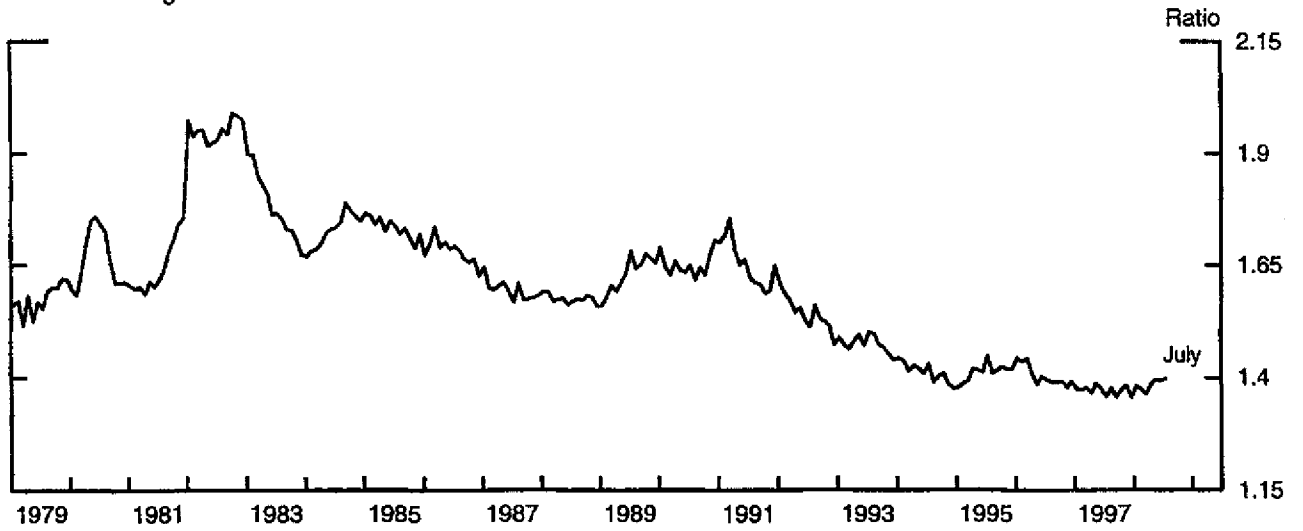
After declining sharply in the second quarter, investment in business inventories fell off further in July. For manufacturing and trade excluding motor vehicles, the book value of inventories rose at a \$23 billion annual rate in July, continuing the downshift in the pace of stockbuilding from the first-quarter bulge. The latest figure translates into a 2-1/2 percent annual rate of growth in the book value of non-auto stocks. Inventory-sales ratios remain moderate on the whole.

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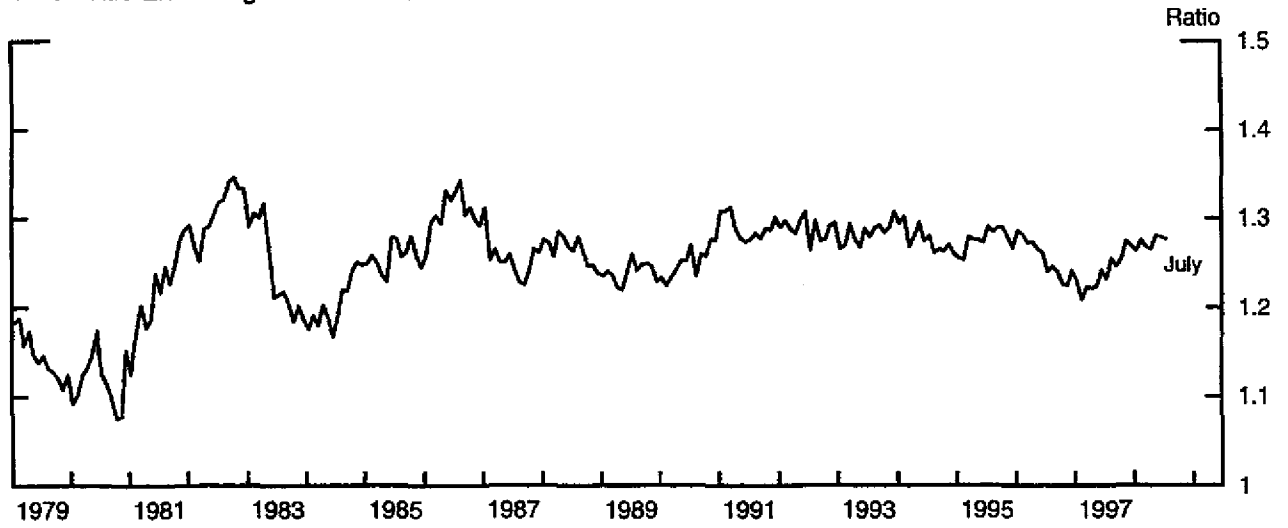
14. Over the October-to-July period, the ratio of exports to shipments fell from 45 percent to 33 percent for computers, from 37 percent to 29 percent for communications equipment, and from 49 percent to 44 percent for equipment excluding high-tech and transportation. Some caveats are required in interpreting these ratios. For computers, parts account for a high proportion of exports. Such shipments are not counted as final demand and thus do not affect expenditures on producers' durable equipment in the national accounts. Also, the definition of the "other equipment" category in the orders and shipments (M-3) release differs slightly from the definition in the merchandise trade report.

### Inventory-Sales Ratios, by Major Sector (Book value)

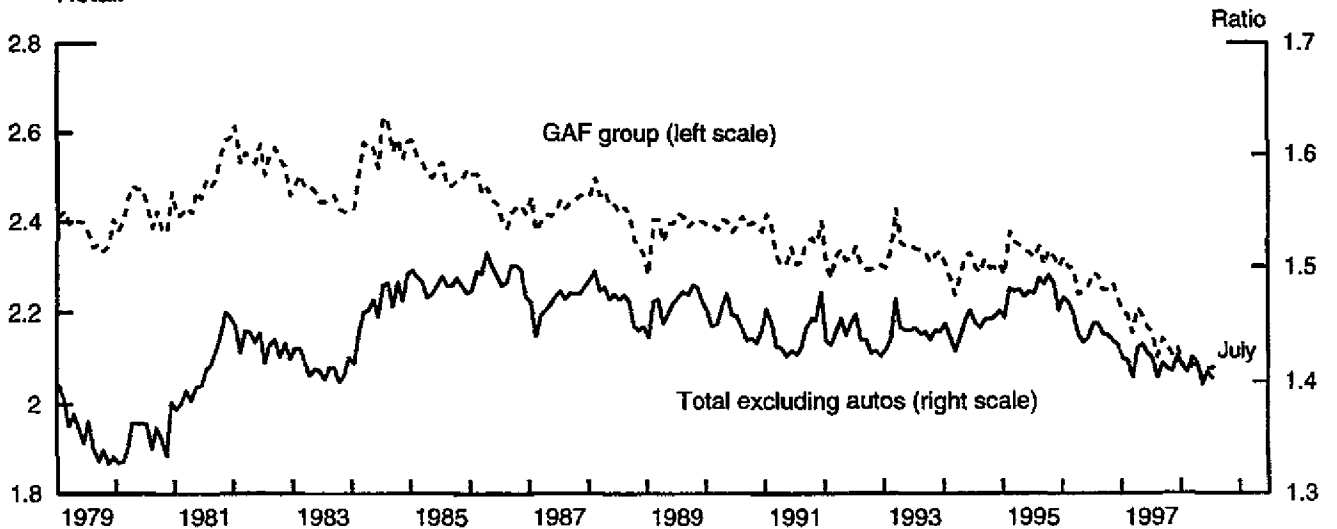
Manufacturing



Wholesale Excluding Motor Vehicles



Retail



In manufacturing, inventories increased at a \$16 billion annual rate in July, just off the second-quarter pace. As in the spring, an above-average share of the July buildup was in stocks of aircraft and parts. Rising inventories of aircraft parts and partially completed airplanes are a natural consequence of the increased production rates at Boeing. However, finished aircraft are also being stockpiled, as Boeing has not yet acquired the legal rights to divert some planes earmarked for struggling Asian airlines to other carriers. Outside of aircraft, manufacturers' inventories grew at a \$10 billion pace in July.

The book value of wholesale inventories excluding motor vehicles was little changed in July after an appreciable buildup in the first half of the year. A slight increase in inventories at distributors of nondurable goods, mainly chemicals and farm products, was offset by a small net drawdown in stocks held by durable goods wholesalers. The latter was led by a further decline in inventories at professional and commercial equipment wholesalers, a category that includes computer distributors. Although much of this decline likely stems from efforts of computer makers to move toward direct delivery of PCs--as indicated by the lowest inventory-sales ratio on record in this category--some of the decrease might also reflect the recent steep drop in PC prices.

In retail trade, book-value inventories dropped again in July, reflecting the sharp decline in stocks at automotive dealerships. Excluding autos, retail inventories rose at a moderate rate, a touch above the pace of accumulation in the second quarter. The buildup was led by a sizable increase in stocks held by furniture and appliance stores. Most other categories registered small positive changes in inventories.

### **Federal Government**

With one month left in the fiscal year, the federal government clearly will post its first unified budget surplus since 1969 and its largest surplus as a share of GDP since 1957. This favorable outcome is the result of a meager increase in outlays and a huge rise in receipts.

Total outlays fell in July and August relative to a year earlier owing in part to the timing of payments for several programs. After adjusting for the timing shifts and excluding deposit insurance outlays and spectrum auction proceeds, spending was 0.2 percent higher than a year earlier. Medicare has been an important contributor to the slowing of outlays: Spending for the program over the twelve months ending in August was only 1.6 percent above the previous twelve months--one of the smallest increases in its history, in part reflecting the cost-containment actions taken in last

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

	July-August			12 months ending in Aug.		
	1997	1998	Percent change	1997	1998	Percent change
<b>Outlays</b>	273.5	266.7	-2.5	1598.5	1633.5	2.2
Deposit insurance	-1.1	-1.0	n.a.	-14.6	-4.4	n.a.
Spectrum auction	-0.7	-0.4	n.a.	-11.1	-1.2	n.a.
Other	275.3	268.1	-2.6	1624.3	1639.1	0.9
<b>Receipts</b>	212.7	231.5	8.8	1561.9	1715.2	9.8
<b>Surplus (+)/deficit (-)</b>	-60.8	-35.3	n.a.	-36.6	81.8	n.a.
<b>Adjusted for payment timing shifts<sup>1</sup> and excluding deposit insurance and spectrum auction</b>						
<b>Outlays</b>	267.7	268.1	0.2	1624.0	1646.7	1.4
National defense	45.6	44.4	-2.7	271.5	269.0	-0.9
Net interest	42.7	42.2	-1.2	246.1	244.4	-0.7
Social security	61.1	63.1	3.3	364.0	377.9	3.8
Medicare	33.6	32.2	-4.1	189.1	192.2	1.6
Medicaid	15.1	16.6	9.7	94.4	101.4	7.5
Other health	4.7	5.1	9.1	28.4	29.1	2.2
Income security	35.5	35.5	-0.1	230.9	231.5	0.3
Other	29.3	29.0	-1.1	199.6	201.2	0.8
<b>Receipts</b>	212.7	231.5	8.8	1561.9	1715.2	9.8
Individual income and payroll taxes	178.7	196.5	9.9	1226.1	1356.0	10.6
Withheld + FICA	173.1	190.5	10.1	1046.2	1144.9	9.4
Nonwithheld + SECA	9.3	10.0	7.8	272.5	310.3	13.9
Refunds (-)	3.7	4.0	9.9	92.6	99.2	7.2
Corporate	6.0	5.5	-7.4	180.1	189.2	5.1
Other	28.0	29.4	5.3	155.7	170.0	9.2
<b>Surplus (+)/deficit (-)</b>	-55.0	-36.6	n.a.	-62.2	68.5	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

year's Balanced Budget Act. Other prominent areas of spending restraint were defense, net interest (reflecting lower interest rates and the reduction in publicly held debt), and income security payments (reflecting the reductions in caseloads for means-tested public assistance programs).

Receipts in July and August were 9 percent higher than a year earlier as receipts of individual income taxes continued to rise more rapidly than the NIPA-based estimates of the underlying tax base (which excludes capital gains). Receipts were held down in August by weak excise tax collections attributable to a delay in payments allowed under last year's Balanced Budget Act.<sup>15</sup>

Congress has yet to complete action on the fiscal 1999 budget. The budget resolution has not been completed owing to disagreements over the extent to which last year's budget agreement should be modified to accommodate tax cuts and spending increases. The House is considering a tax bill that would reduce receipts by \$6 billion in fiscal 1999 and by roughly \$18 billion per year over the succeeding four years. Proposals to boost spending on agriculture, Y2K-related problems, embassy security, and defense are also under consideration, but no decision has been made whether to treat them as emergency measures, and thus raise overall spending, or to require offsets in other programs. As of September 22, only one of the thirteen regular appropriations bills had been sent to the President, and a short-term continuing resolution had been passed to fund the government when the new fiscal year begins October 1.

### **State and Local Governments**

Indicators of real spending by state and local governments so far in the third quarter have been mixed, with employment up and construction down. State and local employment rose substantially in August, adding to a modest increase in July. The bulk of the hiring in August was at local governments, particularly at school districts, for which the increase appears to reflect earlier starting dates for many schools; according to BLS, this trend has been apparent for about five years.<sup>16</sup> Real construction expenditures by state and local governments fell 1-1/2 percent at a

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15. Excise taxes totaled only \$3 billion in August, about half the level recorded in July. The Balanced Budget Act included provisions allowing a delay in payment of certain excise taxes due in August and September until October.

16. Most of these employees are not teachers, who typically choose to be paid on a year-round basis and, hence, are on the payrolls in the summer.

CPI AND PPI INFLATION RATES  
(Percent change)

	From twelve months earlier		1998		1998	
	Aug. 1997	Aug. 1998	Q1	Q2	July	Aug.
			-Annual rate-		-Monthly rate-	
<u>CPI</u>						
All items (100.0) <sup>1</sup>	2.2	1.6	.5	2.0	.2	.2
Food (15.3)	2.5	2.2	1.4	1.9	.2	.2
Energy (7.0)	.8	-7.7	-19.9	-6.7	.0	-1.0
CPI less food and energy (77.7)	2.3	2.5	2.4	2.7	.2	.2
Commodities (24.1)	.6	1.1	.8	1.0	.1	.2
New vehicles (5.1)	.1	-.1	-.3	-1.1	.5	.3
Used cars and trucks (1.9)	-5.2	1.8	.4	4.9	.3	-.1
Apparel (4.9)	1.5	1.2	-1.5	.8	-.3	1.1
Tobacco (0.9)	4.3	12.4	9.6	16.5	2.6	.1
Other Commodities (11.3)	.7	.2	1.6	.3	-.1	-.2
Services (53.6)	3.0	3.1	3.1	3.4	.2	.3
Shelter (29.4)	3.0	3.3	3.1	3.8	.1	.4
Medical care (4.4)	2.7	3.5	3.1	4.1	.2	.3
Other Services (19.8)	3.2	2.7	3.2	2.8	.4	.0
<u>PPI</u>						
Finished goods (100.0) <sup>2</sup>	-.2	-.8	-3.3	.0	.2	-.4
Finished consumer foods (23.2)	-.3	.1	-1.7	.5	.4	-.4
Finished energy (13.6)	-.5	-10.3	-22.0	-8.0	.3	-2.3
Finished goods less food and energy (63.2)	-.1	1.0	.6	1.7	.1	-.1
Consumer goods (38.0)	.1	2.1	1.3	3.2	.3	.0
Capital equipment (25.2)	-.4	-.7	-.7	-.5	.1	-.3
Intermediate materials (100.0) <sup>3</sup>	-.2	-2.1	-4.3	-2.0	.0	-.3
Intermediate materials less food and energy (81.8)	.4	-.5	-.7	-.8	.0	-.1
Crude materials (100.0) <sup>4</sup>	-7.3	-12.0	-35.4	-4.2	-1.8	-2.7
Crude food materials (42.1)	-13.8	-7.7	-14.3	-2.0	-2.8	-1.1
Crude energy (36.4)	-4.9	-18.1	-61.3	-4.2	-.6	-5.1
Crude materials less food and energy (21.5)	3.0	-10.9	-14.1	-8.2	-1.8	-2.0

1. Relative importance weight for CPI, December 1997.
2. Relative importance weight for PPI, December 1997.
3. Relative importance weight for intermediate materials, December 1997.
4. Relative importance weight for crude materials, December 1997.

monthly rate in July, to a level just a bit below the second-quarter average. Much of the weakness in July was in educational buildings and highways.

Gubernatorial elections will take place in nearly three-quarters of the states this fall, and many candidates likely will include tax cuts among their campaign promises. The popularity of tax rate reductions reflects continued strong revenues. Most recently, the Center for the Study of the States reported that revenues increased 9.7 percent over the twelve months ending in the second quarter. The strength was especially apparent in income tax collections, which increased 19.5 percent. Although a number of states were expecting strong gains in personal income tax receipts, the magnitude of the rise came as a surprise to many governments. By comparison, over the 1992 to 1997 period the average annual rise was 6.7 percent. For the twelve months ending in the second quarter of 1998, sales tax receipts rose 5.3 percent, a little below the annual average over the preceding six years, and corporate tax revenue declined a little.

### Prices

Both the overall consumer price index and the index excluding food and energy increased 0.2 percent in July and August. The twelve-month change in the core CPI was 2.5 percent in August, up 0.2 percentage point from the rate recorded over the year-earlier period; the overall index was up only 1.6 percent over the past twelve months because of the sharp decline in energy prices. The PCE deflator excluding food and energy also rose 0.2 percent in July, the latest month for which data are available, but increased just 1.1 percent over the twelve months ending in July.<sup>17</sup>

Consumer food prices rose 0.2 percent in both July and August. The index for fruits and vegetables moved down last month after having risen in July, while price increases for other foods picked up somewhat. Over the twelve months ending in August, overall food prices rose 2.2 percent, down slightly from a 2.5 percent pace in the year-earlier period. The CPI for energy fell 1.0 percent in August after no change in July and is down about 7.7 percent over the past twelve months. Retail gasoline prices dropped 1.5 percent in August, and survey evidence for early September suggests that they have slid further; however, crude oil prices have turned up in recent weeks, suggesting that declines in retail prices of gasoline may be behind us.

The consumer price index for commodities other than food and energy increased 0.2 percent in August, a little faster than its pace in recent months. The

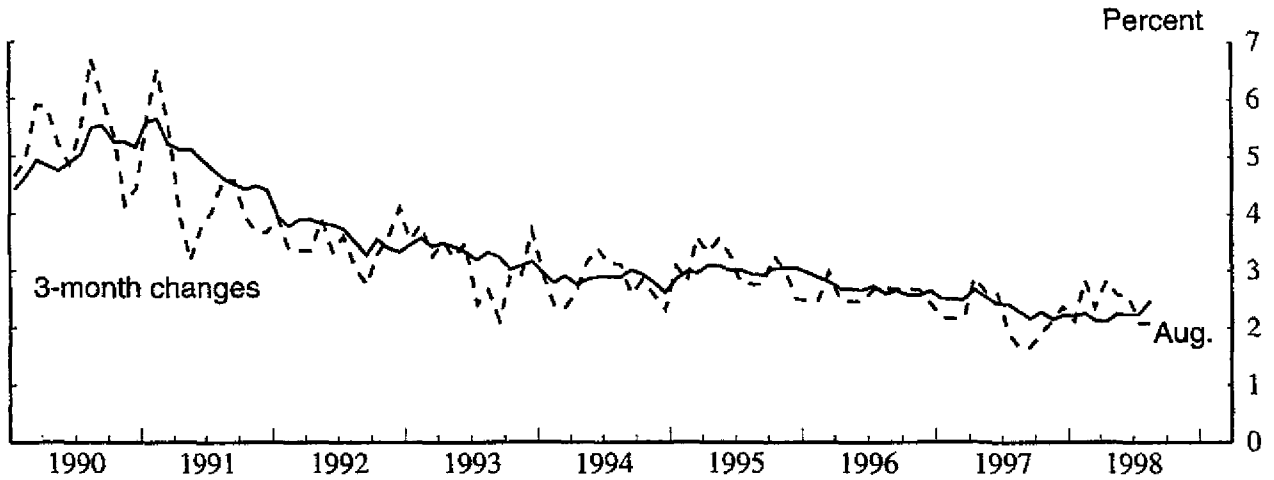
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17. The PCE chain price index excluding food and energy, which is available only on a quarterly basis, shows a similar 1.1 percent increase over the four quarters ending in the second quarter.

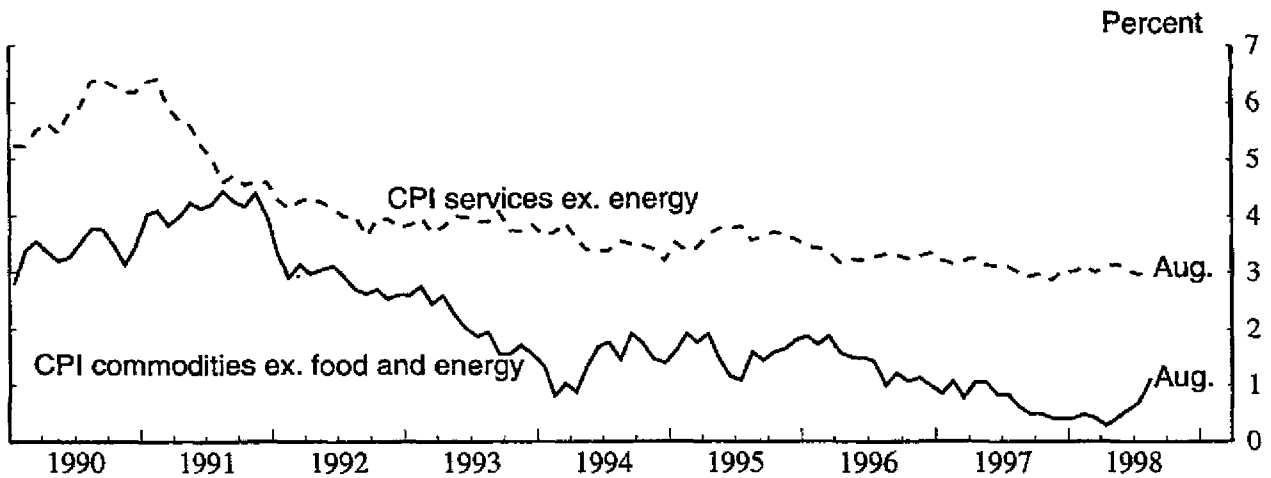
## Measures of Core Consumer Price Inflation

(Twelve-month changes except as noted)

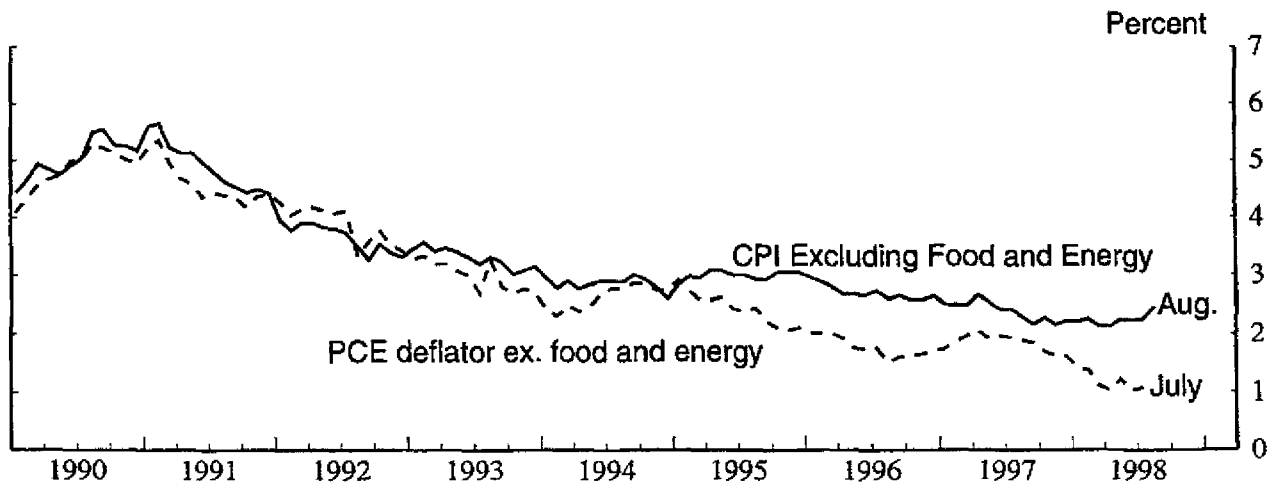
CPI Excluding Food and Energy



CPI Services and Commodities



CPI and PCE





twelve-month change in core commodity prices was 1.1 percent, up from a 0.6 percent pace a year ago. Apparel prices jumped 1.1 percent in August, as the late occurrence of Labor Day caused holiday and "back-to-school" discounts to be concentrated in September this year instead of being offered in August as well.<sup>18</sup> Also, prices of new motor vehicles increased 0.3 percent in August, following a 0.5 percent hike in July, as the Big Three coupon incentives were withdrawn.<sup>19</sup> Looking forward, major automakers have announced flat or lower prices for comparably equipped vehicles in the new model year, and General Motors has announced a sweetening of incentives to bolster post-strike sales. Retail prices of tobacco products were up only 0.1 percent in August--despite another hike in the wholesale price of cigarettes that month--following a 2.6 percent increase in July. Over the past twelve months, the CPI for tobacco has risen 12.4 percent.

Prices of non-energy services rose 0.3 percent in August after increasing 0.2 percent in each of the preceding two months; the index has risen 3.1 percent over the past year, about the same as last year. Owners' equivalent rent increased 0.2 percent in August, a bit less than the average monthly increase over the past year, while rates for lodging away from home jumped 0.7 percent in August, reversing July's drop. Among services excluding energy and shelter, prices for medical care increased 0.3 percent in August--in line with the average pace over the past year. In contrast, telephone service charges dropped 1.1 percent in August and are up only 1/2 percent so far this year.

Most other broad measures of inflation have continued to rise less rapidly than has the CPI, and these prices have also decelerated to a greater degree over the past year. The four-quarter change in the GDP chain price index was just 1 percent in the second quarter, half the rate recorded in 1997:Q2. About one-quarter of the deceleration in GDP prices over the past four quarters can be attributed to a large decline in the rate of change in the implicit price index for services provided to consumers without charge by financial institutions, a component of PCE;<sup>20</sup> elsewhere in PCE, a modest slowing in inflation rates was widespread across expenditure groups.

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18. BLS attempts to account for the timing of Labor Day in its seasonal adjustment procedures but does not feel that it adequately captures the effect. As a result, some of the August increase may be reversed in the September data.

19. Because of bimonthly sampling for some cities in the CPI, the effect of withdrawing coupons was spread over July and August.

20. After rising 13 percent over the four quarters ending in 1997:Q2, imputed prices for services provided without charge by financial institutions increased only 2.3 percent in the year ending in 1998:Q2--somewhat below the long-term average increase in these prices.

BROAD MEASURES OF INFLATION  
(Four-quarter percent change)

	1995 Q2	1996 Q2	1997 Q2	1998 Q2
<u>Product prices</u>				
GDP chain price index	2.4	1.9	2.0	1.0
Nonfarm business chain-type price index <sup>1</sup>	2.2	1.3	2.0	0.7
<u>Expenditure prices</u>				
Gross domestic purchases chain-type price index	2.5	1.7	1.7	0.6
Less food and energy	2.5	1.5	1.7	0.8
PCE chain-type price index	2.6	2.0	1.9	0.8
Less food and energy	2.5	1.8	2.0	1.1
CPI	3.0	2.9	2.3	1.6
Less food and energy	3.0	2.7	2.5	2.2
Median CPI	3.0	3.2	2.9	2.8
Trimmed mean CPI	2.8	2.8	2.5	2.1

1. Excluding housing.

SURVEYS OF (CPI) INFLATION EXPECTATIONS  
(Percent)

	Actual inflation <sup>1</sup>	University of Michigan (1-year) Mean <sup>2</sup>	University of Michigan (1-year) Median <sup>3</sup>	University of Michigan (5- to -10-year) Mean <sup>4</sup>	University of Michigan (5- to -10-year) Median <sup>5</sup>	Professional forecasters (10-year) <sup>6</sup>
1996-Q1	2.7	3.9	2.8	4.2	3.2	3.0
Q2	2.8	4.5	3.0	4.3	3.1	3.0
Q3	2.9	4.2	3.1	4.3	3.2	3.0
Q4	3.2	4.0	3.0	3.9	3.0	3.0
1997-Q1	2.9	3.8	2.9	3.8	3.1	3.0
Q2	2.3	3.6	2.9	3.8	3.0	2.9
Q3	2.2	3.4	2.7	3.6	3.0	3.0
Q4	1.9	3.3	2.8	3.8	3.1	2.7
1998-Q1	1.5	2.8	2.4	3.3	2.9	2.6
Q2	1.6	3.0	2.6	3.3	2.8	2.5
Q3		2.9	2.4	3.1	2.8	2.5
Apr.	1.4	2.7	2.4	3.2	2.7	
May	1.7	3.1	2.6	3.3	2.8	
June	1.7	3.2	2.7	3.3	2.9	2.5
July	1.7	3.1	2.6	3.1	2.7	
Aug.	1.6	2.7	2.4	3.0	2.7	
Sept.		2.8	2.3	3.3	2.9	2.5

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. Average increase for responses to the question: By about what percent per year do you expect prices (CPI) to go up, on the average, during the next 5 to 10 years?
5. Median increase for responses to question above.
6. Compiled by the Federal Reserve Bank of Philadelphia.

Large declines in energy and non-oil import prices have helped hold down GDP prices by reducing materials costs and by providing more intense competition for domestically produced goods, while a deceleration in food prices has contributed directly to slower growth in GDP prices. In addition, a decline in the rate of increase of government prices--in part due to slower growth in average hourly compensation for government workers--to the slowest pace in thirty-eight years contributed 1/4 percentage point to the deceleration in GDP prices over the past year.

Short-term inflation expectations have turned back down recently after having backed up somewhat in the second quarter. According to the Michigan survey, median one-year inflation expectations were 2.4 percent in the third quarter, the same rate as the low recorded in the first quarter of the year and 0.3 percentage point below expectations a year ago. Longer-term inflation expectations appear to have stabilized in the third quarter at very low rates, with both the Michigan median five-to-ten-year inflation expectations and the Philadelphia Fed's survey of professional forecasters ten-year expectations between 1/4 and 1/2 percentage point below the pace recorded a year earlier.

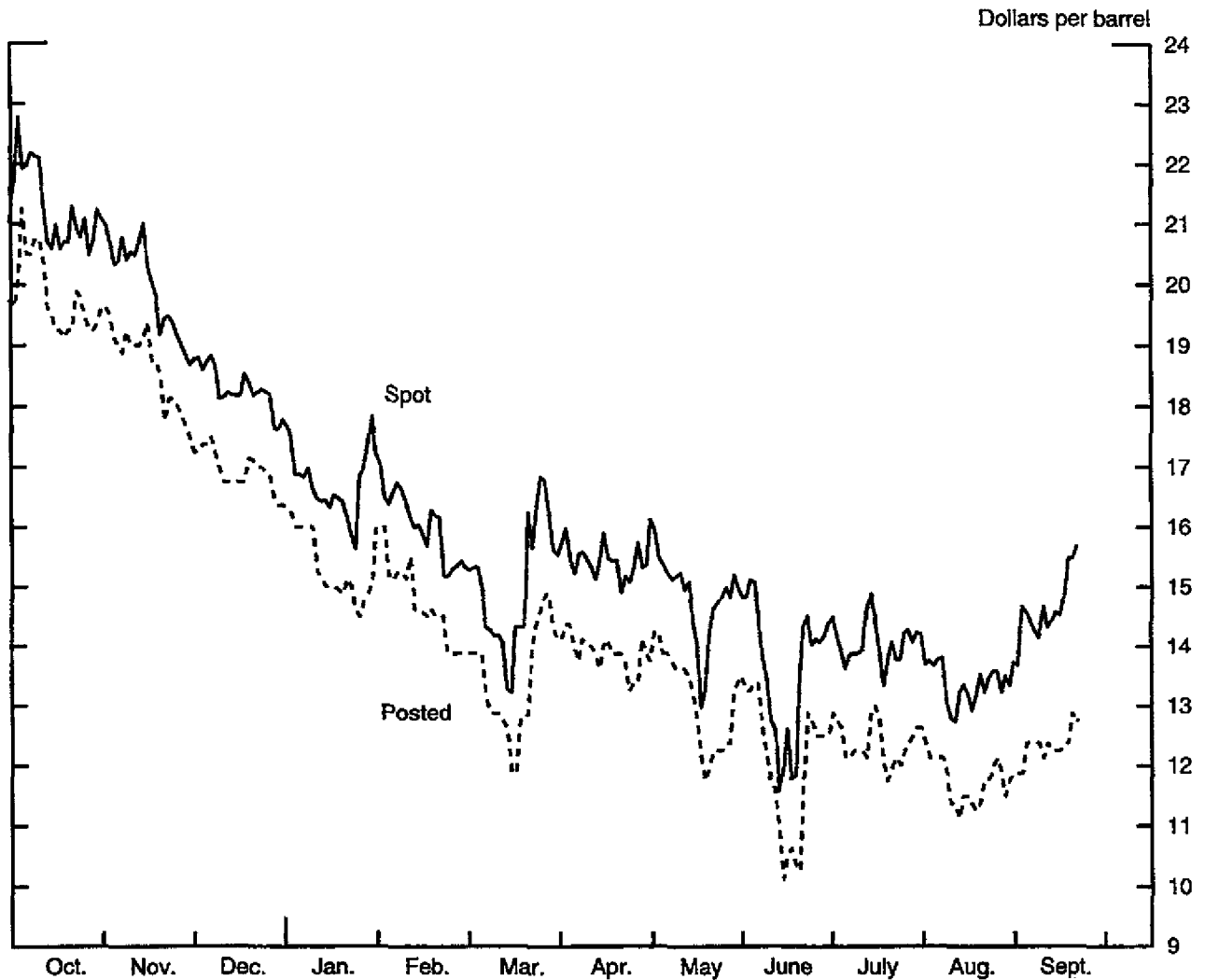
Prices of capital goods continued to weaken in recent months. The PPI for capital equipment fell 0.3 percent in August, after edging up in July, and is down 0.7 percent over the past twelve months. Computer prices fell 4.5 percent in August, led by a whopping decline in personal computer prices. Over the twelve months to August, overall computer prices have dropped 26 percent, compared with 23 percent over the preceding twelve months.

Inflation remains dormant at earlier stages of processing. The PPI for intermediate materials other than food and energy edged down again in August to a level 0.5 percent below a year earlier. The PPI for core crude materials dropped considerably further in both July and August and is down nearly 11 percent over the past year.<sup>21</sup> Within crude materials, price declines have been widespread over the past year, with the drop in metals prices particularly large. Since the mid-August PPI reporting date, many industrial commodity prices have declined further. The Journal of Commerce industrial price index is down about 1-1/4 percent since that time, while the Commodity Research Bureau measure of industrial commodity prices has declined about 4-1/2 percent. Both the JOC and CRB measures include industrial materials, such as metals and fibers, but the JOC measure includes energy commodities and

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21. Raw materials other than petroleum make up a small proportion of the cost structure of finished core consumer goods. Therefore, even for declines in raw materials prices of this magnitude, the direct effect on retail consumer prices is fairly small.

## Daily Spot and Posted Prices of West Texas Intermediate



Note. Posted prices are evaluated as the mean of the range listed in the Wall Street Journal.

## Monthly Average Prices of West Texas Intermediate

Month	Posted	Spot
October	19.80	21.26
November	18.83	20.17
December	16.97	18.32
January	15.33	16.71
February	14.78	16.06
March	13.44	15.02
April	13.90	15.44
May	13.13	14.86
June	12.09	13.66
July	12.36	14.08
August	11.73	13.36
September <sup>1</sup>	12.29	14.61

1. Through September 22, 1998.

## SPOT PRICES OF SELECTED COMMODITIES

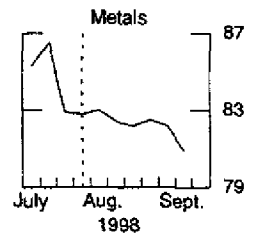
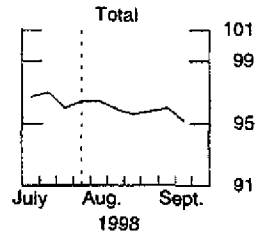
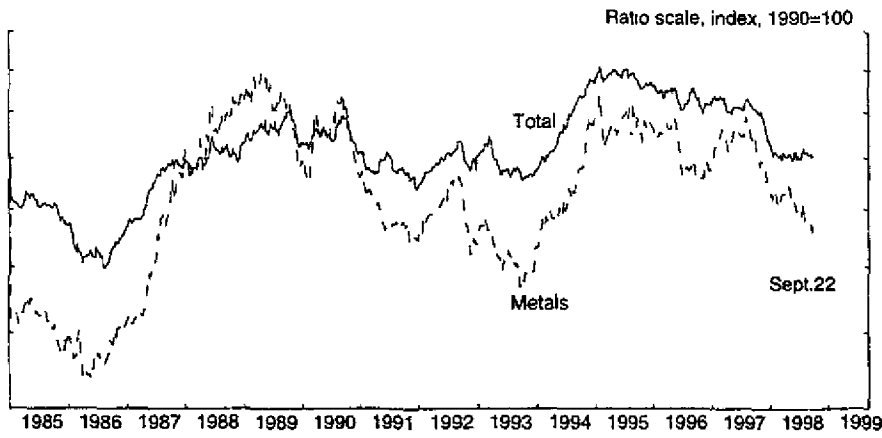
	Current price (\$)	-----Percent change <sup>1</sup> -----				Memo: Year earlier to date
		1996	1997	Dec. 30 to Aug. 11 <sup>2</sup>	Aug. 11 <sup>2</sup> to Sept. 22	
<b>Metals</b>						
Copper (lb.)	.800	-21.3	-24.3	-4.9	3.9	-18.4
Steel scrap (ton)	97.833	-15.1	15.9	-21.8	-9.6	-25.9
Aluminum, London (lb.)	.594	-8.5	-.6	-14.1	1.5	-20.7
<b>Precious metals</b>						
Gold (oz.)	288.900	-4.8	-21.4	-1.9	1.4	-10.0
Silver (oz.)	4.930	-6.1	28.3	-14.6	-5.7	5.9
<b>Forest products</b>						
Lumber (m. bft.)	278.000	59.2	-29.6	4.8	-9.2	-14.5
Plywood (m. sqft.)	365.000	-3.2	-4.8	22.7	-.8	9.0
<b>Petroleum</b>						
Crude oil (barrel)	14.190	29.3	-31.7	-31.2	27.5	-24.0
Gasoline (gal.)	.456	27.2	-25.8	-22.4	17.3	-23.1
Fuel oil (gal.)	.420	18.3	-29.7	-32.8	26.6	-22.5
<b>Livestock</b>						
Steers (cwt.)	59.000	-1.1	3.0	-14.7	1.7	-11.9
Hogs (cwt.)	29.500	14.9	-36.4	.0	-15.7	-39.8
Broilers (lb.)	.708	12.5	-21.2	52.8	-6.2	31.0
<b>U.S. farm crops</b>						
Corn (bu.)	1.750	-24.4	.2	-23.9	-10.0	-31.5
Wheat (bu.)	2.850	-12.8	-22.6	-22.7	4.8	-24.7
Soybeans (bu.)	5.080	-3.7	-1.8	-19.6	-6.4	-20.4
Cotton (lb.)	.731	-8.7	-9.7	9.5	4.4	2.1
<b>Other foodstuffs</b>						
Coffee (lb.)	1.085	34.7	25.4	-22.0	-18.4	-48.3
<b>Memo:</b>						
JOC Industrials	95.200	-4.1	-8.6	-1.7	-1.2	-10.2
JOC Metals	80.900	-8.3	-5.0	-6.8	-2.3	-18.9
KR-CRB Futures	202.780	-.1	-3.2	-12.0	-.1	-16.0
KR-CRB Spot	277.850	.9	-8.4	-5.1	-4.6	-18.1

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

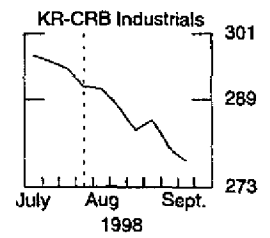
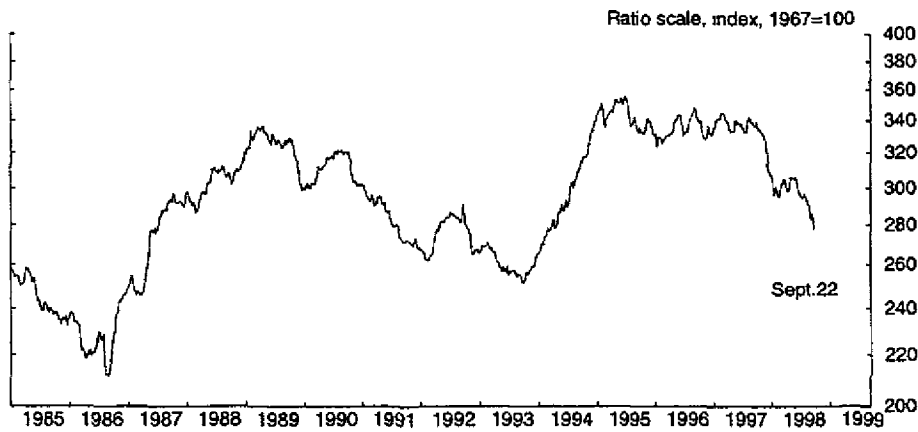
2. Week of the August Greenbook.

## Commodity Price Measures

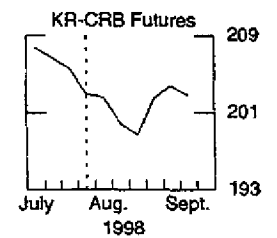
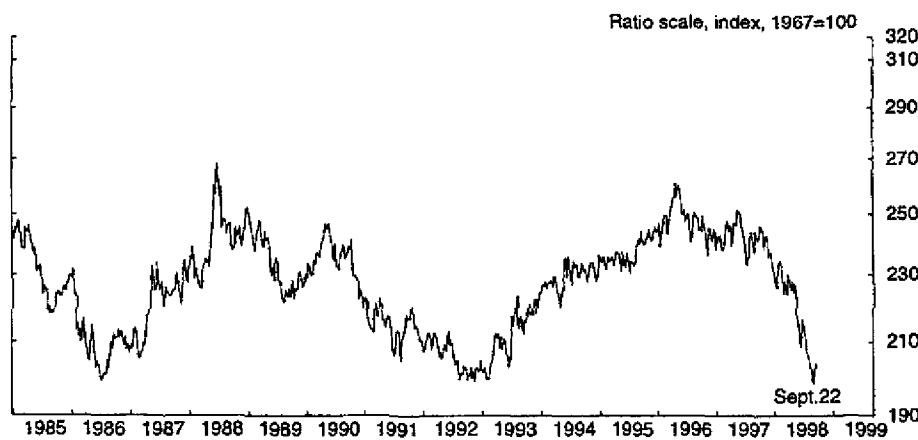
Journal of Commerce Index



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 CIBC, 1994.

forest products not included in the CRB measure. Over the past year, the CRB futures index, which attracts a good deal of market attention, has dropped 16 percent; however, only a small share of this index reflects changes in industrial commodities prices, and its coverage of industrial commodities is narrow--only copper and cotton are included.<sup>22</sup>

### Developments in Agriculture

Agricultural prices remain weak. The PPI for crude foodstuffs fell 7-3/4 percent over the twelve months ending in August, with over half of the decline occurring in July and August. The fall in prices came against a backdrop of favorable reports on the prospective harvests of most food crops, increased levels of livestock production, sluggishness of real agricultural exports, and sizable increases in farm inventories.

In the aggregate, crop output this year probably is going to come close to matching the high level of 1997, despite a moderate cutback in aggregate plantings, several weeks of severe heat and drought across the southern tier of states this past summer, and scattered problems with weather and plant disease in the main agricultural areas of the Midwest. To be sure, the adverse weather in the South did cut sharply into the national output of some crops that are more heavily concentrated in that region--the USDA is projecting production declines for cotton and tobacco of 28 percent and 14 percent respectively. However, these losses appear to have been offset in the aggregate by increased production of the major food commodities--wheat, corn, and soybeans. National average yields of all three crops are expected to be above their estimated long-run trends this year, and, according to the Agriculture Department's latest crop forecasts, combined output of the three crops will be up 4 percent from that of last year.

Livestock output also has moved up appreciably this year, probably by almost 2 percent overall. Output of pork is registering an especially large increase--close to 9 percent in terms of annual totals--and marketings of other livestock products are projected to record percentage gains that are small to moderate. A 1 percent gain in output now anticipated for beef is notable mainly because it contrasts so sharply with earlier expectations that cutbacks in the size of the cattle herd would be constraining the flow of product to consumers this year; the USDA has pushed back to 1999 its forecast of a big decline in the output of beef. By contrast, production gains have

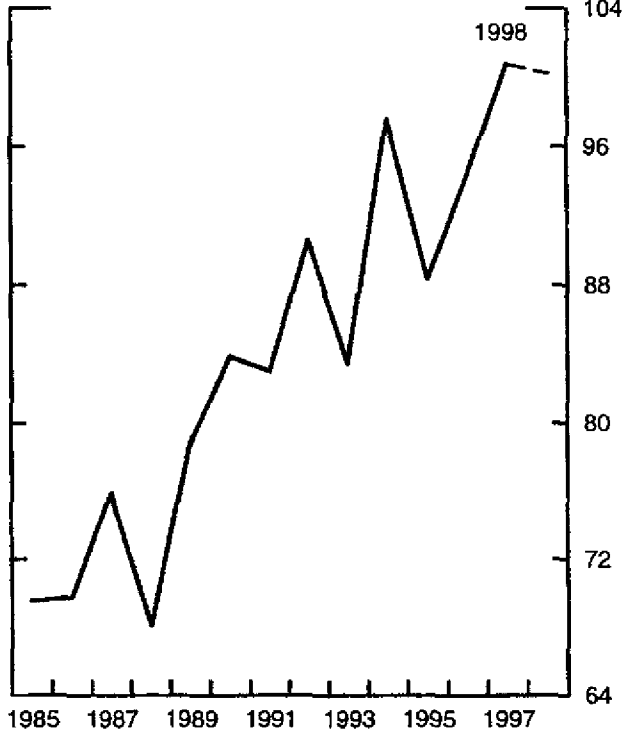
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22. More than half of the CRB futures index is made up of food commodities, with the remaining weight divided among energy commodities, precious metals, and industrial commodities.

## The Farm Sector (BEA data)

Crop Production

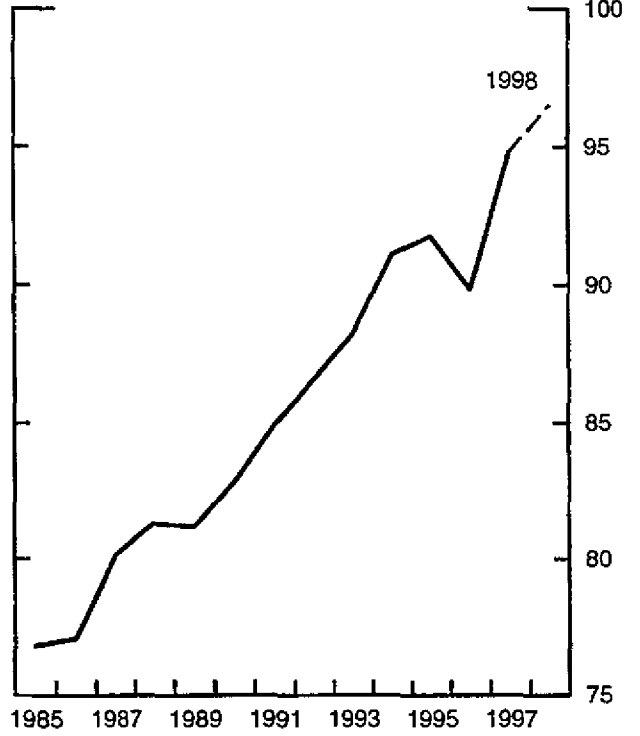
Billions of chained (1992) dollars



Note. Observation for 1998 is a staff estimate derived from USDA commodity data.

Livestock Production

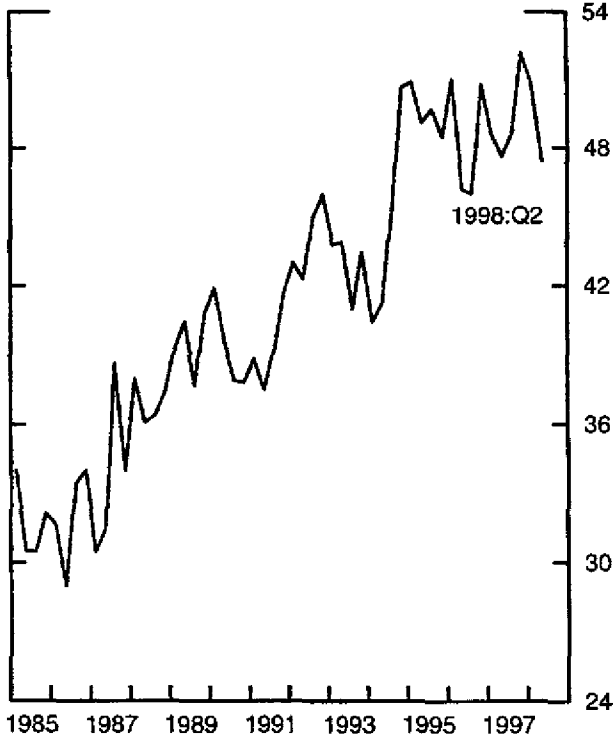
Billions of chained (1992) dollars



Note. Observation for 1998 is a staff estimate derived from USDA commodity data.

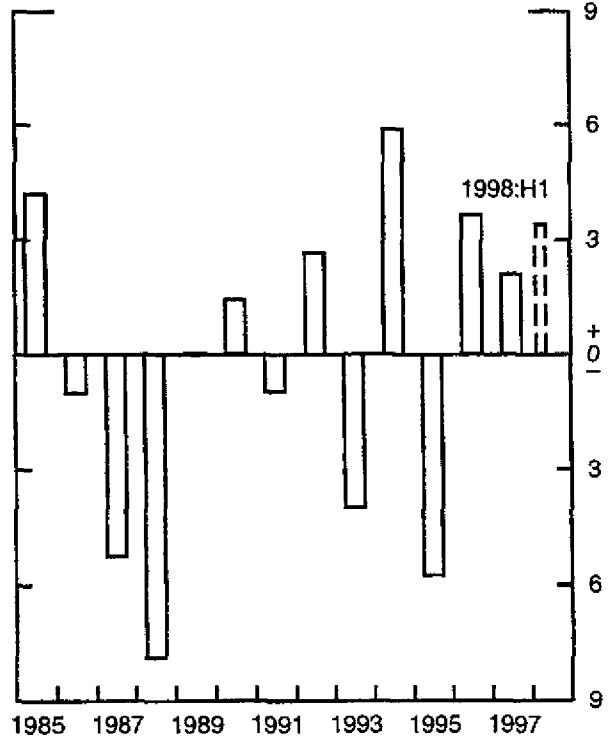
Agricultural Exports

Billions of chained (1992) dollars



Change in Real Farm Inventories

Percent of Gross Farm Output





been smaller than usual for milk and poultry--two farm products that have been among the few to experience rising prices this year.

Farm exports surged for a time during the first half of the 1990s; but gains have been slow since about 1995, and, according to preliminary NIPA data for the second quarter, farm export volume has not grown at all this past year. Exports of some key products--notably the grains--have dropped sharply since the mid-1990s. By contrast, shipments of meats and poultry have continued to move up, although the gains this year will apparently be smaller than those of recent years. The sluggishness of farm exports overall is primarily a reflection of the economic problems in Asia, the region that U.S. producers had been counting on most heavily for market expansion.

Farm inventories changed little, on net, from the end of 1989 to the end of 1995, as temporary spells of accumulation during that period tended to be followed in fairly quick succession by spells of decumulation. The past three years, however, have brought a more sustained period of stockbuilding. According to the NIPA data, nearly 3 percent of all farm output in 1996 and 1997 went into inventories, and a large share of this year's output also seems to be headed for the storage bin. The USDA's September update of its crop forecasts indicates that the combined stocks of wheat, corn, and soybeans at the end of the current marketing year will be the largest since the late 1980s, when big inventory overhangs that had accumulated earlier in that decade finally were worked off.

Clearly, this inventory build is not sustainable. However, the manner in which the buildup will eventually be halted and current excesses worked down is not so obvious. The best alternative, of course, would be the renewal of a healthy uptrend in real farm exports. Absent that, domestic producers will need to adjust output to a level that is more in line with scaled-down prospects for demand. In the past, such adjustments typically were coordinated by the federal government, which provided inducements to farmers to take acreage out of production when stocks seemed to be growing excessively large. But those policy options were eliminated by the Freedom to Farm Act, and the history of recent decades offers little guidance for judging how quickly farmers might act to adjust production in the absence of government supply controls. If next year's early reports on planting intentions do not show significant acreage adjustments--and if exports are still looking sluggish--pressures on the federal government to re-establish some form of supply control in agriculture almost surely will intensify.

Even apart from the possibility of renewed supply management and the costs it might entail, federal spending on agriculture will likely be increasing over the near

term. For example, farmers still have the option of taking out loans from the Commodity Credit Corporation to aid in the financing of inventories, and these loans will likely be used more heavily than in other recent years. So-called loan deficiency payments, which are linked to the CCC loan programs, also are kicking in at present because market prices have dropped below the specified levels that trigger those payments. In the 1999 fiscal year, farmers also will have the option of receiving their "production flexibility payments" at an earlier date than previously had been scheduled; these payments, amounting to several billion dollars per year, are made annually over the seven-year period covered by the Freedom to Farm legislation. Other policy actions to aid farmers seem to have substantial support in Congress and from the Administration, and a number of proposals are currently under discussion.

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# **DOMESTIC FINANCIAL DEVELOPMENTS**

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III-T-1  
**Selected Financial Market Quotations**  
(One-day quotes in percent except as noted)

Instrument	1997		1998		Change to Sept. 22 from selected dates (percentage points)		
	Sept. 30	Dec. 31	FOMC* Aug. 18	Sept. 22	Sept. 30	Dec. 31	FOMC* Aug. 18
<i>Short-term</i>							
<i>Federal funds</i>							
FOMC intended rate	5.50	5.50	5.50	5.50	.00	.00	.00
Realized rate <sup>1</sup>	5.51	5.44	5.55	5.48	-.03	.04	-.07
<i>Treasury bills <sup>2</sup></i>							
3-month	4.93	5.22	4.93	4.69	-.24	-.53	-.24
6-month	5.08	5.23	4.98	4.69	-.39	-.54	-.29
1-year	5.18	5.22	4.98	4.50	-.68	-.72	-.48
<i>Commercial paper</i>							
1-month	5.51	5.65	5.50	5.51	.00	-.14	.01
3-month	5.48	5.57	5.48	5.32	-.16	-.25	-.16
<i>Large negotiable CDs <sup>2</sup></i>							
1-month	5.59	5.65	5.57	5.56	-.03	-.09	-.01
3-month	5.67	5.72	5.59	5.43	-.24	-.29	-.16
6-month	5.72	5.74	5.62	5.34	-.38	-.40	-.28
<i>Eurodollar deposits <sup>3</sup></i>							
1-month	5.56	5.63	5.50	5.44	-.12	-.19	-.06
3-month	5.63	5.72	5.56	5.38	-.25	-.34	-.18
<i>Bank prime rate</i>							
	8.50	8.50	8.50	8.50	.00	.00	.00
<i>Intermediate- and long-term</i>							
<i>U.S. Treasury (constant maturity)</i>							
2-year	5.80	5.66	5.34	4.66	-1.14	-1.00	-.68
10-year	6.12	5.75	5.40	4.73	-1.39	-1.02	-.67
30-year	6.41	5.93	5.56	5.16	-1.25	-.77	-.40
U.S. Treasury 10-year indexed note	3.61	3.70	3.82	3.65	.04	-.05	-.17
Municipal revenue (Bond Buyer) <sup>4</sup>	5.63	5.40	5.34	5.20	-.43	-.20	-.14
Corporate bonds, Moody's seasoned Baa	7.66	7.28	7.14	7.08	-.58	-.20	-.06
High-yield corporate <sup>5</sup>	9.02	9.06	9.53	10.59	1.57	1.53	1.06
<i>Home mortgages (FHLMC survey rate) <sup>6</sup></i>							
30-year fixed	7.28	6.99	6.91	6.66	-.62	-.33	-.25
1-year adjustable	5.51	5.53	5.60	5.43	-.08	-.10	-.17

Stock exchange index	Record high		1997	1998		Change to Sept. 22 from selected dates (percent)		
	Level	Date	Dec. 31	FOMC* Aug. 18	Sept. 22	Record high	Dec. 31	FOMC* Aug. 18
Dow-Jones Industrial	9,337.97	7-17-98	7,908.25	8,574.85	7,897.20	-15.43	-.14	-7.90
S&P 500 Composite	1,186.75	7-17-98	970.43	1,083.67	1,029.63	-13.24	6.10	-4.99
NASDAQ (OTC)	2,014.25	7-20-98	1,570.35	1,818.04	1,697.80	-15.71	8.12	-6.61
Russell 2000	491.41	4-21-98	437.02	403.96	368.24	-25.06	-15.74	-8.84
Wilshire 5000	11,106.10	7-17-98	9,298.19	10,064.79	9,452.79	-14.89	1.66	-6.08

1. Average for two-week reserve maintenance period ending on or before date shown. Most recent observation is average for current maintenance period to date.

2. Secondary market.

3. Bid rates for Eurodollar deposits collected around 9:30 a.m. Eastern time.

4. Most recent Thursday quote.

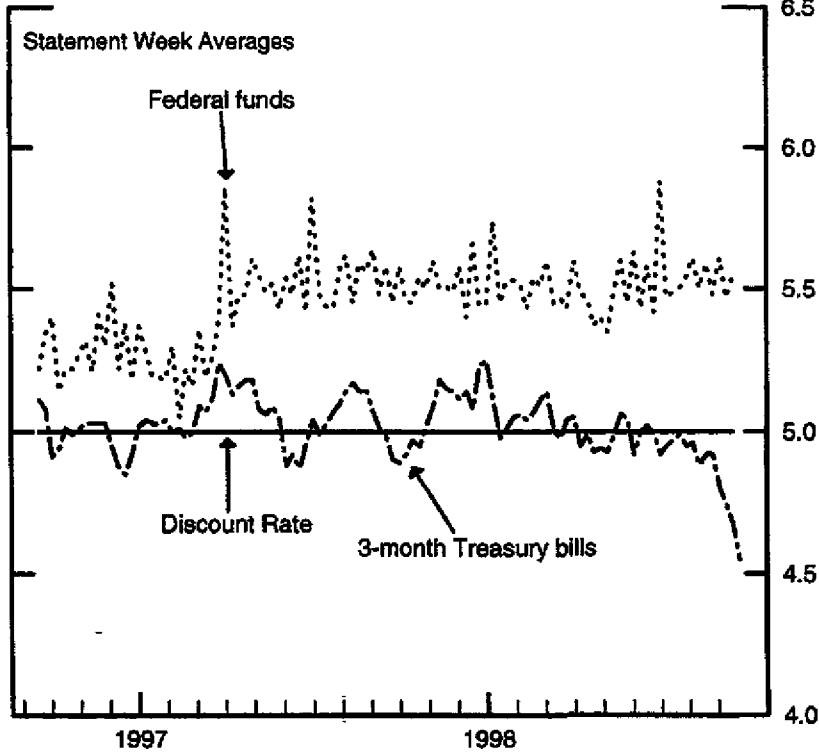
5. Merrill Lynch Master II high-yield bond index composite.

6. For week ending Friday previous to date shown.

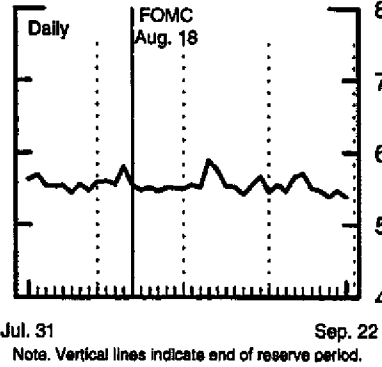
\* Data are as of the close on August 17, 1998.

# Selected Interest Rates

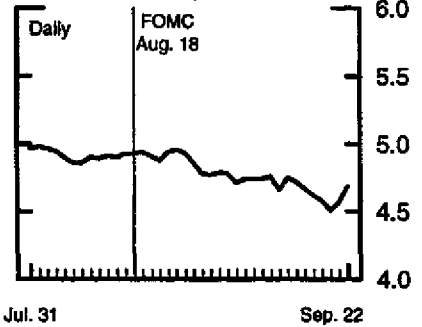
Selected Short-Term Interest Rates



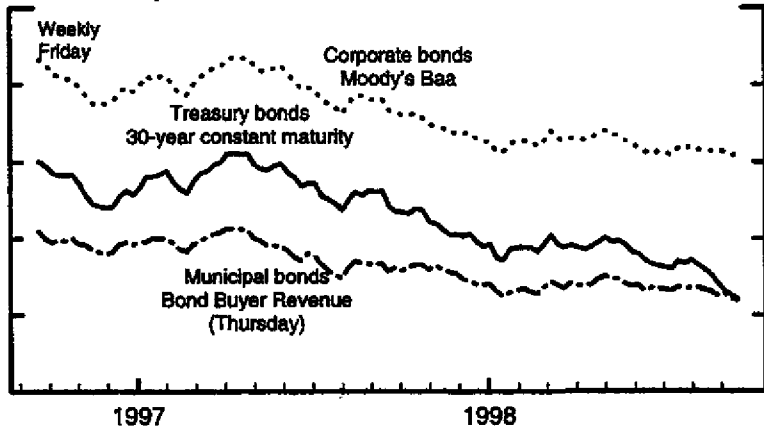
Federal Funds Percent



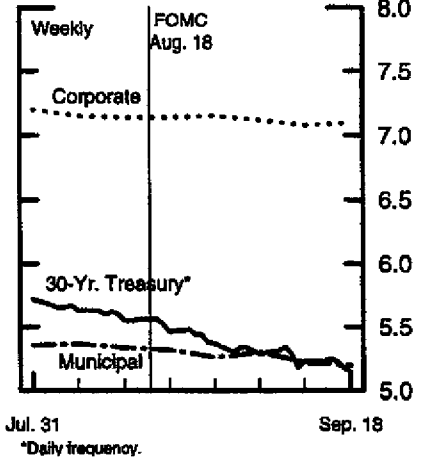
3-Month Treasury Bills Percent



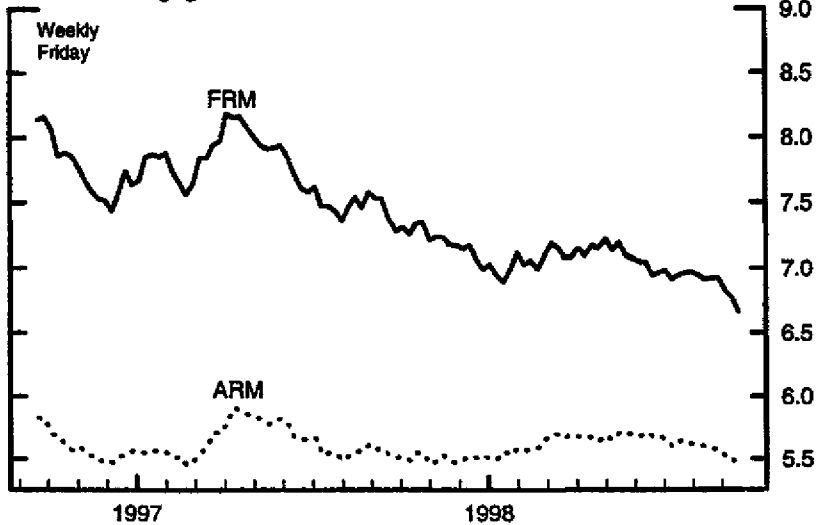
Selected Long-Term Interest Rates



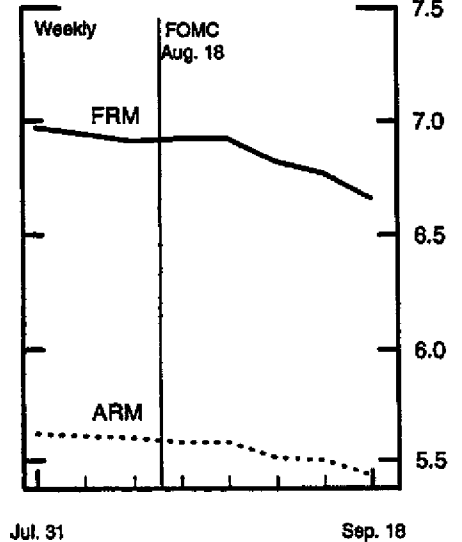
Percent



Selected Mortgage Rates



Percent



## Domestic Financial Developments

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### Overview

An intensification of concerns about the global economy has triggered substantial declines in the values of risk assets in recent weeks. In volatile trading, major equity indexes have fallen between 5 percent and 9 percent since the August FOMC meeting, with financial sector stocks taking especially large hits. Yield spreads on a broad range of debt securities have widened appreciably relative to Treasuries, owing to the heightened preference for safety and liquidity. Even among Treasury securities, investors have shown a marked preference for liquidity, bidding the prices of “on-the-run” securities up notably relative to “off-the-run” issues. The search for a safe haven—and the widespread view that deteriorating prospects for world growth will prompt the Federal Reserve to ease over coming months—has pushed down Treasury yields as much as 2/3 percentage point over the intermeeting period. Indeed, the entire Treasury yield curve has moved far below the 5.5 percent federal funds rate, with the thirty-year bond rate at one point in recent days touching a low of 5.04 percent.

Although bond yields have risen absolutely only for lower-rated corporate credits, the recent market turbulence has disrupted long-term debt issuance along a broad front during the past several weeks. The volume of investment-grade offerings has fallen markedly since the second week of August, and high-yield issuance has virtually ceased. New issuance has dried up in the equity markets as well. Not surprisingly, many firms with urgent financing needs have turned to the commercial paper and bank loan markets. The monetary aggregates have reflected the corresponding expansion of bank credit and the tendency of retail investors to seek refuge in money market funds.

Amid the turmoil, bank loan officers have become more cautious in recent weeks, reportedly tightening underwriting standards and terms on commercial and industrial loans; spreads on syndicated loans, especially for lower-rated borrowers, evidently have widened appreciably. Moreover, financing for commercial real estate transactions from all major sources has been curtailed.

Household sector borrowing has continued to be sizable, largely fueled by increases in mortgage debt; with the drop in mortgage rates to a new cyclical low, another surge in applications for refinancing is now under way. Despite generally positive indicators of household credit quality, increased investor caution has reportedly caused a substantial falloff in sales of securitized subprime loans, likely prompting more sober lending postures among originators.

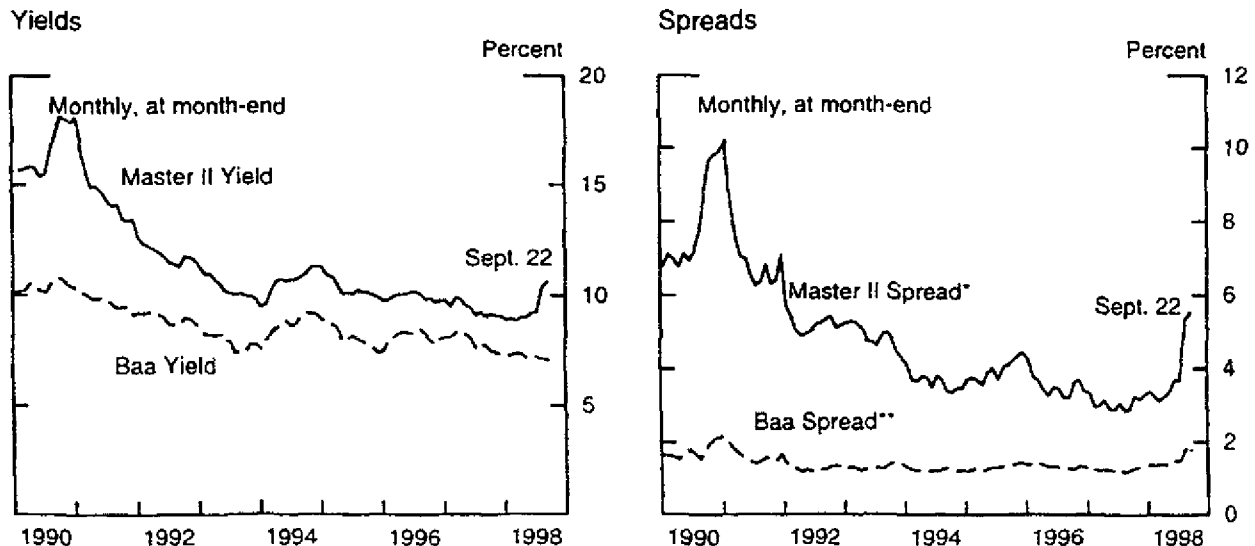
GROSS ISSUANCE OF SECURITIES BY U.S. CORPORATIONS  
(Billions of dollars; monthly rates, not seasonally adjusted)

Type of security	1996	1997	1998				
			Q1	Q2	June	July	Aug.
All U.S. corporations	58.4	69.7	94.3	97.0	109.4	72.5	59.3
Stocks <sup>1</sup>	10.2	9.8	12.7	14.8	17.1	9.4	3.5
Bonds	48.2	59.9	81.6	82.2	92.3	63.1	55.8
<u>Nonfinancial corporations</u>							
Stocks <sup>1</sup>	6.7	5.0	6.1	8.4	10.2	6.1	2.5
Initial public offerings	2.9	1.8	1.2	3.6	6.1	2.6	1.0
Seasoned offerings	3.8	3.2	4.8	7.0	11.1	6.8	2.5
Bonds	12.4	17.0	27.2	26.8	23.5	21.2	18.6
By rating, sold in U.S. <sup>2</sup>							
Investment grade	6.3	7.4	13.1	10.7	11.5	12.9	10.5
Speculative grade	4.8	8.0	12.6	14.3	11.1	6.9	3.0
Public	2.3	1.5	2.1	3.0	4.5	2.3	.6
Rule 144A	2.5	6.5	10.5	11.3	6.6	4.6	2.4
<u>Financial corporations</u>							
Stocks <sup>1</sup>	3.5	4.8	6.6	6.4	6.9	3.3	1.1
Bonds	35.8	42.6	54.3	55.3	68.8	41.4	35.5
<u>Memo:</u>							
Net issuance of commercial paper, nonfinancial corporations <sup>3</sup>	-.1	1.1	4.5	.5	7.6	3.0	11.9
Change in C&I loans at commercial banks <sup>3</sup>	5.3	6.2	3.4	9.0	11.3	5.2	12.3

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.
3. End-of-period basis. Seasonally adjusted.

### Corporate Bond Yields and Spreads



\*Rate over 7-year Treasury  
 \*\*Rate over 30-year Treasury

With the federal government headed for a sizable surplus in FY1998, the Treasury will make a third-quarter paydown of debt for the first time in twenty-five years. The credit quality of states and localities remains strong, and these units have continued to borrow considerable amounts to finance capital outlays and to refund higher-cost debt.

### **Business Finance**

Bond issuance by nonfinancial businesses nearly halted in late August, and conditions have remained difficult in September. Yield spreads of existing issues over Treasuries have widened sharply, especially for "junk" bonds. Despite sizable declines in Treasury yields, the level of investment-grade yields has fallen only a little since the August FOMC, and a broad index of yields on speculative-grade issues actually has risen about 100 basis points. The jump in junk-bond yields reflects some greater concerns about credit quality, but also the reluctance of investors to hold these securities--which offer very limited liquidity--at a time of heightened uncertainty.

Given the inhospitable conditions in the capital markets, higher-quality firms have tapped the commercial paper market, boosting issuance in that market considerably in August and the first half of September. In the speculative-grade sector, where only one borrower has sold debt in volume since mid-August, commercial paper issuance is not a ready alternative. Instead, lower-quality borrowers tend to substitute for market financing by turning to bank loans, but those businesses that have attempted to do so in recent weeks likely found tighter credit standards and terms--as suggested by early information from the special Senior Loan Officer Opinion Survey.<sup>1</sup> The banks that reported having tightened attributed their actions to a less favorable economic outlook, a worsening in industry-specific problems, and a reduced tolerance for risk. Further evidence of a shift in banks' lending attitudes can be found in the syndicated loan market, where lenders have reportedly been pulling back from new credits and spreads on lower-quality loans have widened a good bit.

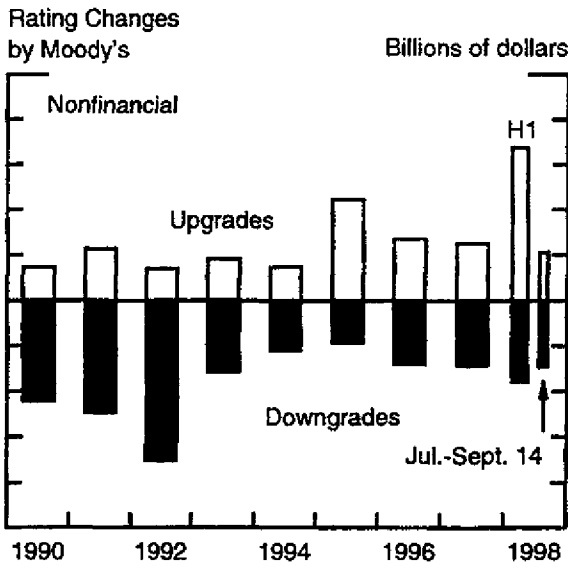
Although concerns about the economic outlook are prompting a reassessment of default risks in some sectors, Moody's downgraded, on net, only a small amount of nonfinancial debt in August and the first half of September. Moreover, its Watchlist--a more timely indicator of credit quality--still points to a small net upgrade of nonfinancial debt in the near term, though some financial institutions have been put on watch for downgrading. With business activity strong to date, the actual default

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1. The full results from the September loan officer survey will be included in the Greenbook supplement to be published at the end of the week.



## Credit Quality, Stock Market Prices, and Corporate Earnings

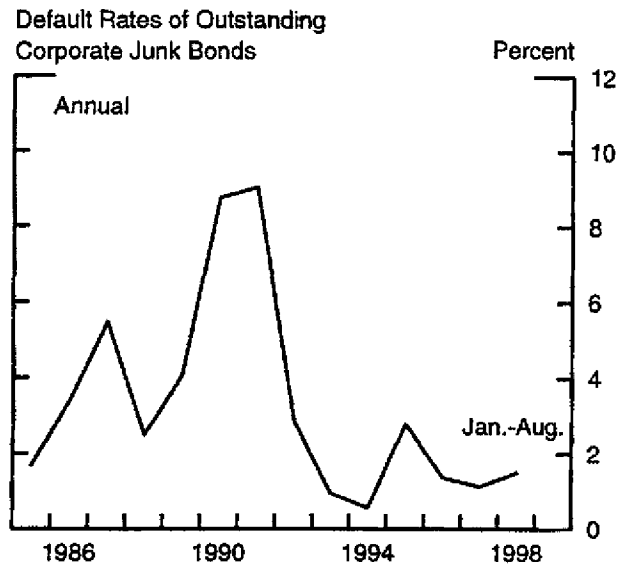


Note. 1998 observations at an annual rate.  
Stock Indexes

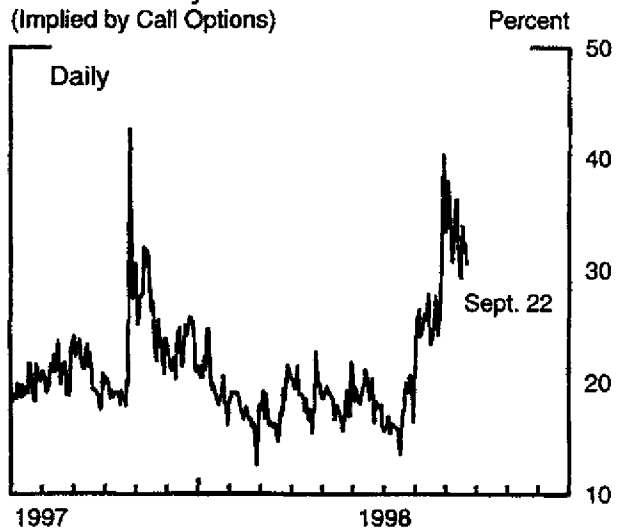
Percent change to Sept. 22 from selected dates

	Last FOMC*	Record high	Year-end 1997
1. DJIA	-8	-15	0
2. S&P 500	-5	-13	6
3. Nasdaq	-7	-16	8
4. Russell 2000	-9	-25	-16
5. Money Center Banks	-28	-40	-20

\*From Aug. 17 close.



Note. Jan.-Aug. observation at an annual rate.  
S&P 500 Volatility (Implied by Call Options)

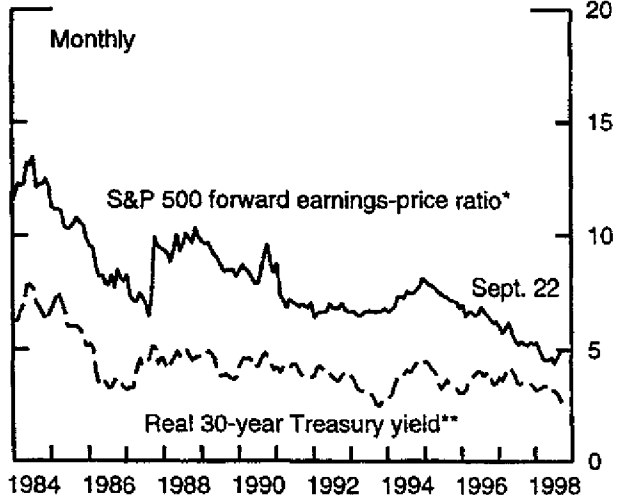


Analysts' Forecasts of Growth in S&P 500 Earnings per Share

Date of forecast:	Forecast Period	
	1997:Q3	1997:Q4
1. Mid July	7.1	12.3
2. Mid August	4.3	10.9
3. September 11	-1.1	9.1

Source. I/B/E/S.

Forward Earnings-Price Ratio against 30-year Treasury Yield



\*Based on I/B/E/S operating earnings over coming 12 months.  
\*\*Nominal yield less Philadelphia Fed ten-year inflation expectations.

rate on corporate debt is well below its average level over the past decade, and the business failure rate remains at its lowest level in ten years.

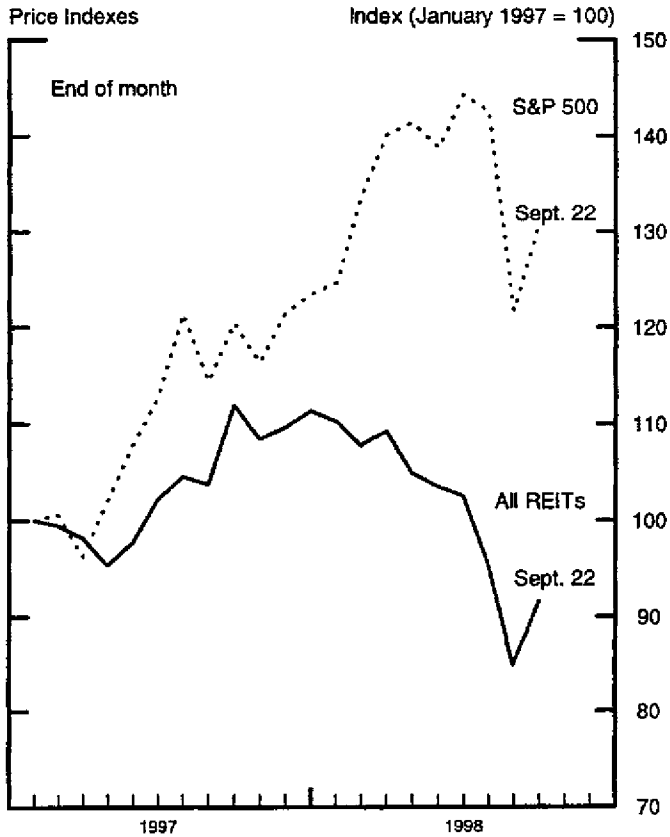
Gross equity issuance also came to a near halt in recent weeks, leaving its volume for August and so far in September well below the pace earlier this year. At the same time, both equity retirements and announcements of share buyback programs have remained strong. Despite the extreme volatility in equity markets, several pending merger deals have been completed since the August FOMC meeting. Nonetheless, if the prospects for future corporate earnings continue to deteriorate, the long list of still-pending deals may shorten as firms reevaluate their strategic alternatives or as financing for cash-payment deals becomes less readily available.

Equity prices declined further over the intermeeting period amid outsized daily swings. During the first week of September, both volume and the implied one-month volatility derived from S&P 500 option prices jumped to extremely high levels. Since then, the market has partially reversed the late-August losses, but implied volatility has remained elevated, suggesting that investors continue to be highly uncertain about events going forward. The DJIA, S&P 500, and NASDAQ indexes have declined between 5 and 8 percent since the last FOMC meeting and are 13 to 16 percent below the record highs posted in July. The Russell 2000 index of smaller-capitalization firms has fallen a bit more than large-cap stocks since mid-August, continuing to underperform broader indexes. Financial sector stocks have been hit especially hard over the intermeeting period—some losing close to half their value since the July highs—as several banks and securities firms have announced substantial losses owing to exposure, direct or indirect, to Russian and other emerging markets, and as investors have worried about additional losses.

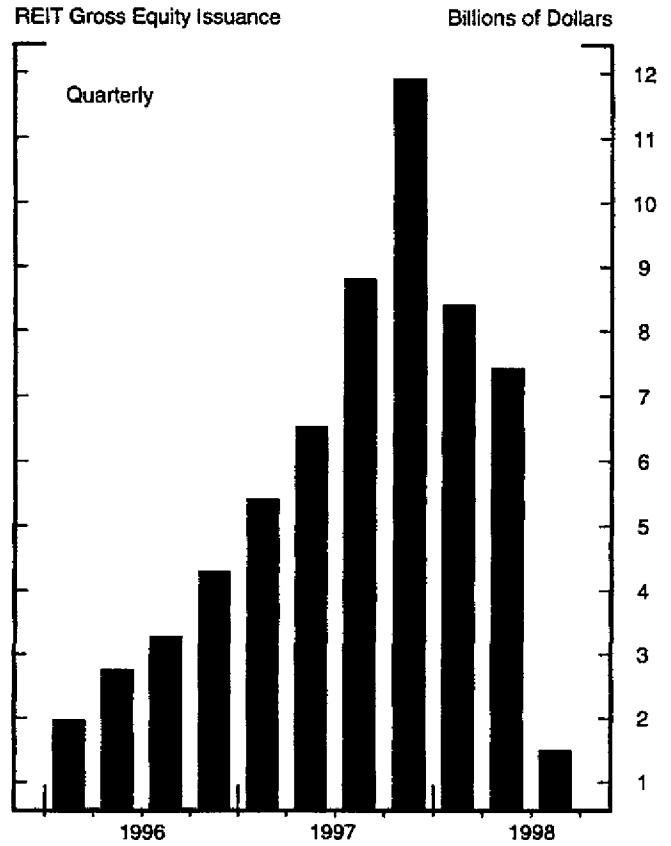
Company analysts have been marking down their estimates of third-quarter operating earnings per share for S&P 500 firms—and by more than is customary as the quarter-end approaches. On the basis of data through the third week of September, earnings growth over the year ended in the third quarter is projected to be slightly negative, well below the 7 percent growth projected for that period as recently as mid-July. Revisions have been concentrated in the energy and financial sectors. Extending a pattern observed since the beginning of the year, analysts have only slightly revised their earnings growth forecasts beyond the current quarter; the latest surveys indicate that a major resurgence of earnings is expected in 1999.

The supply of finance for commercial real estate has tightened dramatically in recent months. Share prices of real estate investment trusts, which dropped 6 percent over the second quarter, have shed an additional 10-1/2 percent since then; the office

### REIT Equity Prices and Issuance

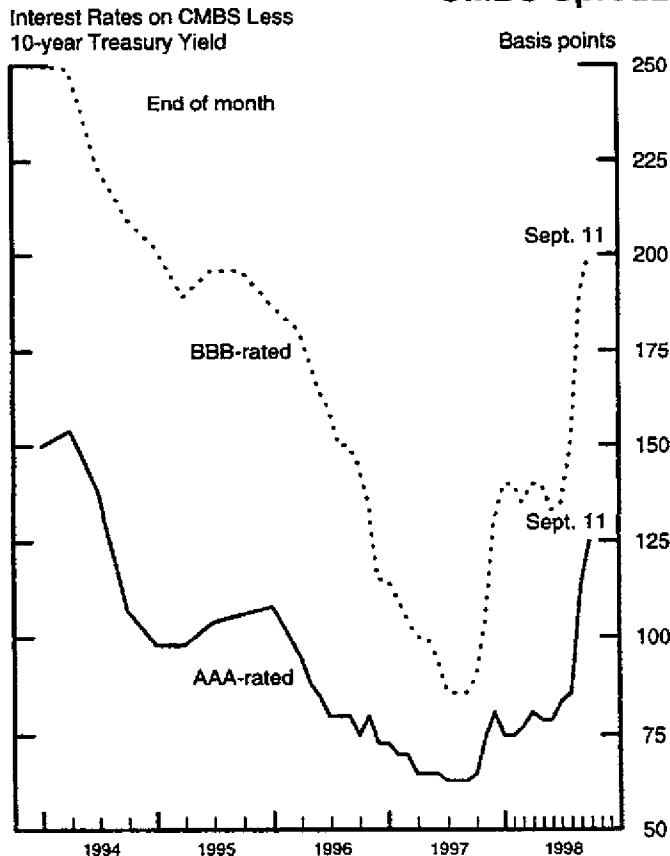


Source. National Association of Real Estate Investment Trusts.

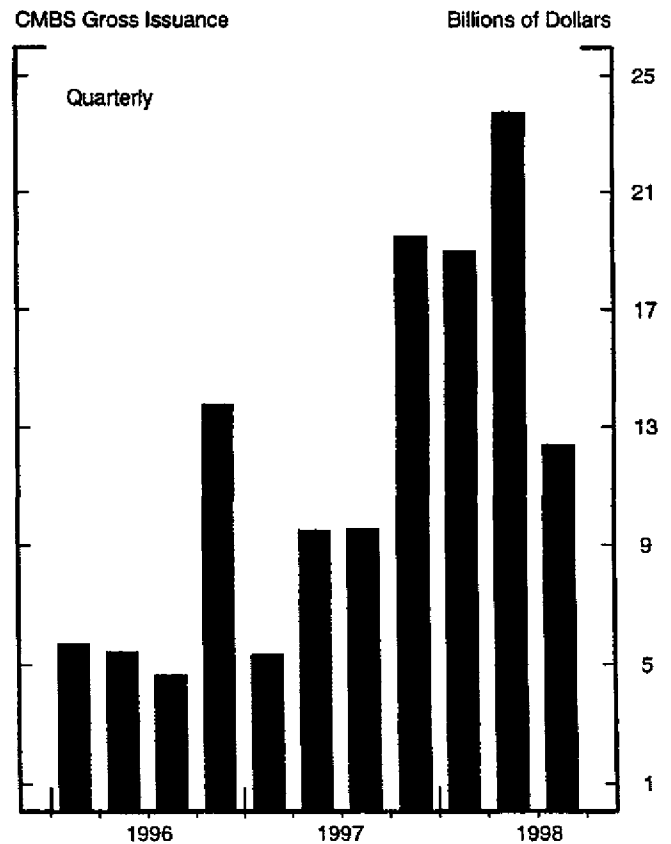


Note. 1998:Q3 is staff estimate.  
Source. National Association of Real Estate Investment Trusts.

### CMBS Spreads and Issuance



Source. Morgan Stanley.



Note. 1998:Q3 is staff estimate.  
Source. Commercial Mortgage Alert

and hotel sectors have been particularly hard hit. Although vacancy rates remain low and rental income growth strong, investors fear that construction already in the pipeline will weigh on earnings in the future.

In this environment, REITs have about stopped issuing shares. Press reports suggest that bank financing for REITs also has been less readily available in the past few months. Reflecting the more limited availability of funding, REIT acquisitions of properties slowed markedly in August, with the value of purchases less than half the average rate from January through July.

The issuance of commercial mortgage-backed securities also has slowed sharply from the robust first-half pace. Yields rose markedly in August for both the investment-grade and speculative-grade tranches of these securities. Thus far in September, investment-grade yields have reversed last month's rise, but yields on lower-rated tranches have continued to rise. Across the entire quality range, spreads on CMBS relative to Treasury securities are at their highest levels since 1995. Moreover, despite the decline in investment-grade yields, many Wall Street conduits have been left holding large pools of mortgages originated in the spring and early summer that cannot be profitably securitized at current CMBS yields.<sup>2</sup> As a result, there are reports of conduits backing out of deals that correspondents had arranged but not closed, and in the last week of August many correspondents stopped quoting rates to borrowers altogether. Initial reports for September suggest that these lenders have still not reentered the market.

### **Household Sector Finance**

Household balance sheets have deteriorated considerably during the third quarter. The ratio of household net worth to income fell noticeably, primarily because of the decline in equity prices. Since the end of the second quarter, the decline is estimated to have trimmed about \$700 billion from the value of households' directly held equities and \$500 billion from the value of assets held indirectly, primarily in mutual funds and pension funds.

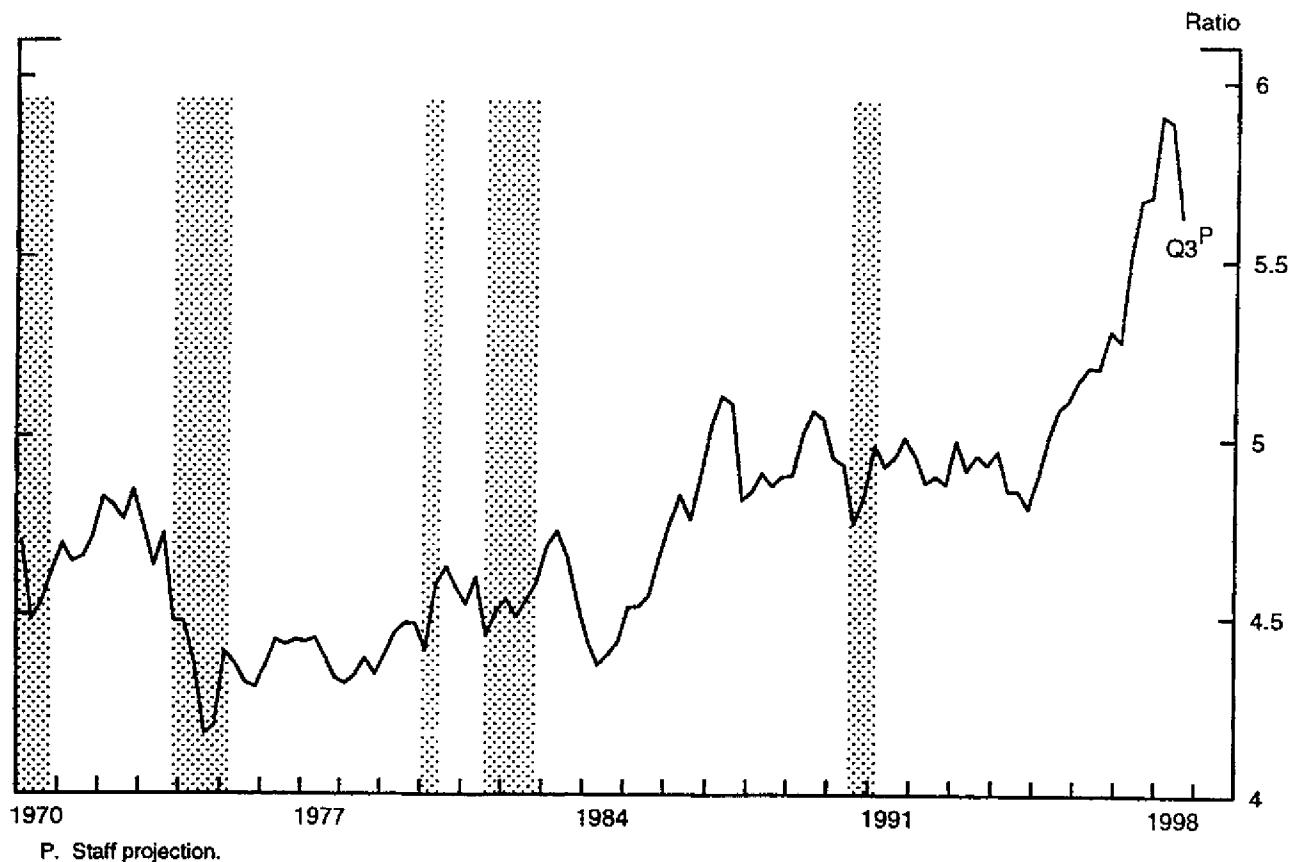
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2. Conduits are firms that facilitate the origination and securitization of mortgages; they usually rely on one or more correspondents, often banks, to originate the loans, and they provide the underwriting standards for the loans and issue the securities. Conduits such as Lehman Brothers, Morgan Stanley, and Capital America (formerly Nomura Securities) are among the largest issuers of CMBS.

Loans originated for securitization are usually securitized two to six months after they are originated. The securitizer, typically a Wall Street conduit, warehouses the loans after origination and bears the interest rate risk.

## Household Net Worth Relative to Disposable Personal Income

(Quarterly, seasonally adjusted)



P. Staff projection.

## Net New Flows into Mutual Funds

(Billions of dollars; quarterly and annual data at monthly rate)

	1996	1997	1998				Memo: End of July	
			Q1	Q2	Jul.	Aug. <sup>e</sup>	Asset level	Liquidity ratio <sup>1</sup>
<b>Total Mutual Funds</b>	<b>30.8</b>	<b>36.2</b>	<b>60.9</b>	<b>37.8</b>	<b>60.1</b>	<b>46.6</b>	<b>5,179</b>	<b>n.a.</b>
<b>Equity Funds</b>	<b>18.0</b>	<b>19.0</b>	<b>20.5</b>	<b>21.7</b>	<b>19.3</b>	<b>-11.5</b>	<b>2,814</b>	<b>5.1</b>
Domestic	14.1	15.8	18.8	18.3	15.2	-6.2	2,399	4.7
International	4.0	3.1	1.6	3.4	4.1	-5.2	415	7.4
<b>Hybrid Funds</b>	<b>1.0</b>	<b>1.4</b>	<b>2.3</b>	<b>1.1</b>	<b>1.1</b>	<b>-0.7</b>	<b>356</b>	<b>6.8</b>
<b>Bond Funds</b>	<b>0.2</b>	<b>2.4</b>	<b>7.3</b>	<b>5.7</b>	<b>7.0</b>	<b>7.4</b>	<b>792</b>	<b>3.3</b>
International	-0.2	-0.1	0.0	-0.0	0.1	-0.3	26	7.6
High-yield	1.0	1.4	2.5	1.1	1.9	-3.0	124	4.8
Other Taxable	-0.1	1.0	3.7	3.3	4.0	7.0	359	4.0
Municipals	-0.5	0.1	1.2	1.3	1.0	3.8	283	2.8
<b>Money Market Funds</b>	<b>11.5</b>	<b>13.5</b>	<b>30.9</b>	<b>9.3</b>	<b>32.7</b>	<b>51.4</b>	<b>1,217</b>	<b>100.0</b>

1. Ratio of liquid assets to total net assets.

e Staff estimates. Money market flow is data.

Source. Investment Company Institute (ICI). Data are not seasonally adjusted.

Although the drop in equity prices caused most of the “rebalancing” of portfolios, households recently took some measured actions to shift their financial holdings into other types of assets. Shareholders pulled more than \$11 billion from equity mutual funds in August and almost \$1 billion from hybrid funds.<sup>3</sup> Preliminary data provided by the ICI on a confidential basis indicate that equity fund flows turned positive in the first half of September, but the rate of inflow was only about half of that posted earlier this year. In contrast, bond funds and, especially, money market funds have received strong inflows recently. Among bond funds, households reallocated assets from global and high-yield bond funds into less-risky government and investment-grade corporate bond funds.

Based on data through mid-September, household debt is estimated to have grown moderately in the third quarter, with its mortgage component increasing at an almost 9 percent annual rate and consumer credit expanding at only a 3 percent pace. Mortgage debt has been fueled by low and declining mortgage rates and brisk home sales. Applications for mortgage refinancing have surged in recent weeks, and confidential data from Freddie Mac show that 37 percent of its mortgage refinancings in July (the latest month available) involved some cashing out of equity. The growth of consumer credit has likely been restrained somewhat by paydowns financed by home equity loans and cash-out mortgage refinancings.

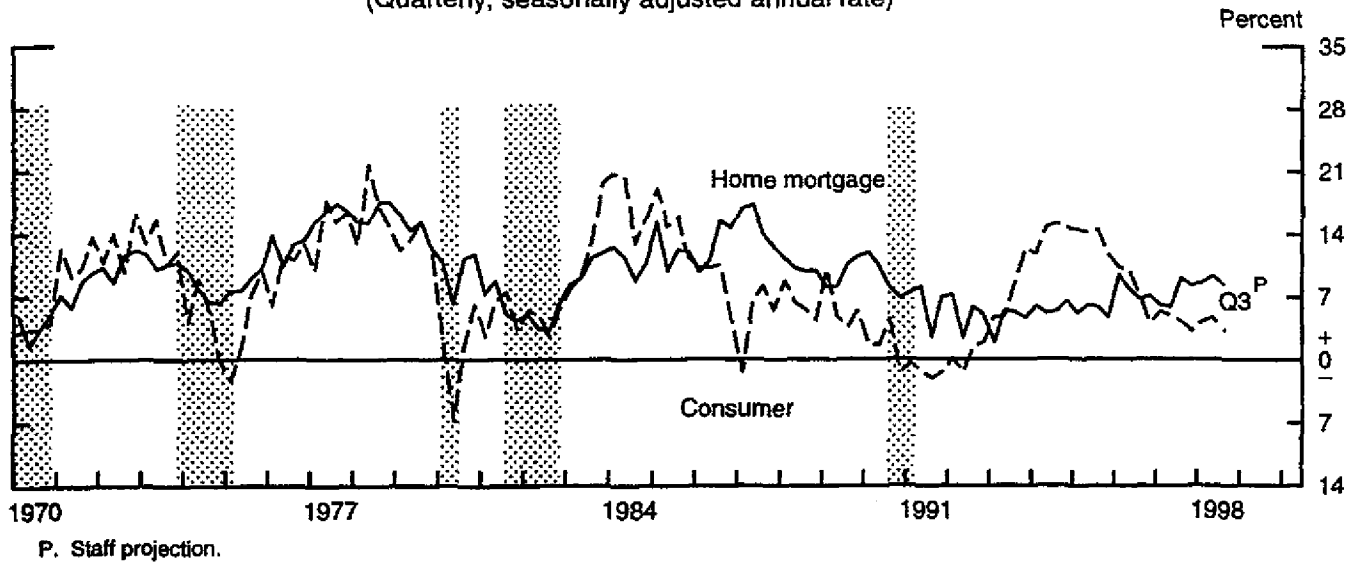
In general, recently released data on household credit quality remain good. Call Report data indicate that the delinquency rate on overall consumer loans in the second quarter remained close to where it has been for more than a year. Similarly, the Call Report delinquency rate on credit card accounts was about unchanged in the second quarter, while the rate calculated by the ABA rose slightly. In contrast, Moody’s reported that the delinquency rate on credit card accounts in securitized pools fell in July—its eighth straight monthly decline. According to the MBA, the home mortgage delinquency rate edged down in the second quarter, and auto finance companies reported that delinquencies dropped in July, to a level well below the second-quarter average.

Despite favorable readings on household credit quality, investors appear to be more reluctant to add asset-backed securities to their portfolios, presumably reflecting

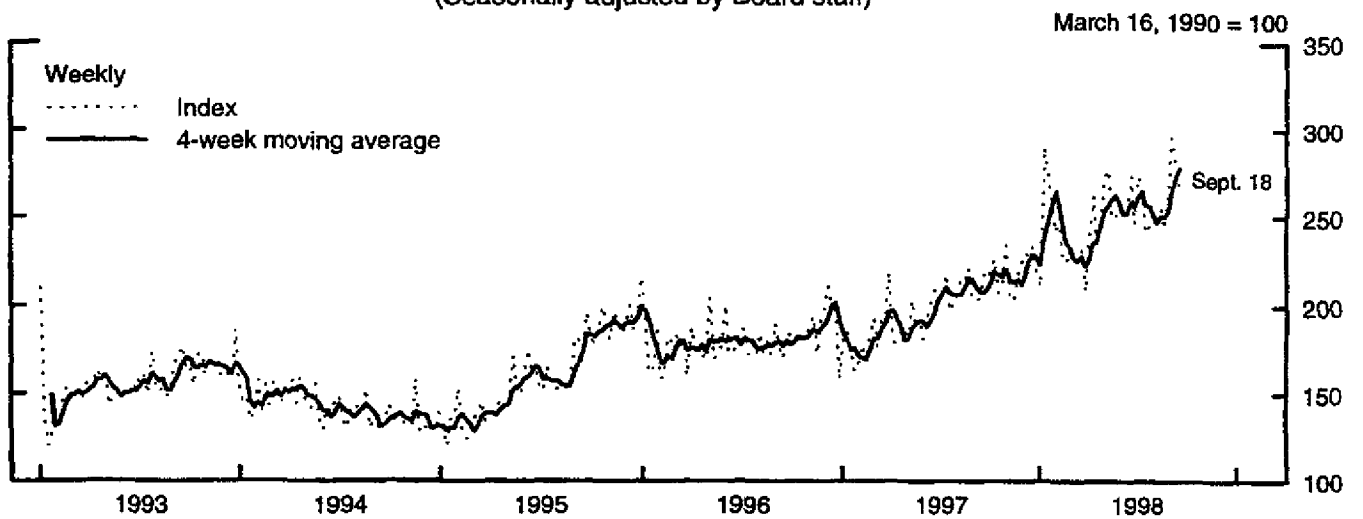
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3. These outflows represented less than one-half percent of the assets of equity and hybrid funds. On average, these mutual funds had more-than-adequate liquidity to cover these redemptions, as shown in the table. Households also shifted a small portion of their assets held in self-directed pension plans. Data from an industry report on 401(k) pension plans indicate that accountholders transferred some of their assets from equities to fixed-income instruments in August, but these transfers represented only about 1 percent of assets in the surveyed plans.

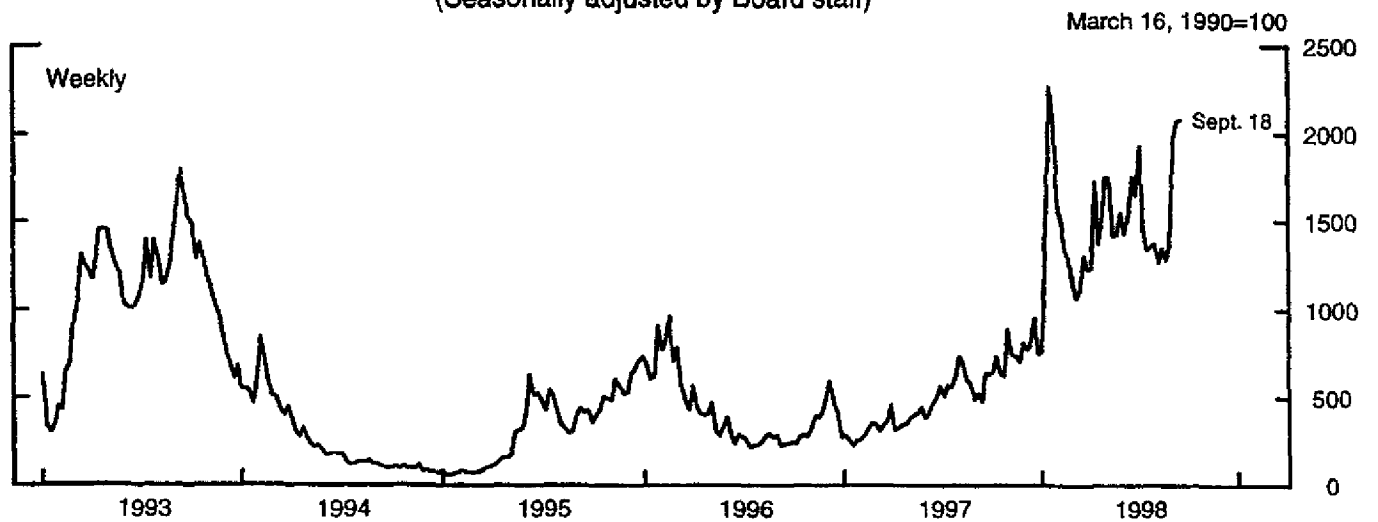
### Household Debt Growth (Quarterly, seasonally adjusted annual rate)



### MBA Mortgage Purchase Application Index (Seasonally adjusted by Board staff)

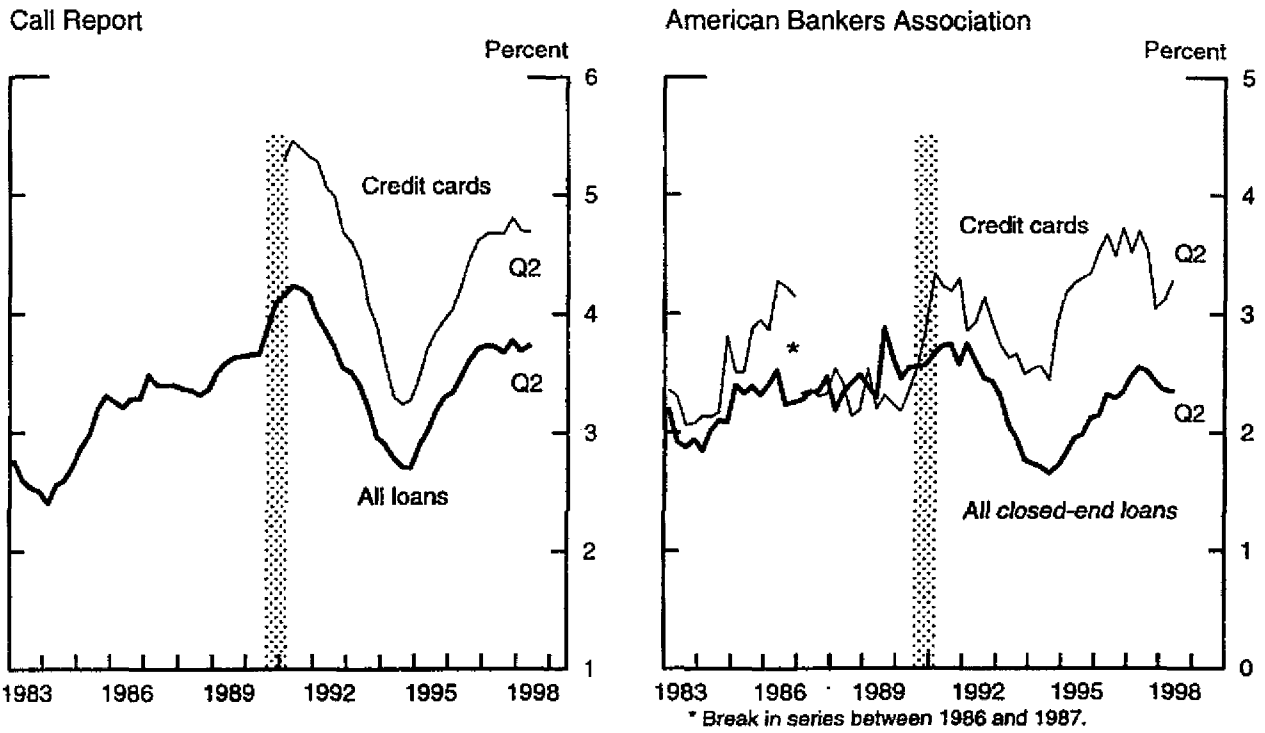


### MBA Mortgage Refinancing Application Index (Seasonally adjusted by Board staff)

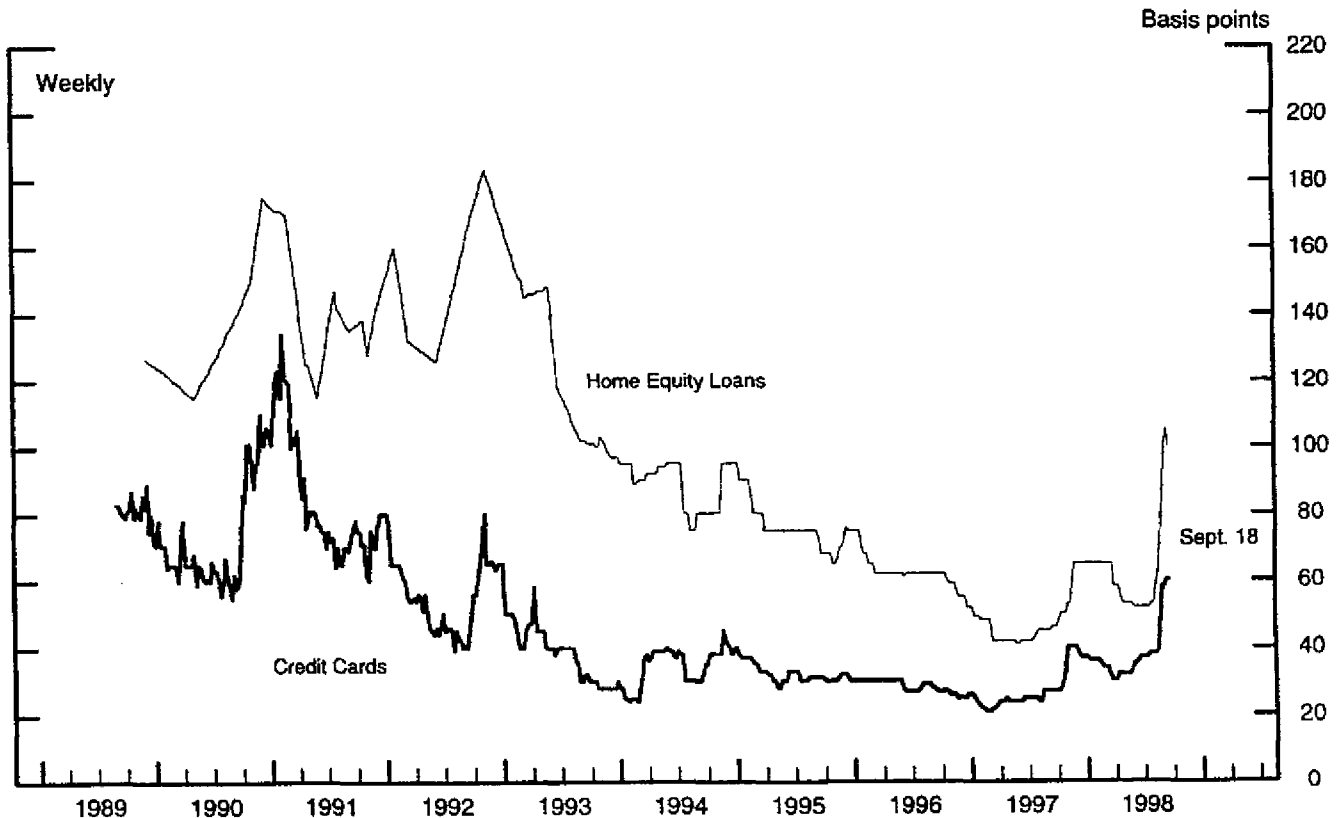


### Consumer Loan Delinquency Rates at Commercial Banks

(Seasonally adjusted, end of quarter)



### Yield Spreads on Aaa-Rated Asset-Backed Securities



Note. Spreads on 2-year fixed-rate issues relative to comparable Treasuries.

Source. Salomon Smith Barney.



## Treasury and Agency Finance

### Treasury Financing (Billions of dollars)

Item	1997	1998				
	Q4	Q1	Q2	June	July	August
<b>Total surplus, deficit (-)</b>	<b>-39.7</b>	<b>-30.2</b>	<b>136.9</b>	<b>51.1</b>	<b>-24.1</b>	<b>-11.2</b>
Means of financing deficit						
Net borrowing	33.7	25.9	-81.8	-12.6	-16.4	34.0
Nonmarketable	15.8	17.3	15.9	4.5	2.5	.3
Marketable	17.9	8.6	-97.7	-17.1	-18.9	33.7
Bills	14.4	4.1	-78.8	-6.7	-3.0	38.3
Coupons	3.5	4.6	-18.9	-10.4	-15.9	-4.7
Decrease in cash balance	11.7	4.3	-44.6	-36.1	36.2	-.4
Other <sup>1</sup>	-5.7	.0	-10.5	-2.3	4.2	-22.5
MEMO						
Cash balance, end of period	31.9	27.6	72.3	72.3	36.1	36.4

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

1. Direct loan financing, accrued items, checks issued less checks paid, and other transactions.

n.a. Not available.

### Net Cash Borrowing of Government-Sponsored Enterprises (Billions of dollars)

Agency	1998				
	Q1	Q2	June	July	August
FHLBs	4.0	10.5	6.4	-.5	6.5
FHLMC	24.1	7.0	-4.4	8.5	5.0
FNMA	11.3	25.1	6.7	9.0	8.0
Farm Credit Banks	-1.2	2.4	1.0	-.2	-6.6
SLMA	-1.4	-3.1	-2.7	n.a.	n.a.

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

less tolerance for risk and a desire for greater liquidity. Spreads have widened, and industry contacts indicate that lower-quality issues and tranches have become more difficult to place with investors. The demand for assets backed by high loan-to-value home equity loans has fallen off especially sharply, and new deals have been sparse in the past few weeks. Some subprime lenders have responded to the scarcity of investors by securing buyer commitments before making loans, while others have scaled back their issuance.

### **Federal Government Finance**

The budget position of the U.S. Treasury continued to improve during the intermeeting period. However, even as it has paid down debt, the Treasury stepped up weekly bill auction sizes by \$3 billion recently, from the low \$13 billion level that had prevailed since April. This increase, while larger than we expected, follows up on the Treasury's stated intent to expand the supply of short-dated debt; the weekly auctions will be split evenly, with \$8 billion each of thirteen- and twenty-six-week bills. The Treasury also plans to raise about \$8 billion in October through a ten-year indexed note auction and is expected to announce in the next few months a regular schedule of quarterly indexed offerings for 1999 and beyond.

The Treasury's new indexed savings bonds, I-bonds, became available this month in several denominations from \$50 to \$5,000. The bonds have no fixed maturity, but cease earning interest after thirty years and incur a penalty if cashed before five years. The bonds pay a fixed rate set by the Treasury every six months, plus an inflation premium based on changes in the CPI-U over a six-month period. The current fixed rate, valid for the life of the bond, is 3.40 percent, and the current inflation compensation brings the nominal return on the bond to an annualized 4.66 percent.

Mounting pressures on international financial markets have accelerated the decline in foreign official holdings of U.S. Treasury securities. Those balances at the Federal Reserve Bank of New York have fallen more than \$20 billion since the end of August--and \$50 billion since June, a decline of nearly 10 percent--apparently in connection with attempts by several central banks to defend their domestic currencies.

Gross debt issuance by government-sponsored enterprises has edged down over the intermeeting period, but it remains at a strong level. Fannie Mae and the Federal Home Loan Bank have brought large issues of new debt to the market, reflecting the ongoing strength of mortgage loan originations and increases in the asset holdings of these agencies.

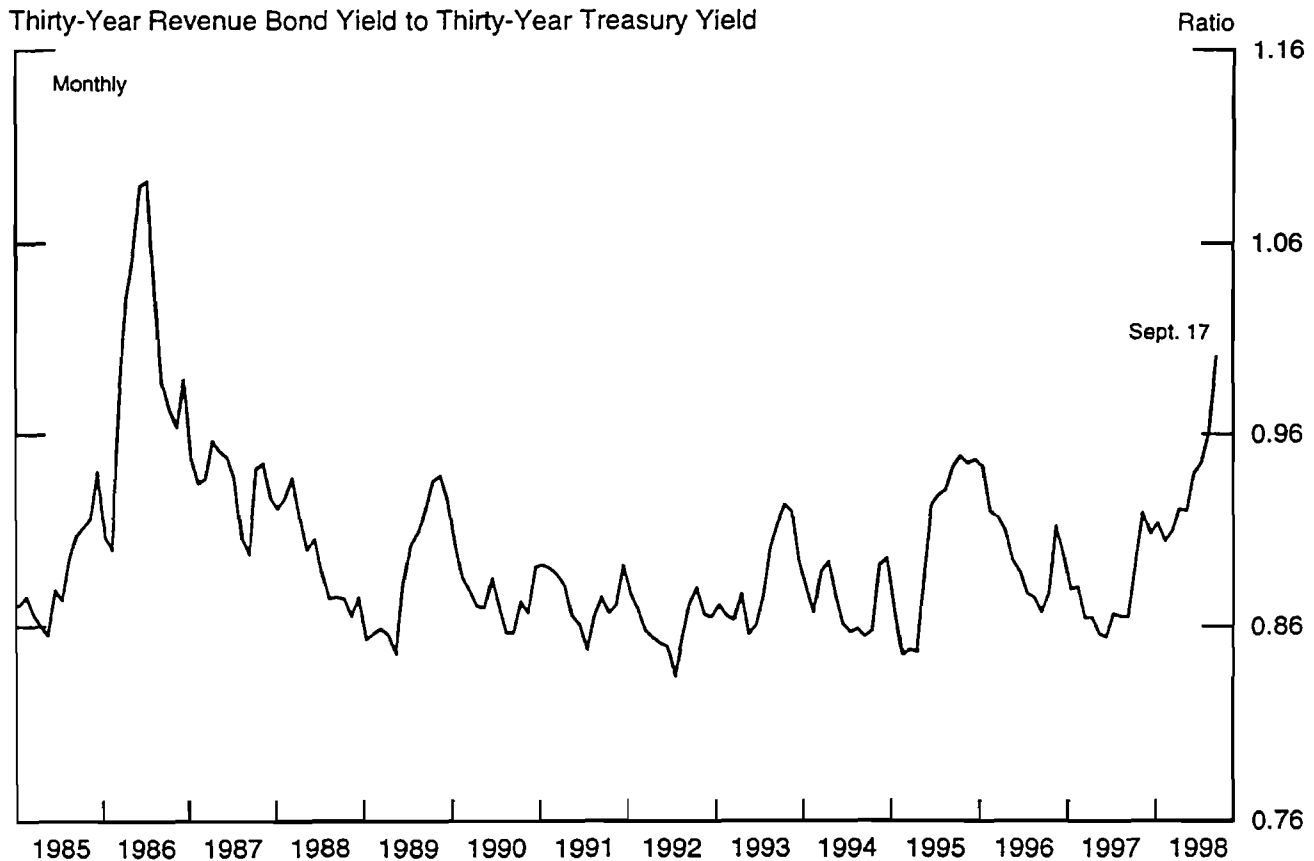
## State and Local Finance

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

	1995	1996	1997	1998				
				Q1	Q2	June	July	Aug.
<b>Total tax-exempt</b>	15.4	17.9	21.5	23.3	27.5	37.3	24.9	23.7
Long-term	12.1	14.3	17.9	22.0	24.3	29.7	22.6	20.3
Refundings <sup>1</sup>	3.6	4.9	6.6	9.5	8.5	10.3	6.7	9.1
New capital	8.5	9.4	11.3	12.5	15.7	19.3	15.9	11.3
Short-term	3.3	3.6	3.6	1.3	3.2	7.6	2.3	3.3
<b>Total taxable</b>	0.7	0.8	1.1	1.3	0.8	0.8	1.3	1.6

Note. Includes issues for public and private purposes.  
1. All issues that include any refunding bonds.

### Tax-Exempt to Taxable Yield Ratio



Note. Average of weekly data. Last value is average of weeks to date.

Although agency debt yields have declined over the intermeeting period, spreads between noncallable agency-issued securities and Treasuries have widened 14 to 29 basis points--almost doubling their norms and indicating the substantial premium that investors are paying for the higher liquidity of the Treasury market. Yield spreads have also widened on even the most liquid issues of agency debt, including the Benchmark and Reference Note series that Fannie Mae and Freddie Mac issued over the past year.

### **Municipal Finance**

Gross issuance of long-term municipal bonds in August and the first three weeks of September was below the torrid second-quarter pace but remained at a high level. Boosted by declining rates, refunding as a percentage of gross long-term issuance rose to 42 percent in August, and incoming data suggest even higher readings for September. Issuance to raise new capital also remained healthy in August and, to date, in September.

On the demand side, uncertainty in the corporate securities market has likely sparked some renewed investor interest in the municipal bond market, as evidenced by larger inflows into municipal bond funds. Nonetheless, because of their relative lack of liquidity, municipal bonds have not benefited as much as Treasuries from safe-haven buying, and the ratio of yields on revenue bonds to Treasury yields has risen to a twelve-year high.

Credit quality in the state and local sector continued to improve over the intermeeting period, with the number of upgrades outpacing downgrades by three to one.

### **Money and Bank Credit**

Both bank credit and the monetary aggregates have been importantly influenced by the turbulence in financial markets. Bank credit expanded at a brisk 16-1/4 percent annual rate in August, after adjusting for mark-to-market accounting effects, with both loans and securities posting sizable gains. Business loans grew at a 12 percent pace in August, even after being held down by a large securitization early in the month. As noted above, the strength in business loans likely reflects, in part, some substitution away from market financing. Incoming data suggest another strong month for business loans in September.

Consumer loans originated by banks expanded at only a 3-1/2 percent pace in August, as households appear to have continued to substitute mortgage and home equity debt for consumer loans. Growth of real estate loans picked up in August to a

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

Type of credit	1997	1998					Aug (billions of \$)	Level, Aug 1998 (billions of \$)
		Q1	Q2	Jun	Jul	Aug		
1. Bank credit: Reported	9.0	11.6	5.4	2.8	4.7	16.1	4,331.9	
2.           Adjusted <sup>1</sup>	8.5	11.2	5.9	0.6	4.6	16.2	4,230.2	
3. Securities: Reported	10.3	17.2	0.6	-6.8	7.8	26.4	1,148.0	
4.           Adjusted <sup>1</sup>	8.5	15.8	2.1	-16.5	7.7	27.9	1,046.3	
5.   U.S. government	6.2	15.7	-3.9	-26.3	6.4	16.6	767.3	
6.   Other <sup>2</sup>	20.8	20.8	10.6	35.7	10.9	46.5	380.7	
7. Loans <sup>3</sup>	8.5	9.7	7.1	6.3	3.6	12.5	3,183.9	
8.   Business	9.0	10.5	5.0	13.8	7.2	11.9	903.6	
9.   Real estate	9.2	7.6	7.2	-0.7	1.4	6.0	1,280.0	
10.   Home equity	15.4	5.4	-0.4	-1.2	-3.7	-1.2	97.3	
11.   Other	8.7	7.8	7.9	-0.4	1.7	6.6	1,182.7	
12. Consumer: Reported	-1.5	-3.5	1.4	-7.8	-14.3	-5.8	494.1	
13.           Adjusted <sup>4</sup>	4.1	3.7	8.9	4.8	2.1	3.4	738.7	
14.   Other <sup>5</sup>	20.4	29.8	17.7	25.9	21.9	48.8	506.2	

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.

MONETARY AGGREGATES  
(Based on seasonally adjusted data)

Aggregate or component	1997	1998		1998			1997:Q4 to Aug. 98 (p)	Level (bil. \$) Aug. 98 (p)
		Q1	Q2	June	July	Aug. (p)		
<u>Aggregate</u>		<u>Percentage change (annual rate)<sup>1</sup></u>						
1. M1	-1.2	3.0	.2	-3.6	-3.2	-3.6	-.1	1068.4
2. M2 <sup>2</sup>	5.7	8.0	7.5	5.3	4.7	8.3	7.3	4242.0
3. M3	8.8	11.0	10.0	6.2	1.0	12.1	9.4	5701.6
<u>Selected Components</u>								
4. Currency	7.5	8.0	5.1	7.4	8.2	6.8	6.9	443.7
5. Demand deposits	-2.0	-1.7	-5.6	-14.8	-16.3	-13.0	-6.7	373.8
6. Other checkable deposits	-12.2	2.4	1.1	-4.4	-3.4	-7.8	-1.1	243.1
7. M2 minus M1 <sup>3</sup>	8.5	9.8	10.1	8.4	7.5	12.4	9.9	3173.7
8. Savings deposits	9.9	12.0	13.6	9.0	14.5	11.7	12.7	1517.3
9. Small time deposits	2.3	.8	-2.6	-1.0	-1.7	-.7	-1.1	960.4
10. Retail money market funds	16.3	19.3	21.7	20.8	5.5	33.1	21.4	696.1
11. M3 minus M2 <sup>4</sup>	19.6	20.3	17.7	8.6	-9.8	23.3	16.0	1459.6
12. Large time deposits, net <sup>5</sup>	17.1	18.8	15.2	16.2	-28.3	11.4	11.2	614.5
13. Institution-only money market mutual funds	21.0	18.9	36.5	28.7	-5.3	36.5	27.1	443.3
14. RPs	17.4	34.1	14.6	-32.6	17.9	33.9	20.7	265.4
15. Eurodollars	31.2	7.6	-18.0	-8.0	9.9	13.3	-1.2	136.4
<u>Memo</u>								
16. Liquid Deposits <sup>6</sup>	4.3	8.2	8.5	3.1	6.8	5.0	7.2	2134.1
17. Sweep-adjusted M1 <sup>7</sup>	6.1	6.6	4.9	2.8	4.6	2.1	4.8	1366.0
18. Monetary base	5.9	6.9	4.1	6.2	5.0	8.9	5.9	497.3
19. Household M2 <sup>8</sup>	6.6	9.3	8.8	7.6	8.0	10.4	9.0	3873.0
		<u>Average monthly change (billions of dollars)<sup>9</sup></u>						
<u>Memo</u>								
<u>Selected managed liabilities at commercial banks:</u>								
20. Large time deposits, gross	11.2	8.5	5.0	4.2	-18.0	9.1	. . .	709.8
21. Net due to related foreign institutions	-3.9	9.5	-16.3	-3.8	14.0	15.1	. . .	193.5
22. U.S. government deposits at commercial banks	.2	-.4	4.3	-10.5	8.6	-19.9	. . .	19.0

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. Sum of seasonally adjusted demand deposits, other checkable deposits, and savings deposits.

7. 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.

8. M2 less demand deposits.

9. 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.

p--Preliminary.

6 percent rate, but in light of low mortgage rates and a robust housing market, the amount of credit that banks originated during the month was likely stronger than the reported number, which was held down by securitizations. Early indications for September suggest that real estate loans are growing at about the same pace registered in August.

Growth in M2 and M3 picked up in August to annual rates of about 8 percent and 12 percent, respectively, returning to the pace of the first quarter of the year after a lull in early summer. M2 was boosted by inflows to retail money market funds, which surged to an annual growth rate of about 33 percent in August and constituted two-thirds of the increase in seasonally adjusted M2. Preliminary data indicate that the sizable inflows continued in the first weeks of September when the equity market continued to experience sizable gyrations. Other components of the monetary aggregates, which are less likely to receive outflows from equity mutual funds, did not show unusual growth in August. Within the non-M2 components of M3, institution-only money funds grew at an annual rate of nearly 37 percent in August, a sharp turnaround from July but not higher than the growth rates seen in many recent months. Growth in large time deposits and RPs was also robust, helping to fund the rapid expansion in bank credit.

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# **INTERNATIONAL DEVELOPMENTS**

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## International Developments

### U.S. International Trade in Goods and Services

In July, the U.S. nominal trade deficit in goods and services was \$13.9 billion, only fractionally larger than in June and smaller than the second-quarter average. In the second quarter, NIPA real net exports made a negative contribution to the annual rate of growth of real GDP of 2.1 percentage points. Trade data for August will be released on October 20.

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

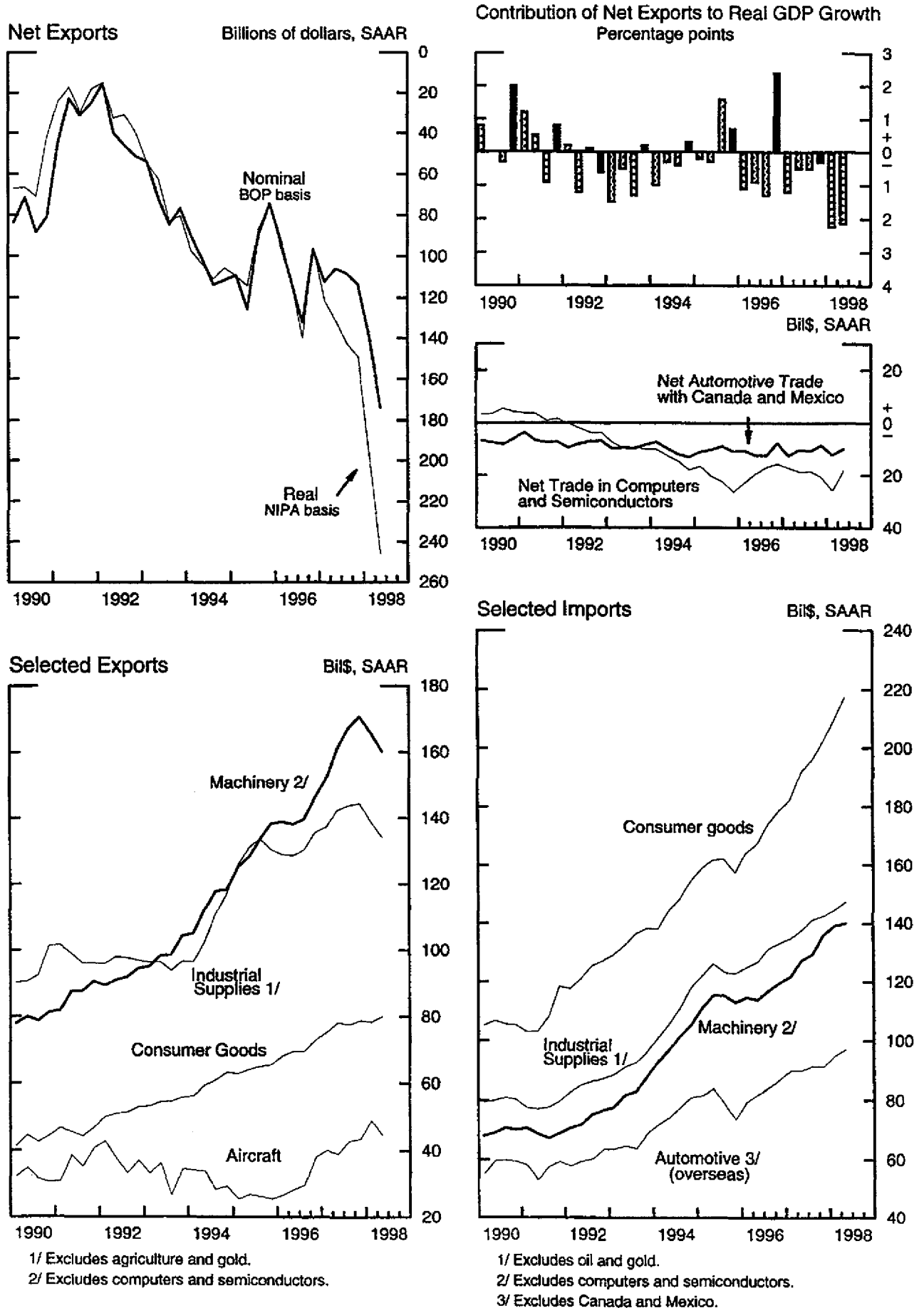
	1997	Annual rates			Monthly rates		
		1997		1998	1998		
		Q4	Q1	Q2	May	Jun	Jul
<u>Real NIPA 1/</u>							
Net exports of G&S	-136.1	-149.0	-198.5	-246.3	...	...	...
<u>Nominal BOP</u>							
Net exports of G&S	-110.2	-113.8	-140.0	-174.3	-15.8	-13.6	-13.9
Goods, net	-198.0	-199.4	-222.8	-257.8	-22.6	-20.5	-20.9
Services, net	87.7	85.5	82.8	83.5	6.8	6.9	7.0

1. In billions of chained (1992) dollars.  
Source. U.S. Dept. of Commerce, Bureaus of Economic Analysis and Census.

The value of exports dropped 1.3 percent in July, primarily a result of decreases in the value of automotive products to Canada and Mexico (a temporary move largely in response to the strike at GM). While exports of consumer goods and industrial supplies moved below average levels recorded in the second quarter, deliveries of aircraft picked up in July to the highest level recorded in more than a year. Exports of machinery held at about June (and Q2 average) levels. There was little change in July in the level of exports to most key countries in Asia.

The value of imports declined 0.8 percent in July. A sharp decrease in imports of vehicles and parts from Canada and Mexico (also a temporary effect of the strike at GM) accounted for much of the decline. Imports of automotive products from other countries declined as well, helped by a sharp drop in imports from Korea (the result of a strike there). Imported consumer goods held at second-quarter average levels in July as did non-oil industrial supplies. For industrial supplies, strengthening imports of steel were offset by reductions in other materials. The value of imported oil in July was less than in June (and the Q2 average); the decline in July was attributable to a drop in price that exceeded the increase in quantity.

### U.S. International Trade in Goods and Services



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

	Levels				Amount Change 1/			
	1998		1998		1998		1998	
	Q1	Q2	Jun	Jul	Q1	Q2	Jun	Jul
<u>Exports of G&amp;S</u>	946.2	921.2	916.5	905.0	-11.7	-25.0	-0.3	-11.5
Goods exports	685.9	659.3	657.2	643.2	-11.3	-26.6	0.6	-14.0
Agricultural	56.4	52.0	52.7	52.9	-4.1	-4.4	2.4	0.3
Gold	5.3	4.2	4.8	2.7	1.9	-1.1	0.4	-2.1
Other goods	624.2	603.0	599.7	587.6	-9.0	-21.2	-2.2	-12.2
Aircraft & pts	48.8	44.8	48.6	54.8	5.3	-4.1	2.0	6.2
Computers	45.5	44.8	46.0	44.8	-3.6	-0.7	2.0	-1.3
Semiconductors	37.8	35.5	35.3	35.7	-1.0	-2.3	0.5	0.4
Other cap gds	168.5	162.8	162.4	161.7	-5.1	-5.6	2.3	-0.8
Automotive	77.7	72.2	67.2	56.9	1.1	-5.5	-4.6	-10.4
to Canada	40.8	39.0	33.9	27.9	-0.5	-1.8	-7.2	-6.1
to Mexico	13.2	12.3	10.7	8.2	-0.1	-0.9	-0.9	-2.5
to ROW	23.7	20.8	22.5	20.8	1.7	-2.9	3.4	-1.8
Ind supplies	138.8	134.1	129.8	129.1	-5.7	-4.7	-7.4	-0.8
Consumer goods	78.3	80.1	82.4	79.9	-0.4	1.7	3.6	-2.5
All other	28.8	28.8	27.9	24.8	0.4	0.0	-7.1	-3.1
Services exports	260.3	261.9	259.3	261.8	-0.4	1.6	-0.9	2.5
<u>Imports of G&amp;S</u>	1086.2	1095.4	1080.2	1072.1	14.5	9.2	-25.9	-8.1
Goods imports	908.7	917.1	903.6	894.5	12.2	8.4	-24.0	-9.0
Petroleum	54.9	53.9	49.5	48.9	-13.7	-1.0	-6.3	-0.6
Gold	6.7	5.5	5.7	5.1	2.9	-1.2	0.2	-0.5
Other goods	847.1	857.7	848.4	840.5	23.0	10.6	-17.9	-7.9
Aircraft & pts	17.9	22.4	23.7	23.5	-0.2	4.6	-0.1	-0.2
Computers	72.4	71.7	69.5	71.0	1.5	-0.7	-5.1	1.4
Semiconductors	36.9	33.5	32.3	31.2	-0.9	-3.3	-1.3	-1.1
Other cap gds	141.8	142.9	140.6	141.1	3.7	1.1	-4.9	0.5
Automotive	148.0	146.0	141.3	127.2	6.9	-2.0	-9.2	-14.1
from Canada	53.1	49.0	43.4	39.8	3.1	-4.0	-6.4	-3.6
from Mexico	27.2	28.5	27.0	20.3	-0.7	1.3	-2.7	-6.7
from ROW	67.7	68.5	70.9	67.1	4.5	0.8	-0.1	-3.8
Ind supplies	144.5	147.3	146.2	146.7	2.2	2.9	-2.8	0.5
Consumer goods	209.1	217.4	218.1	218.6	7.1	8.2	3.4	0.6
Foods	41.7	41.8	43.1	41.2	1.5	0.0	1.6	-1.9
All other	34.8	34.7	33.7	40.1	1.2	-0.1	0.6	6.5
Services imports	177.5	178.4	176.6	177.5	2.3	0.8	-1.9	0.9
Memo:								
Oil qty (mb/d)	10.83	11.80	11.12	11.47	0.13	0.98	-0.83	0.34
Oil price (\$/bbl)	13.90	12.51	12.17	11.67	-3.77	-1.39	-0.59	-0.50

1. Change from previous quarter or month.

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

**Oil imports and prices.** The quantity of imported oil rose between June and July to a rate that was just under the average recorded in the second quarter. Imports had risen 9 percent during 1998-Q2 to a rate of 11.8 mb/d primarily due to an acceleration in stockbuilding, strong consumption and a decline in production. Preliminary Department of Energy statistics indicate that oil imports remained robust in August, primarily reflecting strong consumption.

The price of imported oil increased 0.3 percent in August, the first rise since May. The import price had risen slightly in April and May, following cuts in production by OPEC and non-OPEC countries, and dropped significantly in June and July following reports of surprisingly high levels of oil stocks and a sharp downward revision in estimates of Asian oil consumption. For July-August combined, prices of imported oil declined 21 percent at an annual rate, somewhat less than the decline recorded in the second quarter.

The spot price for WTI fell back below \$13/b in mid-August because of larger-than-expected shipments from Iraq and market disappointment over the pace of production cutbacks from the other OPEC producers. Weak oil demand, particularly in Asia, also contributed to the soft market. Spot WTI has risen thus far in September as OPEC further tightened its production restraints and Iraq announced that it will be unable to maintain its August pace of oil shipments. Several temporary factors have lifted oil prices as well. Storms in the Caribbean and the Gulf of Mexico have shut down oil production intermittently, disturbances in Nigeria have forced cut-backs in liftings, and the maintenance season in the North Sea has resulted in larger production cutbacks of longer duration than the market expected.

**Prices of non-oil imports and exports** decreased 0.3 percent in August. Declines were recorded in prices of all major categories of imports, with the greatest declines in prices of foods and computers. For July-August combined, the decline in prices of non-oil imports was 4.1 percent at an annual rate, a bit more than in the preceding quarter. Notable price declines were recorded in all major trade categories with the exception of imported consumer goods and automotive products, each of which decreased only 1.3 percent at an annual rate.

Prices of agricultural exports resumed declining in August. For July-August combined, agricultural export prices decreased 5 percent at an annual rate, a smaller rate of decline than in the preceding four quarters. Sagging demand from foreign customers and robust world production have placed downward pressure on prices of agricultural exports.

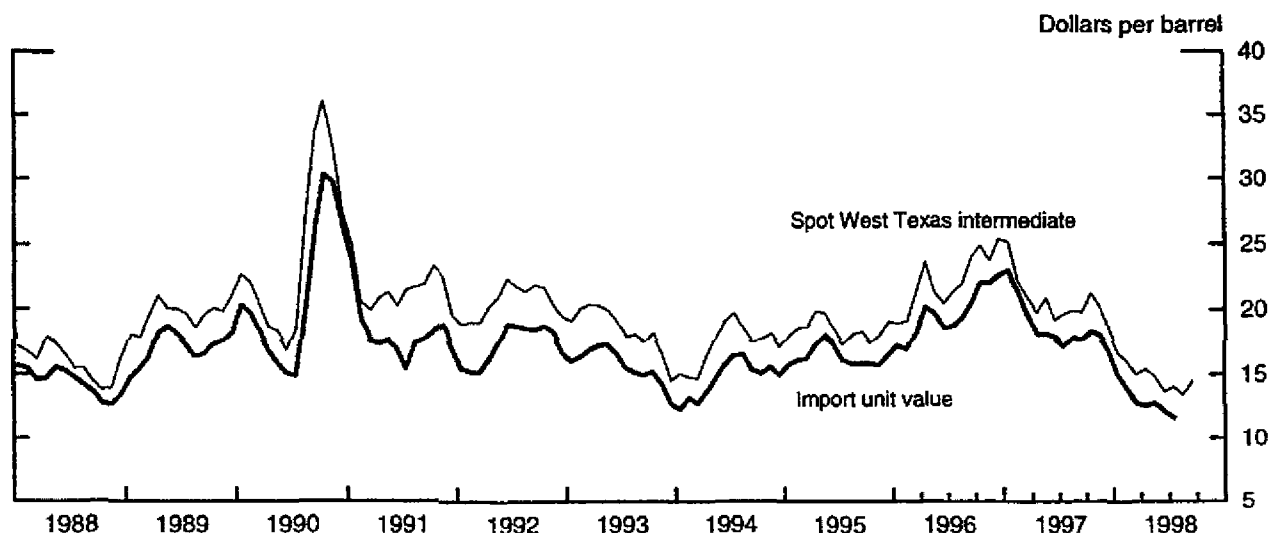
PRICES OF U.S. IMPORTS AND EXPORTS  
(Percentage change from previous period)

	Annual rates			Monthly rates		
	1998			1998		
	Q1	Q2	Q3e/	Jun	Jul	Aug
-----BLS prices (1995=100)-----						
<u>Merchandise imports</u>	-11.6	-5.9	-5.3	-0.8	-0.6	-0.3
Oil	-61.5	-31.7	-21.1	-4.5	-3.1	0.3
Non-oil	-5.3	-3.7	-4.1	-0.4	-0.5	-0.3
Core goods*	-3.8	-2.5	-3.2	-0.2	-0.5	-0.2
Foods, feeds, bev.	-5.1	-0.1	-6.9	0.7	-0.7	-2.4
Ind supp ex oil	-11.1	-4.0	-7.2	-1.1	-1.0	-0.4
Computers	-17.3	-19.2	-8.8	-0.9	-0.6	-1.1
Semiconductors	-17.2	-5.1	-14.6	-2.6	-1.8	-0.8
Cap. goods ex comp & semi	-3.2	-2.6	-3.6	-0.3	-0.6	-0.1
Automotive products	-0.1	-0.8	-1.3	-0.1	-0.1	-0.2
Consumer goods	-1.1	-2.7	-1.3	-0.1	-0.2	-0.1
<u>Merchandise exports</u>	-5.0	-3.4	-3.1	-0.6	-0.1	-0.6
Agricultural	-15.6	-7.0	-4.9	0.0	0.3	-3.7
Nonagricultural	-3.7	-2.8	-2.9	-0.5	-0.3	-0.1
Core goods*	-3.5	-2.0	-2.3	-0.2	-0.4	0.0
Ind supp ex ag	-9.0	-5.2	-7.9	-0.9	-1.1	-0.6
Computers	-10.5	-11.8	-12.7	-3.4	-0.4	-1.2
Semiconductors	-6.8	-9.8	-4.4	-2.0	0.6	-0.4
Cap. goods ex comp & semi	0.0	-0.3	-0.3	-0.2	0.1	-0.1
Automotive products	-0.1	0.3	0.4	0.0	0.1	0.0
Consumer goods	-0.5	-1.4	-0.9	-0.4	0.0	0.0
---Prices in the NIPA accounts (1992=100)---						
<u>Chain-weight</u>						
Imports of gds & serv.	-10.4	-4.6	n.a	...	...	...
Non-oil merchandise	-5.6	-3.7	n.a	...	...	...
Core goods*	-3.3	-1.9	n.a	...	...	...
Exports of gds & serv.	-3.4	-1.9	n.a	...	...	...
Nonag merchandise	-3.5	-2.8	n.a	...	...	...
Core goods*	-2.4	-1.7	n.a	...	...	...

\*/ Excludes computers and semiconductors.

e/ Average of two months.

### Oil Prices



The price of nonagricultural exports decreased marginally in August. For July-August combined, these prices declined at a 3 percent annual rate, about the same rate of decline recorded in the second quarter; the sharpest decreases were in industrial supplies, computers, and semiconductors. Price declines for exported consumer goods and "core" capital goods were less than 1 percent at an annual rate. Prices of exported automotive products increased slightly in July-August.

**U.S. Current Account.** The U.S. current account deficit widened to \$226.1 billion (SAAR) in the second quarter. The bulk of the increase was due to a substantially larger deficit on goods and services, as exports fell sharply and imports continued to rise. The deficit on investment income also rose; income receipts on U.S. assets abroad were unchanged, while income payments on foreign assets increased modestly. Net unilateral transfers rose slightly, as U.S. government grants edged down.

U.S. CURRENT ACCOUNT  
(Billions of dollars, seasonally adjusted annual rates)

	Goods & services balance	Investment income, net	Transfers, net	Current acct balance
<u>Years</u>				
1996	-108.6	14.2	-40.6	-134.9
1997	-110.2	-5.3	-39.7	-155.2
<u>Quarters</u>				
1997-1	-112.5	0.1	-35.5	-148.0
2	-106.1	1.8	-36.1	-140.4
3	-108.4	-6.2	-37.8	-152.4
4	-113.8	-17.0	-49.3	-180.2
1998-1	-140.0	-9.0	-37.9	-186.9
2	-175.8	-13.0	-37.3	-226.1
<u>Memo:</u>				
<u>\$ Change</u>				
Q4-Q3	-5.4	-10.8	-11.5	-27.8
Q1-Q4	-26.2	8.0	11.4	-6.7
Q2-Q1	-35.8	-4.0	0.6	-39.2

Source. U.S. Department of Commerce, Bureau of Economic Analysis.

**U.S. International Financial Transactions**

Foreign official reserve assets in the United States declined further in July, accelerating the outflow seen in the second quarter (line 1 of the Summary of U.S. International Transactions table). Declines by China—both Mainland and Hong Kong—and Singapore more than account for the nearly \$6 billion reduction shown for "other" countries in line 1c. OPEC reserves in the United States also declined significantly in July.

Partial data for August and the first half of September from the FRBNY show a significant further decline—of approximately \$30 billion—in foreign reserves in the United States. With the exception of most industrialized countries in Europe, nearly all countries registered some reduction. The largest of these were in OPEC, greater China, and Russia.

Net foreign private purchases of U.S. securities slowed markedly in July as Treasury transactions swung to net sales and net bond purchases slowed (line 4). Most of the net sales of Treasuries in July (line 4a) were attributable to transactions with financial centers in the United Kingdom and the Caribbean. There were small net purchases of Treasuries recorded against most Asian economies with the exception of Japan, which registered small net sales.

Reduced foreign purchases of bonds (line 4b) reflect declines in foreign purchases of both corporate and government-sponsored agency bonds. Foreign purchases of agencies, which had averaged more than \$6 billion per month during the first half of the year, dropped to \$1 billion in July. Foreign net purchases of U.S. equities in July were little changed from June (line 4c); continued net sales from Asia were more than offset by continued net purchases from Europe.

U.S. net purchases of foreign securities slowed markedly in July (line 5), as bond transactions swung from significant net purchases to net sales. The swing in bond transactions was widespread throughout Europe and Asia. The only region recording an increase in net purchases was Latin America and the Caribbean. In contrast to bonds, U.S. transactions in foreign equities swung from net sales in June to net purchases in July (line 5b). Transactions in Europe account for most of this swing; however, U.S. residents also resumed purchasing equities in Japan in July, after recording net sales in June.

Net capital inflows through bank transactions picked up further in July (line 3). The inflow was more than attributable to interbank transactions with unaffiliated foreigners. On a monthly average basis, banks' net claims on own foreign offices and IBFs were little changed in July (See line 1 of the International Banking Data table).

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

	1996	1997	1997		1998			
			Q3	Q4	Q1	Q2	June	July
<b>Official capital</b>								
1. Change in foreign official assets in U.S. (increase, +)	127.7	19.9	24.0	-26.3	12.4	-9.9	-5.1	-7.4
a. G-10 countries	36.6	1.8	2.1	-12.6	4.0	-10.0	.2	1.7
b. OPEC countries	15.4	13.0	4.7	-.9	-5	.2	-6	-3.4
c. All other countries	75.7	5.1	17.1	-12.7	8.9	-1	-4.8	-5.7
2. Change in U.S. official reserve assets (decrease, +)	6.7	-1.0	-7	-4.5	-4	-1.9	-.7	-1.5
<b>Private capital</b>								
<b>Banks</b>								
3. Change in net foreign positions <sup>1</sup> of banking offices in the U.S.	-50.1	34.6	-8.5	46.2	-5.7	5.6	6.5	14.2
<b>Securities<sup>2</sup></b>								
4. Foreign net purchases of U.S. securities (+)	287.2	346.6	103.8	71.2	77.3	97.1	25.9	8.2
a. Treasury securities <sup>3</sup>	155.6	147.2	40.3	35.5	-1.5	25.9	2.6	-5.4
b. Corporate and other bonds <sup>4</sup>	118.9	128.1	36.3	25.8	47.7	57.0	19.3	9.8
c. Corporate stocks	12.7	71.3	27.2	9.8	31.1	14.2	3.9	3.8
5. U.S. net purchases (-) of foreign securities	-110.6	-89.1	-39.0	-8.8	-12.5	-26.4	-8.8	-1
a. Bonds	-51.4	-48.2	-24.6	-9.1	-9.7	-25.4	-11.3	3.1
b. Stocks	-59.3	-40.9	-14.4	.3	-2.8	-1.0	2.5	-3.2
<b>Other flows (quarterly data, s.a.)</b>								
6. U.S. direct investment (-) abroad	-81.1	-121.8	-27.5	-35.5	-34.3	-40.3	n.a	n.a
7. Foreign direct investment in U.S.	77.6	93.4	19.0	28.5	25.9	22.0	n.a	n.a
8. Foreign holdings of U.S. currency	17.4	24.8	6.6	9.9	.7	2.3	n.a	n.a
9. Other (inflow, +) <sup>5</sup>	-80.3	-50.9	-19.0	14.9	-13.6	17.4	n.a	n.a
<b>U.S. current account balance (s.a.)</b>	<b>-134.9</b>	<b>-155.2</b>	<b>-38.1</b>	<b>-45.0</b>	<b>-46.7</b>	<b>-56.5</b>	<b>n.a</b>	<b>n.a</b>
<b>Statistical discrepancy (s.a.)</b>	<b>-59.6</b>	<b>-99.7</b>	<b>-20.0</b>	<b>-52.0</b>	<b>-3.1</b>	<b>-9.4</b>	<b>n.a</b>	<b>n.a</b>

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 DATA<sup>1</sup>**  
(Billions of dollars)

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>				
	<u>Dec.</u>	<u>Dec.</u>	<u>Dec.</u>	<u>Mar.</u>	<u>May</u>	<u>June</u>	<u>July</u>	<u>Aug.</u>
1. Net claims of U.S. banking offices (excluding IBFs) on own foreign offices and IBFs	-260.0	-231.2	-195.8	-196.8	-188.0	-183.3	-182.5	-192.7
a. U.S.-chartered banks	-86.1	-66.4	-69.8	-78.0	-83.9	-84.1	-77.1	-90.1
b. Foreign-chartered banks	-173.9	-164.8	-126.0	-118.8	-104.1	-99.2	-105.4	-102.6
2. Credit extended to U.S. nonbank residents								
a. By foreign branches of U.S. banks	26.5	31.9	34.4	35.2	36.0	36.2	35.5	35.6
b. By Caribbean offices of foreign-chartered banks	86.3	79.4	90.1	107.0	n.a	108.8	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	94.6	119.5	151.1	142.0	140.7	138.6	137.1	140.1
b. At the Caribbean offices of foreign-chartered banks	92.3	122.2	115.0	119.1	n.a	119.8	n.a	n.a
MEMO: Data as recorded in the U.S. international transactions accounts								
4. Credit extended to U.S. nonbank residents	212.8	239.0	287.2	309.2	n.a	322.2	n.a	n.a
5. Eurodeposits of U.S. nonbank residents	275.8	336.7	415.2	436.9	n.a	425.2	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

In August, however, U.S. banking offices reduced their net claims on own foreign offices and IBFs by about \$10 billion.

Recently released balance of payments data for the second quarter show a slight slowing in foreign direct investment into the United States (line 7 of the Summary table). Nevertheless, the pace of direct investment inflows remains near last year's record pace. Boosted by several large takeovers, U.S. foreign direct investment abroad picked up even further in the second quarter (line 6) and remains well above last year's record pace.

The statistical discrepancy in the U.S. international accounts was negative \$9½ billion in the second quarter, indicating some combination of over-recorded net capital inflows or under-recorded net exports (last line of the Summary table). Though still significant, the discrepancy so far this year is much smaller than that recorded in the previous two years.

### **Foreign Exchange Market**

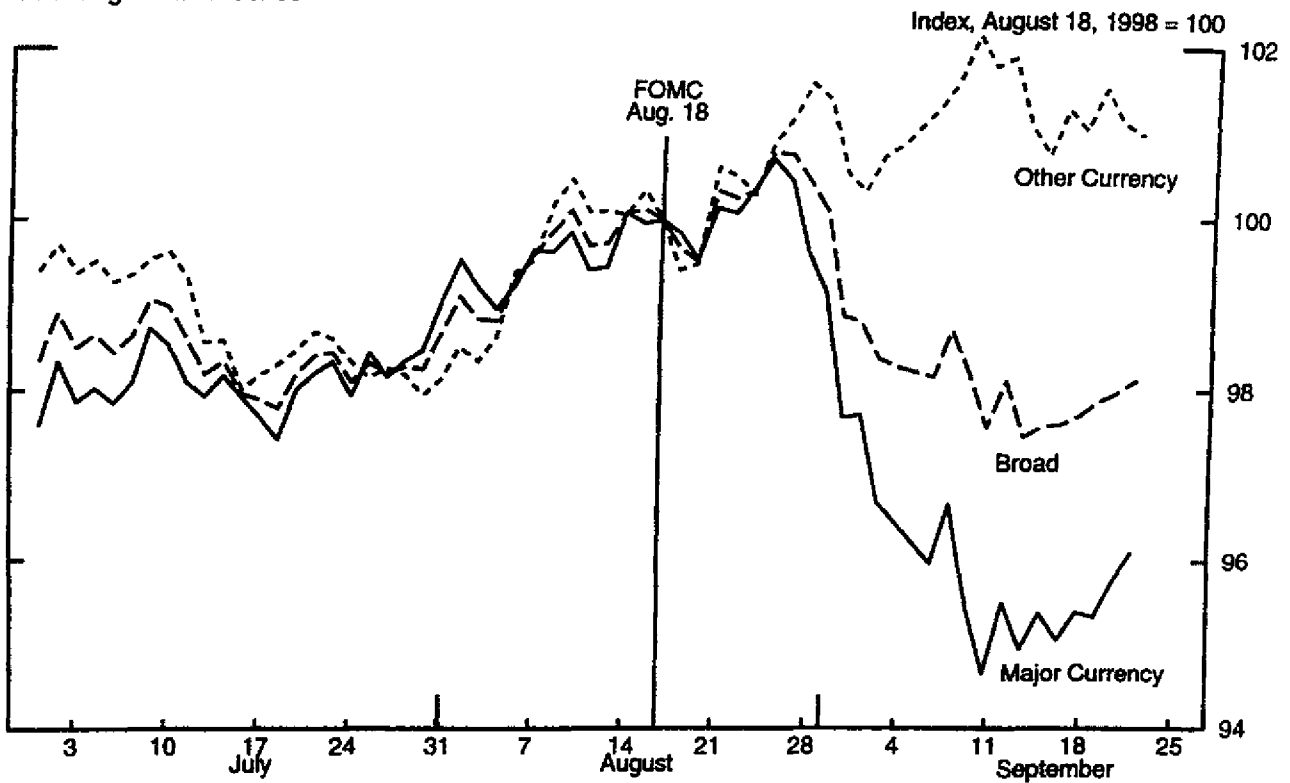
Volatility in world financial markets has risen further since the August 18 FOMC meeting. The August 17 announcement by the Russian government of a suspension of payments on ruble-denominated debt and of an effective devaluation of the ruble ushered in a period of turmoil that spread to other emerging-markets. The protracted debate between the LDP and opposition parties in the face of deteriorating domestic economic conditions in Japan also contributed to an overall concern about the depth of the economic slowdown in Japan and elsewhere. Equity prices in most industrialized and developing countries declined sharply. The price of emerging market debt issues, particularly in Latin America, fell precipitously, as investors sought refuge in government bonds of major industrial countries; as a result, government bond yields fell to new historical lows in most industrial countries. There was also increased pressure on many currencies, first in the Asia-Pacific region and later in Latin America and Northern Europe. Towards the end of the period, widespread speculation about the timing of possible actions to ease monetary policy by the United States and other major industrial countries appeared to be the main factor driving asset price movements. Numerous rumors, also towards the end of the period, of possible aid packages for Latin American countries led to a partial recovery in the value of Latin American assets.

Since the August FOMC meeting, the trade-weighted foreign exchange value of the dollar has depreciated 4 percent, on average, against the 16 major currencies in our narrow index. Over the same time period, the dollar has appreciated ½ percent, on average, against the currencies of other important trading partners in our 29-currency broad index, yielding an overall depreciation of 2 percent in the broad index. With

### Exchange Rates

(Daily data)

Exchange Rate Indexes



### Financial Indicators in Major Industrial Countries

	Three-month rates		Ten-year yields		Equity prices
	Sept. 23	Change	Sept. 23	Change	Change <sup>P</sup>
Canada	5.62	0.44	5.11	-0.45	-8.42
Japan	0.35	-0.35	0.80	-0.41	-6.79
Germany	3.38	-0.06	3.96	-0.45	-12.44
United Kingdom	7.31	-0.32	5.04	-0.57	-10.45
France	3.44	0.02	4.13	-0.43	-14.99
Italy	4.76	0.02	4.43	-0.34	-18.78
Switzerland	1.44	-0.27	2.79	-0.07	-16.76
Australia	4.98	-0.11	5.25	-0.30	1.45
Weighted-average foreign	3.65	0.00	3.64	-0.38	
United States	5.43 <sup>P</sup>	-0.16	4.74 <sup>P</sup>	-0.66	-5.30

Note. Change is in percentage points from August 17 to September 23. <sup>P</sup> Preliminary.

respect to specific currencies, the dollar depreciated 6½ percent in terms of the yen, 6 percent in terms of the mark, and 4 percent against sterling.

Three main factors are thought to have influenced the exchange value of the dollar during the intermeeting period. First, the exposure of the United States to Latin American markets was seen as greater than that of other major industrial nations. Second, particularly after Chairman Greenspan's September 4 speech, most market participants seemed to believe that the Federal Reserve was likely to move to lower interest rates before the end of the year. The central banks of other industrial nations appeared either less likely to match the rate cut or, at the very least, less likely to match the timing of the Federal Reserve. Consistent with that view, the spread between U.S. and German 10-year bond yields declined 21 basis points in the intermeeting period. Third, uncertainty about President Clinton's political future appeared to weigh on the dollar in the later part of the period.

While concerns about trade imbalances in the United States and Japan may have arisen at times during the period, the extent of the appreciation of the yen against the dollar was somewhat puzzling in light of the deepening recession of the Japanese economy and of the severity of its banking sector crisis. Market commentary cited threats of intervention in support of the yen by various Japanese government officials, rumors that Japanese companies were repatriating large amounts of assets in preparation for the end of the fiscal half-year on September 30, and other rumors that many investors who had financed their investments in emerging markets by borrowing yen were closing their positions and buying yen to repay their loans. The surprise announcement on September 9 by the Bank of Japan that they would guide their overnight call rate from slightly below ½ percent to ¼ percent resulted in only a temporary reversal of the yen's trend. The yen's rise in value against the dollar appeared to be an important factor in the diminishing pressure on some of the pegged currencies in Asia, particularly the Hong Kong dollar and the Chinese renminbi, towards the later part of the period. The exchange value of the dollar against other floating currencies in Asia was mixed, as the dollar appreciated 5 percent against the Korean won but depreciated 3¼ percent against the Thai baht. On September 1, Malaysia chose to adopt capital controls and to peg the value of the ringgitt to the dollar; there were concerns that other countries in the region may follow suit.

Contributing to the dollar's depreciation against the mark were statements by several Bundesbank officials, in the weeks following Chairman Greenspan's September 4 speech, indicating that they did not believe a German rate cut to be warranted. Most

market analysts also came to believe that the effective exposure of German banks to the Russian crisis was not as large as had been feared initially. Other euro-zone currencies followed the mark's movement, with the strain on currencies reflected in a few sporadic intervention operations and in small movements in spreads of government bond yields relative to German bunds. The exchange value of the British pound, which rose less against the dollar than most European currencies, was affected by the release of data showing slower growth and a diminished inflation threat in the United Kingdom; this increased the perceived likelihood of a future monetary easing by the Bank of England. Some other European currencies outside of the euro-zone, particularly in Scandinavia, also came under pressure. The Norwegian krone, which was affected by low oil prices, depreciated about 4 percent against the mark

The exchange value of the dollar in terms of the Canadian dollar was little changed on balance.

Moody's September 3 downgrade of the foreign-currency debt ratings of Brazil and Venezuela and its placement of the debt of Mexico and Argentina on review reinforced the already pessimistic outlook about the region's financial stability. The Mexican peso, affected by low oil prices and concerns about neighboring Latin American economies, found little support in soaring cete rates and repeated auctions of dollars by the central bank, with the dollar up 8½ percent against the peso during the period.

Vast capital outflows were reported in Brazil despite large increases in policy interest rates; Brazil's daily capital outflows at times topped \$2 billion but slowed significantly by the third week of September, as numerous unconfirmed rumors circulated of a large international lending package prepared by G-7 nations, led by the United States, and international financial organizations. Columbia and Ecuador devalued their currencies on September 2 and 13, respectively. There was widespread market commentary that the Venezuelan bolivar, under additional pressure from low oil prices and a difficult political situation, would soon have to be devalued.

In Russia, the exchange rate of the ruble was difficult to assess with certainty since quotes originated in a very illiquid market, but a depreciation of at least 50 percent versus the dollar since August 17 was evident.

Equity prices in many of the world's markets have fallen significantly since the last FOMC meeting, in sessions often marked by extreme volatility. Immediately after the Russian debt problems intensified, share prices of financial sector firms in most industrial economies declined, as investors attempted to gauge the exposure of various institutions. Later, concerns about future earnings of corporations faced with declining world demand appeared to be driving equity prices lower. In Asia, Japanese share prices declined more than 6½ percent from already extremely depressed levels. Hong Kong share prices rose 4 percent, supported by unusual equity purchase operations by the Hong Kong Monetary Authority. Share prices in many other Asian markets fell, particularly in Indonesia and the Philippines. European equity indexes fell 10½ percent (United Kingdom) to 19½ percent (Spain -- where prices were most affected by losses in Latin America). Canadian share prices fell 8½ percent. Latin American equity prices were the most volatile; the Brazilian Bovespa and the Argentine Merval lost over 21 percent, but the Mexican Bolsa gained 2½ percent.

Nowhere was the flight-to-quality theme more evident than in bond markets, with soaring yields on most emerging-market sovereign issues standing in contrast to record-low yields on Japanese, Canadian, European and U.S. government bonds. The yield spreads over Treasury securities of most Latin American Brady bonds had widened over 500 basis points by mid-September, but bond prices retraced some of their losses late in the period. Yield spreads of Asian dollar-denominated debt also widened to levels exceeding those of last fall. The collapse of Russian financial markets was evidenced by an increase in the yield spread of the Russian dollar-denominated Prin bond of more than 3000 basis points. In the major foreign industrial economies, yields on bellwether government bond issues generally fell 25 to 55 basis points. German and Japanese bond yields fell 45 and 41 basis points, respectively, reaching new historical lows during the period. In addition, the yield spreads between core and periphery euro-zone countries widened during the intermeeting period; the spread between Italian and German 10-year bellwether issues increased 11 basis points to 47 basis points.

. The Desk did not intervene for the accounts of the System or the Treasury.

## Financial Indicators in Latin America, Asia, and Russia

	Currency/US dollar		Short-term interest rates		Dollar-denominated bond spread		Equities
	Sept. 23	Change	Sept. 22/23	Change	Sept. 22/23	Change	Change
Mexico	10.1050	8.64	38.00	15.50	11.42 <sup>b</sup>	3.68	2.6
Brazil	1.1834	0.89	38.00	18.30	15.09 <sup>b</sup>	5.75	-21.4
Argentina	.9998	0.05	15.93	8.23 <sup>*</sup>	10.76 <sup>b</sup>	2.98	-21.7 <sup>*</sup>
Chile	466.00					-7.78	-16.3
Venezuela	581.75	1.75			18.13 <sup>b</sup>	3.60	-17.6
China	8.2785	-0.38			2.60 <sup>a</sup>	0.23	14.9
Korea	1404.00	5.17	8.30	-1.80	8.77 <sup>a</sup>	2.96	-3.2
Taiwan	34.61	-0.46	6.65	-0.20			-4.3
Singapore	1.7290	-1.98	4.38	-0.25			-0.0
Hong Kong	7.7477	-0.03	8.18	-2.79			3.9 <sup>*</sup>
Malaysia	3.7998	-10.44	7.40	-2.50	9.09 <sup>a</sup>	3.56 <sup>*</sup>	19.0
Thailand	40.45	-3.23	11.50	-2.50	7.98 <sup>y</sup>	3.65 <sup>**</sup>	-1.7
Indonesia	10925	-13.98	70.26	1.26	13.90 <sup>y</sup>	2.80	-36.8 <sup>*</sup>
Philippines	44.40	2.66			7.00 <sup>a</sup>	1.88	-13.2
Russia	15.00	130.77	48.28	2.90 <sup>*</sup>	55.36 <sup>b</sup>	33.06	-56.2

Note. Change is in percentage points from Aug. 17 to Sept. 22 or 23. <sup>b</sup> Stripped Brady bond yield spread over U.S. Treasuries.

<sup>a</sup> Global bond yield spread. <sup>e</sup> Eurobond yield spread. <sup>y</sup> Yankee bond yield spread. <sup>\*</sup>Change from August 14, <sup>\*\*</sup> August 11.

### **Developments in Foreign Industrial Countries**

Data on second-quarter real activity show that the Japanese economy contracted for the third consecutive quarter, hit once again by declining business fixed investment. Available current-quarter data indicate further contraction. European economies felt the effect of the Asian crisis in the second quarter, as a deterioration in net exports offset continued strength in domestic demand. German economic activity slowed sharply in the second quarter, but the slowdown was exaggerated by temporary factors that had raised first-quarter growth at the expense of the second quarter. July orders data indicate a forthcoming deterioration in export growth. Canadian economic activity slowed in the second quarter, partly from the effects of the GM strike and Canadian construction strikes. Recent data on employment and retail sales are also consistent with a slowing economy.

Inflation pressures have eased further in most foreign industrial countries, with inflation falling to zero in Japan. U.K. inflation has met the government's inflation target of 2½ percent for the first time since January. Easing inflation pressures and a slowing U.K. economy have contributed to a recent indication by the Bank of England that a future easing of monetary policy is becoming more likely.

**Individual country notes.** In **Japan**, real GDP contracted 3.3 percent (SAAR) during the second quarter, with total domestic demand plunging 6.2 percent. Business fixed investment dropped 20 percent for the second consecutive quarter. Private consumption and residential investment also declined. Public demand subtracted another ¼ percentage point from growth, with a 2.6 percent drop in government consumption more than offsetting a slight increase in public investment. The decline in domestic demand was offset partially by a 2.9 percentage point contribution from net exports, as exports fell but imports collapsed. GDP during the second quarter was down 4.5 percent from its peak during the first quarter of 1997.

Economic indicators for the third quarter suggest that the economy continues to contract. Unemployment eased a bit in July, but the ratio of offers to applicants fell to 0.50, the lowest level in over 30 years. Industrial production in July declined 0.6 percent from June and was down slightly from the very weak second-quarter average. Household expenditure, retail sales, housing starts, and machinery orders also registered large declines during July.



**JAPANESE REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997		1998	
			Q3	Q4	Q1	Q2
GDP	3.4	-0.4	3.2	-1.5	-5.2	-3.3
Total Domestic Demand	3.3	-2.0	3.5	-3.7	-3.6	-6.2
Consumption	2.4	-0.9	7.0	-4.0	1.1	-3.1
Investment	6.0	-5.4	-2.9	-4.3	-12.8	-12.7
Government Consumption	1.8	0.2	2.8	5.6	-2.3	-2.6
Inventories (contribution)	-0.2	0.2	0.1	-0.5	0.0	-0.3
Exports	8.0	8.5	-5.8	11.3	-15.8	-1.8
Imports	7.0	-4.5	-4.3	-6.5	-5.4	-24.5
Net Exports (contribution)	0.2	1.6	-0.3	2.2	-1.7	2.9

1. Annual changes are Q4/Q4.

Japan's current account surplus during the first seven months of the year was \$113.5 billion at an annual rate, up from \$94.2 billion during 1997. Merchandise exports (valued in dollars) are down 7.5 percent from the 1997 average, but imports have fallen 16.6 percent.

On September 9, the Bank of Japan (BOJ) cut the overnight call-money target to 0.25 percent. The target previously had been set at "slightly below the official discount rate" of 0.5 percent; in recent months, the BOJ had allowed the call-money rate to fluctuate between 40-45 basis points. In a statement explaining the action, the BOJ indicated the rate cut was necessary "to ensure the economy does not worsen further and to prevent the economy from falling into a deflationary spiral." The BOJ also indicated that if circumstances in financial markets were to become more severe, the BOJ would provide large liquidity injections, even if such action caused the call-money rate to fall below the announced target.

The ruling Liberal Democratic Party (LDP) has conducted extended negotiations with the major opposition parties regarding the content of banking legislation. Both sides agree that depositors should be protected using public funds and that efforts should be made to minimize systemic consequences from bank failures. In particular, there is agreement that healthy customers of insolvent banks should continue to have access to liquidity. In addition, the two sides have determined to establish an "emergency financial

sector rehabilitation committee" that would be given power to identify failed banks and to respond either by appointing a receiver or by "nationalizing" the bank through the purchase of outstanding shares. On September 18, the two sides announced the outline of a compromise that would place LTCB under state control (rather than injecting capital into the bank), scrap previous legislation that allocated ¥13 trillion for open bank assistance, and strip the Ministry of Finance of its policymaking functions with respect to the financial sector. The agreement, however, was subsequently called into question as some LDP officials suggested that LTCB might be given public funds before the new legislation is actually approved. The two sides will continue negotiations in an effort to resolve remaining points of dispute.

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

	1997	1998					
	Q4	Q1	Q2	May	Jun	Jul	Aug
Industrial Production	-2.5	-1.2	-5.1	-2.0	1.7	-0.6	n.a.
Housing Starts	0.2	1.1	-6.2	1.1	-3.1	-9.3	n.a.
Machinery Orders	-10.2	-4.2	-6.5	-5.2	12.5	-9.4	n.a.
New Car Registrations	-0.0	-7.5	-3.4	8.7	-1.8	0.8	-3.5
Unemployment Rate (%)	3.5	3.6	4.2	4.1	4.3	4.1	n.a.
Job Offers Ratio <sup>1</sup>	0.69	0.61	0.53	0.53	0.51	0.50	n.a.
Business Sentiment <sup>2</sup>	-11	-31	-38	...	...	...	...
CPI (Tokyo area) <sup>3</sup>	2.1	2.1	0.6	0.8	0.4	0.0	n.a.
Wholesale Prices <sup>3</sup>	1.4	-0.4	-1.6	-1.7	-0.3	-0.3	-0.2

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.

The Obuchi administration announced that in January it will submit to the Diet ¥4 trillion of permanent personal income tax cuts and at least ¥2 trillion of permanent corporate tax cuts. The government in January also will submit a second supplementary budget for FY 1998 that should include at least ¥4 trillion of new "real water" expenditures. Early indications suggest, however, that the initial FY 1999 budget may be as contractionary as the original FY 1998 budget.

Real economic activity in most of the eleven countries scheduled to enter **European Monetary Union** next year continued to expand in the second quarter, although more slowly than in the first quarter. The average unemployment rate continued to fall in most countries, and consumer price inflation remained quiescent across the EMU area. Third quarter indicators, which are scant, point to modest growth. In July, both consumer confidence and business sentiment remained close to their averages in the second quarter.

**EURO-11 ECONOMIC INDICATORS<sup>1</sup>**  
(Percent change from previous period except where noted, SA)

	1996	1997	1997		1998		
			Q3	Q4	Q1	Q2	Jul
GDP	1.9	3.0	0.8	0.6	0.8	0.5	...
Industrial Production <sup>2</sup>	-0.2	6.3	0.2	2.3	0.9	-0.3	n.a.
Unemployment Rate <sup>3</sup>	12.1	12.1	12.1	12.1	11.9	11.6	n.a.
Business Confidence <sup>4</sup>	-16.0	-4.0	-2.0	1.0	2.0	2.0	1.0
Consumer Confidence <sup>4</sup>	-20.0	-15.0	-15.0	-11.0	-8.0	-5.0	-4.0
Consumer Prices <sup>5</sup>	2.0	1.4	1.5	1.4	1.2	1.5	n.a.

1. Weighted by GDP shares, except as otherwise noted.
2. Excludes Austria, Belgium, Luxembourg, Portugal and Spain.
3. Excludes Luxembourg and Portugal.
4. Level of index.
5. Harmonized CPI; percent change from previous year, weighted by shares in private final domestic consumption expenditure.

Real GDP growth in **Germany** dropped back sharply in the second quarter to 0.4 percent (SAAR) from an upwardly revised 5.9 percent pace in the first quarter. Domestic demand also was nearly flat during the second quarter, as private consumption and investment expenditure declined. Industrial production, excluding construction, was unchanged, following a strong surge in the first quarter; including construction, industrial production fell 0.7 percent in the second quarter. Both exports and imports expanded sharply, but their net contribution to second-quarter growth was zero. Government consumption and inventories, a residual, were the only components that made positive contributions to GDP in the second quarter.

**GERMAN REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997		1998	
			Q3	Q4	Q1	Q2
GDP	2.1	2.3	2.3	1.2	5.9	0.4
Total Domestic Demand	1.2	1.5	-0.7	3.2	6.9	0.4
Consumption	1.4	1.0	-2.0	2.3	3.5	-2.7
Investment	2.3	-0.8	3.0	0.5	13.5	-16.5
Government Consumption	0.8	-2.9	-5.0	-11.5	15.9	5.0
Inventories (contribution)	-0.2	1.7	0.8	4.1	-0.9	4.7
Exports	8.5	11.1	23.5	-1.0	0.8	10.2
Imports	5.1	8.2	12.1	5.4	3.9	10.5
Net Exports (contribution)	0.9	0.8	3.1	-1.9	-0.9	0.0

1. Annual changes are Q4/Q4

The marked slowdown in second-quarter growth has been attributed to two factors. First, in anticipation of an increase at the beginning of April in the value-added tax (by 1 percentage point), consumption expenditures were shifted forward. Second, unusually warm first-quarter weather boosted construction, but led to a payback in the second quarter. Nevertheless, construction spending averaged over the first half of the year was below 1997 levels and continues the downtrend seen since 1995. Although July construction, as measured by the IP index, has rebounded smartly, the government cautioned that the most recent IP estimate likely is biased upward by a seasonal adjustment problem.

Forward-looking indicators suggest some slowing of export growth ahead. Manufacturing orders by foreigners (not shown in table) edged down a bit in July and have been roughly constant since the second half of last year. Other indicators are mixed. Business confidence (as measured by the IFO survey) has been falling over the past several months, but domestic manufacturing orders (not shown) in the first half of 1998 are up over 3 percent from the second half of 1997, and capacity utilization -- already high -- has risen further over the past half year.

The August CPI showed inflation (on a 12-month basis) at less than 1 percent, a bit lower than in July. The deceleration was more pronounced in Western Germany. Producer prices (not shown) have fallen nearly 0.4 percent over the year ending July.

	1997	1998					
	Q4	Q1	Q2	May	Jun	Jul	Aug
Industrial Production	0.6	1.9	-0.5	1.0	-1.2	3.8	n.a.
Orders	0.1	2.5	0.0	-0.4	-0.6	1.0	n.a.
Unemployment Rate (%)	11.8	11.5	11.2	11.2	11.0	10.9	10.9
Western Germany	9.9	9.6	9.4	9.4	9.3	9.2	9.2
Eastern Germany	19.5	19.2	18.5	18.5	18.0	17.8	17.7
Capacity Utilization <sup>1</sup>	87.0	87.3	87.2	...	...	...	...
Business Climate <sup>1,2</sup>	17.3	18.3	15.3	16.0	15.0	12.0	n.a.
Consumer Prices <sup>3</sup>							
All-Germany	1.8	1.2	1.3	1.3	1.2	0.9	0.8
Western Germany	1.7	1.1	1.3	1.3	1.1	0.9	0.7

1. Western Germany.

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

3. Percent change from previous year.

In **France**, real GDP rose 2.8 percent (SAAR) in the second quarter, after increasing 2.4 percent in the first quarter. Domestic demand remained robust with private consumption contributing a surprisingly strong 2.4 percentage points. However, much of the strength in private consumption is attributed to the volatile food and energy sectors. Although housing investment took off, fixed investment slowed considerably to 3.7 percent growth from the exceptionally strong 7.8 percent growth registered in the first quarter. Housing seems poised for continued strength during the remainder of the year, given historically low interest rates and higher real incomes. A rundown in inventories contributed negatively following the first quarter's significant build-up, possibly due to the phase-out of the tax incentive on auto purchases. The data are also consistent with continued transition from export-oriented to domestic demand-led growth: Exports stalled in the third quarter, and despite a slowdown in imports, net exports subtracted almost a full percentage point from growth.

Third-quarter data are very limited but suggest continued growth; in July consumer confidence reached record-high levels, and the business outlook remained optimistic.

**FRENCH REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997		1998	
			Q3	Q4	Q1	Q2
GDP	2.4	3.0	3.8	3.1	2.5	2.8
Total Domestic Demand	1.3	1.6	3.7	2.7	5.2	3.8
Consumption	1.8	2.6	5.7	4.0	2.7	4.3
Investment	-0.2	0.8	2.6	0.8	7.7	3.7
Government Consumption	2.6	0.9	1.0	1.3	1.4	1.3
Inventories (contribution)	-0.3	-0.3	-0.4	-0.1	1.6	0.1
Exports	10.4	13.3	13.4	6.3	0.6	0.4
Imports	6.4	9.0	13.8	5.5	8.8	3.1
Net Exports (contribution)	1.1	1.4	0.2	0.4	-2.5	-0.9

1. Annual changes are Q4/Q4.

Inflation remains near 40-year lows. Consumer prices in August rose 0.7 percent on a year-over-year basis, down slightly from the 0.8 percent rate recorded in July.

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

	1997	1998					
	Q4	Q1	Q2	May	Jun	Jul	Aug
Consumption of Manufactured Products	1.4	1.4	1.0	0.4	0.2	n.a.	n.a.
Industrial Production	1.0	0.8	1.0	0.7	-0.3	n.a.	n.a.
Capacity Utilization	81.2	84.8	84.7	...	...	...	...
Unemployment Rate (%)	12.4	12.2	11.9	11.9	11.8	11.8	n.a.
Business Confidence <sup>1</sup>	17.7	19.7	19.7	20.0	22.0	19.0	n.a.
Consumer Prices <sup>2</sup>	1.2	0.7	1.0	1.0	1.0	0.8	0.7

1. Percent balance of manufacturing firms citing an improvement in the outlook versus those citing a worsening.
2. Percent change from previous year.

On September 9, Finance Minister Strauss-Kahn presented his 1999 draft budget to the cabinet. With an assumption of 3 percent real GDP growth next year, the budget

projects a deficit of 2.3 percent of GDP. Spending would increase by 1 percent in real terms, whereas receipts would increase roughly by 1½ percent (despite a projected ½ percent cut in taxes). Achieving the 1999 deficit target not only will require tight control over social security spending (this year's social security budget has overshoot and emergency measures have been agreed upon), but also will require the economy to escape with relatively minor effects from the current global financial market turmoil.

In **Italy**, real economic activity rose modestly in the second quarter. Available data indicate that household consumption, business fixed investment and net exports, as well as calendar effects, contributed positively to second-quarter growth. The rise in private consumption likely reflects the transition to durable goods consumption from non-durables (which were stimulated by the government's recently expired tax-incentive scheme on auto purchases). The rise in net exports suggests that stronger foreign demand from Europe offset, to some degree, the negative effects of weaker demand from Asia. Third-quarter data are limited and mixed; consumer confidence declined in July-September while industrial production rose in July.

**ITALIAN REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997		1998	
			Q3	Q4	Q1	Q2
GDP	-0.2	2.8	2.2	1.2	-0.5	1.7
Total Domestic Demand	-1.1	3.8	-1.1	4.4	3.2	0.8
Consumption	0.9	2.1	1.3	-0.0	0.3	1.4
Investment	-2.7	2.9	3.4	3.9	1.9	0.6
Government Consumption	-0.3	-0.1	0.7	0.5	2.1	1.4
Inventories (contribution)	-1.1	1.9	-2.6	3.5	2.2	-0.5
Exports	3.8	8.9	31.2	-5.6	-5.2	10.2
Imports	0.6	14.4	18.1	6.4	9.3	6.6
Net Exports (contribution)	0.8	-0.9	3.3	-3.1	-3.6	1.0

1. Annual changes are Q4/Q4.

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

	1997	1998					
	Q4	Q1	Q2	June	July	Aug	Sep
Industrial Production	1.3	-0.1	-0.2	-2.2	0.9	n.a.	n.a.
Cap. Utilization <sup>1</sup> (%)	79.0	78.2	79.5	...	...	...	...
Unemployment Rate (%)	12.1	12.1	12.3	...	...	...	...
Consumer Confidence <sup>2</sup>	115.3	118.6	122.7	123.3	118.9	117.0	115.2
Bus. Sentiment <sup>3</sup> (%)	17.0	32.0	11.7	3.0	8.0	n.a.	n.a.
Consumer Prices <sup>4</sup>	1.6	1.7	1.8	1.8	1.8	1.9	1.8

1. NSA.

2. Level of index, NSA.

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

4. Percent change from previous year.

Inflation remains low and stable. Data from eleven cities indicate that consumer price inflation was 1.8 percent in September, unchanged from its second-quarter average.

On September 12, Treasury Minister Ciampi announced that the government's 1999 budget would not be revised despite less optimistic growth projections this year. (The government forecasts a 2½ percent (yr/yr) increase in real GDP this year, although most consensus forecasters now view that figure as unattainable.) With next year's budget, the government hopes to improve fiscal balances by \$7.7 billion equivalent (approximately ½ percent of GDP), about two-thirds of which will come from spending cuts and one-third from new revenue. Prime Minister Prodi aims to present the 1999 budget to parliament on September 29. The parliament will have until the end of the year to ratify the government's proposal.

In the **United Kingdom**, real GDP expanded 2 percent (SAAR) in the second quarter, little changed from the pace in the first quarter. Consumption expenditures increased 3 percent, somewhat weaker than in the first quarter and well below the average quarterly increase last year. Investment spending declined, after surging the previous quarter. Net exports subtracted from growth as imports grew more rapidly than exports, and inventory accumulation contributed 1 percentage point to growth.

Indicators for the third quarter are limited but suggest that growth has been slowing. Industrial production picked up somewhat in July, but manufacturing output



**UNITED KINGDOM REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997		1998	
			Q3	Q4	Q1	Q2
GDP	2.9	2.9	3.0	3.1	2.2	2.0
Total Domestic Demand	2.8	4.3	2.7	5.1	5.4	2.3
Consumption	4.3	5.1	2.8	5.9	3.5	3.0
Investment	2.6	6.5	3.0	4.3	16.3	-7.5
Government Consumption	1.4	0.2	7.4	-0.3	-1.8	4.4
Inventories (contribution)	-0.6	-0.1	-1.0	0.7	0.8	1.0
Exports	7.1	6.5	5.7	-0.2	-9.3	n.a.
Imports	8.0	10.0	3.9	8.3	-2.2	n.a.
Net Exports (contribution)	-0.3	-1.1	0.5	-2.7	-2.3	-0.5

Annual changes are Q4/Q4.

was essentially unchanged. Business confidence in manufacturing, as measured by output expectations from the Confederation of British Industry's Industrial Trends Survey, has fallen sharply in recent months to levels last seen in 1992, reflecting concerns about both domestic and export demand. Survey data suggest that service industries continued to expand in July and August, but at a slower pace than in the first half of the year. The average volume of retail sales in July and August was up 0.8 percent from the second quarter.

Conditions in the labor market have continued to tighten in recent months. The official claims-based unemployment rate moved lower to 4.6 percent in August. Average annual earnings growth fell back to 4.7 percent in June, after peaking at 5.4 percent in April. Although some of the recent increase in earnings reflects bonus payments that are spread unevenly through the year, the Bank of England noted in the *August Inflation Report* that recent earnings data suggest that "unemployment has reached a level likely to prove incompatible with price stability." The twelve-month rate of British retail price inflation (excluding mortgage interest payments) was 2.5 percent in August, meeting the inflation target for the first time since January.

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

	1997	1998					
	Q4	Q1	Q2	May	Jun	Jul	Aug
Industrial Production	-0.9	-0.3	1.1	-1.3	0.9	0.4	n.a.
Retail Sales	1.4	0.9	0.3	1.7	-1.3	0.9	0.4
Unemployment Rate (%)	5.1	4.9	4.8	4.8	4.8	4.7	4.6
Business Confidence <sup>1</sup>	13.0	10.7	-0.7	-2.0	-3.0	-8.0	-15.0
Consumer Prices <sup>2</sup>	2.8	2.5	3.0	3.2	2.8	2.6	2.5
Producer Input Prices <sup>3</sup>	-8.9	-10.0	-8.9	-8.6	-8.9	-8.8	n.a.
Average Earnings <sup>3</sup>	4.6	5.0	5.0	5.0	4.7	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.

In **Canada**, recent data indicate a slowing in growth. GDP in the second quarter was up only 1.8 percent (SAAR). Some of this slowdown reflects the impact of the GM shutdown as well as construction strikes in Ontario. Resolution of these strikes should lead to a shift in production into the third and fourth quarters of this year, but other factors suggest a more pervasive slowdown. These include weak retail sales in June, a slight drop in personal income after taxes in the second quarter, and declines in manufacturing shipments and new orders throughout the summer.

Recent employment data also indicates slower growth. Employment through August was up only 0.4 percent (SAAR) from its level in April. While manufacturing employment has been particularly weak, fairly strong employment growth in service sector jobs, most likely due to the upturn in tourism, has offset declines in manufacturing. As a result of these overall modest employment gains, the unemployment rate fell slightly in August to 8.3 percent.

The trade surplus fell to \$2.9 billion in the second quarter from \$3.2 billion in the previous quarter, despite the past year's depreciation of the Canadian dollar. While exports remained flat in the second quarter, imports experienced modest gains.

**CANADIAN REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997		1998	
			Q3	Q4	Q1	Q2
GDP	2.0	4.0	4.3	2.8	3.4	1.8
Total Domestic Demand	4.1	4.5	6.7	3.0	0.3	3.1
Consumption	3.0	4.3	5.0	2.7	0.6	5.5
Investment	13.8	6.6	12.5	0.3	2.9	5.9
Government Consumption	-0.8	0.4	2.1	-0.7	-0.7	2.9
Inventories (contribution)	0.1	0.6	0.9	1.5	-0.5	-1.9
Exports	2.6	11.1	13.6	7.3	6.3	5.3
Imports	7.8	13.5	23.6	9.2	0.1	6.1
Net Exports (contribution)	-1.6	-0.7	-3.0	-0.6	2.3	-0.2

1. Annual changes are Q4/Q4.

For the first half of 1998 compared with the first half of 1997, roughly two-thirds of the \$10 billion (AR) narrowing in the Canadian trade surplus represents a deterioration in trade with Asia (primarily Japan).

Although declines in the Canadian dollar have created some additional upward price pressure in recent months, inflation in Canada remains subdued and at the bottom of the Bank of Canada's 1 percent to 3 percent target range.

Despite the low inflation outlook and slower growth, the Bank of Canada raised its Bank Rate 100 basis points on August 27. The Bank's decision was driven by the Canadian dollar's fall to record lows in August against the U.S. dollar. Another factor contributing to the Bank's decision was a broad selloff of Canadian assets in August that led to a sharp rise in the spread between Canadian and U.S. long-term rates. Although the rate hike is expected to be a further drag on an already slowing economy, it has contributed to a moderate turnaround of the Canadian dollar and a reduction in long-term rates relative to U.S. rates.

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

	1997	1998					
	Q4	Q1	Q2	May	Jun	Jul	Aug
GDP at Factor Cost	0.6	0.7	0.4	-0.3	-0.1	n.a.	n.a.
Industrial Production	0.6	-0.3	0.7	-0.4	-0.3	n.a.	n.a.
Manufacturing Survey: Shipments	0.9	-0.5	-0.7	-1.0	-3.4	-2.4	n.a.
New Orders	1.5	-1.7	-0.7	-0.6	-2.5	-1.4	n.a.
Retail Sales	1.7	0.3	1.5	0.3	-1.8	1.4	n.a.
Housing Starts	0.1	1.8	-8.7	-4.1	-4.6	-6.6	n.a.
Employment	0.4	0.7	0.7	-0.0	-0.3	0.2	0.3
Unemployment Rate (%)	8.9	8.7	8.4	8.4	8.4	8.4	8.3
Consumer Prices <sup>1</sup>	1.0	1.0	1.0	1.1	1.0	1.0	0.8
Consumer Attitudes <sup>2</sup>	117.0	118.4	115.8	...	...	...	...
Business Confidence <sup>3</sup>	159.2	155.0	148.9	...	...	...	...

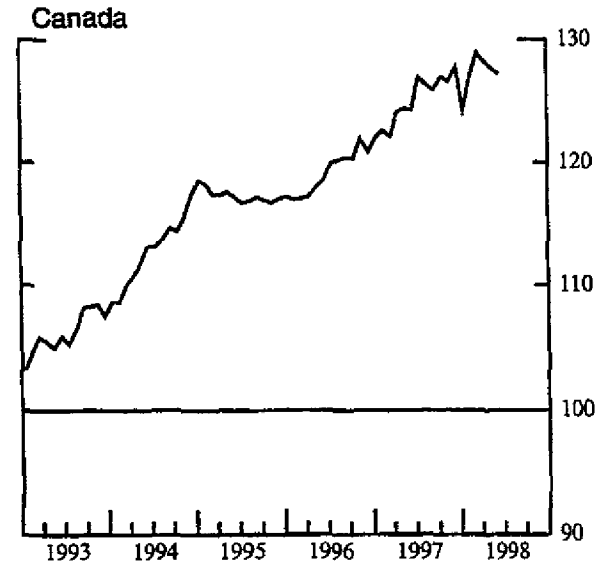
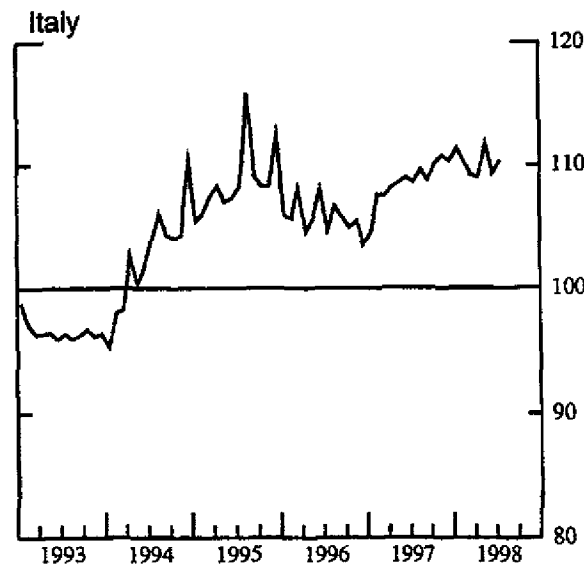
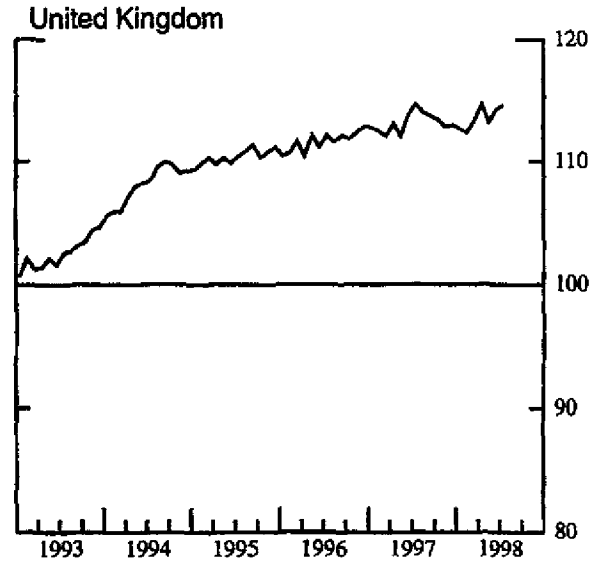
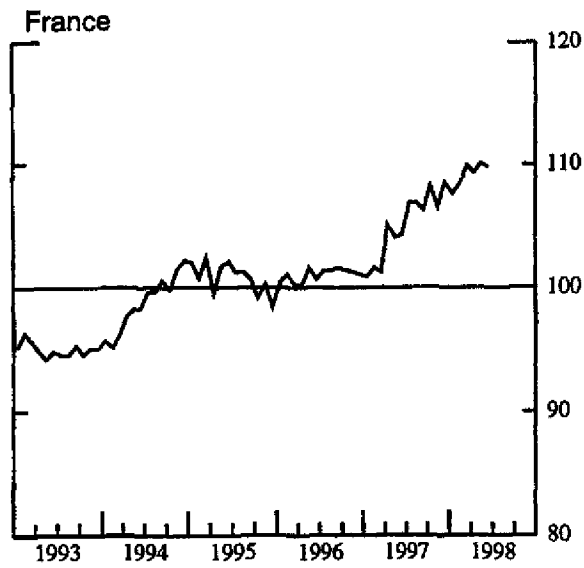
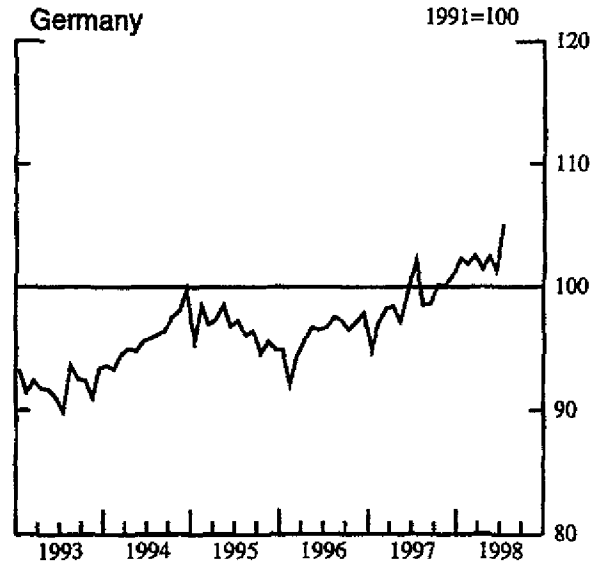
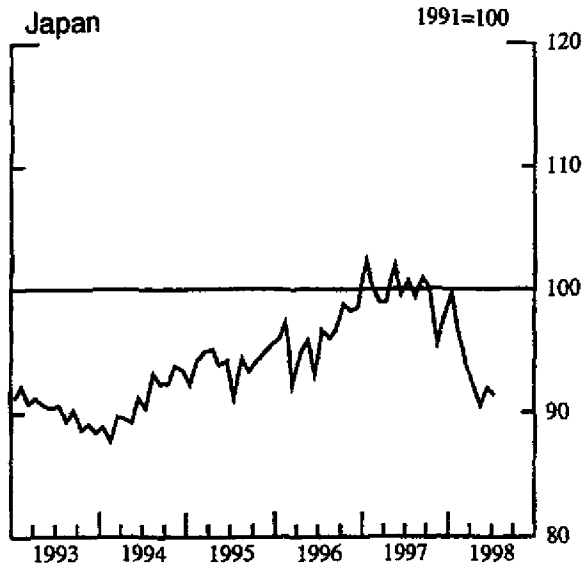
1. Percent change from year earlier.
2. Level of index, 1991 = 100.
3. Level of index, 1977 = 100.

**EXTERNAL BALANCES**  
(Billions of U.S. dollars, SAAR)

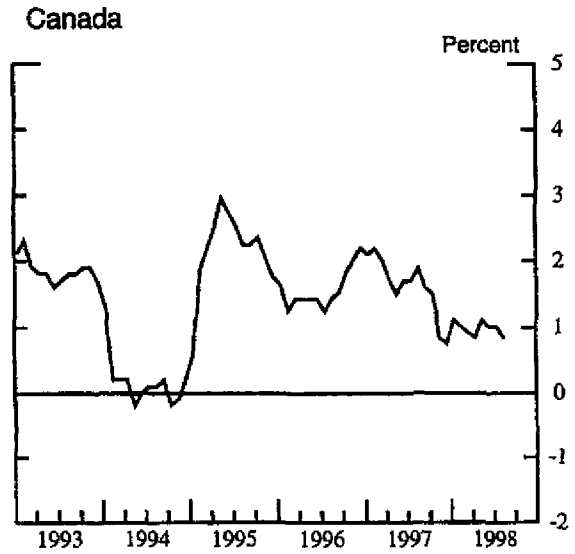
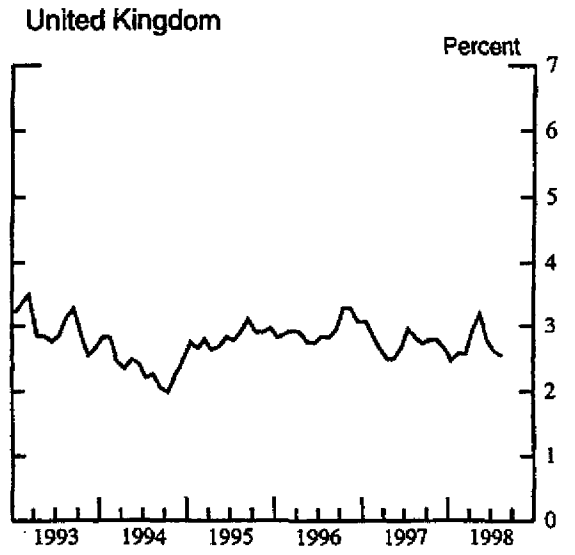
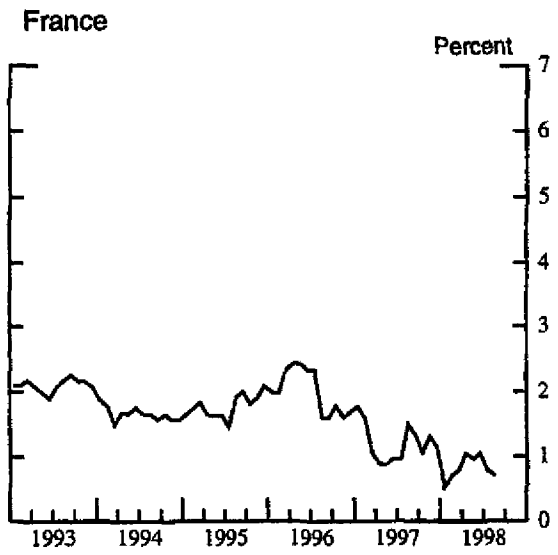
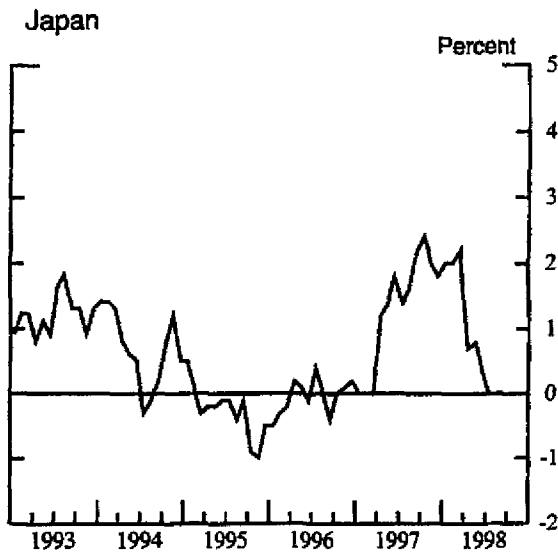
	1997	1998				
	Q4	Q1	Q2	May	Jun	Jul
Japan: trade	98.8	98.0	114.0	140.2	89.9	114.3
current account	112.9	115.9	111.8	133.5	125.3	111.9
Germany: trade <sup>1</sup>	75.8	65.4	81.8	95.8	74.7	94.8
current account <sup>1</sup>	12.8	-16.0	15.4	8.3	23.4	-8.7
France: trade	31.4	26.8	28.0	26.2	29.3	28.0
current account	43.9	35.7	36.8	45.1	22.3	n.a.
U.K.: trade	-28.1	-31.5	-31.2	-37.3	-28.5	n.a.
current account	0.3	-21.2	n.a.	...	...	...
Italy: trade	28.9	25.2	n.a.	34.7	n.a.	n.a.
current account <sup>1</sup>	37.6	10.3	n.a.	35.4	n.a.	n.a.
Canada: trade	11.2	13.1	9.6	11.2	7.4	12.5
current account	-13.2	-12.0	-11.7	...	...	...

1. The current account includes goods, services, and private and official transfers.

### Industrial Production in Selected Industrial Countries



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



**Economic Situation in Other Countries**

Economic activity has weakened in most emerging market economies, with output declining in Korea, Hong Kong, Russia, and the ASEAN countries and the pace of growth slowing in Mexico and Argentina. Inflation remains low to moderate in most countries, with notable exceptions being Indonesia and Venezuela, and, since August, Russia. The general adjustment toward surpluses in external balances in Asia continued, whereas in Latin America external deficits have generally widened.

In mid-August, the Russian ruble was devalued, and the government announced a restructuring of its short-term debt and a 90-day moratorium on private external debt service. Subsequently, turmoil spread to Latin American financial markets: Latin stock markets have tumbled, and Brady spreads and domestic interest rates have risen sharply since mid-August. The contagion effects from the Russian devaluation have fueled currency pressures in several Latin American countries, especially Brazil, as well as in Hong Kong. In several other Asian countries, currencies have stabilized.

**Individual country notes.** In Korea, real GDP extended its first-quarter decline in the second quarter, and preliminary indicators suggest further deterioration in the third quarter. Real GDP fell 6.6 percent in the second quarter from a year earlier, compared with a 3.8 percent drop on this basis in the first quarter. The decline in the second quarter from the previous quarter is estimated at about 3.5 percent (SAAR), considerably slower than the estimated 23 percent rate of decline in the first quarter. Early indicators point to further weakness in the third quarter. In July, industrial production fell nearly 13 percent from a year earlier, and the average factory operation rate dropped to 64 percent as domestic construction orders and retail sales also continued to weaken. In August, heavy flooding and a strike at Hyundai motors likely further depressed activity. Reflecting this weak activity, the inflation rate has continued to ease, with the 12-month consumer price inflation rate moving below 7 percent in August.

Korea's current account was in surplus by \$44 billion (AR) in the first seven months of the year. This rise represents a positive swing of \$62 billion from the \$18 billion deficit rate recorded in the corresponding period last year. The won's relative strength, along with the continued weakness of activity, has led the monetary authorities to lower interest rates further, with the overnight rate moving down to about 8 percent.



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

	1996	1997	1998				
			Q1	Q2	Jun	Jul	Aug
Real GDP	6.8	5.5	-3.8	-6.6	...	...	...
Industrial Production	7.1	6.7	-7.8	-11.7	-13.2	-12.9	n.a.
Consumer Prices	4.9	4.4	8.9	8.2	7.5	7.3	6.9
Trade Balance <sup>1</sup>	-15.0	-3.2	38.2	45.6	38.4	44.4	n.a.
Current Account <sup>1</sup>	-23.0	-8.2	42.7	46.4	42.0	46.8	n.a.

1. Billions of U.S. dollars, AR, NSA.

Additional actions toward restructuring the banking system have been made in recent weeks. Two new bank mergers have been announced, including one which would create the country's largest bank. In addition, the Financial Supervisory Commission has indicated that the government would provide \$3.3 billion (in the form of increased capital and purchases of bad loans) to support a previously announced bank merger. Despite these actions, it is still unclear if the government's overall provision of resources to facilitate bank restructuring will be adequate, especially given the limited role up to now of the private sector—especially foreign—in bank recapitalization.

In the ASEAN region, weakening domestic demand, tight credit conditions, and Japan's worsening economy continued to dampen economic activity. Malaysia's GDP is estimated to have fallen 7.4 percent in the second quarter of 1998 (SAAR), although this represents a much slower decline than in the first quarter. Industrial production fell steeply in Singapore in July, although in Malaysia and Thailand, seasonally adjusted figures indicate that industrial production may have bottomed out.

## ASEAN ECONOMIC INDICATORS: GROWTH

	1996	1997	1998					
			Q1	Q2	May	Jun	Jul	
Real GDP, SAAR								
Indonesia	8.0	4.7	-28.9	-31.6	...	...	...	
Malaysia	8.6	7.8	-25.6	-7.4	...	...	...	
Philippines	5.8	5.2	-0.8	-7.4	...	...	...	
Singapore	6.9	7.7	1.4	-2.6	...	...	...	
Thailand	6.4	-0.4	n.a.	n.a.	...	...	...	
Industrial Production <sup>1</sup>								
Indonesia	6.6	6.2	-7.1	-19.3	n.a.	n.a.	n.a.	
Malaysia	11.0	10.7	-0.8	-6.1	-8.3	-6.0	-8.0	
Philippines	8.4	8.8	-7.0	-2.1	-2.1	1.2	n.a.	
Singapore	3.3	4.6	6.1	-1.0	-4.3	-0.8	-6.2	
Thailand	7.2	-0.4	-16.9	-15.7	-17.3	-13.5	n.a.	

1. Year-over-Year.

Consumer prices, particularly for food, continued to rise rapidly in Indonesia, prompting the government to abolish restrictions preventing private traders from importing rice. Elsewhere, inflationary pressures eased, as domestic demand weakened and currencies stabilized.

## ASEAN ECONOMIC INDICATORS: INFLATION

(Percent change from year earlier)

	1996	1997	1998					
			Q1	Q2	May	Jun	Jul	Aug
Consumer Prices								
Indonesia	8.0	6.5	29.7	52.2	52.2	59.5	72.0	81.0
Malaysia	3.5	2.7	4.3	5.7	5.4	6.2	5.8	n.a.
Philippines	8.4	5.1	7.0	9.0	9.1	9.9	10.1	9.5
Singapore	1.4	2.0	1.0	0.3	0.4	-0.2	-0.4	-0.8
Thailand	5.8	5.6	9.0	10.3	10.2	10.6	10.0	7.6

All the ASEAN countries are now running trade surpluses, reflecting sharply lower imports compared to this time last year, rather than improvements in export

revenues. Trade surpluses narrowed in July in most ASEAN countries, as demand for exports from within the region weakened.

**ASEAN ECONOMIC INDICATORS: TRADE BALANCE<sup>1</sup>**

	1996	1997	1998					
			Q1	Q2	May	Jun	Jul	Aug
Indonesia	6.9	11.9	20.3	24.8	24.1	28.2	n.a.	n.a.
Malaysia	-0.1	-0.2	8.9	13.8	11.8	18.2	11.7	n.a.
Philippines	-11.9	-10.5	-4.9	-1.0	-2.5	1.5	0.4	n.a.
Singapore <sup>2</sup>	-5.9	-5.8	4.0	9.5	10.0	10.5	7.5	n.a.
Thailand	-16.1	-4.6	12.5	10.1	11.5	11.1	12.0	11.7

1. Billions of U.S. dollars, AR, NSA.

2. Non-oil trade balance.

On September 1, Malaysia introduced exchange controls and put in place measures requiring ringgit held overseas to be returned to Malaysia before the end of the month. The new rules mean that non-residents who purchased ringgit securities before September 1 of this year will have to keep their funds in Malaysia until at least September 1, 1999. Non-residents who purchase a ringgit security after September 1 of this year will have to keep their funds in Malaysia for at least one year after the date of purchase. Shortly after introducing controls, Malaysia fixed its exchange rate at 3.8 ringgit per dollar, and Finance Minister and Deputy Prime Minister Anwar Ibrahim was sacked from government by Prime Minister Mahathir, and later arrested.

Indonesia and Thailand announced major plans for bank restructuring, including the closing of some banks and nationalizing of others. A new tougher bankruptcy law went into effect in Indonesia which is designed to give creditors more power to force debtors to restructure and pay off their debts. Thailand's government, along with major foreign and domestic creditors, agreed upon a framework for restructuring corporate debt with an emphasis on rehabilitating debtors.

In **Hong Kong**, government officials have indicated that they expect GDP in the second quarter of 1998 to be about 5 percent below its year-earlier level, which staff estimates is consistent with decline of 3 to 4 percent SAAR. Unemployment continued to rise, reaching 5 percent in the June-August period. Reflecting weak imports, Hong Kong's merchandise trade deficit in the first seven months of 1998 has narrowed to \$15 billion from \$20 billion over the same period of 1997. Data released in August on the components of GDP in the first quarter do suggest, however, that the improvement in merchandise trade has been offset somewhat by a deterioration in net services exports.

In mid-August, Hong Kong's currency peg came under renewed speculative pressure, and stock prices declined sharply. Hong Kong authorities attributed the declines to a so-called "double-play" by speculators who simultaneously shorted the stock market and sold the currency. The speculators' hope was that the currency attack would force interest rates upwards, causing the stock market to fall, even if the currency peg was maintained. In response, the Hong Kong Monetary Authority (HKMA) spent an estimated \$10-15 billion buying stocks in the second half of August, hoping to ensure that speculators lost money when most of their short-sales contracts expired on August 28. Between August 13 and 28, the stock market rose nearly 20 percent, and authorities claimed success over speculators; recently the HKMA has ceased intervention in the stock market and stock prices have declined somewhat. Hong Kong's foreign exchange reserves were \$97 billion at the end of July, but are now estimated to be less than \$80 billion.

**HONG KONG ECONOMIC INDICATORS**  
(Percent change from year earlier except where noted)

	1996	1997	1998				
			Q1	Q2	Jun	Jul	Aug
Real GDP <sup>1</sup>	5.0	5.3	-12.3	n.a.	...	...	...
Consumer Prices <sup>2</sup>	6.5	5.2	4.9	3.9	3.9	3.2	2.7
Trade Balance <sup>3</sup>	-17.8	-20.6	-16.8	-18.0	-10.2	-6.2	n.a.

1. Percent change from previous period, SAAR.

2. End of period.

3. Billions of U.S. dollars, AR, NSA. Imports are c.i.f.

In early September, the HKMA announced a set of technical adjustments to the operation of Hong Kong's currency peg to the U.S. dollar, which it argues strengthen the peg by removing some HKMA discretion and by increasing interbank activity. These adjustments include several measures that appear to make it easier for banks to borrow from the discount window. This increased access is expected to make it easier for banks to obtain liquidity when needed, thereby limiting volatility in short-term interest rates. Additionally, all banks will now be allowed to convert clearing balances (essentially, Hong Kong bank reserves) into foreign currency with the HKMA, rather than having to exchange currency in the market, and the HKMA has pledged to increase transparency by making balance-sheet information available as quickly as possible.

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

	1996	1997	1998				
			Q1	Q2	Jun	Jul	Aug
Real GDP <sup>1</sup>	9.7	8.8	7.2	7.0	...	...	...
Industrial Production	13.0	11.1	8.2	8.1	7.9	7.6	7.9
Consumer Prices <sup>2</sup>	7.0	0.4	0.7	-1.3	-1.3	-1.4	-1.4
Trade Balance <sup>3</sup>	12.2	40.3	42.2	47.4	45.5	50.4	56.4

1. Cumulative from beginning of year.

2. End of period.

3. Billions of U.S. dollars, AR, NSA.

In **China**, industrial production remained relatively weak in August, and consumer prices continued to decline. In recent months, China has suffered widespread flooding, reportedly the worst since 1954, and these floods are expected to have an adverse effect on output in 1998H2. Net exports remained strong, reflecting weak import growth. In the first eight months, exports rose 5½ percent compared with the same period in 1997, while imports rose less than ½ percent. Total reserves less gold, which increased \$33 billion in 1997 before stabilizing in the first half of 1998, were \$144 billion in July.

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

	1996	1997	1998				
			Q1	Q2	Jun	Jul	Aug
Real GDP	5.7	6.8	5.9	5.2	...	...	...
Industrial Production	1.8	6.8	4.6	4.3	5.4	3.3	4.6
Consumer Prices <sup>1</sup>	2.5	0.2	2.6	1.4	1.4	0.9	0.4
Trade Balance <sup>2</sup>	14.8	7.7	-0.2	5.4	6.2	12.6	15.6
Current Account <sup>2</sup>	11.0	7.7	0.1	3.0	...	...	...

1. End of period.

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

In **Taiwan**, the twelve-month growth in industrial production slowed significantly in July but then rose back in August, and consumer price inflation has moderated from already low levels. Consistent with a slowing economy, the trade balance has improved sharply in recent months, primarily reflecting slowing imports: In

the three months to August, exports rose 3 percent, and imports fell 6 percent. Total official reserves less gold stood at \$84 billion at the end of July.

In Mexico, economic activity has begun to show signs of decelerating. Recent data indicate that real GDP growth slowed in the second quarter to 4.3 percent. The slowdown was evident in the construction sector, which has been hit hard by public sector budget cuts and a reduction in government spending on investment.

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

	1996	1997	1998				
			Q1	Q2	Jun	Jul	Aug
Real GDP	5.1	7.0	6.6	4.3	...	...	...
Industrial Production	10.4	9.2	9.8	5.0	7.0	5.3	n.a.
Unemployment Rate (%)	5.5	3.7	3.5	3.2	3.4	3.2	n.a.
Consumer Prices	27.7	15.7	15.3	15.3	15.1	15.4	15.5
Trade Balance <sup>1</sup>	6.5	0.6	-7.2	-4.8	-6.0	-9.6	-8.3
Imports <sup>1</sup>	89.5	109.8	120.0	124.0	129.6	118.8	119.8
Exports <sup>1</sup>	96.0	110.4	112.8	119.2	123.6	109.2	111.5
Current Account <sup>1</sup>	-2.3	-7.4	-13.8	-13.8	...	...	...

1. Billions of U.S. dollars, AR, NSA.

The trade deficit was sizeable again in August as oil prices remained low. Consumer prices increased 15.5 percent in August over a year ago and inflationary expectations, as reported by the Bank of Mexico, have been revised upward. The collapse of the Russian ruble and its reverberations in international financial markets during the past month has caused sharp declines in the peso and stock prices; the 28-day Cetes interest rate increased by about 25 percentage points, but subsequently receded 10 percentage points, with the Brady spreads moving in tandem. Continued price pressures and volatility in the foreign exchange market has prompted the Bank of Mexico to tighten monetary policy, introducing several changes to help control monetary conditions.

**Brazilian** financial markets have been hit hard over the past few weeks by repercussions from the financial turmoil in Russia. Since mid-August, the spread on Brazilian Brady par bonds over U.S. Treasuries has increased precipitously. The Bovespa stock price index has plunged. Net private capital outflows have been strongly negative. To defend the currency, the *real*, the central bank has spent at least \$20 billion

of its reserves since mid-August; as of September 20, reserves stood at an estimated \$47 billion, down from a peak of \$70 billion at the end of July. In early September, the central bank raised the overnight borrowing rate from 20 to 30 percent, and then to 50 percent on September 10, after witnessing a 15 percent drop for the day in the Bovespa index. Stock market prices and Brady bonds recovered some of their previous losses in mid-September, fueled in part by hopes that Brazil will be receiving substantial assistance from multilateral and bilateral donors.

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

	1996	1997	1998				
			Q1	Q2	Jun	Jul	Aug
Real GDP <sup>1</sup>	2.9	3.0	-4.3	n.a.	...	...	...
Industrial Production <sup>1</sup>	5.4	2.0	-6.6	10.1	-16.6	-5.7	n.a.
Open Unemployment Rate (%)	5.4	5.6	7.6	8.0	7.9	8.0	n.a.
Consumer Prices <sup>2</sup>	9.4	4.3	7.4	4.1	2.4	-3.3	-5.7
Trade Balance <sup>3</sup>	-5.5	-8.4	-6.4	-1.6	0.0	-4.6	-7.9
Current Account <sup>3</sup>	-24.3	-33.8	-24.0	-31.6	-29.8	-24.3	n.a.

1. Percent-change from previous period, SAAR.

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

3. Billions of U.S. dollars, AR, NSA.

Downward pressures on the currency have been fueled by Brazil's persistently large fiscal deficit (about 7 percent of GDP) and current account deficit (about 3½ - 4 percent of GDP). The Brazilian government has announced two budget cuts for 1998 totaling about ½ percent of GDP and further cuts down the road. These announcements have failed to impress market observers, who want to see more dramatic steps. It will be very difficult for President Cardoso to take unpopular steps to reduce the budget deficit before the October 3 presidential elections, in which he is considered the front-runner.

The interest rate increase, if prolonged, will further depress the Brazilian economy, which has been struggling to recover from the downturn in the first quarter of 1998. Unemployment has been high by historical standards, at 8 percent, and industrial output declined considerably in July. The interest rate rise will also greatly increase the government's cost of servicing its debt, particularly since about 70 percent of the federal government's domestic securities (or about \$200 billion) are indexed to the overnight interbank rate.

In **Argentina**, second-quarter real GDP grew by nearly 7 percent from a year earlier. This represents only a slight slowing in the pace of growth in the first half of the year, compared with last year. However, industrial production data indicate that growth has decelerated further in the second half of the year: industrial production grew only 1.7 percent and 0.7 percent over the preceding 12-months in July and August, respectively, compared with an average of over 5 percent in the second quarter. Inflation remained low and the 12-month consumer price inflation rate was slightly over 1 percent in August. With exports falling nearly 2 percent from a year ago in July, external balances, which had been narrowing in general earlier this year, have widened again: the cumulative trade deficit through July this year was about \$3 billion (AR), compared with slightly over \$1 billion (AR) over the same period in 1997.

Financial markets in Argentina have been hit hard since the August devaluation of the Russian ruble. Since mid-August, Argentine stocks have plunged about 25 percent and Brady spreads have increased sharply; and the rate on 30-day peso deposits has roughly doubled. However, in contrast to the "Tequila" crisis of 1995, so far at least, international reserves and deposits have been almost unaffected: international reserves (excluding gold) stood at about \$24 billion on September 18, roughly unchanged from their mid-August level.

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

	1996	1997	1998				
			Q1	Q2	Jun	Jul	Aug
Real GDP	4.2	8.4	7.2	6.9	...	...	...
Industrial Production (SA)	3.1	8.6	6.8	5.1	5.8	1.7	0.7
Unemployment Rate (%) <sup>2</sup>	17.2	14.9	...	13.2	...	...	...
Consumer Prices <sup>1</sup>	0.1	0.3	0.8	1.1	1.1	1.2	1.1
Trade Balance <sup>3</sup>	1.8	-2.3	-4.8	-1.2	-1.7	-6.3	n.a.
Current Account <sup>3</sup>	-3.8	-9.5	-15.8	n.a.	...	...	...

1. End of period.

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, AR, NSA.

The Argentine congress passed two reform bills in September. One provides for tax reforms, which the IMF has been pressing for under its \$2.8 billion Extended Fund Facility (EFF) with Argentina. The second is a labor reform bill; this bill falls



considerably short of the commitments made to the IMF under the EFF. The upper house of congress also passed another landmark measure dubbed "fiscal convertibility," which would prohibit budget deficits of more than 2 percent of GDP and restrict yearly growth in domestic debt to 1 percent of GDP. This bill now awaits approval by the lower house.

The Venezuelan economy is moving into a sharp recession, as evidenced by a decline in oil exports due to the slump in world oil prices, rising unemployment, soaring interest rates, and plunging auto sales, which declined nearly 30 percent in August from a year earlier. Inflation is running high, with the 12-month inflation rate in August at over 35 percent. Weak oil prices and an overvalued currency have turned a current account surplus of about \$6 billion in 1997 to a surplus of only \$1.5 billion (AR) in the first quarter and a slight deficit in the second quarter.

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

	1996	1997	1998				
			Q1	Q2	Jun	Jul	Aug
Real GDP	-0.4	5.1	...	...	...	...	...
Unemployment Rate (NSA, %)	11.8	11.7	11.6	11.9	...	...	...
Consumer Prices <sup>1</sup>	103.3	37.6	38.3	39.0	39.0	38.1	36.5
Non-oil Trade Balance <sup>2</sup>	-4.9	-6.8	-7.4	-6.5	n.a.	n.a.	n.a.
Trade Balance <sup>2</sup>	13.6	11.4	6.1	4.8	n.a.	n.a.	n.a.
Current Account <sup>2</sup>	8.8	6.0	1.5	-0.3	...	...	...

1. End of period.

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

With an already troubled economy, an overvalued currency, a widening fiscal deficit, and considerable political uncertainty, contagion effects arising since the devaluation of the Russian ruble have had a big impact on Venezuelan financial markets. The stock market has declined by about 25 percent since mid-August. Brady spreads rose sharply from 1300 basis points to over 2500 basis points between mid-August and early September, but have recovered partially since then. The domestic interest rate on 90-day commercial bank deposits has risen nearly three-fold since the start of the year. International reserves (excluding gold) were about \$10 billion on September 17, down by about \$4 billion since the start of the year.

Populist candidate Hugo Chavez is still comfortably the front-runner candidate for the December presidential elections, according to polls. Although Chavez has recently been toning down somewhat his radical and anti-market policy positions, it is still very uncertain what directions macroeconomic policy would take if he is elected.

The **Russian** economy entered a new period of crisis on August 17, as the government effectively devalued the ruble and announced a 90-day moratorium on private external debt service along with a unilateral restructuring of short-term domestic debt. The debt restructuring, which was supposed to be completed by September 26, offered investors a 5 percent cash payment along with options for exchanging the remaining debt for a mixture of ruble and dollar-denominated bonds. The terms were widely viewed as implying sizable losses for investors. Foreign investors are also concerned that domestic banks are getting a better deal, as they will reportedly be allowed to swap some of the frozen bonds to the Central Bank to replenish reserves drawn down under a plan to inject liquidity into the banking system. Acting Finance Minister Zadornov is meeting with foreign investors this week, and new terms for the restructuring are expected to be offered soon.

At the time that the restructuring was announced, the government maintained that it would continue to meet all other obligations, including sovereign debt inherited from the Soviet Union. However, last week the government reportedly missed some of its payments to Paris Club members, and concerns have been expressed about its ability to meet interest payments due later this year and next, particularly in the absence of further international assistance. The IMF is still considering what criteria Russia must meet to obtain a second, \$4.3 billion, tranche of an IMF-led \$22.6 billion aid package, \$4.8 billion of which was disbursed in July and largely spent in a futile attempt to defend the ruble. (The second tranche had been scheduled for mid-September.) Both the IMF and the G-7 governments have indicated that any further aid will be conditioned on continued economic reform.

However, recent reports suggest that the new government will place a higher priority on social welfare and support for domestic industry than on macroeconomic stabilization, at least in the short run. The financial crisis led to the ouster of Sergei Kiriyenko as prime minister, as well as the resignation of Sergei Dubinin as chief of the central bank. Following two failed attempts to reinstate Viktor Chernomyrdin as prime minister, Yeltsin turned to foreign minister Yevgeny Primakov, who was easily confirmed by the Duma. Although financial markets welcomed the resolution of the political crisis, concerns about the future course of economic policy were raised by the

appointment of Yuri Maslyukov, former head of the Soviet-era Gosplan central planning agency, as the top deputy for economic affairs and the reappointment of central bank chief Viktor Gerashchenko, who is widely blamed for pursuing inflationary policies during his previous tenure. Statements by Primakov and the other appointees have indicated that one of the government's highest priorities will be eliminating massive wage and other payments arrears, which many fear could lead to uncontrolled money creation and result in hyperinflation.

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

	1996	1997	1998				
			Q1	Q2	Jun	Jul	Aug
Real GDP	-6.3	0.4	0.0	-0.9	-1.6	-4.5	-8.2
Industrial Production	-5.2	1.9	1.4	-1.3	-2.5	-9.4	-11.5
Unemployment Rate	9.3	9.0	9.1	10.0	11.5	11.4	n.a.
Consumer Prices	52.8	14.8	9.3	7.3	6.4	5.7	21.6
Ruble Depreciation	12.5	12.7	6.1	7.0	7.6	7.8	28.4
Trade Balance <sup>1</sup>	25.3	19.8	9.2	0.1	-3.6	n.a.	n.a.
Current Account <sup>1</sup>	2.5	-0.6	n.a.	n.a.	...	...	...

1. Billions of U.S. dollars, AR, NSA.

The financial crisis has already had repercussions for the real economy. Real GDP was down 8 percent in August relative to a year earlier, and industrial production was down over 11 percent. The sharp depreciation of the ruble since mid-August has also resulted in a surge in inflation to over 20 percent in August from a little under 6 percent in July (12-month change).