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July 3, 1985

# **RECENT DEVELOPMENTS**

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Prepared for the Federal Open Market Committee

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

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## DOMESTIC NONFINANCIAL DEVELOPMENTS

Economic activity apparently posted a small rise in the second quarter, following a quarter of virtually no growth. Consumer spending has been well-maintained despite a slowing in income growth, and construction in both the residential and nonresidential areas remains strong. However, outlays for producers' durable equipment have been sluggish for several months, and industrial production continues to be damped by high levels of imports. Recent increases in prices and wages have been small, after a brief run-up earlier in the year.

### Industrial Production and Capacity Utilization

The index of industrial production declined somewhat in both April and May and has shown little net change since the summer of 1984. Industries that produce for defense and space programs have continued to expand briskly this year, and strength in nonresidential construction and home building has led to increased output of construction supplies in each of the past three months. But output of other products and materials has remained sluggish, with production of consumer goods little changed in recent months and still about 1 percent below last summer's level. Also, the production of business equipment--a source of growth throughout 1984--has weakened in 1985, as the pace of output flattened for most types of machinery and declines occurred in computers and mining equipment. Capacity utilization slipped another 0.4 percentage point in May to 80.3 percent, 2-1/2 percentage points below the level of last July.

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

	1984	1985	1985		
	Q4	Q1	Mar.	Apr.	May
	---Annual rate---		---Monthly rate---		
Total	-2.3	1.9	.3	-.2	-.1
Final products	2.6	1.7	.4	.1	-.1
Consumer goods	-1.2	.5	.3	-.1	.0
Durable	-3.8	5.4	1.3	-1.6	-.2
Nondurable	-.2	-1.4	-.1	.4	.1
Business equipment	4.2	.2	-.2	-.1	-.4
Defense and space equipment	16.2	10.7	1.7	1.2	.3
Construction supplies	-6.4	-1.3	.6	.6	.3
Materials	-7.7	2.8	.1	-.6	-.3
Durable goods	-6.0	-.6	.2	-.3	-.7
Nondurable goods	-8.9	.0	.2	-.5	-.4
Energy materials	-10.6	19.0	-.4	-1.1	.7

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

	1978-80	1982	1967-82	1985		
	High	Low	Avg.	Mar.	Apr.	May
Total industry	87.3	69.6	82.4	81.1	80.7	80.3
Manufacturing	87.5	68.8	81.8	81.1	80.7	80.4
Durable	89.4	64.8	80.5	81.9	81.3	80.9
Nondurable	87.2	73.8	83.9	80.0	80.0	79.7
Mining	90.4	69.6	86.5	76.4	74.2	73.7
Utilities <sup>1</sup>	86.8	79.0	88.6	85.0	85.2	85.6
Industrial materials	88.9	66.6	83.3	80.8	80.1	79.7
Metal materials	95.4	46.2	82.2	69.8	70.1	69.6
Paper materials	97.9	86.3	93.4	95.5	93.0	n.a.
Chemical materials	91.3	64.0	85.1	75.5	74.6	n.a.

1. The 1978-80 high is below the 1967-82 average because of the unusually slow growth in demand for electricity.

### Employment and Unemployment

Despite the weakness in the industrial sector of the economy, overall labor demand has continued to expand in recent months. Nonfarm payroll employment increased 345,000 in May with most of the hiring again occurring in trade, finance, and services. Since the beginning of the year, job gains in this group of industries have accounted for almost all of private nonfarm employment growth. Hiring has been particularly brisk in the trade sector, where increases have averaged about 90,000 per month since January, and in business services. Construction employment also remained robust during the spring, reflecting strength in both residential and nonresidential building activity.

In contrast, manufacturers reduced their payrolls further in May, bringing the cumulative job loss since January to more than 160,000. Cutbacks have been particularly large in the apparel and electrical equipment industries. In some industries (steel, textiles, chemicals, and petroleum products), the current level of employment is below that reached at the trough of the recession in 1982.

As measured by the household survey, employment and unemployment were little changed in May. The civilian jobless rate remained at 7.3 percent for the fourth consecutive month--having moved little over the past year.

### Personal Income and Consumption

Consumer spending has continued to grow rapidly, despite slower income growth recently and reports of some slippage in consumer confidence from its recovery highs. So far this year, gains in personal income have averaged around \$12 billion per month, or 4.7 percent at an annual rate, compared with increases averaging \$21 billion per month

**CHANGES IN EMPLOYMENT<sup>1</sup>**  
(Thousands of employees; based on seasonally adjusted data)

	1983	1984	1984		1985	1985	
			Q3	Q4	Q1	Apr.	May
-Average monthly changes-							
Nonfarm payroll employment <sup>2</sup>	293	327	307	285	273	208	345
Strike adjusted	293	329	299	298	267	181	344
Manufacturing	79	52	12	41	-26	-57	-28
Durable	61	45	24	30	-17	-40	-3
Nondurable	18	7	-13	11	-9	-17	-25
Construction	25	29	14	28	28	95	32
Trade	85	106	98	110	91	50	132
Finance and services	103	106	115	98	150	102	144
Total government	4	17	50	-1	20	-3	48
Manufacturing production workers	73	33	0	23	-33	-57	-18
Total employment <sup>3</sup>	331	270	1	293	282	-174	15
Nonagricultural	338	266	17	271	290	-240	131

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

2. Survey of establishments. Strike-adjusted data noted.

3. Survey of households.

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

	1983	1984	1984		1985	1985	
			Q3	Q4	Q1	Apr.	May
Civilian, 16 years and older	9.6	7.5	7.4	7.2	7.3	7.3	7.3
Teenagers	22.4	18.9	18.6	18.4	18.5	17.7	18.9
20-24 years old	14.5	11.4	11.4	10.9	11.1	11.0	11.8
Men, 25 years and older	7.8	5.7	5.5	5.4	5.4	5.5	5.0
Women, 25 years and older	7.2	6.0	6.0	5.8	6.0	6.0	6.1
White	8.4	6.5	6.4	6.2	6.3	6.3	6.2
Black	19.5	15.9	15.8	15.1	15.5	15.3	15.6
Fulltime workers	9.5	7.2	7.1	7.0	7.0	6.9	6.8
Memo:							
Total national <sup>1</sup>	9.5	7.4	7.3	7.1	7.2	7.2	7.2

1. Includes resident Armed Forces as employed.

during 1984. Much of the slowdown in income growth can be attributed to the lack of growth in manufacturing payrolls and smaller increases in personal interest income.

Despite the reduced income gains, nominal personal consumption expenditures rose 0.7 percent in May, after an even stronger advance the month before. Financing incentives on many domestic models and increased supplies of Japanese cars boosted total auto sales to an 11.3 million unit annual rate, the best monthly pace since April of 1979. Many of the financing programs for domestic models were phased out by the end of May, and sales of U.S. autos slowed. Among major types of discretionary merchandise, outlays for furniture and appliances at retail stores rebounded 4.8 percent (not at an annual rate) in May, after declining in the two preceding months, while spending for apparel and general merchandise was 1-1/2 percent above the first-quarter level.

The personal saving rate was 6.6 percent in May, boosted by the delayed receipt of federal personal tax refunds. The refund, delays have buffeted monthly estimates of disposable income and the saving rate--lowering them in February-March and raising them in April-May. The average saving rate for the first five months of this year, a measure that should be relatively free of distortions from refund processing problems, was 5.2 percent--nearly one percentage point less than the 1984 annual average.

Both the Conference Board index of confidence and the Michigan Survey Research Center index of sentiment were lower in May than in April, and both were noticeably below last summer's high levels. However, the indexes are quite high and, in the Michigan survey, two-thirds of the

PERSONAL INCOME AND EXPENDITURES  
(Based on seasonally adjusted data)

	1983	1984	1984		1985	1985		
			Q3	Q4	Q1	Mar.	Apr.	May
- - Percentage changes at annual rates <sup>1</sup> - -								
Total Personal Income								
Nominal	7.5	9.2	8.7	6.6	6.3	3.9	12.4	-6.2
Real <sup>2</sup>	4.3	5.8	4.2	4.1	3.0	-3	11.8	—
Disposable Personal Income								
Nominal	8.5	8.9	8.4	6.0	1.6	-8.4	39.6	19.6
Real	5.3	5.6	3.9	3.5	-1.6	-11.7	39.1	—
Expenditures								
Nominal	9.0	7.5	5.0	6.1	8.6	-2.3	11.5	8.9
Real	5.8	4.2	.7	3.6	5.2	-5.5	10.8	--
- - Changes in billions of dollars <sup>3</sup> - -								
Total personal income	17.0	21.0	20.6	14.5	14.8	10.2	32.5	-16.5
Wages and salaries	11.1	11.4	8.3	11.9	9.9	13.8	9.0	5.6
Private	9.5	9.6	6.5	10.5	7.0	12.1	4.2	7.0
Manufacturing	3.3	2.6	1.2	3.3	.7	2.5	-1.9	.8
Other income	6.8	10.6	12.9	3.3	8.5	-2.7	24.1	-21.6
Disposable personal income	16.3	17.2	18.2	9.9	-5.8	-18.5	87.1	44.6
Expenditures	15.7	14.1	11.9	10.6	11.9	-4.7	23.4	18.3
Durables	3.9	2.4	-2.9	6.1	-.6	-3.3	3.8	2.7
Nondurables	3.9	4.3	4.0	.2	1.6	-2.3	16.5	6.5
Services	7.9	7.5	10.9	4.4	10.8	1.0	3.1	9.1
Personal saving rate (percent)	5.0	6.1	6.3	6.2	4.5	3.6	5.8	6.6

1. Changes over periods longer than one quarter are measured from final quarter of preceding period to final quarter of period indicated. Changes for quarterly periods are compounded rates of change; monthly changes are not compounded.

2. Total personal income is deflated by the personal consumption expenditure deflator.

3. Average monthly changes are from the final month of the preceding period to the final month of period indicated; monthly figures are changes from the preceding month.

RETAIL SALES  
(Percent change from previous period;  
based on seasonally adjusted data)

	1984	1985	May	1985		
	Q4	Q1	Q1	Mar.	Apr.	May
Total sales	2.0	1.6	1.8	-.2	2.4	-.8
(Real) <sup>1</sup>	1.5	1.1	1.4	-.5	2.2	-.8
Total, less automotive, gasoline and nonconsumer stores	1.4	1.1	1.4	-.5	.8	.3
GAF <sup>2</sup>	3.2	1.1	2.0	.1	.2	.4
Durable	4.1	2.5	2.0	-.7	4.4	-2.2
Automotive group <sup>3</sup>	4.2	4.4	2.5	-1.8	6.5	-3.0
Furniture & appliances	5.2	1.1	3.5	-.6	-1.7	4.8
Nondurable	.8	1.1	1.7	.1	1.3	.0
Apparel	2.9	1.1	1.6	3.0	-.7	-1.4
Food	.2	1.3	.3	-.4	1.6	-1.0
General merchandise <sup>4</sup>	2.5	1.0	1.6	-.9	1.4	-.5
Gasoline stations	1.1	-.6	5.1	4.1	3.0	.3

1. BCD series 59. Data are available approximately three weeks following the retail sales release.

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

3. Sales of the automotive group frequently differ from sales of new cars on a unit basis because of broader coverage (for example, parts, used cars, and servicing), seasonal factors, and sampling.

4. General merchandise excludes mail-order nonstores.

AUTO SALES, PRODUCTION & INVENTORIES  
(Millions of units; seasonally adjusted annual rates)

	1984		1985	1985			
	Q3	Q4	Q1	Mar.	Apr.	May	June
Total sales <sup>1</sup>	10.3	10.3	10.9	10.4	11.0	11.3	—
Imports	2.4	2.8	2.4	2.2	2.3	2.8	—
Domestic	7.9	7.5	8.5	8.2	8.6	8.5	8.1 <sup>2</sup>
Domestic production	7.5	7.7	8.4	8.3	8.1	8.0	—
Domestic inventories	1.32	1.44	1.49	1.49	1.53	1.49	—
Days' supply <sup>3</sup>	52	58	55	56	54	54	—

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

2. First twenty days

3. Quarterly days' supply are based on end of quarter stocks and average sales for the quarter.

respondents thought it was a good time to buy a car--close to the all-time peak reported one month earlier. Survey respondents expected consumer prices to increase 4.7 percent during the next 12 months, within the range of price expectations reported since mid-1983.

#### Business Fixed Investment

Growth in business fixed investment in recent months has been concentrated in the structures area. The value of nonresidential construction put in place rose 4.8 percent in April and another 0.9 percent in May, with solid advances in virtually all major categories. For the first five months of 1985, nonresidential construction has grown at almost a 35 percent annual rate, with both commercial and other building expanding at about that same rate.

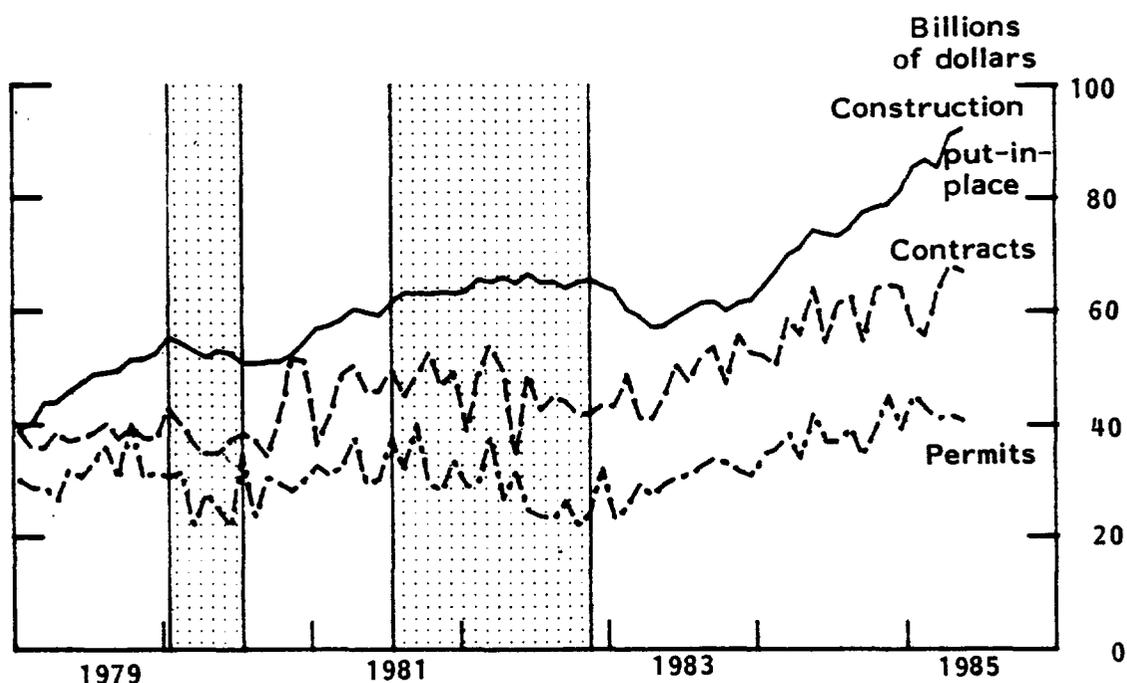
Outlays for producers' durable equipment appear to have revived a bit after a dip in the first quarter. Shipments of nondefense capital goods fell 3 percent between March and May; the decline probably reflects a sharp drop in exports of capital goods while shipments to domestic purchasers appear to have risen slightly. Imports of capital goods, which have satisfied much of the rise in domestic equipment demand throughout the expansion, edged down in both April and May.

New orders for nondefense capital goods rose 0.9 percent in May, following a large drop in April and little growth in the first quarter. On balance, new orders have been virtually flat since last fall. New orders for computers and related equipment have been particularly volatile since late last year; however, these orders have shown little net change over the past half-year. In contrast, the value of nonresidential building contracts has continued to trend upward, albeit more slowly than earlier in the expansion.

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

	1984		1985	1985		
	Q3	Q4	Q1	Mar.	Apr.	May
<b><u>Producers' durable equipment</u></b>						
Nondefense capital goods						
Shipments	2.6	3.2	-3.5	5.4	-1.8	-1.2
Orders	-4.4	-4.0	1.7	-7.8	-6.6	.8
Unfilled orders	1.9	-2.3	.7	-.4	-1.4	-1.0
Imports of capital goods excluding autos	23.1	-16.0	10.7	4.7	-1.5	-2.1
Exports of capital goods excluding autos	1.4	2.2	4.4	16.5	-12.3	1.3
Sales of heavy-weight trucks (thousands of units, A.R.)	252	316	312	320	286	264
<b><u>Nonresidential structures</u></b>						
Nonresidential construction	2.5	4.1	8.2	-1.6	4.8	.9
Commercial building	4.5	7.9	11.1	.8	3.2	.4

**NONRESIDENTIAL CONSTRUCTION,  
CONTRACTS, AND PERMITS<sup>1</sup>**



1. Source: F.W. Dodge and Census.

The Commerce Department's capital spending survey, conducted in April and May, indicates that firms are still planning to increase nominal plant and equipment outlays by roughly 9 percent in 1985. Moreover, total capital appropriations (net of cancellations) for the nation's 1,000 largest manufacturers rose about 8-1/2 percent in the first quarter.

#### Business Inventories

On balance, the pace of business inventory investment remained moderate into early spring. In manufacturing, stocks have remained low relative to sales as firms have kept tight control over inventories and responded quickly to weakness in orders. Indeed, book value data indicate a sizable decline in factory stocks between March and May. In the trade sector, auto dealers' stocks rose rapidly in the first quarter, but more recently sales have outpaced production. Excluding autos, trade inventories have generally continued to rise at a somewhat slower rate than during 1984. On balance, stocks do not appear to be excessive in the trade sector, with the possible exception of nondurable retail outlets where inventory-sales ratios have been on the high side of historical experience.

#### Housing

Housing demand appears to be quite strong. Although starts declined in May, they averaged 1.8 million units (annual rate) in April and May--the same as the elevated first-quarter pace. Moreover, newly-issued building permits, which typically exhibit less monthly variation than starts, continued to trend upward in May--reaching their highest level in almost a year.

Activity in the multifamily sector has been particularly volatile in recent months. Starts fell 20 percent in May and reversed much of the

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

	1984		1985			
	Q3	Q4	Q1	Mar.	Apr. <sup>F</sup>	May <sup>P</sup>
<b>Book Value Basis:</b>						
Total	52.2	31.8	21.3	-2.1	25.1	—
Manufacturing	29.3	4.7	1.8	.3	-1.5	-12.3
Wholesale Trade	15.5	6.4	6.6	2.8	3.6	—
Retail Trade	7.5	20.7	12.9	-5.2	23.0	—
Automotive	.1	11.7	8.7	2.0	12.2	—
Ex. Auto	7.4	9.0	4.1	-7.2	10.8	—
<b>Constant Dollar Basis:</b>						
Total	24.3	11.5	15.0	4.6	14.5	—
Manufacturing	13.0	-.1	2.1	-.1	3.2	—
Wholesale	8.8	3.5	2.8	.0	3.7	—
Retail	2.5	8.1	10.1	4.7	7.6	—
Automotive	.4	5.0	6.2	5.0	3.3	—
Ex. Auto	2.1	3.1	3.9	-.3	4.4	—

INVENTORIES RELATIVE TO SALES<sup>1</sup>

	1984		1985					
	Q3	Q4	Q1	Mar.	Apr. <sup>F</sup>	May <sup>P</sup>		
	Cyclical Reference Points <sup>2</sup>							
Book Value Basis:	<u>81 low</u>	<u>82 high</u>						
Total	1.39	1.53	1.37	1.37	1.38	1.36	—	
Manufacturing	1.60	1.77	1.50	1.48	1.48	1.47	1.48	1.46
Wholesale	1.06	1.28	1.14	1.16	1.17	1.17	1.14	—
Retail	1.36	1.43	1.39	1.41	1.42	1.42	1.40	—
Automotive	1.59	1.88	1.45	1.51	1.54	1.55	1.50	—
Ex. Auto	1.29	1.35	1.38	1.39	1.39	1.38	1.37	—
<b>Constant Dollar Basis:</b>								
Total	1.62	1.75	1.55	1.55	1.56	1.56	1.55	—
Manufacturing	1.91	2.11	1.79	1.77	1.78	1.77	1.78	—
Wholesale	1.34	1.52	1.36	1.37	1.38	1.38	1.35	—
Retail	1.34	1.44	1.34	1.36	1.38	1.38	1.37	—
Automotive	1.49	1.81	1.32	1.40	1.47	1.46	1.44	—
Ex. Auto	1.28	1.37	1.34	1.35	1.36	1.36	1.35	—

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

upsurge of the preceding two months. For the first five months of 1985, starts of multifamily units exceeded the strong 1984 pace, despite the large number of units currently under construction and multifamily vacancy rates that are at an 11-year high.

In the single-family sector, May's new home sales rebounded from the weakness in April--returning to about the average of the first quarter. In general, the recent decline in mortgage rates seems to be stirring buyer interest. Early June trade reports suggested that builders' expectations for sales already had improved noticeably.

#### Federal Sector

Federal receipts and outlays have both increased rapidly in the current fiscal year, and the federal budget deficit has widened. At the end of May, the unified budget deficit for the fiscal year was \$16 billion above year earlier levels. On the receipts side, delays in the processing of individual income tax returns have distorted the monthly pattern of receipts; however, the cumulative totals through May should show little distortion from the refund delays. For the tax collection season as a whole, net income tax settlements show a sizable increase because of a \$15 billion rise in estimated and final tax payments.

Regarding outlays, cyclically-sensitive spending has slowed, and budget cuts have damped outlay growth for many nondefense discretionary programs. This slowing has been offset by large increases in agricultural price support programs and net interest. Defense spending continues to lag to an unusual degree, relative to available spending authority.

In action toward a FY1986 congressional budget, the House passed its budget resolution in late May. The House version would cut \$56 billion from the projected 1986 baseline deficit, \$83 billion from the 1987 deficit, and \$120 billion from the 1988 deficit. The Senate had earlier approved a budget resolution that proposed cuts of about the same amount from the 1986 deficit but somewhat larger cuts than the House version in both 1987 and 1988. In addition, there are substantial differences between the House and Senate versions regarding how cuts ought to be achieved.

#### Exports and Imports

In May, the U.S. merchandise trade deficit rose \$17 billion (annual rate) and, for the April-May period combined, the deficit averaged about \$130 billion--roughly the same as the record level recorded in the third quarter of last year. The widening of the deficit in the first two months of the second quarter was attributable to a drop in exports, as imports were essentially unchanged from their first-quarter level. The decline in exports was fairly widespread by commodity category, with the largest decreases coming in agricultural products, capital goods, and industrial supplies. On the import side, a 10 percent rebound in oil imports in April-May was fully offset by small declines in nonoil commodity categories. Nonetheless, nonoil imports in the first two months of the second quarter continued to be very strong. (Further discussion of international developments is included in Section IV.)

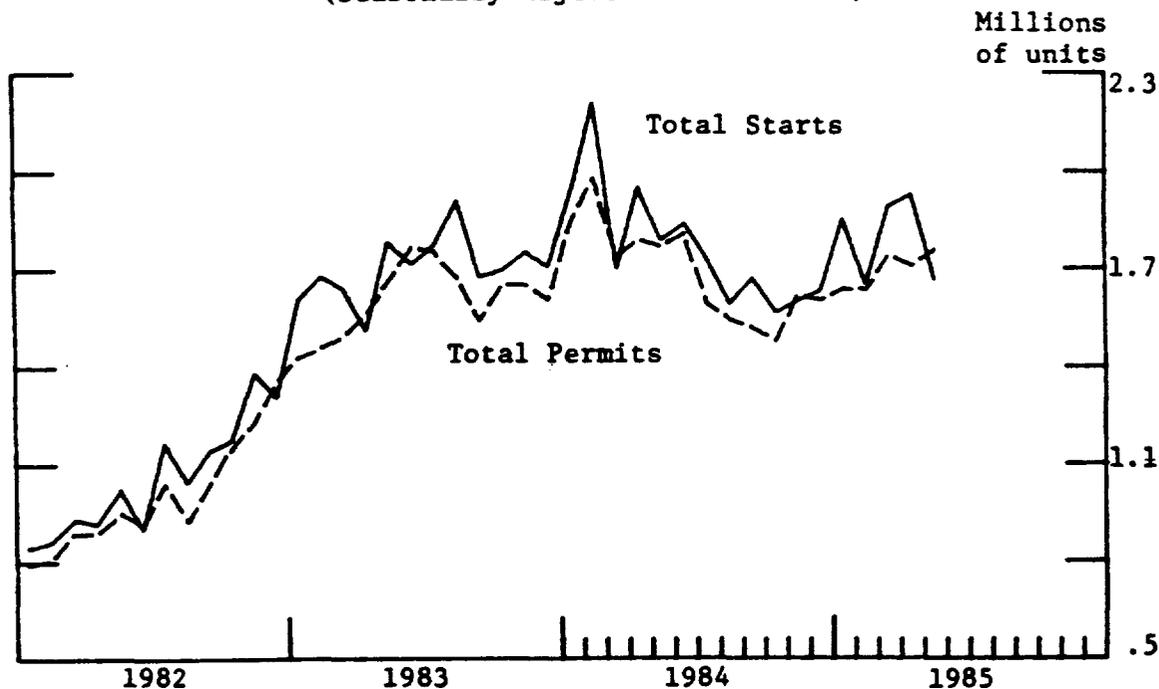
**PRIVATE HOUSING ACTIVITY**  
(Seasonally adjusted annual rates, millions of units)

	1984	1984		1985			
	Annual	Q3	Q4	Q1	Mar.	Apr.	
<b>All units</b>							
Permits	1.68	1.55	1.56	1.67	1.74	1.70	1.76
Starts	1.75	1.66	1.60	1.80	1.89	1.93	1.66
<b>Single-family units</b>							
Permits	.92	.86	.84	.94	.99	.95	.92
Starts	1.08	.99	1.05	1.12	1.17	1.16	1.04
<b>Sales</b>							
New homes	.64	.61	.62	.67	.70	.62	.68
Existing homes	2.87	2.76	2.81	2.97	3.03	3.04	3.01
<b>Multifamily units</b>							
Permits	.76	.69	.73	.73	.75	.76	.83
Starts	.67	.67	.55	.67	.72	.77	.62
<b>Mobile home shipments</b>	.30	.30	.29	.28	.28	.29	n.a.

1. Preliminary estimates.

n.a.--not available.

**HOUSING STARTS AND NEWLY ISSUED PERMITS**  
(Seasonally adjusted annual rate)



Prices

Recent inflation rates have been relatively moderate, after some larger price increases earlier this year. The consumer price index rose just 0.2 percent in May, as did the producer price index for finished goods. So far in 1985, the overall CPI and the index excluding food and energy have risen at about their 1984 paces--4 and 4-3/4 percent, respectively.

At both the producer and consumer levels, prices of commodities other than food and energy changed little, on average, from March through May. Declines were registered in consumer prices for new and used cars and for apparel, following sizable increases in the first quarter. In addition, producer prices of both consumer goods and capital equipment have been relatively flat since March. Consumer prices of nonenergy services, however, were up 0.7 percent in the May CPI--reflecting mainly a jump in the volatile rental component. Over the first five months of 1985, prices of nonenergy services have risen at about a 5-1/2 percent annual rate--the same as in 1984.

Food prices at the consumer level edged down in April and May, as generally ample supplies led to declines in prices of meats, poultry, and fresh fruits and vegetables. The index for the latter has nearly retraced its weather-related upsurge of early 1985. Consumer energy prices, which had risen sharply earlier in the year slowed to a 0.5 percent increase in May.

At earlier stages of processing, PPI prices of intermediate materials, excluding food and energy items, advanced 0.2 percent in May on the strength of an upturn in prices of construction materials. On balance,

though, this broad price index for domestically manufactured inputs to production has edged down so far this year and is only slightly above its year-earlier level. The producer price index of crude materials other than food and energy also has declined further this year and now stands about 9 percent below its May 1984 level.

### Wages and Labor Costs

Wage increases appear to have been small in the second quarter. The hourly earnings index for production and nonsupervisory workers in the private nonfarm economy rose just 0.1 percent in May after a similar small increase the month before. Earlier in the year, this measure of wage growth had accelerated somewhat, mainly due to some sizable pay adjustments in the manufacturing sector. In recent months, however, the rise in manufacturing wages has eased and the rate of wage increase in the service-producing sector has continued to edge lower.

In the union sector, recent wage settlements on balance have been small, and pressures to cut costs continue to be felt in some industries that are susceptible to import or nonunion competition. For example, new agreements in the apparel industry, which cover roughly 200,000 union members, call for an initial wage freeze. And settlements at several airlines, including United, have instituted two-tier pay scales, with lower entry salaries for newly-hired pilots. Also, a tentative settlement has been reached with the largest of the unions representing railroad workers--the United Transportation Union--calling for essentially COLA-only wage increases over the next three years.

FISCAL YEAR TO DATE BUDGET TOTALS  
(Unified budget, billions of dollars)

Month	1984			1985		
	Receipts	Outlays	Deficit	Receipts	Outlays	Deficit
October	45.2	70.2	25.1	52.3	81.0	28.8
November	91.4	138.0	46.7	103.7	161.0	57.2
December	147.9	212.7	63.3	166.1	238.6	72.4
January	210.5	280.8	68.8	236.6	315.5	78.9
February	258.4	349.0	89.2	290.6	390.4	99.8
March	302.8	422.1	117.8	340.2	468.4	128.2
April	383.0	490.7	106.3	434.8	550.7	115.8
May	420.5	562.1	140.2	474.6	630.8	156.2
FY Total	666.5	841.8	175.3	740.6e	943.6e	203.0e

e--Administration estimate, April Budget Update.

INDIVIDUAL ESTIMATED AND FINAL TAX RECEIPTS<sup>1</sup> SINCE JANUARY 1  
(Millions of dollars, not at annual rates nor seasonally adjusted)

Cumulative totals through:	Individual refunds		Estimated and final receipts		Net estimated and final receipts <sup>2</sup>	
	1984	1985	1984	1985	1984	1985
January 31	128	270	14,110	14,830	13,982	14,560
February 28	2,905	1,341	15,975	16,716	13,070	15,375
March 31	19,547	12,870	19,425	20,529	-1,222	7,659
April 30	35,080	31,582	55,811	68,780	20,731	37,198
May 31	58,079	60,040	64,013	77,968	5,934	17,928
June 18	58,733	60,772	69,297	83,982	10,564	23,210

1. Includes payment of estimated Social Security taxes by self-employed individuals.

2. Estimated and final receipts less refunds.

Source: Daily Treasury Statement.

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

	Relative Importance Dec. 1984	1983	1984	1984		1985	1985	
				Q3	Q4	Q1	Apr.	May
				-Annual rate-			-Monthly rate-	
All items <sup>2</sup>	100.0	3.8	4.0	4.5	3.0	4.1	.4	.2
Food	18.7	2.6	3.8	3.9	3.7	2.6	-.2	-.1
Energy	11.5	-.5	.2	.1	-.7	-.8	1.8	.3
All items less food and energy <sup>3</sup>	69.8	4.9	4.7	5.3	3.5	5.4	.3	.3
Commodities <sup>3</sup>	26.3	5.0	3.1	3.8	.9	6.6	.0	-.2
Services <sup>3</sup>	43.5	4.8	5.6	6.2	5.0	5.0	.4	.7
Memorandum: CPI-W <sup>4</sup>	100.0	3.3	3.5	7.5	1.6	4.0	.4	.2

1. Changes are from final month of preceding period to final month of period indicated.
2. Official index for all urban consumers, based on a rental equivalence measure for owner-occupied housing after December 1982.
3. Data not strictly comparable. Before 1983, they are based on unofficial series that exclude the major components of homeownership; beginning in 1983, data include a rental equivalence measure of homeowners costs.
4. Index for urban wage earners and clerical workers, based on a rental equivalence measure for owner-occupied housing after December 1984.

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

	Relative Importance Dec. 1984	1983	1984	1984		1985	1985	
				Q3	Q4	Q1	Apr.	May
				--Annual rate--			--Monthly rate--	
Finished goods	100.0	.6	1.7	.0	1.1	1.0	.3	.2
Consumer foods	24.4	2.3	3.5	4.5	3.3	-2.4	-1.0	-1.1
Consumer energy	11.5	-9.2	-4.1	-19.7	5.6	-21.0	5.8	3.4
Other consumer goods	42.4	1.9	2.2	2.5	-.2	6.6	-.2	.2
Capital equipment	21.6	1.9	1.8	2.3	-1.1	6.5	.0	.0
Intermediate materials <sup>2</sup>	95.1	1.4	1.7	-1.1	1.2	-2.5	.3	.3
Exc. energy	80.1	3.0	2.1	.9	1.5	-1.0	.0	.2
Crude food materials	53.0	8.0	-1.2	-1.7	10.6	-24.1	-3.0	-2.4
Crude energy	31.7	-4.6	-1.3	.4	-7.6	-12.7	.1	2.0
Other crude materials	15.4	15.5	-3.3	-15.3	-10.7	-13.4	2.1	-1.5

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

HOURLY EARNINGS INDEX<sup>1</sup>  
 (Percentage change; based on seasonally adjusted data)<sup>2</sup>

	1983	1984	1984	1985	1985			Year to date <sup>3</sup>
			H2	Q1	Mar.	Apr.	May	
	--Annual rate--				--Monthly rate--			
Total private nonfarm	4.0	3.1	2.8	3.5	.3	.2	.1	3.1
Manufacturing	2.8	3.3	3.1	5.2	.3	.3	.3	4.6
Durable	2.2	3.1	2.7	5.9	.3	.3	.4	5.0
Nondurable	3.9	3.7	3.8	4.0	.5	.3	.2	3.9
Contract construction	2.0	1.3	-.1	5.2	-.6	.3	-.4	2.3
Transportation and public utilities	4.3	2.9	2.5	2.7	.8	-.2	.0	2.3
Finance, insurance and real estate	5.9	3.6	3.0	5.4	.1	.2	.2	4.2
Total trade	4.8	2.6	2.5	1.8	.0	.1	.0	1.4
Services	4.8	4.0	3.9	2.1	.6	.2	.1	3.0

1. Excludes the effect of interindustry shifts in employment and fluctuations in overtime hours in manufacturing.

2. Changes over periods longer than one quarter are measured from final quarter of preceding period to final quarter of period indicated. Quarterly changes are compounded annual rates.

3. Changes are from fourth-quarter averages to May at compound annual rates.

III-T-1  
SELECTED FINANCIAL MARKET QUOTATIONS<sup>1</sup>  
(Percent)

	1982/1983	1984	1985				Change from:	
	Cyclical low	Highs	FOMC March 26	FOMC May 21	June lows	July 2	1984 highs	FOMC May 21
<b>Short-term rates</b>								
Federal funds <sup>2</sup>	8.46	11.63	8.57	8.03	7.38	7.70	-3.93	-.33
Treasury bills <sup>3</sup>								
3-month	7.08	10.67	8.34	7.30	6.66	6.95	-3.72	-.35
6-month	7.62	10.77	8.80	7.43	6.81	7.05	-3.72	-.38
1-year	7.73	11.13	8.98	7.64	6.98	7.19	-3.94	-.45
Commercial paper								
1-month	8.00	11.42	8.63	7.54	6.95	7.54	-3.88	--
3-month	7.97	11.35	8.75	7.56	7.01	7.46	-3.89	-.10
Large negotiable CDs <sup>3</sup>								
1-month	8.08	11.52	8.60	7.59	7.09	7.55	-3.97	-.04
3-month	8.12	11.79	8.79	7.66	7.18	7.61	-4.18	-.05
6-month	8.20	12.30	9.35	7.84	7.30	7.70	-4.60	-.14
Eurodollar deposits <sup>4</sup>								
1-month	8.68	11.89	8.78	7.84	7.45	7.56	-4.33	-.28
3-month	8.71	12.20	9.19	8.01	7.50	7.70	-4.50	-.31
Bank prime rate	10.50	13.00	10.50	10.00	9.50	9.50	-3.50	-.50
Treasury bill futures								
Sept. 1985 contract			8.86	7.65	6.77	7.07	--	-.58
Dec. 1985 contract			9.74	8.00	7.12	7.41	--	-.59
<b>Intermediate- and long-term rates</b>								
U.S. Treasury (constant maturity)								
3-year	9.33	13.49	10.97	9.39	8.73	9.08	-4.41	-.31
10-year	10.12	13.99	11.77	10.60	9.83	10.20	-3.79	-.40
30-year	10.27	13.94	11.72	10.85	10.23	10.43	-3.51	-.42
Municipal revenue (Bond Buyer Index)	9.21	11.44	10.24 <sup>5</sup>	9.34 <sup>5</sup>	9.10	9.24 <sup>5</sup>	-2.20	-.10
Corporate--A utility Recently offered	11.64	15.30	13.11 <sup>e</sup>	12.02 <sup>e</sup>	11.50	11.56 <sup>e</sup>	-3.74	-.46
Home mortgage rates								
S&L fixed-rate	12.55	14.68	13.24 <sup>6</sup>	12.94 <sup>6</sup>	12.05	12.15 <sup>6</sup>	-2.53	-.79
S&L ARM, 1-yr.	n.a.	12.31	10.97 <sup>6</sup>	10.59 <sup>6</sup>	9.83	9.77 <sup>6</sup>	-2.54	-.82
	1983	1984	1985		Percent change from:			
	Highs	Lows	Lows	FOMC May 21	July 2	1984 lows	FOMC May 21	
<b>Stock prices</b>								
Dow-Jones Industrial	1287.20	1086.57	1184.96	1309.70	1334.01	22.8	1.9	
NYSE Composite	99.63	85.13	94.60	109.65	111.28	30.7	1.5	
AMEX Composite	249.03	187.16	202.06	232.47	231.79	23.8	-.3	
NASDAQ (OTC)	328.91	225.30	246.00	293.94	296.91	31.8	1.0	

1. One-day quotes except as noted.

2. Averages for two-week reserve maintenance period closest to date shown. Last observation is the average so far in the maintenance period ending July 3, 1985.

3. Secondary market.

4. Averages for statement week closest to date shown.

5. One-day quotes for preceding Thursday.

6. One-day quotes for preceding Friday.  
e--estimated.

## DOMESTIC FINANCIAL DEVELOPMENTS

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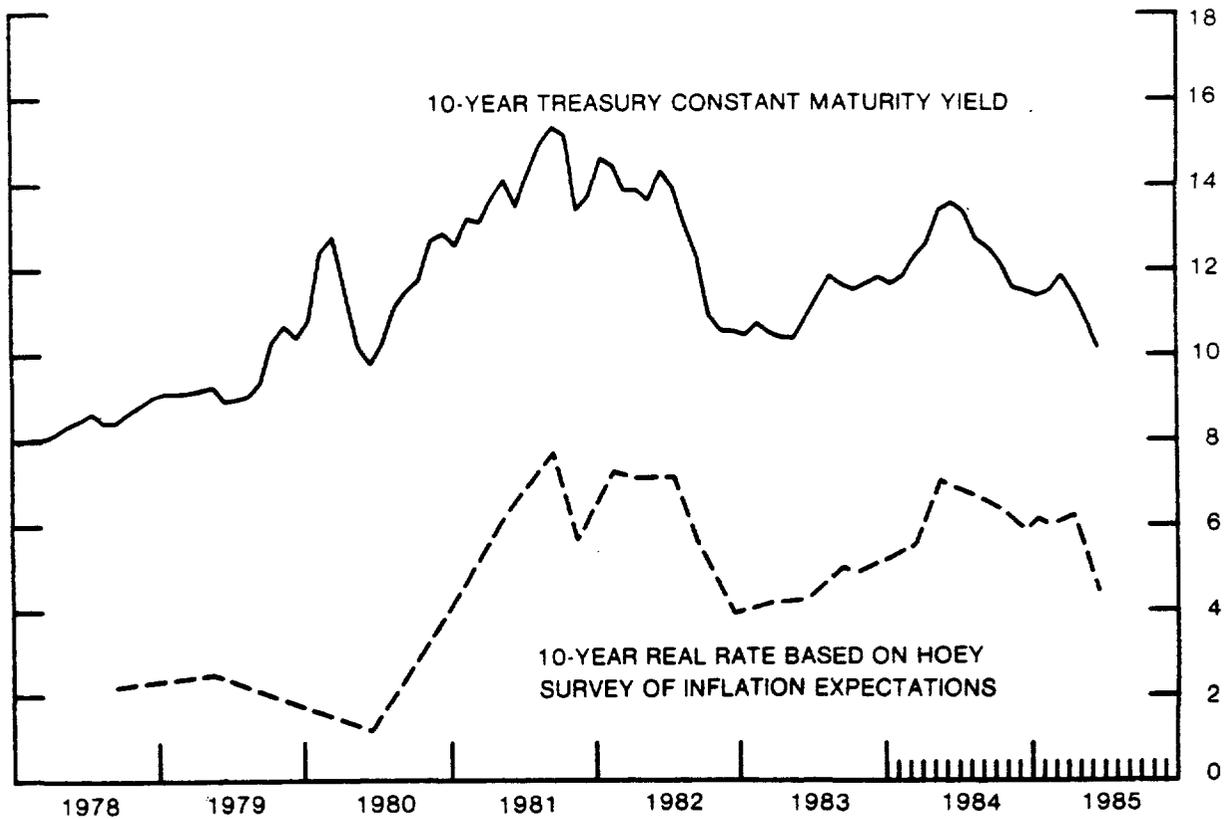
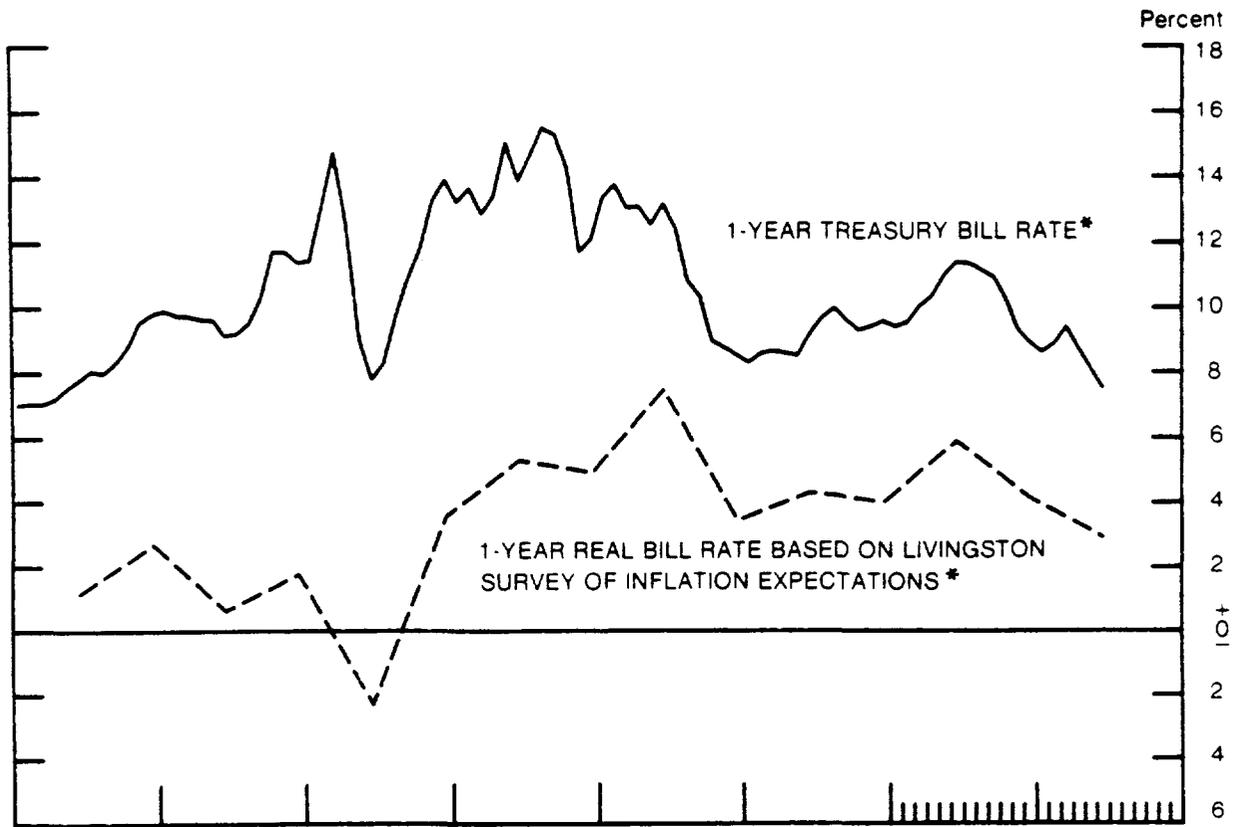
M1 continued to expand at an exceptionally rapid pace in June, moving still further above the band associated with the FOMC's 1985 target range. The strength in narrow money contributed in turn to faster growth in the broader aggregates, which also were buoyed by more vigorous increases in such non-M1 components as MMDAs and money market mutual fund shares.

The persistence of brisk growth in M1, coupled with unanticipated firmness in some key economic indicators, led to a partial reversal after mid-June of a credit market rally that had been based heavily on expectations of another cut in the discount rate to stimulate business activity. Yields on most private short-term market instruments have declined slightly on balance since the May FOMC meeting; Treasury bill rates, however, have fallen about 40 basis points, apparently reflecting in part some shift in investor preferences in light of concerns about the banking system. Bond rates, perhaps influenced more by developments in petroleum markets and implications for future inflationary pressures, have posted declines comparable to those in bill rates, thus maintaining a steep yield curve. Home mortgage rates, catching up with the rally in other markets, are off approximately 3/4 of a percentage point.

While nominal interest rates have declined substantially since mid-1984, approaching 1978 or 1979 levels, estimates based on surveys of inflation expectations indicate that real interest rates have declined somewhat less. Indeed, real long-term rates remain considerably above past norms (see chart on page III-2).

Aggregate borrowing by nonfinancial corporations appears to have been heavy in June and in the second quarter as a whole, even though the

### Selected Survey-Based Measures of Real Interest Rates



\*Bill rates calculated on a coupon equivalent basis.

gap between capital outlays and internal funds remained moderate. Issuance of long-term bonds surged to a record volume last month, partly in connection with mergers, buyouts, and share repurchases. In the household sector, credit growth apparently remained sizable through the spring--most markedly in the consumer installment credit area, but with mortgage credit demand reportedly strengthening recently in response to lower interest rates. Borrowing by state and local governments has been quite strong, boosted by a heavy volume of refundings. The federal government also stepped up its borrowing during the second quarter, building its cash balance in the process.

#### Monetary Aggregates and Bank Credit

M1 growth accelerated sharply in May to a 14 percent annual rate, and was still more rapid in June.<sup>1</sup> The strength in money demand, which has exceeded model predictions, has encompassed all of the major components of M1. Tax refunds/payments and gyrations in Treasury cash balances do not appear to have been a significant factor in the M1 pattern. The publicity given to improper cash management practices by E. F. Hutton also appears not to have significantly affected holdings of M1 balances by other corporations.

M2 increased at an 8-1/2 percent annual rate in May, and accelerated further in June to edge above the upper end of its 6-to-9 percent 1985 target cone. Some of the pickup in M2 growth in May was accounted for by its M1 components, but a sharp rise in overnight RPs also was important; the latter development appeared to be associated with financing of increased Treasury security holdings that were acquired by banks. The further acceleration of M2 in June can be traced in large part to faster growth in

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1. Statements about June behavior of the monetary and credit aggregates are based on preliminary data for the latter part of the month, which are subject to large revision.

MONETARY AGGREGATES  
(Based on seasonally adjusted data unless otherwise noted)<sup>1</sup>

July 2, 1985

	1983:Q4 to 1984:Q4		1985				Growth from Q4 1984 to June 1985
	Q1	Q2 <sup>pa</sup>	Apr.	May	June <sup>pe</sup>		
----- Percentage change at annual rates -----							
1. M1	5.2	10.6	10	5.9	14.0	18	11
2. M2	7.7	12.0	5	-0.8	8.4	13	9
3. M3	10.4	10.7	5	0.2	7.6	11	8
							Levels in billions of dollars May 1985
<u>Selected components</u>							
4. Currency	7.2	6.3	7	3.0	10.4	10	163.1
5. Demand deposits	1.1	7.0	8	2.9	15.7	21	255.8
6. Other checkable deposits	10.5	21.1	16	13.3	15.5	20	157.3
7. M2 minus M1 <sup>2</sup>	8.6	12.5	4	-2.9	6.7	12	1862.9
8. Overnight RPs and Eurodollars, NSA <sup>3</sup>	7.3	64.0	-26	-152.2	95.3	4	63.9
9. General purpose and broker/dealer money market mutual fund shares, NSA	17.0	32.7	-1	-8.9	-28.6	23	172.1
10. Commercial banks	8.1	13.6	9	8.9	8.4	15	808.6
11. Savings deposits, SA, plus MMDAs, NSA <sup>4</sup>	5.2	29.2	11	3.2	9.2	27	418.6
12. Small time deposits	11.1	-1.8	7	15.0	7.1	2	389.6
13. Thrift institutions	7.3	7.9	6	3.5	8.4	7	836.3
14. Savings deposits, SA, plus MMDAs, NSA <sup>4</sup>	-3.6	17.8	10	1.4	6.1	11	334.4
15. Small time deposits	15.5	1.7	4	4.8	9.9	4	501.9
16. M3 minus M2 <sup>5</sup>	22.1	5.5	5	4.4	4.6	3	630.8
17. Large time deposits	26.0	9.0	7	10.5	2.2	-9	428.1
18. At commercial banks, net <sup>6</sup>	16.0	2.6	8	15.1	-4.0	-18	272.0
19. At thrift institutions	48.8	21.0	3	0.8	13.2	6	156.0
20. Institution-only money market mutual fund shares, NSA	33.6	31.2	8	2.0	78.5	72	63.5
21. Term RPs, NSA	45.6	-19.5	24	52.2	-35.0	-5	69.8
22. Term Eurodollars, NSA	-8.3	2.0	-13	-59.6	-3.0	-27	80.1

-- Average monthly change in billions of dollars --

MEMORANDA:

23. Managed liabilities at commercial banks (24+25)	4.7	4.1	-2	-9.2	5.1	-2	442.6
24. Large time deposits, gross	3.2	1.4	-1	2.6	-1.5	-4	331.0
25. Nondeposit funds	1.5	2.7	-1	-11.8	6.6	2	111.6
26. Net due to related foreign institutions, NSA	0.9	0.5	-2	-3.3	3.3	-4	-30.4
27. Other <sup>7</sup>	0.5	2.2	0	-8.5	3.3	6	142.0
28. U.S. government deposits at commercial banks <sup>8</sup>	0.2	-1.4	2	2.8	8.0	-5	22.6

1. Quarterly growth rates are computed on a quarterly average basis. Dollar amounts shown under memoranda for quarterly changes are calculated on an end-month-of-quarter basis.

2. Nontransactions M2 is seasonally adjusted as a whole.

3. Overnight and continuing contract RPs issued to the nonbank public by commercial banks plus overnight Eurodollar deposits issued by branches of U.S. banks to U.S. nonbank customers, both net of amounts held by money market mutual funds. Excludes retail RPs, which are in the small time deposit component.

4. Growth rates are for savings deposits, seasonally adjusted, plus money market deposit accounts (MMDAs), not seasonally adjusted. Commercial bank savings deposits excluding MMDAs increased during May and June 1985 at rates of 8.0 percent and 12 percent respectively. At thrift institutions, savings deposits excluding MMDAs increased during May 1985 at a rate of 5.0 percent and also increased in June at a rate of 5 percent on a rounded basis.

5. The non-M2 component of M3 is seasonally adjusted as a whole.

6. Net of large-denomination time deposits held by money market mutual funds and thrift institutions.

7. Consists of borrowings from other than commercial banks in the form of federal funds purchased, securities sold under agreements to repurchase, and other liabilities for borrowed money (including borrowings from the Federal Reserve and unaffiliated foreign banks, loan RPs and other minor items). Data are partially estimated.

8. Consists of Treasury demand deposits at commercial banks and Treasury note balances.

pe--preliminary estimate

retail deposits and a swing to expansion of money funds, owing to the lagging adjustment of returns to declining market rates.

In the retail deposit category, a pickup in MMDAs more than offset a slowdown in small time deposits--a pattern consistent with a flattening of the yield curve of offering rates during May and June. Savings deposits expanded in May at the fastest rate since the introduction of MMDAs, and this development continued in June.

After rising at a 7-1/2 percent annual rate in May, M3 growth quickened in June, although its non-M2 component continued to expand slowly. M3 ended the first half of 1985 in the upper portion of its 6-to-9-1/2 percent growth rate target range. Among the non-M2 components of M3, only institutional money market mutual funds and large time deposits at thrifts have risen since April. The large time deposit component of M3 was about flat in May and down somewhat in June as runoffs at commercial banks more than offset growth at thrifts. Greater core deposit inflows and somewhat weaker credit growth lessened bank needs for managed liabilities in June. Expansion in large CDs at thrifts reportedly may be traced to their efforts to shift away from very short-term sources of funds such as RPs into liabilities with maturities of six months or more.

Growth in total loans and investments at commercial banks, after accelerating markedly in May, slowed in June, largely reflecting a reduced pace of security acquisitions. Loan growth was slightly less rapid in June than in May or in the first quarter. Real estate lending continued at its recent substantial clip, but consumer loans decelerated over May and June, perhaps reflecting concessionary terms on auto loans offered by major automobile finance companies. Business loans booked domestically grew

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

July 2, 1985

	1984	1985			1985		Levels in bil. of dollars JuneP
	Q4	Q1	Q2P	Apr.	May	JuneP	
----- Commercial Bank Credit -----							
1. Total loans and securities at banks	9.8	10.3	9.6	4.7	13.3	10.6	1801.0
2. Securities	1.8	5.2	2.0	-13.0	20.3	10.6	411.6
3. U.S. government securities	3.4	10.3	0.2	-26.1	22.1	5.0	267.0
4. Other securities	-5.6	-3.4	17.0	12.1	17.1	21.1	144.6
5. Total loans	12.8	11.7	10.7	10.0	11.2	10.6	1389.5
6. Business loans	7.8	10.2	3.2	1.2	6.0	2.5	484.3
7. Security loans	37.5	16.5	82.9	84.1	82.1	67.2	39.6
8. Real estate loans	12.1	10.9	12.5	12.8	12.0	12.5	397.9
9. Consumer loans	16.1	17.4	14.5	16.5	14.5	12.1	271.4
----- Short- and Intermediate-Term Business Credit -----							
10. Business loans net of bankers acceptances	7.9	9.3	4.4	3.8	6.5	2.7	481.2
11. Loans at foreign branches <sup>2</sup>	26.0	-45.1	23.3	-25.4	19.5	76.6	20.0
12. Sum of lines 10 & 11	8.7	6.9	5.1	2.4	7.5	5.3	501.2
13. Commercial paper issued by nonfinancial firms <sup>3</sup>	51.2	-6.0	32.7	41.6	43.4	10.9	78.0
14. Sums of lines 12 & 13	13.7	5.2	8.6	7.4	12.2	6.0	579.2
15. Bankers acceptances: U.S. trade related <sup>4,5</sup>	-6.5	-5.5	n.a.	-29.9	3.4	n.a.	35.3 (May)
16. Line 14 plus bankers acceptances: U.S. trade related	12.4	4.4	n.a.	5.4	11.7	n.a.	611.6 (May)
17. Finance company loans to business <sup>4</sup>	23.2	20.8	n.a.	10.3	n.a.	n.a.	141.0 (April)
18. Total short- and intermediate- term business credit (sum of lines 16 & 17)	14.4	7.4	n.a.	6.3	n.a.	n.a.	746.7 (April)

n.a.--not available.

p--preliminary.

1. Average of Wednesdays for domestically chartered banks and average of current and preceding ends of months for foreign-related institutions.

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

3. Average of Wednesdays.

4. Based on average of current and preceding ends of month.

5. Includes acceptances financing U.S. imports, U.S. exports and domestic shipment and storage of goods.

moderately during the past two months, but loans booked at foreign branches increased sharply--likely owing to a relatively wide interest differential favoring LIBOR over prime-based pricing. (The prime rate was cut from 10 to 9-1/2 percent in mid-June). Taken together, domestic plus foreign branch loans to businesses grew at a pace in May and June roughly in line with the moderate rate of the first four months of the year. Issuance of commercial paper by nonfinancial business slowed in June from the substantial volume of the previous two months.

#### Business Finance

Since the last FOMC meeting, corporate bond yields have declined nearly 1/2 percentage point, to five-year lows. Yield spreads between long-term corporates and Treasuries have remained near their lowest levels of the last six years. Corporate bond issuance attracted by the lower level of interest rates has been extremely large in the past two months. A large proportion of this volume has financed the net absorption of equities in mergers, buyouts, and share repurchase programs, although some of the long-term borrowing has been motivated by a desire to repay loans and short-term paper.

The volume of bond offerings by U.S. corporations soared to an all-time high in June, on the heels of strong issuance earlier in the spring. Bonds issued to finance exchanges for equity shares represented more than half of the estimated \$10 billion of nonfinancial bond offerings in domestic markets in June. Borrowing by financial firms also has been sizable as May volume surpassed the April record, and June also was large; among the financial company issues in May were two publicly offered bonds backed by auto loans, another step in the "securitization" of credit.

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

	1984		1985				
	Year	H2	Q1	Q2 <sup>P</sup>	Apr. <sup>P</sup>	May <sup>P</sup>	June <sup>P</sup>
Corporate securities - total <sup>1</sup>	9.88	12.09	12.32	16.48	14.18	14.18	21.10
Public offerings in U.S.	8.00	9.58	9.35	14.28	11.45	12.60	18.80
Stocks--total <sup>2</sup>	1.89	1.71	2.21	3.07	2.61	2.80	3.80
Nonfinancial	1.08	.97	1.12	1.75	1.84	1.40	2.00
Utility	.22	.19	.43	.39	.58	.30	.30
Industrial	.86	.78	.70	1.36	1.26	1.10	1.70
Financial	.81	.74	1.08	1.32	.77	1.40	1.80
Bonds--total <sup>1</sup>	6.11	7.87	7.14	11.21	8.84	9.80	15.00
By industry							
Nonfinancial	2.80	3.89	4.14	5.86	3.43	4.05	10.10
Utility	.87	1.19	.79	1.60	1.19	2.40	1.20
Industrial	1.93	2.70	3.35	4.26	2.24	1.65	8.90
Financial	3.31	3.98	3.00	5.35	5.41	5.75	4.90
By quality <sup>3</sup>							
Aaa and Aa	1.85	2.62	1.23	2.71	3.32	2.62	2.20
A and Baa	2.11	2.71	3.97	5.32	2.99	3.66	9.30
Less than Baa	1.09	1.47	.94	1.67	1.46	1.95	1.60
No rating (or unknown)	.25	.28	.27	.52	.60	.21	.75
Memo items:							
Equity based bonds <sup>4</sup>	.50	.71	.44	1.03	1.28	.80	1.00
Mortgage-backed bonds	.81	.79	.73	.99	.47	1.36	1.15
Variable rate notes	.72	.89	.99	1.50	1.10	.42	2.98
Bonds sold abroad - total	1.88	2.51	2.97	2.20	2.73	1.58	2.30
Nonfinancial	.84	1.03	1.05	.99	1.37	.56	1.05
Financial	1.04	1.48	1.92	1.21	1.36	1.02	1.25

p--preliminary.

1. Securities issued in the private placement market are not included. Total reflects gross proceeds rather than par value of original discount bonds.

2. Includes equity issues associated with debt/equity swaps.

3. Bonds categorized according to Moody's bond ratings. Excludes mortgage-backed bonds.

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

Issuance of corporate bonds has been concentrated more in the domestic market recently as Euromarket borrowing has eased off some from the higher volume of the previous two quarters, reflecting the more favorable rates available domestically. It also has been concentrated in the short and intermediate maturities; and with the recent stock market gains, a large proportion of longer-term issues has been convertible into equity. Issuance of low-and unrated bonds by both financial and nonfinancial firms also picked up in the second quarter after a comparative lull in the first quarter. Corporate borrowing in the tax-exempt market remained weak throughout the first half of the year, after the surge of issues that preceded imposition at the beginning of this year of more stringent arbitrage restrictions and limits on bond issues for industrial development.

New equity issues expanded during the second quarter, boosted by higher stock prices. However, owing to mergers and financial restructuring, net share retirements in the second quarter are estimated to have been nearly \$75 billion at an annual rate for the nonfinancial sector, somewhat below the level of the first quarter and roughly equal to the volume last year. During June, when several broad stock price indexes registered new highs, equity issuance picked up to about \$3.8 billion, the largest monthly volume since November 1983.

#### U.S. Government Securities Markets

The combined (on- and off-budget) federal deficit in the April-to-June quarter is estimated by the staff at about \$36 billion. The deficit is expected to widen again to about \$55 billion in the current quarter. During the second quarter, the Treasury borrowed a net \$38-1/2 billion in the market and raised another \$6-1/2 million from nonmarketable issues--mostly

TREASURY AND AGENCY FINANCING<sup>1</sup>  
(Total for period: billions of dollars)

	1985				
	Q1	Q2 <sup>pe</sup>	April	May	June <sup>pe</sup>
<u>Treasury financing</u>					
Combined surplus/deficit(-)	-58.6	-35.7	11.4	-42.0	-5.1
Means of financing deficit:					
Net cash borrowing from the public	41.8	45.0	17.0	16.3	11.7
Marketable borrowings/ repayments(-)	37.0	38.5	16.4	13.5	8.6
Bills	5.1	2.4	.4	1.4	.6
Coupons	31.9	36.1	16.0	12.1	8.0
Nonmarketable	4.8	6.5	.6	2.8	3.1
Decrease in the cash balance	3.7	-10.1	-26.1	28.9	-12.9
Memo: Cash balance at end of period	13.9	24.0	40.0	11.1	24.0
Other <sup>2</sup>	13.1	.8	-2.3	-3.2	6.3
<u>Federally sponsored credit agencies, net cash borrowing<sup>3</sup></u>					
	3.8	6.3	.3	3.6	2.4
FHLB	.2	4.5	-.2	2.3	2.4
FNMA	2.6	2.2	.6	1.3	.3
Farm Credit Banks	-1.1	-1.5	-.3	-.6	-.6
FHLMC <sup>4</sup>	1.6	.4	.1	.2	.1
SLMA	.5	.7	.1	.4	.2

pe--staff preliminary estimate.

1. Data reported on a not seasonally adjusted, payment basis.

2. Includes checks issued less checks paid, accrued items and other transactions.

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

4. Data for May are preliminary.

securities specially tailored for state and local governments as a temporary repository for proceeds from tax-exempt refunding bonds. With borrowing in excess of current needs, the Treasury cash balance grew by \$10 billion.

The end-of-quarter financing, to settle in early July, raised \$14 billion of new money, and thus made considerable progress toward covering third-quarter cash needs. During the third quarter, the Treasury is expected to maintain its cash balance at about the current level in anticipation of heavy fourth-quarter financing needs.

Net borrowing by the federally sponsored credit agencies surged to more than \$6 billion in the second quarter. The Federal Home Loan Banks accounted for much of this volume. There was a substantial increase in demand by thrift institutions for advances, as they reportedly sought to reduce reliance on brokered deposits and RPs and to take advantage of recent lower interest rates available on longer-term advances. FNMA also borrowed heavily, to fund mortgage purchases.

The Farm Credit Banks reduced their outstanding debt further during the second quarter, as FCB loan volume continued to decline. Production Credit Associations (PCAs) which lend directly to agricultural producers have experienced severe pressures owing to increasing loan losses; their lending has trended down as more creditworthy borrowers have tended to obtain financing elsewhere at more attractive rates. Accordingly, demands for credit from the Federal Intermediate Credit Banks--which are part of the Farm Credit Bank System and the primary source of funds for PCAs--have fallen off.

#### Tax-Exempt Securities Markets

Offerings of tax-exempt bonds were very strong in May and June--indeed, the largest since the record \$17.7 billion last December. Heavy

volume in recent months primarily reflected a step-up in refunding issues.

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

	1984	1985				
	Year	Q1	Q2 <sup>P</sup>	Apr.	May <sup>P</sup>	June <sup>P</sup>
Total	10.60	8.67	13.87	15.12	13.50	13.70
Short-term <sup>1</sup>	1.71	.72	2.60	4.81	1.00	2.70
Long-term	8.89	7.95	11.27	10.31	12.50	11.00
Refundings <sup>2</sup>	1.05	1.78	3.82	2.76	4.70	4.00
New capital	7.84	6.17	7.45	7.55	7.80	7.00
Total housing	1.69	1.18	1.53	1.50	1.60	1.50

p--preliminary.

1. Does not include tax-exempt commercial paper.

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

Borrowing was stimulated by the downtrend in municipal bond yields in May and early June. Since then, municipal rates, like other market rates, have backed up a bit. By late June, the Bond Buyer 30-year revenue index was 10 basis points below its level at the time of the May FOMC meeting, and about 100 basis points below its recent high in March. The net decline in municipal bond rates during the intermeeting period has been less than for taxable bonds, probably as a result of the heavy supply of refunding bonds coming to market.

The increased volume of refunding bonds does appear to reflect mainly the current low level of rates; market reports suggest that the proposed ban on advance refundings in the President's tax reform program has played little, if any, role. A substantial share of the refundings has been undertaken by public power authorities. Proceeds of many recent refundings will not be used to refinance outstanding issues until the early 1990s, when the initial call dates are reached.

Trading began on June 11 in a new municipal bond futures contract at the Chicago Board of Trade. The value of this contract is based on a new index, compiled by the Bond Buyer, of prices of a continually changing set of 40 recently offered, actively traded tax-exempt issues. The contract itself has been trading actively since its introduction; trading to date reportedly has been strongly dominated by speculators, as is usually the case with new contracts.

### Mortgage Markets

Before turning up in the latter part of June, home mortgage rates had fallen markedly after the last FOMC meeting, reaching the lowest levels in several years. In the primary market, contract rates on new conventional fixed-rate loan commitments at S&Ls are down 115 basis points from their recent peak in late March, and the ceiling rate on standard VA-guaranteed loans was lowered to 11.5 percent, effective June 5, the third cut in two months. Yield declines have been smaller in the secondary market, where they tended to match developments in the bond market.

Adjustable-rate home loans continue to offer substantial initial rate advantages as compared with fixed-rate loans, consistent with the steepness of the yield curve in securities markets. Despite an initial rate advantage of more than 2 percentage points, however, ARMs in recent months have accounted for only half of all home loans originated, compared with a high of two-thirds reached in mid-1984. The general reduction in interest rates since late 1984 appears partly responsible for the reduced share, as lower costs of credit have allowed home buyers to afford both a house and the certainty of a fixed-rate loan. Higher premiums and more selective underwriting standards for private mortgage insurance on ARMs also may have been contributing factors.

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

	Mortgage commitments		Net change in mortgage assets <sup>1</sup>		
			Total	Mortgage loans	Mortgage-backed securities
	New (1)	Outstanding <sup>2</sup> (2)			
1984-Oct.	16.9	69.2	5.5	5.2	.3
Nov.	16.9	69.2	4.5	5.9	-1.4
Dec.	17.5	69.6	3.4	2.8	.6
1985-Jan.	16.9	68.7	3.5	4.3	-.9
Feb.	16.1	68.6	3.2	2.5	.6
Mar.	16.0	67.9	5.1	5.0	.1
Apr. r	16.5	66.5	4.1	4.9	-.8
May p	16.2	66.1	2.0	3.0	-1.0

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

2. End of month. Includes loans in process.

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

Period	Total	GNMAs	FHLMCs	FNMAs	Memo: FNMA and
					FHLMC swap issues
1983-Q1	7.1	3.8	2.0	1.3	2.2
Q2	7.4	4.8	1.4	1.2	1.9
Q3	7.6	4.8	1.5	1.2	2.1
Q4	5.7	3.4	1.7	.7	2.0
1984-Q1	4.9	2.7	.9	1.3	1.6
Q2	4.0	2.3	1.1	.5	1.5
Q3	5.1	2.2	1.4	1.5	2.7
Q4	6.1	2.0	2.8	1.3	3.6
1985-Q1	6.4	2.7	2.4	1.3	3.0
1984-Oct.	6.2	2.5	2.6	1.1	3.4
Nov.	4.6	1.4	2.0	1.2	2.7
Dec.	7.5	2.1	3.8	1.6	4.7
1985-Jan.	5.5	2.7	2.0	.9	2.3
Feb.	6.9	2.7	2.4	1.8	3.3
Mar.	6.6	2.8	2.8	1.1	3.3
Apr. r	6.4	2.6	2.0	1.9	3.3
May p	7.9	3.6	3.3	1.0	3.3

p--preliminary.

r--revised.

As interest rates have moderated, growth in residential mortgage debt appears to have picked up slightly over the spring from the first-quarter pace. New issues of federally related mortgage pass-through securities rebounded in May to their largest volume in two years, with both FHLMC and GNMA issuance up sharply. All Freddie Mac securities and almost all of the GNMA securities were backed by fixed-rate loans; pass-through securities collateralized by adjustable-rate mortgages have not been well received to date by investors, in part because of the caps on annual rate adjustments on the underlying mortgages. Thrifts, by contrast, have continued to account for a smaller than usual share of net mortgage lending. Mortgage-related assets at FSLIC-insured institutions grew only 2 percent in the first five months of this year, compared with 7 percent during the same period in 1984.

The net worth regulations that became effective in the first quarter of 1985 have been the major factor in damping thrift asset growth, according to industry observers. Thrifts have been originating mortgages at a brisk pace, but many of these loans have then been sold. Furthermore, thrifts have continued to be net sellers of mortgage-backed securities, as lower interest rates since March have allowed institutions to realize capital gains by liquidating assets acquired when rates were higher.

#### Consumer Installment Credit

Consumer installment credit evidently grew rapidly in May, perhaps at about the elevated pace of the first four months of the year. Robust auto sales, stimulated in part by concessionary finance rates offered on some new-car models by the captive auto finance companies, likely contributed heavily to the May credit expansion. Delays in distributing

CONSUMER INSTALLMENT CREDIT

	1983	1984	1984 Q4	1985 Q1	1985		
					Feb.	Mar.	Apr.
----- Percent rate of growth, SAAR -----							
Change in outstandings--total	14.6	20.0	17.1	21.8	23.6	21.4	20.8
By type:							
Automobile credit	13.4	20.6	18.8	22.0	21.9	22.8	23.0
Revolving credit	17.7	23.9	20.1	30.0	31.3	31.8	25.0
All other <sup>1</sup>	14.0	17.5	14.0	17.3	21.2	14.6	16.5
----- Billions of dollars, SAAR -----							
Change in outstandings--total	48.7	76.8	74.1	98.4	108.5	100.1	99.2
By type:							
Automobile credit	16.9	29.5	31.0	37.9	38.4	40.7	41.9
Revolving credit	12.4	19.6	18.2	28.5	30.3	31.6	25.5
All other <sup>1</sup>	19.5	27.8	25.0	32.1	39.8	27.8	31.9
By major holder:							
Commercial banks	19.5	40.4	33.1	54.9	60.9	58.2	46.2
Finance companies	9.3	9.3	9.5	16.6	14.4	24.6	22.6
All other	20.0	27.1	31.6	27.0	33.2	17.4	30.4
----- Annual percentage rate -----							
Interest rates							
At commercial banks <sup>2</sup>							
New cars, 48 mos.	13.92	13.71	13.91	13.37	13.37	n.a.	13.16 <sup>4</sup>
Personal, 24 mos.	16.68	16.47	16.63	16.21	16.21	n.a.	16.09 <sup>4</sup>
Credit cards	18.78	18.77	18.82	18.85	18.85	n.a.	18.74 <sup>4</sup>
At auto finance companies <sup>3</sup>							
New cars	12.58	14.62	15.22	13.85	13.78	12.65	11.87 <sup>4</sup>
Used cars	18.74	17.85	18.28	17.86	17.91	17.78	17.84 <sup>4</sup>

1. Includes primarily personal cash loans, home improvement loans, mobile home loans, and sales finance contracts for non-automotive consumer durable goods.

2. Average of "most common" rates charged, on loans of specified type and maturity, during the first week in the middle month of each quarter.

3. Average rate for all loans of each type made during the period, regardless of maturity.

4. Data are for May 1985.

n.a.--not available.

federal income tax refund checks probably had boosted installment credit earlier in the year, but the more recent catch-up may have restrained credit expansion to a degree in May and perhaps in June.

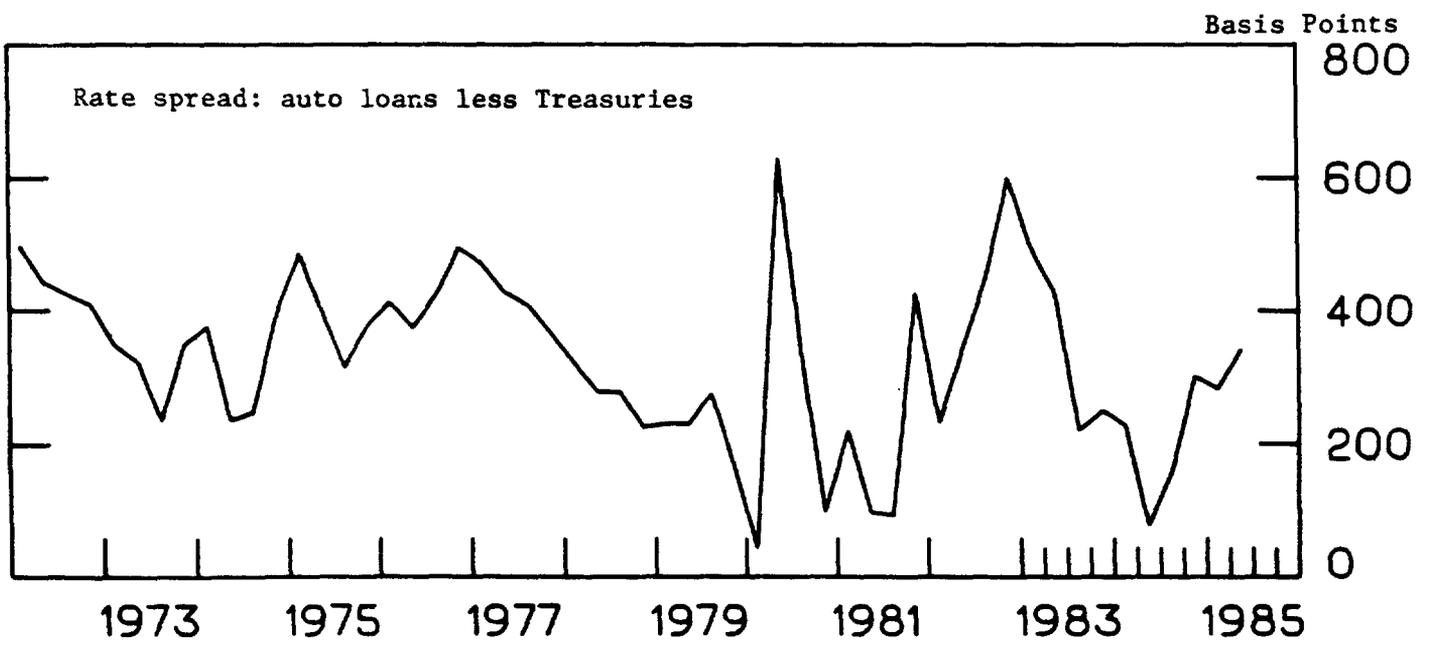
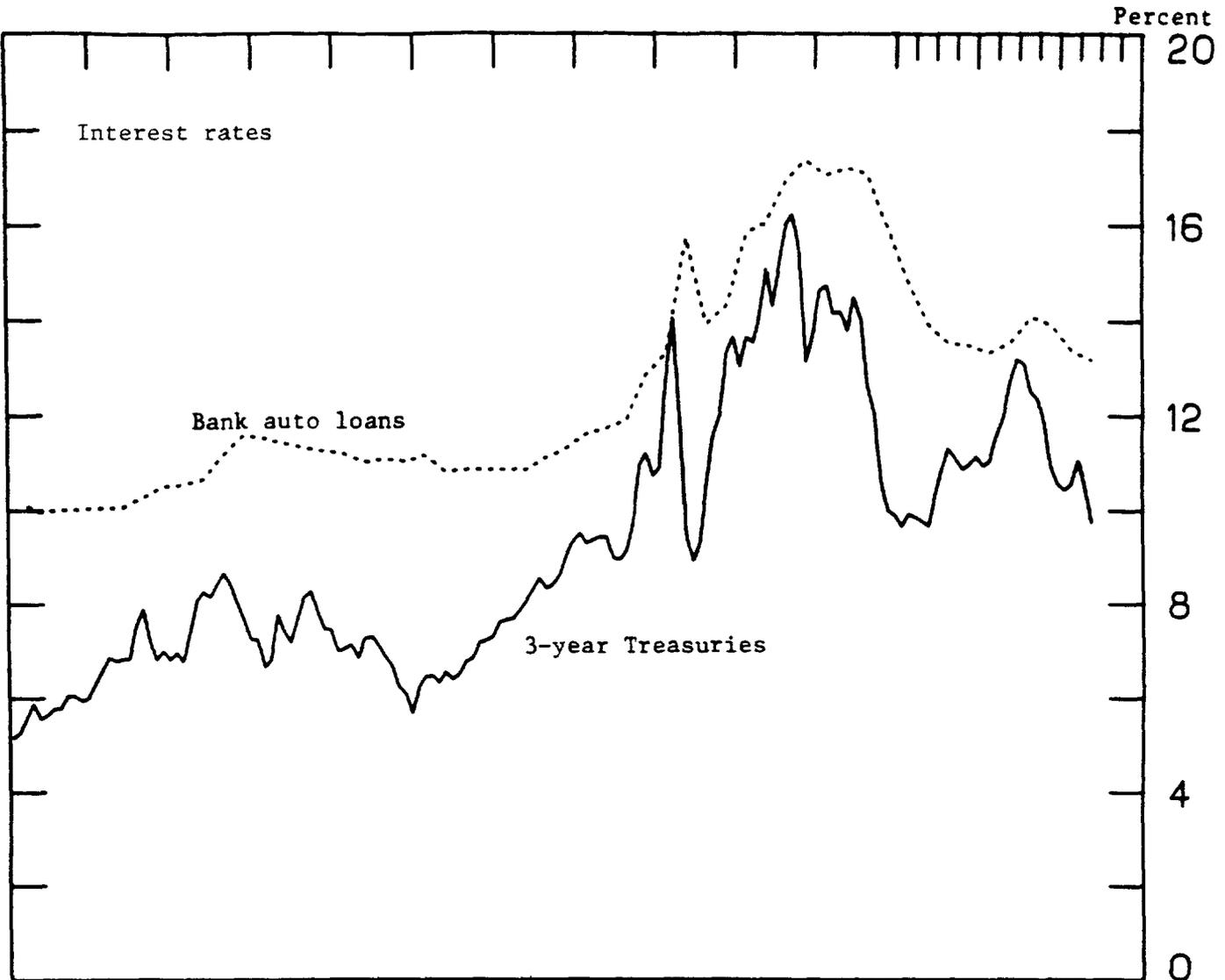
As household debt has continued to grow rapidly, it appears that consumers in the aggregate have experienced more difficulty in making timely payments on their loans. At commercial banks, the delinquency rate on consumer installment loans increased sharply during the first quarter, although it remained slightly below the average for the past ten years. Auto loan delinquencies at captive finance companies also continued to rise from the relatively low levels of last fall. Delinquent mortgage loans, already high, climbed to a record level during the first quarter, according to a Mortgage Bankers Association series covering a cross-section of lenders; a FHLBB series for S&Ls also reached a record high in May.

Information about delinquency experience on consumer loans at commercial banks, developed from the June Senior Loan Officer Opinion Survey, suggests that little further deterioration occurred during the second quarter. For the most part, loan officers judged their level of delinquencies in June to be somewhat below the norm of the past ten years.

On balance, the step-up in delinquencies so far in 1985 does not appear to have reduced the willingness of commercial banks to make consumer loans. To the contrary, continuing the pattern of the past couple of years, a high proportion of bank respondents in the June survey reported equal or greater willingness to lend to consumers, as compared with three months earlier.

Under these circumstances, interest rates on consumer loans at commercial banks have been cut somewhat, although they have continued to

III-18  
COMMERCIAL BANK NEW-AUTO LOANS  
AND 3-YEAR TREASURY SECURITIES



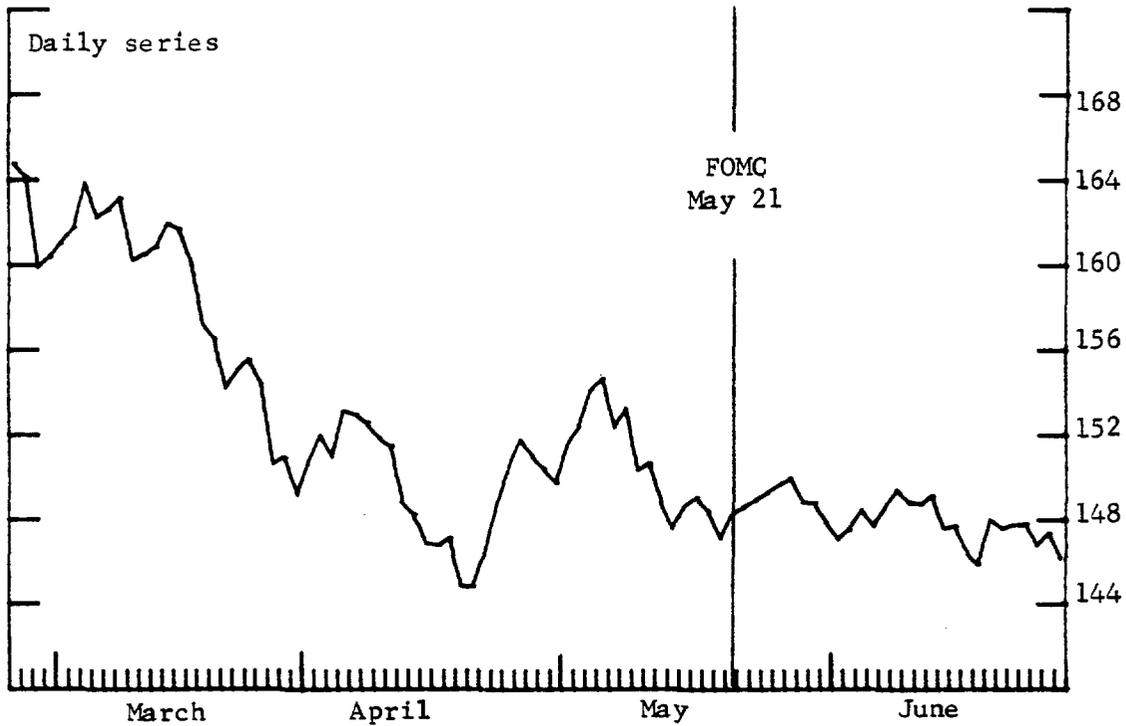
lag declines in market rates generally. On new-car loans, the spread between bank rates and yields on comparable-maturity Treasury securities in early May was at about the middle of its range of the past dozen years. As market rates rose between mid-1983 and mid-1984, consumer rates had remained essentially stable, resulting in a narrowing yield spread. The more recent decline in market rates--with consumer rates still relatively stable--has restored a more typical yield relationship.

Foreign Exchange Markets

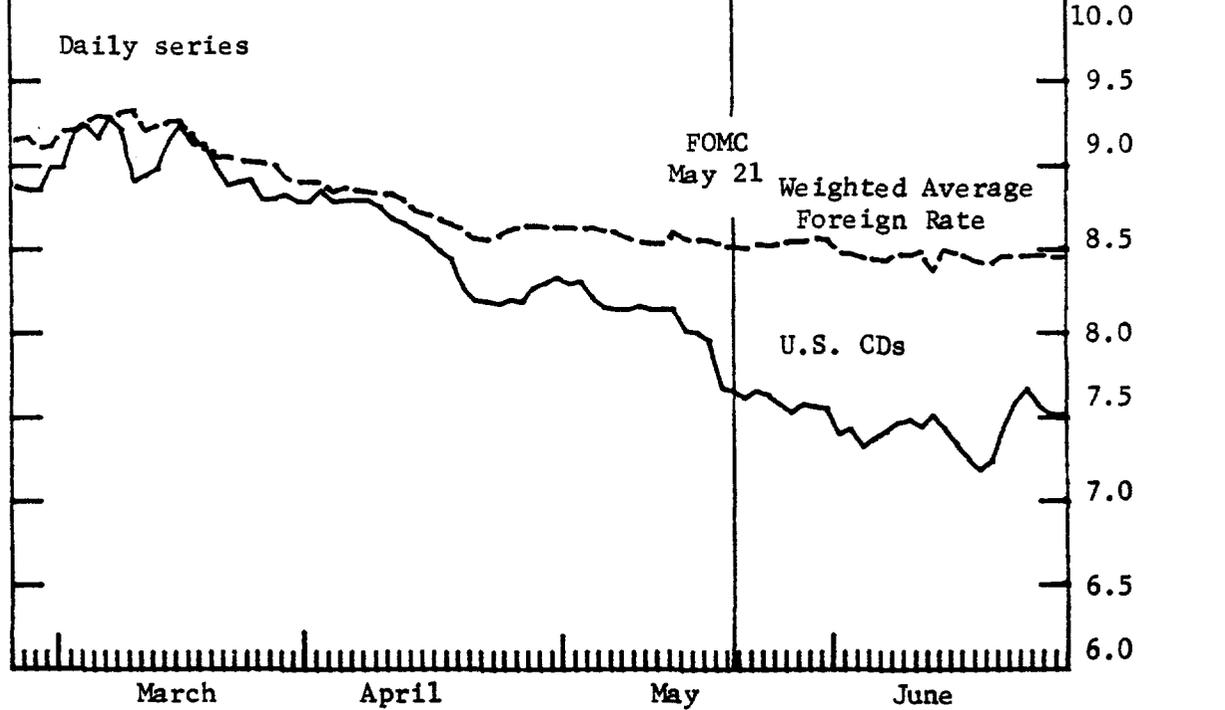
The trade-weighted value of the dollar has depreciated by about 1 percent on balance since the last FOMC meeting, as shown in the top panel of the chart. The dollar has continued to fluctuate in response to shifting assessments of the strength of U.S. economic activity and the stance of U.S. monetary policy, although the magnitude of these fluctuations has been less pronounced than earlier in the year. At its current level the dollar's weighted average exchange value is about 10 percent below its peak of late February.

The gap between U.S. short-term interest rates and the average level of short-term interest rates abroad has also showed little net change since the last FOMC meeting, with both series easing slightly on balance over the period, as shown in the bottom panel of the chart. German short-term interest rates have eased further as the Bundesbank has continued to supply substantial liquidity to the market through repurchase agreements undertaken at reduced rates.

Weighted Average Exchange Value of the U.S. Dollar March 1973=100



3-Month Interest Rates Percent per annum



U.S. International Financial Transactions

U.S. international transactions data for April indicate a net inflow of \$3.5 billion reported by U.S. banking offices, private foreign net purchases of U.S. Treasury securities totalling \$3.9 billion, and a small increase in foreign official reserve holdings in the United States following a large decline in the first quarter: see the Summary Table on U.S. International Transactions. The resumption in April of strong private foreign net purchases of U.S. Treasury securities included net purchases of \$1-1/2 billion by Japanese residents and more than \$1 billion by the World Bank. Each of these two purchasers acquired, net, about \$5-1/2 billion of Treasury securities during 1984 and 1985Q1, accounting between them for nearly half of the \$29 billion in total private foreign net purchases since the beginning of 1984.

Japanese securities houses are understood to have acquired around three-quarters of the \$1 billion in foreign targeted notes (FTNs) that the Treasury auctioned in early June. The Treasury was able to auction that issue at a yield 19 basis points below the yield on the companion domestic security. It is not clear that the FTNs were acquired for Japanese investors, however, since major Japanese investors (e.g., trust banks and life insurance companies) would appear to have no interest in anonymity and can obtain higher yields by acquiring other U.S. Treasury securities. Nevertheless, the fact that the two previously issued FTNs have both been trading in secondary markets, since mid-April, at yields averaging 20 to 40 basis points less than their domestic companion issues suggests that the Japanese securities

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

	1983 Year	1984 Year	1984				1985			
			Q1	Q2	Q3	Q4	Q1	Feb.	Mar.	Apr.
<b>Private Capital</b>										
<b>Banks</b>										
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	13.4	22.0	12.9	0.7	9.9	-1.6	15.5	4.3	2.2	3.5
<b>Securities</b>										
2. Private securities transactions, net	1.6	8.0	2.2	-0.2	0.3	5.7	7.0	4.3	1.1	1.3
a) foreign net purchases (+) of U.S. corporate bonds	2.2	13.8	0.5	0.6	2.6	10.1	10.6	4.7	3.0	1.9
b) foreign net purchases (+) of U.S. corporate stocks	6.4	-0.8	1.0	-0.1	-1.0	-0.8	-1.1	*	-0.5	0.1
c) U.S. net purchases (-) of foreign securities	-7.0	-5.0	0.7	-0.7	-1.3	-3.6	-2.5	-0.5	-1.4	-0.8
3. Foreign net purchases (+) of U.S. Treasury obligations <sup>1/</sup>	8.3	22.5	1.4	6.5	5.1	9.5	2.7	0.7	1.0	3.9
<b>Official Capital</b>										
4. Changes in foreign official reserve assets in U.S. (+ = increase)	5.2	2.7	-3.0	-0.8	-0.5	7.1	-10.9	-3.5	-3.6	0.8
a) By area										
G-10 countries (incl. Switz.)	6.4	3.1	2.3	-0.7	-0.8	2.2	-5.5	-2.6	-3.0	1.5
OPEC	-8.5	-5.3	-2.8	-2.4	-0.6	0.6	-1.7	-1.7	0.6	-1.9
All other countries	7.3	5.0	-2.6	2.4	0.8	4.3	-3.7	0.8	-1.1	1.2
b) By type										
U.S. Treasury securities	7.0	4.7	-0.3	-0.3	-0.6	5.8	-7.2	-3.4	-3.1	1.7
Other <sup>2/</sup>	-1.7	-2.0	-2.8	-0.5	**	1.2	-3.7	-0.1	-0.5	
5. Changes in U.S. official reserve assets (+ = decrease)	-1.2	-2.7	-0.7	-0.6	-0.8	-1.1	-0.2	-0.4	-0.2	*
<b>Other transactions (Quarterly data)</b>										
6. U.S. direct investment (-) abroad	-4.9	-4.5	-3.1	2.0	2.0	-5.4	0.6	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	11.3	22.5	3.3	9.3	5.2	4.7	2.7	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) <sup>3/</sup> <sup>4/</sup>	-1.4	6.3	1.3	5.7	0.3	-0.4	-4.1	n.a.	n.a.	n.a.
9. U.S. current account balance <sup>4/</sup>	-41.6	-101.5	-19.1	-24.5	-32.5	-25.5	-30.0	n.a.	n.a.	n.a.
10. Statistical discrepancy <sup>4/</sup>	9.3	24.7	4.8	1.9	11.0	7.0	16.7	n.a.	n.a.	n.a.

<b>MEMO:</b>										
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-61.1	-107.4	-25.2	-25.4	-32.4	-24.4	-29.3	-8.3	-10.2	-9.5

1. Includes U.S. Treasury notes publicly issued to private foreign residents.
  2. Includes deposits in banks, commercial paper, acceptances, & borrowing under repurchase agreements.
  3. Includes U.S. government assets other than official reserves, transactions by nonbanking concerns, and other banking and official transactions not shown elsewhere.
  4. Includes seasonal adjustment for quarterly data.
- \* Less than \$50 million.

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

houses could have expected to profit from buying up the third FTN. The opening up of those yield differentials followed a five-month period beginning in mid-November, about two weeks after the first FTN auction, during which the differentials remained narrow enough to encourage substantial exchanges of FTNs for domestic companion securities. In fact, the exchange option was exercised on about one-fourth of the auctioned volumes of each of the first two FTN issues; those conversions have essentially ceased as the yield differentials have opened.

Another component of the U.S. net capital inflow in recent months has been the continuing decline in the Eurodollar holdings of U.S. nonbank residents: see line 5 of the International Banking Data Table. Most of the decline since March 1984 has occurred at the foreign branches of the 16 largest U.S. banks. This shift appears related to funding decisions by the large banks. A recent Annual Report of one of those banks, for example, states that in managing its liabilities, the bank has sought to reduce its traditional reliance on wholesale money markets as sources of funds, in part because new sources of funds have become available through deregulation and the creation of retail deposits without interest rate ceilings (in particular, money market deposit accounts).

Data as of the end of March have recently become available on the consolidated claims on foreigners of the domestic and foreign offices of U.S.-chartered banks. The change in those claims during the first

INTERNATIONAL BANKING DATA  
(Billions of dollars)

	1981	1982	1983	1984			1985			
	Dec.	Dec.	Dec.	June	Sept.	Dec.	Mar.	Apr.	May	June 3/
1. Net Claims of U.S. Banking Offices (excluding IBFs) on Own Foreign Offices	7.8	32.9	39.3	32.2	30.2	25.4	25.8	28.5	25.9	n.a.
2. Net Claims of U.S. Banking Offices on Own IBFs <u>1/</u>	11.8	16.2	5.2	4.4	6.3	7.8	6.1	6.8	5.8	n.a.
3. Sum of lines 1 and 2										
of which:	19.6	49.1	44.5	35.2	36.4	33.2	31.7	35.0	31.5	36.2
(a) U.S.-chartered banks	22.3	40.0	40.5	33.6	35.9	32.1	30.4	33.3	30.5	33.7
(b) Foreign-chartered banks	-2.6	9.1	4.0	1.6	.5	1.1	1.3	1.7	1.0	2.6
4. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	13.2	15.8	18.6	19.9	20.2	20.7	19.1	19.3	19.4	20.0
5. Eurodollar Holdings of U.S. Nonbank Residents <u>2/</u>	95.5	112.6	124.2	124.3	122.7	117.4	118.5	112.9	112.7	109.8

1. Corresponds to net claims of international banking facilities (IBFs) on all foreign residents, including all banks whether related or not, and all nonbanks.
2. Include terms and overnight Eurodollars held by money market mutual funds.
3. Through June 17, 1985.

Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactions accounts. Line 1 is an estimate constructed as the residual of line 3 minus line 2. Line 2 is data for the last Wednesday of the month for the sample of monthly IBF reporters. Line 3 is an average of daily data reported to the Federal Reserve by U.S. banking offices. Line 4 is an average of daily data. Line 5 is the month-end value for data through September 1983. For dates after September 1983, the overnight portion is an average of daily data and the term portion is an average of Wednesday data.

quarter was negligible. Over the 12 months to the end of March, U.S. banks' foreign claims declined by 6 percent. This mainly reflected the effects of the higher exchange rate of the dollar on the stock of nondollar claims, as well as reductions in dollar interbank placements as banks made efforts to improve their capital/asset ratios. Claims on every borrowing group decreased, the drop being proportionately largest for claims on G-10 countries (8 percent) and smallest for claims on non-OPEC developing countries (1 percent). However, net new lending to non-OPEC developing countries in the 12 months ending in March may have been slightly positive, perhaps equivalent to about 2 percent of outstandings, because outstandings were reduced by various factors -- loan charge-offs, sales of claims to nonbanks, exercise of official guarantees, and exchange rate changes -- in addition to repayments by borrowers.

U.S. Merchandise Trade

In May, the U.S. merchandise trade deficit was larger than that recorded in April. For the April-May period combined, the deficit reached the record level of the third quarter of last year.

The increase in the deficit for April from the first quarter was attributable to a decline in exports. By commodity category, the drop in exports was fairly widespread, with the largest declines coming in agricultural exports, capital goods and industrial supplies.

The drop in agricultural exports was largely in corn and soybeans with a notable decline also in cotton. At the present time, the largest markets for U.S. corn are the U.S.S.R. and Japan. World

U.S. MERCHANDISE TRADE<sup>1/</sup>

	Year	1984		1985			
	1984	Q3	Q4	Q1	Apr.-May	Apr.	May
<u>Value (Bil. \$, SAAR)</u>							
Exports	220.3	222.1	225.4	223.2	210.3	210.7	209.9
Agricultural	38.4	36.9	38.3	34.0	28.8	32.5	25.0
Nonagricultural	181.9	185.3	187.2	189.3	181.6	178.2	184.9
Imports	328.6	352.1	323.6	341.0	338.0	329.7	346.3
Oil	57.5	57.8	56.8	45.2	50.2	46.1	54.2
Nonoil	271.1	294.4	266.9	295.8	287.9	283.6	292.1
Trade Balance	-108.3	-130.0	-98.2	-117.8	-127.7	-119.0	-136.4
<u>Volume (Bil 72\$, SAAR)</u>							
Exports							
Agricultural	16.3	15.7	17.3	15.6	n.a.	15.0	n.a.
Nonagricultural	63.0	64.0	64.2	64.6	n.a.	61.0	n.a.
Imports							
Oil	5.3	5.4	5.3	4.3	n.a.	4.4	n.a.
Nonoil	104.0	112.4	102.0	115.9	n.a.	111.9	n.a.

1/ International transactions and GNP basis. Monthly data are estimated.

supplies of corn and soybeans are ample, reflecting very good harvests in the Southern Hemisphere. Argentina is exporting a record amount of soybeans, and soybean exports by Brazil are strong also. U.S. cotton exports are facing strong competition from cotton exported by Pakistan and China.

Many of the industrial supplies export items that recorded decreases in the April-May period also declined in the first quarter; these include chemicals, fuel oil, paper, gold and steelmaking materials. The reduction in exports of capital goods was fairly broadly spread among various categories of machinery. Exports of commercial aircraft declined from a high first-quarter rate.

Imports in the April-May period were about unchanged from the first quarter rate. Increases in oil imports, passenger cars from Japan, trucks, aircraft and coffee were offset by declines in a wide range of other major commodity categories. Decreases were recorded in machinery (particularly office machines and other electronic items), steel, clothing, diamonds, gold and agricultural products other than coffee.

Oil imports averaged 5 million barrels per day in the April-May period, about 10 percent more than the relatively low first-quarter rate. Most of the additional imports appear to have been added to inventories. The price of imported oil averaged \$26.95 per barrel in April-May, up marginally from the first-quarter average. In mid-April, world spot market prices, for crude oil and products, began a decline that continued through June. These declines will be reflected in import prices with a lag of about two months.

## OIL IMPORTS

	Year 1984	1984			1985		
		Q3	Q4	Q1	Apr.-May	Apr.	May
Volume (mbd, SA)	5.60	5.66	5.58	4.61	5.08	4.72	5.45
Price (\$/BBL)	27.95	27.91	27.59	26.86	27.00	26.76	27.24
Value (Bil. \$, SAAR)	57.48	57.76	56.80	45.22	50.14	46.12	54.18

U.S. Current Account: 1985-Q1

The U.S. current account was in deficit by \$120 billion, SAAR, in the first quarter of 1985; this was an \$18 billion larger deficit than in the previous quarter. Most of the increase in the deficit was attributable to merchandise trade -- imports expanded and exports declined a bit. In addition, net portfolio income declined (primarily a reduction in private income receipts). Partly offsetting the trade and net portfolio income results were an increase in military sales to foreigners, a reduction in military expenditures abroad, a reduction in U.S. government grants to developing countries, and a small increase in net receipts from other services. See the table on the following page.

U.S. CURRENT ACCOUNT  
(billions of dollars, SAAR)

	1984r	1984r				1985	\$ Changes 85Q1-84Q4
		Q1	Q2	Q3	Q4	Q1	
1. Trade Balance	-108.3	-102.3	-102.6	-130.0	-98.2	-117.7	-19.5
2. Exports	220.3	215.0	218.7	222.1	225.4	223.2	-2.2
3. Imports	328.6	317.3	321.3	352.1	323.6	341.0	17.4
4. Investment income, net	19.1	32.9	14.5	13.0	16.0	10.5	-5.5
5. Direct investment, net	12.9	25.1	7.8	7.1	11.5	10.1	-1.4
6. Capital gains or losses <sup>1/</sup>	-9.1	0.2	-11.5	-15.3	-9.8	-10.5	-0.7
7. Other D.I. income	22.0	24.9	19.3	22.4	21.3	20.6	-0.7
8. Portfolio income net	6.2	7.9	6.6	5.9	4.5	0.4	-4.1
9. Military, net	-1.8	-1.4	-2.4	-1.0	-2.3	-0.4	1.9
10. Other services, net	0.9	3.3	1.4	-0.5	-1.0	0.3	1.3
11. Unilateral transfers	-11.4	-8.8	-8.9	-11.5	-16.4	-12.7	3.7
12. <u>Current Account Balance</u>	<u>-101.5</u>	<u>-76.3</u>	<u>-98.0</u>	<u>-130.0</u>	<u>-101.9</u>	<u>-120.0</u>	<u>-18.1</u>
13. Excluding capital gains or losses	-92.4	-76.5	-86.5	-114.7	-92.1	-109.5	-17.4
Memo:							
Statistical discrepancy, not AR	24.7	4.8	1.9	11.0	7.0	16.7	9.7

<sup>1/</sup> Gains or losses on foreign-currency denominated assets owing to their revaluation at current exchange rates, and other valuation adjustments. Plus = gains; minus = losses.

Foreign Economic Developments. First quarter figures for real gross national product showed few signs of increased vigor in the major foreign industrial economies. The rate of economic growth slowed sharply in Japan in the first quarter, although recent data on industrial production suggest that part of this decline is temporary. The level of economic activity fell in Germany and was flat in France, in part the result of an exceptionally severe winter. Although Canada, Italy, and the United Kingdom continue to experience moderate economic growth, only in Canada was this growth sufficient to effect a reduction in the unemployment rate. Unemployment in Europe remains very high.

Inflation rates in the major industrial countries have remained broadly unchanged in recent months except in the United Kingdom, where increases in mortgage rates and indirect taxes contributed to a rise in the retail price index. In Italy, the government won an important victory when the referendum to reinstate lost wage indexation points was defeated, eliminating a potential additional source of inflationary pressure.

The current account surpluses of Japan, Germany, and the United Kingdom have increased during 1985, in the case of Japan to a record rate. The trade balances of Italy and France remain in deficit and the Italian external position is showing signs of further deterioration.

Individual Country Notes. Although the pace of economic activity in Japan slowed sharply in the first quarter, later indicators point to a continued healthy expansion, though at a slower pace than occurred last year. Real GNP rose by only 0.4 percent (s.a.a.r.) in the first quarter, following a 9.9 percent jump in the fourth quarter. Erratic

July 3, 1985

REAL GNP AND INDUSTRIAL PRODUCTION IN MAJOR INDUSTRIAL COUNTRIES  
(PERCENTAGE CHANGE FROM PREVIOUS PERIOD, SEASONALLY ADJUSTED)

	Q4/Q4 1983	Q4/Q4 1984	1984			1985	1985					LATEST 3 MONTHS FROM YEAR AGO+
			Q2	Q3	Q4	Q1	JAN.	FEB.	MAR.	APR.	MAY	
<b>CANADA</b>												
GNP	1.1	4.3	.7	1.6	.8	.9	*	*	*	*	*	4.2
IP	16.1	5.2	1.5	3.2	.3	-.4	-.8	-.3	-.4	N.A.	N.A.	4.5
<b>FRANCE</b>												
GDP	.8	1.4	-.2	.8	-.2	.0	*	*	*	*	*	.5
IP	2.4	1.3	-1.0	3.1	-2.5	-.5	-1.6	3.9	1.5	-2.2	N.A.	1.0
<b>GERMANY</b>												
GNP	3.1	2.5	-1.9	2.4	1.0	-.8	*	*	*	*	*	.6
IP	6.0	3.6	-4.1	5.7	1.4	-1.2	-1.7	-.3	.9	-.2	.6	3.5
<b>ITALY</b>												
GDP	1.2	2.0	.7	1.1	-.6	.7	*	*	*	*	*	1.9
IP	1.7	1.6	.5	1.9	-1.8	1.9	-4.0	8.9	.3	-4.5	N.A.	4.6
<b>JAPAN</b>												
GNP	3.9	6.5	1.8	.6	2.4	.1	*	*	*	*	*	5.1
IP	8.6	10.7	2.8	1.5	2.8	-.6	-.2	.7	-1.9	2.8	1.9	6.5
<b>UNITED KINGDOM</b>												
GDP	3.7	2.7	-.7	1.1	1.5	.8	*	*	*	*	*	2.8
IP	5.4	-.6	-2.0	.4	.8	2.0	.9	-.1	2.2	.9	N.A.	3.1
<b>UNITED STATES</b>												
GNP	6.3	5.7	1.7	.4	1.0	.1	*	*	*	*	*	3.3
IP	15.0	5.9	2.1	1.6	-.6	.4	.2	.1	.3	-.2	-.1	2.2

\* DATA NOT AVAILABLE ON A MONTHLY OR QUARTERLY BASIS.

+ IF QUARTERLY DATA, LATEST QUARTER FROM YEAR AGO.

July 3, 1985

CONSUMER AND WHOLESALE PRICES IN MAJOR INDUSTRIAL COUNTRIES  
(PERCENTAGE CHANGE FROM PREVIOUS PERIOD)

	Q4/Q4 1983	Q4/Q4 1984	1984				1985		1985				LATEST 3 MONTHS FROM YEAR AGO
			Q1	Q2	Q3	Q4	Q1	Q2	MAR.	APR.	MAY	JUNE	
<b>CANADA</b>													
CPI	4.6	3.7	1.2	.9	.9	.7	1.2	N.A.	.2	.4	.2	N.A.	3.8
WPI	3.5	3.6	1.6	1.2	.5	.3	1.0	N.A.	.5	.1	N.A.	N.A.	2.8
<b>FRANCE</b>													
CPI	9.8	6.8	1.7	1.8	1.7	1.4	1.4	N.A.	.7	.7	.5	N.A.	6.5
WPI	14.6	10.5	3.4	2.9	2.2	1.6	1.6	N.A.	-.0	.0	.7	N.A.	6.9
<b>GERMANY</b>													
CPI	2.7	2.0	.9	.5	.0	.7	1.1	.6	.3	.2	.2	.0	2.5
WPI	.9	1.0	1.7	.8	-1.4	.0	1.9	N.A.	1.8	-.3	N.A.	N.A.	1.8
<b>ITALY</b>													
CPI	13.0	8.8	2.8	2.1	1.4	2.2	2.6	2.2	.7	.9	.6	.5	8.8
WPI	9.1	8.8	3.2	2.2	1.2	1.9	2.7	N.A.	1.6	.6	N.A.	N.A.	8.5
<b>JAPAN</b>													
CPI	1.9	2.4	.9	.6	-.2	1.2	.6	.5	.4	.4	.1	-.1	2.1
WPI	-3.3	.5	.1	-.1	.8	-.3	.4	N.A.	-.3	-.4	-.2	N.A.	.5
<b>UNITED KINGDOM</b>													
CPI	5.1	4.8	.6	2.0	.9	1.2	1.3	N.A.	.9	2.1	.5	N.A.	6.7
WPI	5.6	6.0	1.8	2.3	.6	1.3	1.7	N.A.	.7	1.2	.2	N.A.	5.6
<b>UNITED STATES</b>													
CPI (SA)	3.2	4.1	1.3	.9	.9	.9	.8	N.A.	.5	.4	.2	N.A.	3.7
WPI (SA)	.8	1.7	1.2	.4	.0	.1	.2	N.A.	.2	.3	.2	N.A.	.7

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July 3, 1985

TRADE AND CURRENT ACCOUNT BALANCES OF MAJOR INDUSTRIAL COUNTRIES 1/  
(BILLIONS OF U.S. DOLLARS; SEASONALLY ADJUSTED)

	1983	1984	1983 Q4	1984				1985 Q1	1985			
				Q1	Q2	Q3	Q4		FEB.	MAR.	APR.	MAY
<b>CANADA</b>												
TRADE	14.4	16.1	3.5	3.5	4.1	4.1	4.4	4.0	1.3	1.6	1.6	N.A.
CURRENT ACCOUNT	1.4	1.8	.0	.0	.4	.5	.9	.5	*	*	*	*
<b>FRANCE</b>												
TRADE 2/	-5.9	-2.7	-.2	-1.5	-1.2	.4	-.3	-1.1	-.6	-.1	-.4	-.1
CURRENT ACCOUNT 2/	-4.9	-.1	.2	-.7	-.4	.9	.1	-.7	*	*	*	*
<b>GERMANY</b>												
TRADE	16.4	18.8	3.4	4.3	3.2	5.0	6.3	4.5	1.6	1.5	1.9	2.4
CURRENT ACCOUNT (NSA)	4.2	5.8	3.7	.8	-.1	-.9	6.0	1.3	.7	.8	1.3	1.9
<b>ITALY</b>												
TRADE	-7.9	-10.7	-1.0	-2.2	-2.9	-1.4	-4.2	-3.8	-1.0	-1.4	-1.4	N.A.
CURRENT ACCOUNT (NSA)	.8	-3.2	.1	-1.7	-1.0	1.3	-1.7	N.A.	*	*	*	*
<b>JAPAN</b>												
TRADE 2/	31.3	44.5	8.7	10.0	11.1	10.1	13.2	11.6	3.5	3.2	3.8	N.A.
CURRENT ACCOUNT	21.0	35.0	6.0	7.2	9.2	7.4	11.5	9.4	2.7	2.5	3.8	N.A.
<b>UNITED KINGDOM</b>												
TRADE	-.8	-5.7	-.0	-.2	-1.8	-2.1	-1.6	-1.5	-.3	-1.1	-.3	.3
CURRENT ACCOUNT 2/	4.4	.0	.9	.9	-.8	-.8	.8	-.1	.1	-.6	.3	.9
<b>UNITED STATES</b>												
TRADE	-62.0	-108.3	-19.4	-25.6	-25.6	-32.5	-24.6	-29.4	-8.2	-10.4	-9.9	-11.4
CURRENT ACCOUNT	-40.8	-101.5	-17.4	-19.1	-24.5	-32.5	-25.5	-30.0	*	*	*	*

1/ THE CURRENT ACCOUNT INCLUDES GOODS, SERVICES AND PRIVATE AND OFFICIAL TRANSFERS.

2/ QUARTERLY DATA ARE SUBJECT TO REVISION AND ARE NOT CONSISTENT WITH ANNUAL DATA.

\* COMPARABLE MONTHLY OR QUARTERLY CURRENT ACCOUNT DATA ARE NOT PUBLISHED.

swings in investment and exports account for the sharp swings in real output. On the positive side, real private consumption in the first quarter rose by almost 4 percent, more than double the rate of increase in the previous quarter. New housing starts were up by 6-1/2 percent in the first four months of 1985 from the corresponding period of last year. Industrial production increased sharply in April and May after a 0.6 percent decline in the first quarter. Also, the May survey of the Bank of Japan reported that major Japanese companies are planning a 10.8 percent increase in investment in the current fiscal year (which began April 1); the February survey showed an expected gain of only 5.2 percent for fiscal 1985.

Price increases continue to be modest. In the three months ending in June the Tokyo consumer price index rose by about 2 percent from the corresponding period of last year. The current account surplus continues to grow: in the first four months of this year, the current account surplus was about \$40 billion (s.a.a.r.), compared with a \$32 billion surplus for the corresponding period of last year. Japan's external balance is expected to continue to increase, in part because of the almost 25 percent higher quota on automobile exports to the United States for the current fiscal year and because of the expected resumption of export growth to China.

Prime Minister Nakasone is expected to announce by mid-July the final version of his "Action Program" that is intended to increase the openness of the Japanese economy. The program is to be implemented over a three-year period and is expected to include tariff reductions as well as the easing of some non-tariff barriers. One part of the

program will consist of tariff reductions in 1986 and 1987 on a wide range of manufactured and agricultural products. Japanese officials are reported to be concerned that the program will be perceived as insufficient by its trading partners.

Real GNP in Germany declined 3.2 percent (s.a.a.r.) in the first quarter to a level only 0.6 percent above the first quarter of 1984. Since December, the rate of unemployment has increased from 9 percent (s.a.) to about 9-1/2 percent. The source of weakness has been domestic demand. In association with stagnating disposable incomes, private consumption expenditures fell, as did public consumption as a result of continued fiscal restraint. Investment also declined as a sharp fall in the construction sector, in part the result of an unusually severe winter, swamped a strong increase in investment in equipment. Recent data on order volumes, however, suggest that the first-quarter slump in economic activity may have been, at least in part, a largely weather-related deviation from a moderate growth path. After declining in April, the index of industrial production rose moderately in May to about its fourth-quarter average.

Consumer prices rose less than 0.1 percent in June to a level 2.5 percent above June 1984. The 12-month inflation rate has been 2.5 percent for the past four months.

The current account surplus was \$1.9 billion in May for a cumulative \$4.5 billion (n.s.a.) surplus so far this year. This compares to a cumulative \$1.7 billion (n.s.a.) surplus for the same period of last year. The volume of exports in the first quarter was almost 8 percent above its year-earlier level.

On July 2 Finance Minister Stoltenberg announced that the cabinet has approved the draft of the 1986 budget. The government is holding to its fiscal plans, according to which a sizeable tax cut is to occur in two installments, in 1986 and in 1988, despite growing pressure to consolidate the tax cut in 1986. Limited measures will also be introduced to stimulate construction.

Economic activity in France has remained weak in recent months. Industrial production in April declined by 2.2 percent (s.a.), more than reversing the increase of the previous month, and leaving industrial production only 1.6 percent above its year-earlier level. Real GDP showed no increase in the first quarter and was up by only 0.5 percent on a year-over-year basis. The unemployment rate increased slightly in April to a near-record 10.6 percent. Consumer prices increased by 0.5 percent (s.a.) in May and were 6.5 percent above their year-earlier level. After decreasing each month last year, the year-over-year consumer price inflation rate has remained nearly unchanged at 6-1/2 percent so far this year.

The trade account was in deficit by \$130 million (s.a.) in May, following a deficit of nearly \$500 million the previous month. For the first five months of 1985, the trade deficit rate was \$4 billion (s.a.a.r.), compared with the \$5 billion deficit rate in the corresponding period last year. The current account was in deficit by \$700 million (s.a.) in the first quarter, following surpluses in the third and fourth quarters last year.

On July 2 the Bank of France announced new measures designed to reduce above-target money supply growth. The measures include a

reduction in recourse to monetary financing by the Treasury, restrictions on firms' foreign currency borrowings, and a 1.5 percent reduction in the ceilings used to determine banks' excess credit growth. As of May, year-over-year growth in M2R was 7.4 percent, above the 4 percent to 6 percent monetary target range for this year.

Real gross domestic product (average measure) grew 3.2 percent (s.a.a.r.) in the United Kingdom in the first quarter of 1985. Investment growth was particularly strong as corporations advanced capital expenditure plans before the rates of depreciation allowable for tax purposes were reduced on April 1. The industrial production index rose 0.9 percent (s.a.) in April to reach its highest level since December, 1979. This growth, however, was not sufficient to reduce the unemployment rate, which remained at 13.1 percent (s.a.) in May.

The year-over-year rate of increase in the retail price index was 7 percent in May, up about 2 percentage points from January. One-time changes in the price level, reflecting earlier increases in mortgage rates and indirect taxes, account for part of the increase in measured inflation. The trade account was in surplus in May, the first time in over a year, and the current account was in substantial surplus. The cumulative current account surplus for the first five months of the year was \$2.6 billion (s.a.a.r.). In 1984, the current account was in near balance.

On May 22 the Bank of England announced a technical change in the definition of its monetary target ranges. Instead of setting the target as the growth rate from some base level, the Bank will now apply the target to the 12-month growth rates of the targeted aggregate for

each month during the target period. The monetary targets remained unchanged at 3-7 percent annual growth for M0 and 5-9 percent for £M3. In May, M0 was within its target range while the 12-month growth rate for £M3 was 12.2 percent, about 3 percent age points above the top of its target range.

Real GNP in Canada increased 3.7 percent (s.a.a.r.) in the first quarter of 1985 after a slightly smaller gain in the final quarter of 1984. Inventory accumulation and personal consumption expenditures showed large increases. Business investment, however, was little changed for the fifth consecutive quarter. In May the Canadian unemployment rate fell to 10.5 percent, a decline of 0.6 percentage points from the first-quarter average.

Inflation in Canada continued to be moderate. The consumer price index increased at an annual rate of 2.9 percent in May, and was 4 percent above last year's level. Meanwhile, the current account surplus was \$0.5 billion (s.a.) in the first quarter of 1985, a decline from the fourth-quarter surplus of \$0.9 billion, but matching last year's average quarterly pace. The trade surplus declined in April, but continued to show a sizable surplus of \$1.6 billion (s.a.).

The new conservative government in Canada presented its first budget to Parliament on May 24. Finance Minister Michael Wilson projected that new tax and spending measures would reduce the Federal deficit to 7.5 percent of GDP in fiscal 1985-86, from 8.4 percent of GDP in fiscal 1984-85. Most of the deficit reduction results from outlay reductions.

Real GNP in Italy rose 2.6 percent (s.a.a.r.) in the first quarter after a relatively weak fourth quarter. Industrial production in April was 3 percent (s.a.) higher than its year-earlier level. Official household surveys held in March, April, and May show on average a slight weakening of consumer confidence about the general economic situation of the country.

In June, the cost of living index was 8.7 percent above its year-earlier level, an inflation rate broadly unchanged since November. However, on June 9 and 10, the Italian electorate rejected a referendum sponsored by the Italian Communist Party designed to reinstate the wage indexation points lost during the seven-month freeze in 1984. This vote underscores the public's general approval of the economic policies of Prime Minister Craxi's coalition government.

The trade deficit in April was \$1.4 billion (s.a.). Italy's cumulative quarterly trade deficit for the first four months of this year was \$5.4 billion (s.a.), and there is increasing concern that the current account will register an uncomfortably large deficit in 1985.

Economic Situation in Major Developing Countries

Declining interest rates on international markets since mid-1984 are beginning to reduce substantially the debt-service requirements of developing countries that have large floating-interest debts to banks. The decline in LIBOR since the summer of 1984, together with negotiation of lower interest spreads under debt rescheduling agreements, is likely to reduce the average interest cost on LIBOR-based debt to about a 9-1/2 percent annual rate during the second half of 1985. In comparison, the average interest cost of such debt was about 12 percent in 1984. Nevertheless, important political factions in a number of Latin American countries continue to urge joint action by major debtors to limit their external interest payments to some reduced fraction of their countries' annual export earnings.

The decline in world oil prices is further relieving the balance of payments pressure on three major debtors--Brazil, Chile, and the Philippines--that have experienced a protracted period of austerity and adjustment but have avoided so far a pattern of serious delinquencies on their external debt. For Mexico, however, the decline in oil export earnings is expected to account for about one-third of the likely \$5 billion deterioration in its merchandise trade surplus from 1984 to 1985.

In mid-June, Argentina reached agreement with the IMF on deep cuts in the fiscal deficit and introduced a sweeping monetary reform. These moves signal an important breakthrough toward resolution of the serious internal and external financial problems that have plagued Argentina since 1982. Although further fiscal adjustments by the Argentine

government will be required, the IMF Executive Board is expected to approve the agreement in early August.

The central commitment by the Argentine government in its preliminary agreement with the IMF is to reduce the nonfinancial fiscal deficit from 8-1/2 percent of GDP in 1984 to about 2-1/2 percent by the fourth quarter of 1985. Most of the requisite fiscal measures were taken in May and June, including a 10 percent import surcharge, increases in export taxes by 7-10 percentage points, and sharp increases in fuel and utility prices. The monetary reform program announced on June 14 is designed to achieve a rapid deceleration of inflation through a wage and price freeze, a new currency (called the austral) that initially has been held to a fixed rate against the dollar, and an end to central bank financing of the government deficit. Before the reform was announced, credit policy had been tightened to produce highly positive real interest rates, and the currency had been devalued by 15.3 percent against the dollar. The IMF Executive Board will consider this program in early August as a basis for reinstatement of Argentina's existing \$1.2 billion stand-by agreement, which runs until March 1986. The reinstatement of the IMF agreement is expected to allow activation of the \$4.2 billion credit from foreign banks negotiated in late 1984-- with disbursements of \$2.2 billion to begin in mid September.

In view of these developments, the United States and 11 other countries agreed in mid-June to provide \$483 million in bridge financing. The bridge loan is expected to be repaid from IMF disbursements in mid-August and late September. On June 12, Argentina paid \$250 million from its reserves to the banks. Another \$320 million, drawn

from the bridge loan, was paid during the last few days of June, bringing interest current up to February 28. While reaction of the Argentine public to the government program has been generally favorable, effective implementation of the program is not assured. Federal bank supervisors are advising U.S. banks to use conservative accounting treatment for interest payments received through October.

In late May and again in late June, Mexico's peso came under renewed pressure in U.S. markets on rumors of a speedup of peso devaluation, speculation about further weakening in oil prices, and possibly unease about the government's willingness to take fiscal measures needed to conform with the stabilization program approved by the IMF on June 7. In U.S. markets the peso sold at a discount of about 20 percent from the controlled rate through most of June, dropping to a discount of 23 percent by July 2. On June 17, Mexico reduced the export price of its heavy grade of crude oil by \$1.50 per barrel after experiencing a sharp decline in the volume of crude lifted by its customers in preceding weeks. The merchandise trade surplus may amount to only about \$9 billion in 1985, down from \$14 billion in 1984. On the other hand, net interest payments may decline by up to \$1-1/2 billion in 1985. Mexico's IMF-approved program for 1985 calls for reduction of the public sector deficit to 4.1 percent of GDP from 6.2 percent in 1984, but this result is unlikely to be achieved unless substantial new measures are taken after the congressional, state and municipal elections on July 7. Mexico's consumer prices rose by 2.4 percent in May, the smallest monthly increase since 1981, and stood about 55 percent higher than a year earlier. Interest rates on short-term deposits, which had been

raised to positive real levels in March, were increased significantly further in late May and in June, and now result in positive real yields of 5-10 percent annually on short-term deposits and Treasury bills.

Ongoing negotiations between Brazil's new government and the IMF regarding a 1985-86 standby arrangement are expected to be protracted. The main sticking point in the present negotiations with the IMF continues to be the allowable size of the fiscal deficit, which has increased significantly in the past few months, in great part because of a 3-1/2 month freeze on the prices of industrial products, including those produced by state enterprises. At the end of May, commercial banks granted Brazil's request for an extension through August in the life of the interbank, trade credit, and redeposit facilities. Inflation has receded to an average monthly rate of about 7.5 percent during the April-June period after averaging 12 percent during the first three months of the year. This improvement reflects the impact of price controls and does not appear sustainable.

Venezuela and its bank advisory committee have completed the terms sheet for the multi-year rescheduling agreement negotiated last September. Previous disagreements about provisions for currency switching of dollar denominated debt, the obligation of the public sector to provide foreign exchange to private sector debtors, and the organization of a re-lending facility have been resolved. The circulation of the terms sheet to Venezuela's 450 creditor banks began in early June, and Venezuelan authorities hope to have the final agreement signed by October. Before the final signing of the rescheduling agreement, however, Venezuela must show further progress in the review for registra-

tion of some \$12 billion in private sector debt. About \$10-1/2 billion of this private sector debt has been reviewed so far, with about \$7-1/2 billion having been registered as eligible to obtain foreign exchange at a preferential rate.

Chile reached agreement on June 27 with its bank advisory committee regarding rescheduling of bank debt falling due during 1985-87, maintenance of trade credit facilities, and new loans, partly guaranteed by the World Bank, totalling \$1.085 billion during 1985-86. Chile's proposed three-year IMF extended arrangement is now expected to be approved by the Fund in mid-July.

In Peru, the president-elect Garcia's public statements suggest that he will seek to renegotiate the country's foreign debts without parallel efforts to negotiate with the IMF on Peru's economic stabilization program. He has said that he will honor Peru's foreign debt obligations and implement adjustment measures, but without straining further Peru's domestic economic and political situation. Interest arrears to foreign commercial banks have exceeded 180 days for several months, although the current government has been making partial interest payments each month since the beginning of this year and has been implementing some fiscal adjustment measures. The new administration has not yet made clear whether it intends to pay such arrears (totalling about \$325 million) through use of its foreign exchange reserves or to implement quickly further reductions in the budget deficit after it takes office on July 28.

On May 20, the Philippines and its creditor banks signed agreements providing for a new \$925 million medium-term loan and a \$3 billion

revolving trade credit facility. Banks are also expected to agree to reschedule approximately \$5.8 billion in Philippine debt falling due between October 1983 and December 1986. The IMF Executive Board approved on May 30 a modification of the December 1984 stand-by program, and the Philippines appears to be complying with the revised performance criteria. This will permit the Philippines to draw SDR 106 million on the IMF in early July and also to receive the first disbursement of \$400 million from the \$925 million new money facility. During the first quarter of 1985 the current account deficit narrowed to \$65 million from \$521 million in the same quarter a year earlier.