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February 5, 1986

RECENT DEVELOPMENTS

Prepared for the Federal Open Market Committee

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

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DOMESTIC NONFINANCIAL DEVELOPMENTS

SELECTED DOMESTIC NONFINANCIAL DATA
(Seasonally adjusted)

	Latest data			Percent change from		
	Period	Release date	Data	Preceding period	Three periods earlier	Year earlier
				(At annual rates)		
Civilian labor force	Dec.	01-08-86	116.2	1.0	1.5	1.5
Unemployment rate (%)[1]	Dec.	01-08-86	6.9	7.0	7.1	7.2
Insured unemployment rate (%)[1]	Nov.	01-24-86	2.8	2.7	2.8	2.7
Nonfarm employment, payroll (mil.)	Dec.	01-08-86	99.1	3.9	3.4	3.1
Manufacturing	Dec.	01-08-86	19.4	2.8	2.9	-.9
Nonmanufacturing	Dec.	01-08-86	79.6	4.2	3.6	4.1
Private nonfarm:						
Average weekly hours (hr.)[1]	Dec.	01-08-86	35.1	35.0	35.1	35.2
Hourly earnings ($)[1]	Dec.	01-08-86	8.75	8.67	8.65	8.47
Manufacturing:						
Average weekly hours (hr.)[1]	Dec.	01-08-86	41.0	40.7	40.7	40.6
Unit labor cost (1967=100)	Dec.	01-30-86	83.0	-5.8	-2.9	-7.3
Industrial production (1977=100)	Dec.	01-16-86	126.0	8.6	2.9	2.2
Consumer goods	Dec.	01-16-86	123.0	9.8	3.9	2.8
Business equipment	Dec.	01-16-86	142.1	1.7	-.3	2.7
Defense & space equipment	Dec.	01-16-86	182.0	6.0	10.1	10.1
Materials	Dec.	01-16-86	115.1	9.5	3.2	.4
Consumer prices all items (1967=100)	Dec.	01-22-86	327.8	5.1	5.2	3.7
All items, excluding food & energy	Dec.	01-22-86	320.4	3.4	5.1	4.4
Food	Dec.	01-22-86	315.2	9.6	6.8	2.6
Producer prices: (1967=100)						
Finished goods	Dec.	01-10-86	297.8	4.4	8.2	2.0
Intermediate materials, nonfood	Dec.	01-10-86	326.3	4.8	2.6	.0
Crude foodstuffs & feedstuffs	Dec.	01-10-86	244.6	3.0	50.9	-6.2
Personal income ($ bil.)[2]	Dec.	01-23-86	3,394.0	16.7	10.2	5.8
				(Not at annual rates)		
Mfgrs. new orders dur. goods ($ bil.)	Dec.	02-03-86	108.2	4.3	1.5	6.8
Capital goods industries	Dec.	02-03-86	37.1	13.9	-.6	8.1
Nondefense	Dec.	02-03-86	30.6	18.6	4.6	13.7
Defense	Dec.	02-03-86	6.5	-3.9	-19.3	-12.2
Inventories to sales ratio:[1]						
Manufacturing and trade, total	Nov.	02-03-86	1.35	1.37	1.34	1.37
Manufacturing	Dec.	02-03-86	1.40	1.41	1.46	1.46
Trade	Nov.	01-09-86	1.30	1.31	1.26	1.27
Ratio: Mfgrs.' durable goods inventories to unfilled orders[1]	Dec.	02-03-86	.535	.542	.538	.553
Retail sales, total ($ bil.)	Dec.	01-14-86	117.9	1.9	-1.4	6.6
GAF[3]	Dec.	01-14-86	26.0	.6	1.9	5.7
Auto sales, total (mil. units.)[2]	Dec.	01-08-86	11.4	17.2	-19.5	4.8
Domestic models	Dec.	01-08-86	7.9	23.4	-29.6	-2.6
Foreign models	Dec.	01-08-86	3.5	5.4	18.2	26.2
Plant and equipmment expen.[4]						
Total nonfarm business	1986	12-19-85	393.52	—	—	2.4
Manufacturing	1986	12-19-85	152.30	—	—	-.1
Nonmanufacturing	1986	12-19-85	241.23	—	—	4.1
Housing starts, private (thous.)[2]	Dec.	01-17-86	1,840	17.5	13.9	12.9
Leading indicators (1967=100)	Dec.	01-30-86	173.6	.9	1.8	5.8

1. Actual data used in lieu of percent changes for earlier periods.
2. At annual rates.
3. Excludes mail order houses.
4. Planned-Commerce October and November 1985 Survey.

Incoming data indicate a pickup in the pace of production and spending in December, although for the fourth quarter as a whole, activity appears to have advanced at about the same rate as earlier in the year. Prices reflected some transitory upward pressures from food and energy, but wage increase have remained in line with the moderate rates over the preceding two years.

Industrial Production and Capacity Utilization

Industrial production rose an estimated 0.7 percent in December after no change, on net, over the preceding two months. Production gains occurred in most market groups in December. Consumer goods and materials both increased 0.8 percent, and output of business equipment, which had softened earlier in the year, edged up 0.2 percent, in part because of an apparent firming in the production of computers and other high technology equipment. Autos were assembled at an 8.1 million unit annual rate, almost 5 percent higher than their November pace, and likely rose further in January.

Capacity utilization in manufacturing, mining, and utilities rose in December for the second consecutive month, increasing 0.4 percentage points to 80.5 percent. Nonetheless, the year-end operating rate remained below the most recent peak of 82.0 percent in the summer of 1984.

Employment and Unemployment

Nonfarm payroll employment advanced 320,000 in December, and the fourth-quarter rise was somewhat above the average for the preceding three quarters. The service sector extended its trend of strong growth, with

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

	1985 Annual[1]	1985 Q3	1985 Q4	1985 Oct.	1985 Nov.	1985 Dec.
		--Annual rate--		--Monthly rate--		
Total Index	1.6	2.0	1.3	-.6	.6	.7
Products	2.7	4.0	1.5	-.8	.8	.6
Final products	2.2	4.0	1.2	-1.0	1.0	.6
Consumer goods	2.2	3.9	2.6	-.9	1.1	.8
Durable	1.1	3.6	3.8	-1.4	2.9	.8
Nondurable	2.7	4.0	2.2	-.7	.5	.8
Equipment	2.1	4.0	-.4	-1.0	.9	.3
Business	1.7	1.8	-2.1	-1.4	1.2	.2
Defense and space	10.1	9.8	11.9	.8	1.2	.5
Intermediate products	4.4	4.2	2.6	-.2	.2	.7
Construction supplies	5.5	8.7	1.7	-.5	.4	.6
Materials	.0	-1.1	.9	-.2	.2	.8
Durable goods	-1.7	-2.2	2.8	.1	1.3	.6
Nondurable goods	1.9	9.4	-2.5	-1.6	-.3	.8
Energy materials	2.0	-7.7	.3	.6	-1.6	1.2

1. Annual changes are from the fourth quarter of 1984 to the fourth quarter of 1985.

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

	1978-80 High	1982 Low	1967-84 Avg.	1984 High	1985 Oct.	1985 Nov.	1985 Dec.
Total industry	86.9	69.5	81.7	82.0	79.8	80.1	80.5
Manufacturing	86.5	68.0	80.7	81.8	79.5	79.9	80.3
Durable	86.3	63.7	78.8	80.4	77.3	77.9	78.2
Mining	95.2	76.9	88.0	86.4	80.6	79.2	79.4
Utilities	88.5	78.0	88.1	85.6	82.8	83.1	84.0
Industrial materials	89.1	68.4	82.7	83.1	79.2	79.1	79.6
Metal materials	93.6	45.7	78.9	70.6	69.4	71.0	70.0
Paper materials	97.3	79.9	91.3	97.2	88.8	90.2	n.a.
Chemical materials	87.9	63.3	80.9	79.1	79.7	79.0	n.a.

sharp gains in business and health services and moderate increases in finance, transportation, and wholesale trade. At retail trade establishments, however, employment growth slackened considerably toward year end owing primarily to less-than-usual holiday hiring at general merchandise stores.

Labor demand has perked up in the manufacturing sector in recent months. The number of factory jobs rose 45,000 in December, the third consecutive monthly increase; thus, manufacturing employment has recovered nearly half of the loss experienced earlier in the year. In addition, the factory workweek moved up further during the fourth quarter. Together with increased employment, the longer workweek contributed to a sizable increase in production worker hours.

The unemployment rate, which was little changed over the first nine months of the year, drifted down from 7.1 percent in October to 6.9 percent in December. On balance, jobless rates for adults edged down in 1985, while unemployment among teenagers showed little improvement.

Personal Income and Consumption

After slumping early in the fourth quarter, the consumer sector closed out the year on a strong note, with sizable increases in December in both personal income and consumption expenditures. Personal income in December was up 1.4 percent--the largest monthly advance reported in the present expansion. Wages and salaries posted a sharp gain. In addition, nonwage income was boosted by subsidy payments to farmers, a recovery of rental

CHANGES IN EMPLOYMENT[1]
(Thousands of employees; based on seasonally adjusted data)

	1984	1985	1985 Q1	1985 Q2	1985 Q3	1985 Q4	1985 Oct.	1985 Nov.	1985 Dec.
	-Average monthly changes-								
Nonfarm payroll employment[2]	327	247	273	188	248	281	342	180	320
Strike adjusted	329	246	267	182	254	280	337	182	321
Manufacturing	52	-15	-26	-43	-40	47	59	37	45
Durable	45	-15	-17	-30	-37	25	44	14	18
Nondurable	7	-1	-9	-12	-3	22	15	23	27
Construction	29	25	28	28	28	14	32	-5	16
Trade	106	68	91	77	50	53	96	15	48
Finance and services	106	126	150	94	127	132	113	149	135
Total government	17	37	20	23	80	24	34	-23	60
Private nonfarm production workers	253	169	182	130	148	216	262	181	206
Manufacturing production workers	33	-16	-33	-47	-27	45	53	27	54
Total employment[3]	269	163	234	-117	306	229	294	156	237
Nonagricultural	265	183	259	-59	347	184	253	144	156

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)

	1984	1985	1985 Q1	1985 Q2	1985 Q3	1985 Q4	1985 Oct.	1985 Nov.	1985 Dec.
Civilian, 16 years and older	7.5	7.2	7.3	7.3	7.2	7.0	7.1	7.0	6.9
Teenagers	18.9	18.6	18.5	18.4	18.3	19.0	19.8	18.4	18.8
20-24 years old	11.5	11.0	11.1	11.3	11.0	10.8	10.9	11.0	10.6
Men, 25 years and older	5.7	5.3	5.4	5.4	5.3	5.2	5.3	5.2	5.1
Women, 25 years and older	6.0	5.9	6.0	6.0	5.9	5.5	5.6	5.6	5.4
White	6.5	6.2	6.3	6.3	6.2	6.0	6.1	5.9	5.9
Black	15.9	15.1	15.4	15.0	14.8	15.1	14.9	15.6	14.9
Fulltime workers	7.2	6.9	7.0	6.9	6.9	6.7	6.8	6.7	6.6
Memo:									
Total national[1]	7.4	7.1	7.2	7.2	7.1	6.9	7.0	6.9	6.8

1. Includes resident Armed Forces as employed.

income after severe flooding in several eastern states, and higher interest receipts.

Personal consumption expenditures, which had been held down by sluggish auto sales earlier in the fourth quarter, increased 2 percent in December. Boosted by an expanded round of incentive programs, sales of domestic autos registered a strong rebound toward the end of the month and were at an advanced 8.6 million unit annual rate in January. For the fourth quarter as a whole, there were strong gains in outlays for furniture and appliances and in sales of "other durable goods" (including toys, jewelry, electronic games, and sports equipment). Spending for nondurable goods also was up in the fourth quarter, and service outlays rose by an unusually large amount as colder weather induced sharply greater use of electricity and gas.

With expenditures rising considerably faster than disposable personal income, the saving rate fell in December to 3.7 percent. Although the recent BEA revisions generally raised the level of the saving rate, the past few quarters still show a sharp decline in the rate and for 1985 as a whole, the average saving rate was only 4.6 percent, about 2 percentage points less than in 1984.

Business Fixed Investment

Real spending for nonresidential fixed investment surged 10-1/2 percent at an annual rate in the fourth quarter. Spending growth was especially rapid for producers' durable equipment, possibly reflecting firms' attempts to lock in tax benefits that might be eliminated for equipment purchased after 1985.

PERSONAL INCOME AND EXPENDITURES
(Based on seasonally adjusted data)

	1984	1985	1985 Q1	Q2	Q3	Q4	1985 Oct.	Nov.	Dec.
	----Percentage changes at annual rates[1]----								
Total Personal Income									
Nominal	8.6	5.4	7.0	4.9	2.3	7.3	7.5	6.0	16.7
Real[2]	4.3	2.2	4.5	1.5	.1	2.7	2.2	.7	11.4[e]
Disposable Personal Income									
Nominal	8.1	4.5	2.3	12.0	-2.5	6.9	7.7	5.3	17.3
Real	3.9	1.3	-.3	8.2	-4.5	2.4	2.9	-.9	12.8[e]
Expenditures									
Nominal	7.5	6.2	7.4	6.2	6.8	4.2	-15.2	8.5	24.5
Real	3.4	2.9	4.8	2.6	4.6	-.2	-20.0	2.3	20.0[e]
	----Changes in billions of dollars[3]----								
Total personal income	20.5	15.6	16.9	7.4	9.8	28.0	20.8	16.7	46.6
Wages and salaries	12.7	10.3	9.8	9.2	7.6	14.5	10.2	11.8	21.6
Private	10.7	8.0	7.0	7.6	5.8	11.6	8.7	7.3	18.9
Manufacturing	2.8	1.2	.8	.3	.8	3.0	4.9	-.4	4.4
Other income	8.8	6.7	10.9	-1.1	2.7	14.5	11.3	5.7	26.4
Disposable personal income	16.2	11.7	-4.2	20.6	6.8	23.8	18.1	12.4	40.8
Expenditures	14.7	14.3	8.9	13.4	22.1	12.8	-33.5	18.5	53.5
Durables	2.8	2.0	1.4	-1.1	13.7	-6.2	-46.1	5.7	21.8
Motor vehicles and parts	1.1	.8	1.0	-1.4	11.8	-8.4	-48.8	5.1	18.5
Furn. and household equip.	.9	.8	.1	.5	1.2	1.4	3.0	.0	1.3
Nondurables	4.6	4.0	2.7	4.3	4.4	4.7	4.4	.5	9.2
Clothing and shoes	1.0	.8	1.1	-.2	.6	1.6	.4	3.0	1.5
Gasoline and oil	-.3	.6	.6	.7	-.2	1.1	.9	.1	2.4
Services	7.3	8.3	4.8	10.2	4.0	14.3	8.2	12.4	22.4
Personal saving rate (percent)	6.5	4.6	4.8	5.9	3.7	4.1	4.5	4.2	3.7

1. Annual changes 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.
e--FRB estimate.

RETAIL SALES
(Seasonally adjusted percentage change)

	1985				1985		
	Q1	Q2	Q3	Q4	Oct.	Nov.	Dec.
Total sales	1.6	2.7	2.0	-.7	-3.9	.7	1.9
(REAL)[2]	1.1	2.3	1.9	-1.6	-4.1	.1	1.5
Total less automotive group, nonconsumer stores, and gasoline stations	1.1	1.3	1.0	1.6	.3	.4	.8
Previous estimate[1]			1.0	--	.0	1.4	--
GAF[3]	1.1	1.5	1.0	2.3	.2	1.1	.6
Durable	2.5	4.3	4.2	-3.8	-10.0	.7	4.3
Automotive group	4.4	5.6	6.2	-8.9	-17.3	1.1	5.7
Furniture and appliances	1.1	2.0	1.6	4.7	2.6	-.8	.1
Other durable goods	-.6	.4	.7	4.4	2.6	-.4	5.4
Nondurable	1.1	1.7	.7	1.1	.0	.6	.6
Apparel	1.1	3.3	1.0	3.1	.0	1.6	2.0
Food	1.3	1.4	.9	1.3	-1.1	1.1	1.1
General merchandise[4]	1.0	.6	.7	.9	-.7	1.7	.3
Gasoline stations	-.6	5.1	-1.5	1.2	.6	1.3	1.4

1. Based on incomplete sample counts approximately one month ago.
2. BCD series 59. Data are available approximately 3 weeks following the retail sales release.
3. General merchandise, apparel, furniture and appliance stores.
4. General merchandise excludes mail order nonstores; mail order sales are also excluded in the GAF grouping.

Data are unavailable because of a future release date.

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

	1985			1985			1986
	Q2	Q3	Q4	Oct.	Nov.	Dec.	Jan.
Total auto sales[1]	10.9	12.3	10.2	9.6	9.7	11.4	
Imports	2.7	2.9	3.4	3.3	3.4	3.5	
Domestic	8.3	9.4	6.8	6.3	6.4	7.9	8.6
Domestic production	8.0	8.2	7.8	7.6	7.8	8.1	
Domestic inventories	1.51	1.31	1.67	1.48	1.63	1.67	
Days' supply[2]	56	50	75	73	78	65	

1. Components may not add to totals due to rounding.
2. Days' supply for the quarter are based on end-of-quarter stocks and average sales for the quarter.

Nominal shipments of nondefense capital goods increased 4-1/4 percent (not at an annual rate) in December, resulting in a 3-1/2 percent gain for the fourth quarter as a whole. Spending advanced for nearly all categories of equipment, with particularly robust growth for electrical machinery. Fourth-quarter shipments of office and computing equipment increased 1-1/4 percent in nominal terms and apparently included IBM's sales of its new Sierra mainframe computer. With prices for computers and related equipment falling sharply, this modest increase in nominal shipments reflects considerable growth in real computer spending. Partially offsetting the rise in overall fourth-quarter shipments was a substantial decline in business auto purchases from their incentive-boosted third-quarter levels.

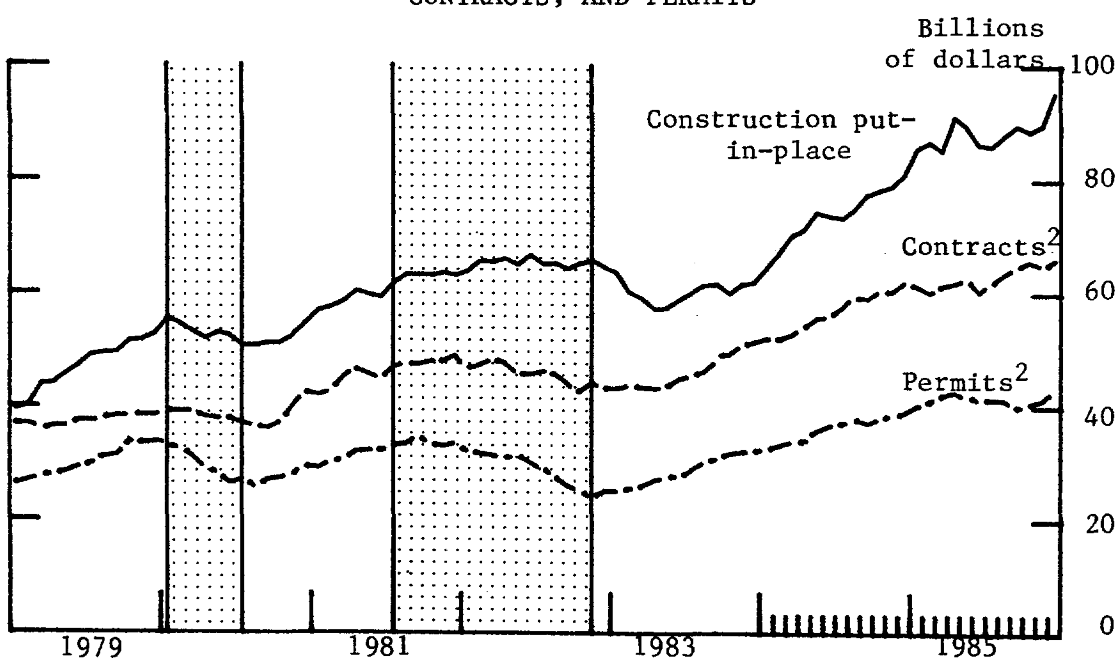
Outlays for nonresidential construction advanced 5.1 percent in December, after having been little changed on balance since August. About one-half of the robust December increase occurred in the office sector, which earlier had appeared to be softening.

Indicators of future spending point to slower fixed investment growth than the rapid fourth-quarter pace. Despite a large increase in December, new orders for nondefense capital goods were relatively flat in the fourth quarter, and new commitments for nonresidential construction do not suggest that spending on structures will show much near-term strength. In addition, the Commerce Department fall survey of capital spending plans, taken in October and November, suggests lackluster investment spending in 1986, with businesses expecting to increase nominal outlays only 2-1/2 percent this year.

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

	1985 Q2	1985 Q3	1985 Q4	1985 Oct.	1985 Nov.	1985 Dec.
Producers' durable equipment						
Nondefense capital goods						
Shipments	2.6	.2	3.5	3.7	.2	4.2
Excluding aircraft and parts	3.2	-1.4	4.1	3.1	2.4	-.2
Office and store machinery	7.0	-7.4	1.3	1.6	-4.6	.5
Orders	-1.6	5.6	.0	-7.3	-4.8	18.6
Excluding aircraft and parts	-4.1	2.3	-1.3	-5.8	7.3	-5.8
Office and store machinery	-20.3	5.3	-17.4	-4.8	-4.8	-30.3
Imports of capital goods excluding autos	-2.6	7.3	--	8.8	--	--
Exports of capital goods excluding autos	-2.0	-1.4	-.6	.3	-.3	1.8
Sales of heavy-weight trucks (thousands of units, A.R.)	276	264	303	253	315	342
Nonresidential structures						
Nonresidential construction	3.7	-1.1	2.1	-1.0	.6	5.1
Commercial building	1.6	-.3	4.6	-.7	.4	7.3
Office	1.9	-1.7	2.1	-1.2	-.7	10.7
Other commercial	1.1	1.4	7.3	-.3	1.5	3.9

NONRESIDENTIAL CONSTRUCTION, CONTRACTS, AND PERMITS[1]



1. Source: F. W. Dodge and Census.
2. Six-month moving average.

Housing

After weakening in November, both housing starts and building permits rebounded strongly in December. For the final quarter of 1985, both starts and permits averaged 1.73 million units--very close to their average rates for the first three quarters of the year.

The strength in December housing starts was in part attributable to a 20 percent increase in the volatile multifamily component. A heavy volume of tax-free financing provided by state and local bonds may have added some temporary strength to this sector towards the end of the year. Nonetheless, rental vacancy rates are near their highest level in almost two decades, and construction of new multifamily units over the second half of 1985 was down somewhat from the advanced pace seen earlier last year.

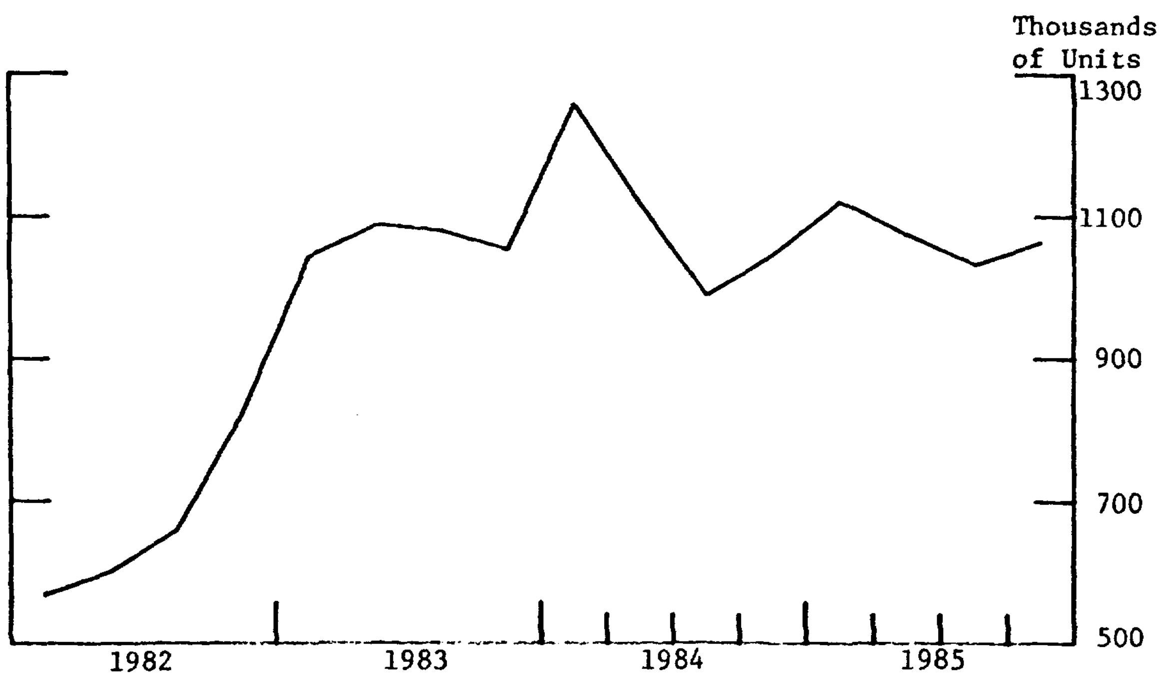
In the single-family sector, starts were up sharply in December from an unusually weak November pace, but the total for the quarter remained in the same general range that has prevailed since early 1983. The impact on demand of declines in mortgage interest rates since mid-1984 may have been counteracted by tighter loan qualification standards and by the affect of continuing slower rates of appreciation in home prices on buyer attitudes. In the sales area, new home sales improved a bit at year-end, and existing home sales registered their fifth consecutive quarterly increase in the final period of 1985, bringing the level of such activity to its highest pace in six years.

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

	1985	1985			1985		
	Annual	H1	Q3	Q4[1]	Oct.	Nov.	Dec.[1]
All units							
Permits	1.72	1.70	1.76	1.73	1.69	1.66	1.84
Starts	1.73	1.78	1.67	1.73	1.77	1.57	1.84
Single-family units							
Permits	.95	.94	.97	.95	.97	.92	.96
Starts	1.07	1.10	1.03	1.07	1.12	.96	1.11
Sales							
New homes	.69	.68	.71	.69	.63	.71	.72
Existing homes	3.22	3.01	3.36	3.50	3.55	3.42	3.53
Multifamily units							
Permits	.77	.76	.79	.78	.72	.74	.88
Starts	.66	.69	.64	.66	.65	.61	.73
Mobile home shipments	n.a.	.28	.29	n.a.	.30	.29	n.a.

1. Preliminary estimates.
n.a.--Not available.

SINGLE-FAMILY HOUSING STARTS



Business Inventories

Business inventory investment in late 1985 reflected a sharp runup in auto dealers' stocks and continuing efforts to keep stocks lean in most other sectors, particularly manufacturing. Indeed, the book value of manufacturing inventories fell at an annual rate of $16-1/2 billion in December, the sixth consecutive monthly decline, and the stock-sales ratio at year end was particularly low by historical standards. For some industries, especially electrical machinery, the potential for inventory building looks promising. On the other hand producers of basic metals and some types of nonelectrical machinery are still faced with sluggish orders and may continue to take a cautious inventory stance.

In the trade sector, the sharp accumulation of nonauto retail stocks reported earlier in the fall appears to have subsided in November, owing in part to the steady pickup in retail sales. Moreover, judging by advance reports on orders and sales for December, the inventory situation at nonauto trade establishments probably improved further in that month. In contrast, there was a further increase in auto dealers' stocks.

Federal Government

Real federal government purchases rose sharply in the fourth quarter as farmers relied heavily on the Commodity Credit Corporation to help finance the growing inventory of farm crops. In the second half of 1985, the real stocks owned or financed by the CCC accumulated at a record $20 billion annual rate. Meanwhile, real defense purchases were essentially unchanged in the fourth quarter after a sharp increase in the previous

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

	1985 Q2	1985 Q3	1985 Q4	1985 Oct.	1985 Nov.r	1985 Dec.p
Book Value Basis:						
Total	3.6	-3.0	--	39.1	17.1	--
Manufacturing	-2.0	-6.6	-13.7	-19.0	-5.4	-16.6
Wholesale	6.5	-2.0	--	6.8	.8	--
Retail	-.9	5.7	--	51.3	21.8	--
Automotive	-1.3	-6.5	--	28.8	28.8	--
Ex. auto	.4	12.2	--	22.5	-7.0	--
Constant Dollar Basis:						
Total	7.0	1.5	--	24.1	10.2	--
Manufacturing	-.2	-4.0	--	-21.9	-6.4	--
Wholesale	8.0	3.3	--	.6	-2.2	--
Retail	-.8	2.2	--	45.3	18.8	--
Automotive	-1.1	-5.7	--	28.4	24.9	--
Ex. auto	.3	7.9	--	17.0	-6.1	--

INVENTORIES RELATIVE TO SALES[1]

	Cyclical Reference Points[2] 81 low	Cyclical Reference Points[2] 82 high	1985 Q2	1985 Q3	1985 Q4	1985 Oct.	1985 Nov.r	1985 Dec.p
Book Value Basis:								
Total	1.39	1.53	1.37	1.35	--	1.37	1.35	--
Manufacturing	1.60	1.77	1.47	1.46	1.41	1.43	1.41	1.40
Wholesale	1.06	1.28	1.17	1.17	--	1.19	1.17	--
Retail	1.36	1.43	1.38	1.37	--	1.43	1.44	--
Automotive	1.59	1.88	1.45	1.30	--	1.57	1.64	--
Ex. Auto	1.29	1.35	1.36	1.39	--	1.39	1.38	--
Constant Dollar Basis:								
Total	1.60	1.69	1.55	1.53	--	1.54	1.53	--
Manufacturing	1.89	2.00	1.78	1.76	--	1.74	1.71	--
Wholesale	1.29	1.44	1.30	1.31	--	1.32	1.30	--
Retail	1.38	1.47	1.40	1.37	--	1.44	1.46	--
Automotive	1.57	1.83	1.30	1.15	--	1.44	1.51	--
Ex. auto	1.33	1.40	1.43	1.44	--	1.44	1.45	--

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

In addition to increases in defense and agricultural spending this past year, interest outlays and social security and medicare payments also showed significant growth. Meanwhile, increases in revenues failed to match the rise in spending; and as a result, the federal budget deficit (including off-budget outlays) was $75 billion in the fourth quarter, up about $4 billion from the high level of a year earlier.

The administration and CBO announced in their Gramm-Rudman-Hollings report on January 15 that, assuming real economic growth of 3-1/2 to 4 percent, the federal deficit would total about $220 billion in fiscal 1986 as a whole. This finding triggered the process that led to the President's sequestration order on February 1, which is designed to reduce outlays $11.7 billion ($20 billion at an annual rate) between March 1 and September 30.

On February 5, the administration released its fiscal 1987 budget proposals, which will be discussed in more detail in an appendix to the Greenbook supplement. The budget documents provide estimates of federal receipts and outlays along with a legislative blueprint for meeting the deficit targets specified in the Gramm-Rudman-Hollings legislation. The administration's current services estimates indicate that the deficit for FY1987 would be $182 billion and decline to around $104 billion by 1991.[1] In order to meet the $144 billion Gramm-Rudman-Hollings deficit

1. These estimates assume that current laws applying to taxes and entitlements are unchanged, that there is 3 percent real growth in the defense budget and that real nondefense spending is constant. They also assume that there will be a relatively favorable economic performance of 4 percent annual real GNP growth, declining inflation and interest rates, and marginally lower levels of unemployment.

target for fiscal 1987, the President proposed substantial reductions in nondefense programs, including several domestic program eliminations.

State and Local Sector

Real purchases of goods and services in the state and local sector were flat in the fourth quarter after two quarters of exceptionally strong growth. Real construction outlays, which showed unusual strength in mid-year, dropped at an 11 percent annual rate in the fourth quarter. In contrast, employment continued to advance, rising 76,000 from September to December. The fiscal position of state and local government continued to weaken during the fall despite the slowing in nominal outlays, and the operating and capital account surplus (excluding social insurance funds) is estimated to have fallen to its lowest level in the current expansion. The fourth-quarter decline in the surplus reflected sharply reduced growth in sales tax receipts along with a slowdown in the growth of federal grants.

Prices

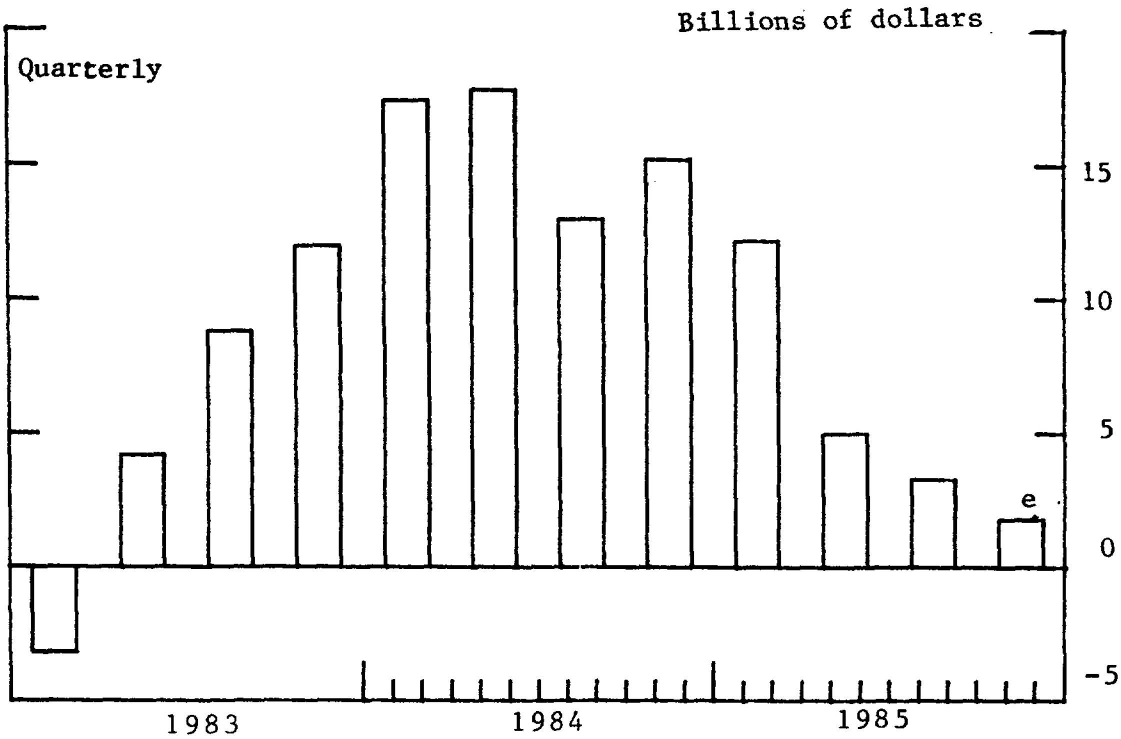
Price increases during the closing months of 1985 were larger than in previous months, but the pickup mainly reflected increases in agricultural and energy prices that appear unlikely to persist. The consumer price index for all urban consumers rose 0.6 percent in November and 0.4 percent in December; during the same months, producer prices in finished goods were up 0.8 and 0.4 percent, respectively. However, outside the food and energy sectors, consumer prices rose in November and December at an average rate similar to that for the year as a whole, and producer

ADMINISTRATION CURRENT SERVICES BUDGET
(Fiscal years)

	1986	1987	1988	1989	1990	1991
	------------- Billions of dollars ------------					
Revenues	777	844	927	989	1,053	1,120
Outlays	982	1,026	1,077	1,128	1,179	1,224
Deficit	206	182	150	139	126	104
Memo:						
Deficit reduction proposals	3	38	56	71	91	105
Deficit with proposals	203	144	94	68	36	-1

Source: Budget of the United States Government, Fiscal Year 1987.

STATE AND LOCAL SECTOR:
OPERATING AND CAPITAL ACCOUNT SURPLUS*
(Billions of dollars at an annual rate)



*--Excludes Social Insurance Funds.
e--Estimate.

prices excluding food and energy were little changed over the two-month period.

There are indications that the recent acceleration in food prices may be short-lived. At the farm level, prices of domestically-produced crude foods leveled off in December and appear to have declined in January. In addition, the Department of Agriculture, in implementing the new Farm Bill, has announced price support levels for a number of farm crops that are significantly lower than the 1985 levels. These lower support prices will become effective with the 1986 harvests, but may start to influence market prices even sooner. In contrast, higher prices for coffee, reflecting drought conditions in Brazil, appear likely to boost food price inflation in the near-term.

In the energy sector, petroleum prices have tumbled since the start of the year in response to the effects of a substantial increase in Saudi Arabian production that started in October. The spot price of crude oil has dropped by about $10 per barrel since early January, to the lowest level in six years. The spot prices of petroleum products also have plummeted. At a meeting in early February, OPEC was unable to agree on a coordinate strategy to constrain output or stem the downward pressures on prices.

The price data for items other than food and energy did not exhibit any significant acceleration toward the end of 1985. At the producer level, prices of capital equipment were unchanged on net from October to December, and the prices of consumer goods were up only slightly. Serivce prices rose, on average, at about the same pace as during the year as a whole.

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

	Relative Importance 1984 Dec.	1984	1985	1985 Q3	1985 Q4	1985 Nov.	1985 Dec.
				-Annual rate-		-Monthly rate-	
All items[2]	100.0	4.0	3.8	2.3	5.3	.6	.4
Food	18.7	3.8	2.7	1.8	7.0	.7	.8
Energy	11.5	.2	1.8	-4.3	3.3	.9	.7
All items less food and energy[3]	69.8	4.7	4.4	3.5	5.2	.4	.3
Commodities	26.3	3.1	2.1	.8	2.8	.2	.1
Services	43.5	5.6	5.7	5.0	6.6	.6	.4
Memorandum:							
CPI-W[4]	100.0	3.5	3.6	1.8	5.4	.6	.4

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)[1]

	Relative Importance Dec. 1984	1984	1985	1985 Q3	1985 Q4	1985 Nov.	1985 Dec.
				-Annual rate-		-Monthly rate-	
Finished goods	100.0	1.7	1.8	-2.4	8.5	.8	.4
Consumer foods	24.4	3.5	.3	-1.6	16.0	1.6	.8
Consumer energy	11.5	-4.1	.0	-12.8	20.2	3.1	1.8
Other consumer goods	42.4	2.2	2.7	-.2	3.4	.1	.0
Capital equipment	21.6	1.8	2.7	-1.2	4.2	.1	-.1
Intermediate materials[2]	95.1	1.7	-.1	-1.2	2.6	.2	.4
Exc. energy	80.1	2.1	-.2	-1.2	.4	.0	.1
Crude food materials	53.0	-1.2	-6.4	-19.9	61.4	5.8	.2
Crude energy	31.7	-1.3	-4.3	-4.7	-3.1	-.1	-.5
Other crude materials	15.4	-3.3	-4.5	-4.2	-2.7	-.2	-1.0

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

There was no appreciable evidence of dollar-related price hikes in major domestic price measures through December, although increases are anticipated in coming months in light of announced rises for items such as cars and electronic equipment.

The prices of spot industrial commodities have been relatively flat since the start of 1986. In contrast, the prices of precious metals shot up temporarily, apparently in response to the heightened political and economic uncertainties associated with the U.S. freezing of Libyan assets and labor unrest in South Africa; these increases, however, were largely reversed in early February.

Wage and Labor Costs

Measures of wage change generally suggest that pay increases remained quite moderate in the fourth quarter and that wage inflation leveled off last year after decelerating in 1983 and 1984. The hourly earnings index, which measures wages of production and nonsupervisory workers, rose 0.8 percent in December, bringing the quarterly increase to 3.3 percent at an annual rate. For the year as a whole, the hourly earnings index rose 3 percent--about the same rate of increase as in 1984.

A more comprehensive measure of wages, the employment cost index for wages and salaries, rose 4.1 percent in 1985; the higher rate in the ECI reflects larger increases for workers excluded from the hourly earnings index. Although the wages and salaries component of the ECI rose at about the same pace as in 1984, hourly compensation costs, which include employer costs for employee benefits as well as wages and salaries,

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

	1983	1984	1985	1985 Q1	Q2	Q3	Q4
Hourly earnings index, wages of production workers[1]							
Total private nonfarm	4.0	3.1	3.0	3.5	3.2	2.0	3.3
Manufacturing	2.8	3.3	3.2	5.2	3.5	2.0	2.2
Nonmanufacturing	4.5	3.0	2.9	2.8	3.0	2.0	3.8
Employment cost index, wages and salaries of all persons[2]							
Total	5.0	4.1	4.1	4.7	4.3	5.3	2.3
By occupation:							
White collar	6.0	4.4	4.9	5.7	4.9	5.9	3.2
Blue collar	3.8	3.6	3.4	3.8	4.1	4.7	1.0
Service workers	4.6	6.2	2.3	.3	2.0	6.3	1.0
By bargaining status:							
Union	4.6	3.4	3.1	2.7	4.3	3.6	1.9
Nonunion	5.2	4.5	4.6	5.8	4.3	6.0	2.3
Employment cost index, compensation of all persons[2]							
Total	5.7	4.9	3.9	5.0	3.3	5.2	2.2
Major collective bargaining agreements							
First-year wage adjustments	2.6	2.4	2.3	--	--	--	--
Total effective wage change	4.0	3.7	3.3	--	--	--	--
Labor costs and productivity, all persons[1]							
Compensation per hour	3.9	3.8	3.7	4.8	3.8	2.8	3.5
Output per hour	3.4	.8	-.1	.5	.7	.3	-1.8
Unit labor costs	.5	2.9	3.8	4.3	3.1	2.5	5.4

1. Changes are from final quarter of preceding period to final quarter of period indicated. Quarterly and year-to-date changes at compound rates. Seasonally adjusted data.
2. Changes are from final month of preceding period to final month of period indicated. Quarterly changes at compound rates; not seasonally adjusted.

in compensation apparently reflected a sharp slowing in the growth of fringe benefits as employers sought to reduce insurance and pension costs.

The results of collective bargaining agreements indicate that wage increases were especially small for union workers last year. Specified wage adjustments, exclusive of any lump-sum payments and COLAs, for the 2.2 million workers covered by major union settlements reached during 1985 averaged 2.3 percent during the first contract year and 2.7 percent over the contract life.

Despite continued moderation in wages, unit labor costs picked up last year owing to slower productivity growth. In the fourth quarter of 1985, productivity fell 1-3/4 percent at an annual rate as hiring was brisk in the face of moderate output growth. With productivity essentially flat over 1985, all of last year's 3-3/4 percent increase in nonfarm compensation per hour was passed through to labor costs. As a result, unit labor costs were up 3.8 percent in 1985 compared with a 3 percent rise in 1984.

DOMESTIC FINANCIAL DEVELOPMENTS

III-T-1

SELECTED FINANCIAL MARKET QUOTATIONS[1]

(Percent)

	1982/1983 Cyclical lows	1984 Highs	1985 March highs	1985 June lows	1985 FOMC Dec.	1986 Feb. 4	Change from: 1984 highs	Change from: FOMC Dec.
Short-term rates								
Federal funds[2]	8.46	11.63	8.58	7.38	8.05	7.85	-3.78	-0.20
Treasury bills[3]								
3-month	7.08	10.67	8.80	6.66	7.00	6.98	-3.69	-0.02
6-month	7.62	10.77	9.13	6.81	7.00	7.04	-3.73	0.04
1-year	7.73	11.13	9.25	6.98	7.02	7.05	-4.08	0.03
Commercial paper								
1-month	8.00	11.42	8.94	6.95	7.77	7.68	-3.74	-0.09
3-month	7.97	11.35	9.12	7.01	7.66	7.62	-3.73	-0.04
Large negotiable CDs[3]								
1-month	8.08	11.52	8.89	7.09	7.69	7.70	-3.82	0.01
3-month	8.12	11.79	9.29	7.18	7.63	7.70	-4.09	0.07
6-month	8.20	12.30	9.92	7.30	7.63	7.70	-4.60	0.07
Eurodollar deposits[4]								
1-month	8.68	11.89	8.89	7.45	7.98	8.00	-3.89	0.02
3-month	8.71	12.20	9.58	7.50	7.86	8.00	-4.20	0.14
Bank prime rate	10.50	13.00	10.50	9.50	9.50	9.50	-3.50	--
reasury bill futures								
Mar. 1986 contract			10.58	7.47	6.68	6.77	--	0.09
Jun. 1986 contract			10.74	7.78	6.76	6.80	--	0.04
Intermediate- and long-term rates								
U.S. Treasury (constant maturity)								
3-year	9.33	13.49	11.22	8.73	8.18	8.10	-5.39	-0.08
10-year	10.12	13.99	12.02	9.83	9.04	8.96	-5.03	-0.08
30-year	10.27	13.94	11.97	10.23	9.35	9.23	-4.71	-0.12
Municipal revenue (Bond Buyer index)	9.21	11.44	10.25	9.10	8.96[5]	8.29[5]	-3.15	-0.67
Corporate--A utility Recently offered	11.64	15.30	13.23	11.50	10.95[6]	10.57e	-4.73	-0.38
Home mortgage rates								
S&L fixed-rate	12.55	14.68	13.29	12.05	11.14[6]	10.89[6]	-3.79	-0.25
S&L ARM, 1-yr.	n.a.	12.31	11.14	9.83	9.17[6]	8.97[6]	-3.34	-0.20

	1983 Highs	1984 Lows	1985 Highs	1985 FOMC Dec.	1986 Feb. 4	Percent change from: 1984 lows	Percent change from: FOMC Dec.
Stock prices							
Dow-Jones Industrial	1287.20	1086.57	1553.10	1544.50	1593.23	46.6	3.2
NYSE Composite	99.63	85.13	121.90	121.17	122.72	44.2	1.3
AMEX Composite	249.03	187.16	246.13	243.85	240.30	28.4	-1.5
NASDAQ (OTC)	328.91	225.30	325.16	323.25	337.88	50.0	4.5

1. One-day quotes except as noted.
verages for two-week reserve maintenance period st to date shown. Last observation is for the tenance period ending January 29, 1986.
. 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--estimate

Most interest rates have changed little on balance since the December FOMC meeting. The securities markets have been rather volatile, however, reflecting in part the substantial uncertainties surrounding prospects for implementation of the Gramm-Rudman Act and the objectives of the G-5 authorities with respect to interest and exchange rates. Traders also responded strongly to indications of domestic output and price trends: interest rates turned up in mid-January when some stronger-than-expected economic data dampened hopes of a near-term cut in the discount rate, but they then moved back down when spot oil prices plunged and official estimates of modest fourth-quarter growth in GNP were published. Market participants have responded only minimally to incoming money figures in the belief that the Federal Reserve is giving the monetary aggregates little weight in its operational decisions.

M1 growth slowed sharply in January from its brisk November-December pace, reflecting a large runoff of demand deposits. M2 also decelerated markedly, held down not only by the moderation in M1 but also by weakness in its nontransactions component, especially overnight RPs. M3 about matched its December growth rate as heavier issuance by banks of large time deposits offset the slowdown in M2.

Aggregate borrowing by domestic nonfinancial sectors probably tapered off in January, led by a reduction in credit demands by governmental units. The Treasury's funding needs were reduced by an unusually large buildup in its cash balance because of a surge in year-end sales of nonmarketable securities to state and local governments. State and local units, which had raised a huge volume of funds late last year, virtually ceased borrowing

MONETARY AGGREGATES
(Based on seasonally adjusted data unless otherwise noted)[1]

	1984:Q4 to 1985:Q4	1985 Q3	1985 Q4	1985 Nov.	1985 Dec.	1986 Jan.pe	Growth from Q4 1984 to Dec. 1985
	------ Percentage change at annual rates ------						
1. M1[2]	11.6 (12.1)	15.0	8.9	13.4	13.2	4	11.9 (12.4)
2. M2	8.6	10.2	5.9	6.7	7.8	2	8.6
3. M3	8.0	8.3	6.7	5.7	7.1	7	7.9
							Levels in billions of dollars Dec. 1985
Selected components							
4. Currency	7.6	9.1	7.4	8.5	5.6	6	170.8
5. Demand deposits	8.3	11.9	4.7	10.5	20.3	-7	270.8
6. Other checkable deposits	21.7	26.1	17.2	23.0	10.2	20	177.2
7. M2 minus M1[3]	7.7	8.7	4.9	4.6	6.0	1	1938.9
8. Overnight RPs and Eurodollars, NSA	21.0	19.3	27.6	30.4	71.5	-59	72.9
9. General purpose and broker/dealer money market mutual fund shares, NSA	9.1	4.1	0.0	-3.4	-4.8	10	175.8
10. Commercial banks	9.2	7.8	4.7	7.2	7.5	8	841.3
11. Savings deposits, SA, plus MMDAs, NSA[4]	19.0	19.2	11.2	13.6	6.9	12	457.1
12. Small time deposits	-0.6	-4.4	-2.7	-0.3	8.2	3	384.2
13. Thrift institutions	5.1	3.9	1.8	2.7	4.5	1	851.0
14. Savings deposits, SA, plus MMDAs, NSA[4]	14.2	16.7	9.1	6.1	-3.0	2	356.9
15. Small time deposits	-0.5	-4.6	-3.1	0.5	9.8	0	494.1
6. M3 minus M2[5]	5.5	0.6	10.3	1.7	4.4	27	650.0
Large time deposits	6.5	-3.0	13.3	12.2	9.3	24	441.1
. At commercial banks, net[6]	6.0	-3.2	16.1	12.6	5.1	34	281.3
19. At thrift institutions	7.4	-2.8	8.5	11.5	16.0	7	159.7
20. Institution-only money market mutual fund shares, NSA	11.1	1.3	3.1	22.7	0.0	35	64.5
21. Term RPs, NSA	5.6	-8.1	35.4	62.9	33.9	0	76.4
22. Term Eurodollars, NSA	-3.7	-4.0	-6.0	-9.0	-43.7	-16	76.8
	-- Average monthly change in billions of dollars --						
MEMORANDA:							
23. Managed liabilities at commercial banks (24+25)	2.4	2.4	5.7	4.0	6.0	9	463.3
24. Large time deposits, gross	0.9	1.2	2.3	2.1	0.5	9	337.1
25. Nondeposit funds	1.5	1.2	3.4	1.9	5.5	0	126.2
26. Net due to related foreign institutions, NSA	0.4	1.3	0.8	-1.7	0.6	3	-27.7
27. Other[7]	1.1	-0.1	2.5	3.6	4.9	-3	153.9
28. U.S. government deposits at commercial banks[8]	0.2	-0.7	1.2	9.6	5.5	0	18.9

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. Figures in parentheses calculated from Q2 1985 base.
3. Nontransactions M2 is seasonally adjusted as a whole.
4. Growth rates are for savings deposits, seasonally adjusted, plus money market deposit accounts (MMDAs), not seasonally adjusted. Commercial bank savings deposits excluding MMDAs decreased during December 1985 and January 1986 at rates of 5.7 percent and 3 percent respectively. At thrift institutions, savings deposits excluding MMDAs decreased during December 1985 at a rate of 2.0 percent and increased during January 1986 at a rate of 5 percent.
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.
Consists of Treasury demand deposits and note balances at commercial banks.
reliminary estimate
—not available.

on January 1 amid uncertainty about the tax-exempt status of issues marketed after that date; the drying up in municipal bond volume resulted in a widely anticipated drop in tax-exempt bond rates.

Borrowing by nonfinancial businesses remained generally strong in January, mainly in the long-term sector, although it retreated from its vigorous year-end pace (which included many tax-exempt bond issues). Only fragmentary evidence is available for household borrowing in January. In the mortgage market, where interest rates were at seven-year lows, borrowing seemed to be maintaining its vigor entering the new year. Also, consumer installment borrowing likely picked up in January with the reintroduction of below-market rates for new-car loans by auto finance companies.

Monetary Aggregates and Bank Credit

Note on the monetary data: Annual benchmark and seasonal factor revisions are in process. The data reported here are on an unrevised basis. A discussion of revisions to the monetary aggregates will be included in the Bluebook.

Expansion in both M1 and M2 abated considerably during January. The slowdown in M1, to a 4 percent annual rate, reflected a runoff of demand deposits, which have been unusually volatile in recent weeks. Meanwhile, growth in currency remained moderate whereas growth in other checkable deposits resumed a strong uptrend, even though the removal on January 1 of the regulatory minimum balance of $1,000 on Super NOW accounts has not boosted OCD inflows appreciably; depository institutions generally have not lowered their required minimum balances to earn rates above the 5-1/4 percent ceiling on regular NOWs.

The deceleration in M2 also was evident in its nontransactions component, where weakness was largely accounted for by a runoff in overnight

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

	1985					1986	Levels in bil. of dollars
	Q2	Q3	Q4	Nov.	Dec.	Jan.p	Januaryp
	Commercial Bank Credit						
1. Total loans and securities at banks	9.3	8.6	11.8	16.4	16.6	17	1922.4
2. Securities	5.5	12.4	19.6	30.8	26.2	25	454.4
3. U.S. government securities	0.0	9.0	-3.5	22.2	-18.8	-29	264.1
4. Other securities	16.1	18.8	61.3	45.7	103.0	109	190.3
5. Total loans	10.4	7.4	9.4	12.0	13.7	15	1468.0
6. Business loans	2.6	2.4	5.5	8.9	8.1	4	495.4
7. Security loans	87.8	-19.0	2.1	-9.5	22.3	160	43.4
8. Real estate loans	12.4	11.2	13.0	13.6	11.5	8	426.1
9. Consumer loans	14.9	11.1	8.8	10.7	11.4	24	292.2
10. All other loans	7.1	12.3	14.3	22.9	34.3	14	211.0
	Short- and Intermediate-Term Business Credit						
11. Business loans net of bankers acceptances	3.6	2.2	5.0	8.4	7.1	3	490.9
12. Loans at foreign branches[2]	17.0	-4.1	-6.2	6.3	-6.2	13	19.3
13. Sum of lines 11 & 12	4.0	2.0	4.5	8.1	6.4	4	510.3
14. Commercial paper issued by nonfinancial firms[3]	33.8	-1.5	55.5	64.6	36.2	-12	87.8
15. Sums of lines 13 & 14	7.9	1.5	11.4	16.0	10.9	1	598.0
16. Bankers acceptances: U.S. trade related[4,5]	-12.2	-1.1	-13.8	-42.0	21.8	n.a.	33.7 (Dec)
17. Line 14 plus bankers acceptances: U.S. trade related	6.7	1.4	9.9	12.6	11.7	n.a.	631.3 (Dec)
18. Finance company loans to business[4]	8.0	3.1	n.a.	27.3	n.a.	n.a.	148.4 (Nov)
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	6.9	1.5	n.a.	15.6	n.a.	n.a.	773.6 (Nov)

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

RPs that accompanied a reduction in holdings of government securities by commercial banks. Overall inflows of retail deposits ebbed a bit in January owing to minimal gains at thrift institutions. At both commercial banks and thrifts the more liquid MMDAs and savings accounts strengthened, but inflows to small time deposits slowed.

M3 growth in January remained at December's 7 percent annual rate despite the deceleration in M2. The strength in its non-M2 component was concentrated in issuance of large time deposits by commercial banks. By contrast, growth in large time deposits at thrifts slackened in January. S&Ls had augmented their retail deposits in December by selling CDs and borrowing about $1 billion from their FHLBs; some of these funds were used to accumulate liquid assets. FSLIC-insured institutions appear to have been seeking to raise temporarily the level of their liabilities at year-end because any required additions to net worth in 1986 will be based on the growth in an institution's liabilities from the end of 1985.

Total bank credit advanced at a 17 percent annual rate in January as the month-average level was swelled by late-December acquisitions of tax-exempt assets in anticipation of changes in tax laws. Purchases of tax-exempt bonds again boosted growth of the "other securities" category to an annual rate exceeding 100 percent in January, more than offsetting a sharp decline in holdings of U.S. government securities.

Lending by banks quickened in January, spurred substantially by year-end acquisitions of nonrated industrial development bonds, classified as loans to states and municipalities, and included in "all other loans" in the table. Consumer loans advanced at an estimated 24 percent annual rate, and security loans also increased sharply, but growth in real estate loans

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

	1984	1985	1985				1986
	Year	Year^p	Q3	Q4^p	Nov.^p	Dec.^p	Jan.^p
Corporate securities - total[1]	9.88	15.99	15.56	19.05	17.80	20.73	20.30
Public offerings in U.S.	8.00	12.84	12.65	14.62	13.53	18.80	15.80
Stocks--total[2]	1.89	2.91	3.02	3.14	2.63	4.50	2.80
Nonfinancial	1.08	1.60	1.53	1.76	1.35	2.70	1.80
Utility	.22	.35	.19	.27	.04	.20	.30
Industrial	.86	1.25	1.34	1.49	1.31	2.50	1.50
Financial	.81	1.31	1.49	1.38	1.28	1.80	1.00
Bonds--total[1]	6.11	9.93	9.63	11.48	10.90	14.30	13.00
By industry							
Nonfinancial	2.80	5.20	4.86	6.02	6.35	6.95	6.10
Utility	.87	1.51	1.60	2.28	1.34	3.60	1.40
Industrial	1.93	3.69	3.26	3.74	5.01	3.35	4.70
Financial	3.31	4.73	4.77	5.46	4.55	7.35	6.90
By quality[3]							
Aaa and Aa	1.85	2.31	2.58	2.65	2.21	3.26	2.70
A and Baa	2.11	4.58	3.81	5.18	5.12	6.79	4.30
Less than Baa	1.09	1.41	1.35	1.72	2.15	2.14	4.00
No rating (or unknown)	.25	.33	.24	.37	.17	.47	.30
Memo items:							
Equity based bonds[4]	.63	.70	.84	.38	.66	.24	1.19
Mortgage-backed bonds	.81	1.30	1.65	1.56	1.25	1.64	1.70
Variable-rate notes	.72	.86	.41	.55	.72	.45	.35
Bonds sold abroad - total	1.88	3.15	2.91	4.43	4.27	1.91	4.50
Nonfinancial	.84	1.26	1.23	1.73	1.18	1.15	1.50
Financial	1.04	1.89	1.68	2.70	3.09	.76	3.00

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 that entitle the holder to purchase equity in the future.

moved down to an 8 percent rate and business loans expanded at only a 4 percent rate in January.

Business Finance

Borrowing by nonfinancial businesses, though dropping below its year-end pace, remained strong in January, with the bulk of the financing continuing to be concentrated in long-term markets. Businesses late last year were taking advantage of lower long-term interest rates to lengthen the maturity of their debt, a pattern that apparently carried over into January. A persistent flood of share retirements also has kept longer-term business borrowing high despite a relatively small margin of capital expenditures over internally generated funds.

Short-term borrowing, in contrast, has weakened progressively since November; the total of business loans at banks and commercial paper was about unchanged in January. In addition, borrowing by state and local authorities for the benefit of businesses dried up in January after an enormous year-end surge to beat the effective date under proposed legislation for new restraints on tax-exempt debt issuance.

Although offerings by nonfinancial corporations edged down during January, total public offerings of taxable U.S. corporate bonds here and abroad surpassed the very strong December volume. With the uptick in U.S. rates early in the month, some activity shifted back to the Euromarket where rate movements typically lag the domestic market. In addition to a few large banks and insurance companies, the finance subsidiaries of the auto companies tapped the Euromarkets in January.

In equity markets, broad stock price indexes have fluctuated considerably, partly in sympathy with bond rates. Most recorded new highs in

TREASURY AND AGENCY FINANCING[1]
(Total for period; billions of dollars)

	1985			1986	
	Q4	Nov.	Dec.	Q1[f]	Jan.[p]
Treasury financing					
Combined surplus/deficit(-)	-75.2	-33.4	-14.7	-64.8	-4.5
Means of financing deficit:					
Net cash borrowing from the public	90.6	45.9	33.4	37.3	12.7
Marketable borrowings/ repayments(-)	63.3	39.5	17.2	35.8	12.2
Bills	15.7	7.9	2.3	-4.8	-.3
Coupons	47.6	31.6	14.9	40.6	12.5
Nonmarketable	27.3	6.4	16.2	1.5	.5
Decrease in the cash balance	-13.8	-8.3	-20.8	21.5	-9.3
Memo: Cash balance at end of period	30.9	10.1	30.9	9.4	40.2
Other[2]	-1.6	-4.2	2.1	6.0	1.1
Federally sponsored credit agencies, net cash borrowing[3]	6.3	-.5	1.5	2.7	-1.5
FHLBs	2.1	.7	1.0	1.0	-1.1
FNMA	2.2	2.0	-.7	2.5	.8
Farm Credit Banks	2.5	-1.2	.7	-2.5	-1.8
FHLMC	-1.2	-2.2	.5	1.0	.4
SLMA	0.7	.2	.0	.7	.2

p--preliminary. f--staff forecast.
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.

December and again in early January, then climbed to still higher levels in the first days of February. The upward movement of share prices in December had helped to lift new equity issues to their largest monthly volume of 1985; equity issues waned in mid-January when share prices dipped temporarily, but still posted a fairly strong month.

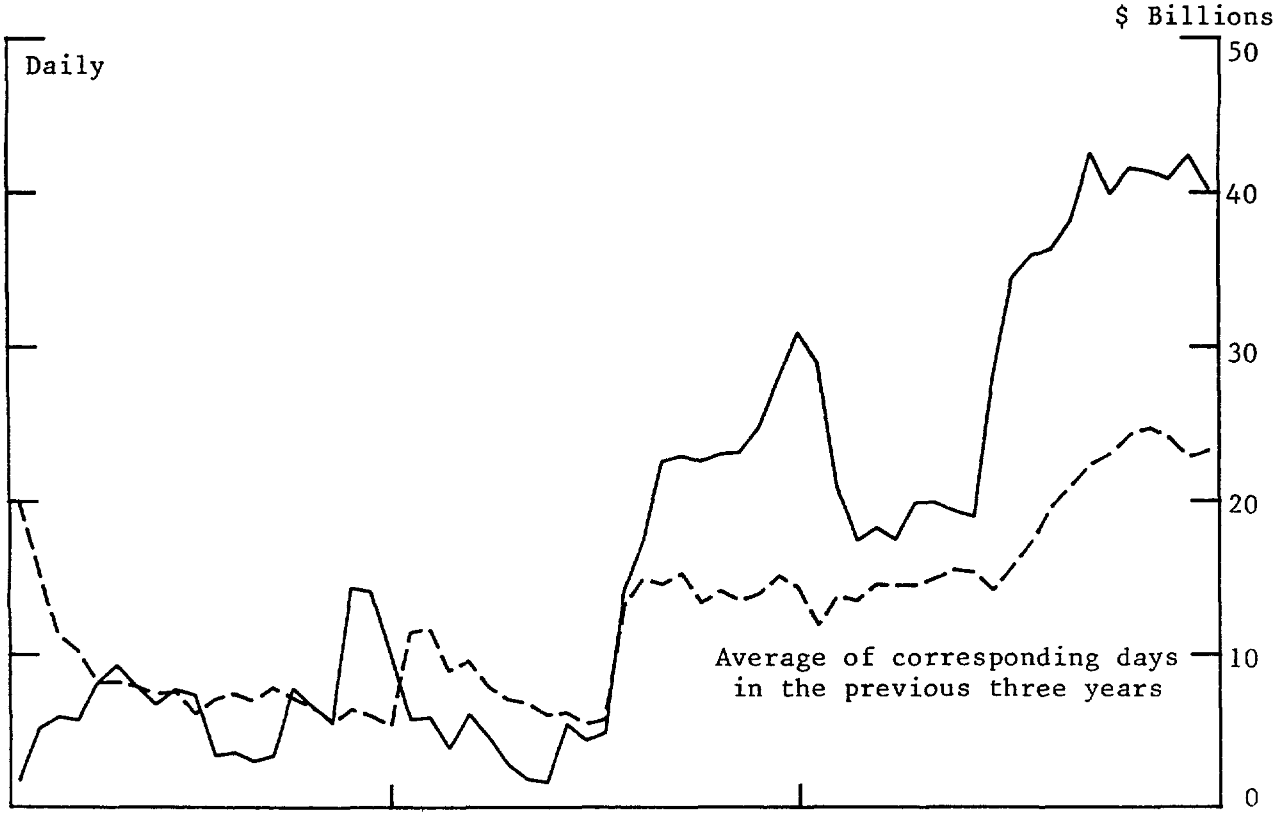
Stock prices of S&Ls have been especially strong recently, increasing about 19 percent since the beginning of the year, after an advance of nearly 90 percent in 1985. Most of the gains in S&L share prices last year occurred in the fourth quarter as many institutions reported higher-than-expected earnings and the outlook for interest rates was viewed favorably. Share prices of energy concerns and banks with large foreign lending have moved counter to the stock market as a whole recently, depressed mainly by oil price developments; some large banks also posted relatively poor earnings. The AMEX composite index, about one-fourth of which represents energy firms, is down slightly from its level at the time of the last FOMC meeting and nearly 4 percent from its January high.

Treasury and Federally Sponsored Agency Finance

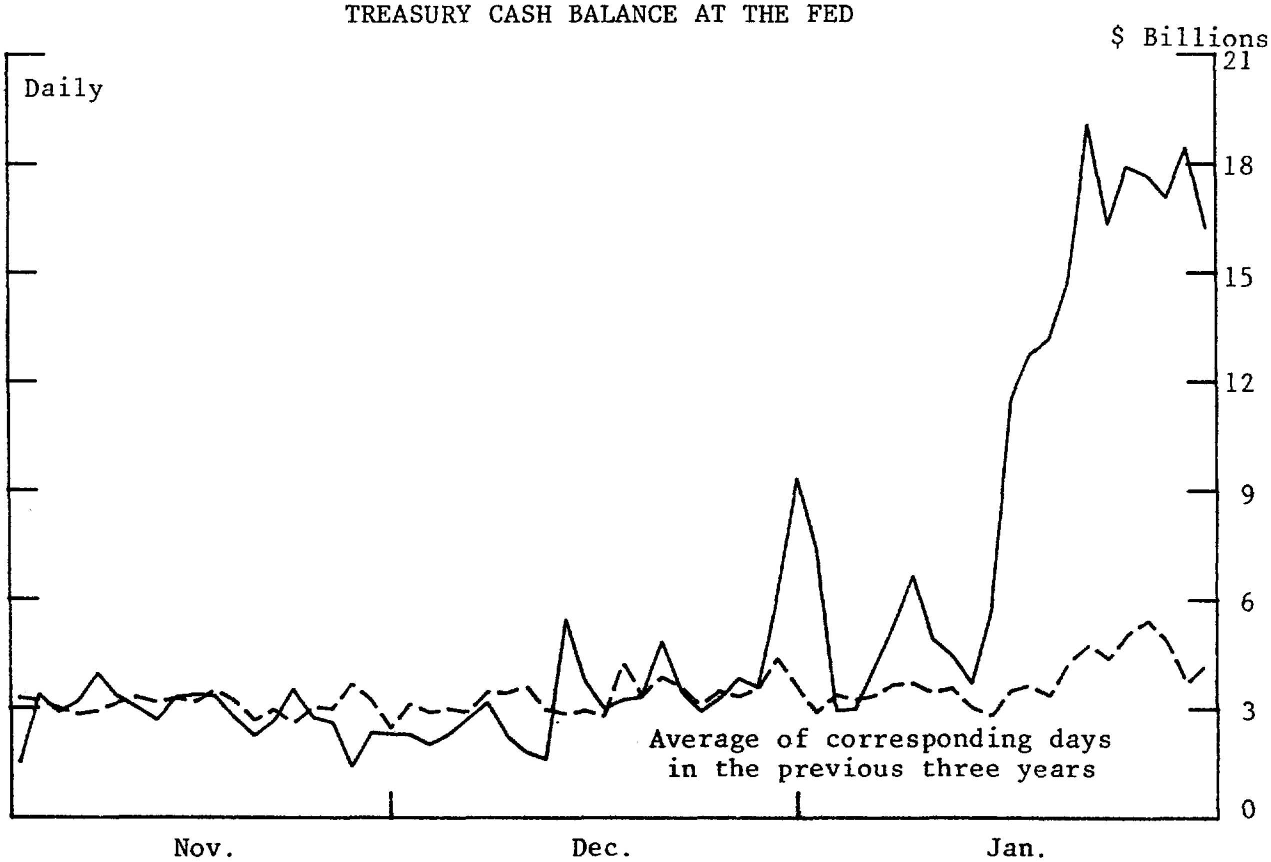
The staff is projecting the federal government's combined deficit for the current quarter to be about $65 billion, compared with $75 billion the previous quarter. To help finance this deficit, the Treasury is expected to borrow roughly $37 billion, net, and to draw down its cash balance by about $22 billion.

The Treasury will raise about $41 billion, or more than the total amount of net new money, in auctions of marketable coupon issues. An important contribution to this volume will be $14-1/4 billion of net funds raised in the mid-quarter financing, plus up to $1 billion in a special

TOTAL TREASURY CASH BALANCE



TREASURY CASH BALANCE AT THE FED



foreign-targeted 10-year note, the fourth such Treasury issue. Because it started the year with a large cash balance, the Treasury has reduced the gross size of the regular weekly bill auctions, which resulted in the beginning of a modest paydown in late January that will be augmented by a runoff of cash management bills that mature this quarter. The Treasury's total cash balance, and consequently its balance at Federal Reserve Banks, reached an exceptionally high level last month as a result of record issuance in December of nonmarketable securities to state and local governments, followed by sizable tax receipts in mid-January.[1] The large and rising cash balance has complicated reserve management and probably contributed to some upward pressure on the federal funds rate.

Borrowing by the federally sponsored credit agencies was curtailed somewhat in the fourth quarter by a $1-1/4 billion paydown in debt by the Federal Home Loan Mortgage Corporation. Freddie Mac was able to reduce its borrowing in the market last quarter because it sold back to the Financial Corporation of America some of the mortgages it had purchased when that troubled firm was unable to raise funds through regular market channels. Agency borrowing may be slowing substantially further in the current quarter, as the FHLBs and the Farm Credit Banks together reduced their outstanding debt by about $3.0 billion in January.

Spreads between rates on sponsored-agency securities and on Treasury securities have narrowed significantly in recent weeks. With the December passage of the financial aid bill for the Farm Credit Banks reaffirming

1. The Treasury's total cash balance surged to a bit above $40 billion in mid-January when auctions of 7-year notes and 20-year bonds settled. The balance will be on a downtrend over most of the rest of the quarter, falling to a low in early March in the neighborhood of $10 billion (the mid-quarter financing will be largely offset by mid-quarter interest payments).

the government's commitment to the sponsored agencies, investors became considerably less concerned about the credit quality of agency securities. The most recently priced six-month security of the Farm Credit Banks had a spread over Treasury securities of about 35 basis points; last fall, the six-month Farm Credit security carried a premium of about 100 basis points; nevertheless, current spreads on Farm Credit securities still are much wider than those that existed before the financial problems of the Farm Credit Banks became widely recognized. In contrast, spreads on the securities of the other sponsored agencies have returned to the margins that existed before credit quality reemerged as an issue last year.

Tax-Exempt Market

The tax-exempt securities market has been characterized in recent months by great uncertainty concerning prospects for tax reform legislation. The primary questions center on what types of municipal bonds will lose their tax-exempt status--and when--if a reform law is enacted. The House-passed bill, for instance, has a retroactive effective date of January 1, 1986. As a result of the uncertainties, offerings of municipal bonds totaled only $2-1/2 billion in January, down dramatically from the frenetic average monthly volume of nearly $30 billion in the fourth quarter of last year.

Virtually no private-purpose bonds were offered in January. The House bill would place all private-purpose issues under a state-by-state volume limitation that would constrain total offerings to just over $40 billion in 1986. Sales of these bonds totaled $62 billion in 1984 and, boosted by anticipatory financings, may have reached $95 billion in 1985. The proposed legislation leaves unclear which issuers could come to the market under the tightened constraints.

Although public-purpose bonds would not be subject to volume limits under the House bill, issuance of these bonds apparently has been curtailed because of other restrictions in the bill; for example, issues designed to earn arbitrage profits could be stripped of their tax-exempt status. As a result, some offerings have been withdrawn. Others have been accompanied by special legal "side opinions" assuring investors that the issuer will take any necessary action to comply with the provisions of the House bill. In addition, some market participants fear that a new, more restrictive bill retaining the January 1, 1986, effective date may emerge from the Senate.

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

	1984	1985	1985				1986
	Year	Year[p]	Q3	Q4[p]	Nov.	Dec.[p]	Jan.[e]
Total	10.60	17.78	16.30	29.55	30.65	36.00	3.30
Short-term[1]	1.71	1.98	2.68	.97	.70	1.00	.80
Long-term	8.89	15.80	13.62	28.58	29.95	35.00	2.50
Refundings[2]	1.05	4.58	4.20	8.35	10.25	8.00	--
New capital	7.84	11.22	9.42	20.23	19.70	27.00	--
Total housing	1.69	1.97	2.23	1.98	2.70P	2.60	--
Single-family[3]	1.12	.97	.96	.98	.90P	.80	--

p--preliminary.
e--staff estimate.
1. Does not include tax-exempt commercial paper.
2. Includes all refunding bonds, not just advance refundings.
3. Data from the Department of Housing and Urban Development.

Facing such uncertainties, investors have begun to require premiums on new issues of 20 to 50 basis points above yields in the secondary market for comparable 1985 issues. Even so, the Bond Buyer revenue bond index has declined about 145 basis points from its peak in late September, and now

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

					Memo:	
Period	Total	GNMAs	FHLMCs	FNMAs	FNMA and FHLMC swap issues	Total issues less swaps
1985-Q1	6.4	2.7	2.4	1.3	3.0	3.4
Q2	7.5	3.3	2.8	1.5	3.3	4.2
Q3	10.4	4.1	3.8	2.5	4.7	5.7
Q4 p	11.5	5.2	3.6	2.7	4.6	6.9
1985-Mar.	6.6	2.8	2.8	1.1	3.3	3.3
Apr.	6.4	2.6	2.0	1.9	3.3	3.1
May	7.8	3.6	3.2	1.0	3.2	4.6
June	8.4	3.6	3.3	1.5	3.5	4.9
July	9.6	3.9	4.2	1.5	4.1	5.5
Aug.	9.1	4.2	2.7	2.2	3.9	5.2
Sep.	12.6	4.4	4.5	3.7	6.1	6.5
Oct.	11.1	5.8	3.1	2.2	3.8	7.3
Nov. r	11.2	5.3	3.4	2.5	4.3	6.9
Dec. p	12.1	4.5	4.3	3.4	5.8	6.3

r--revised. p--preliminary.

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

	Mortgage commitments		Net change in mortgage assets[1]		
	New (1)	Outstanding[2] (2)	Total (3)	Mortgage loans (4)	Mortgage-backed securities (5)
1985-Jan.	16.9	69.1	3.5	4.3	-.9
Feb.	16.1	68.5	3.2	2.5	.6
Mar.	16.0	67.7	5.1	5.0	.1
Apr.	16.5	66.1	4.1	4.9	-.8
May	16.8	65.5	1.7	2.9	-1.2
June	16.3	66.1	-2.2	2.7	-5.0
July	18.1	66.6	2.6	4.8	-2.2
Aug. r	21.3	64.8	8.1	5.4	2.7
Sept.r	21.5	66.1	9.4	4.4	5.0
Oct. r	22.8	65.8	5.1	6.2	-1.2
Nov. r	19.8	66.5	3.2	3.4	-.1
Dec. p	20.0	67.3	5.2	5.5	-.2

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.
r--revised. p--preliminary.

stands 67 basis points below its level just prior to the last FOMC meeting. The G.O. index is 52 basis points below its level in mid-December.

Mortgage Markets

Continuing the decline that began in early November, mortgage rates in the primary market have edged down further on balance since the December FOMC meeting. As a result, the nominal cost of home mortgage credit is near its lowest level in seven years. Commitments for conventional 30-year fixed-rate mortgages at savings and loans were available at contract rates averaging a little less than 11 percent in late January. One-year adjustable-rate mortgages at a subsample of these institutions were being offered at initial rates of just under 9 percent.

The decline in mortgage interest rates during the fourth quarter contributed to continued robust growth in mortgage debt. Preliminary figures indicate an 11 percent annual rate of expansion for total (residential plus nonresidential) mortgage debt, in line with the pace in each of the previous several quarters. Partial data suggest continuation of this growth rate into the new year.

Mortgage pooling remained vigorous during the fourth quarter, amounting to one-half of the overall growth in residential mortgage debt. Issuance of pass-through securities rose for the sixth consecutive quarter to a record volume, and showed additional strength in January. Newly issued GNMAs have been accounting for nearly half the total pass-through issuance. Originations of FHA/VA single-family loans--the bulk of which are sold into GNMA pools--doubled their year-earlier volume in the second half of 1985, responding in part to tightened qualification standards in the conventional market and increased private insurance premiums for high loan-to-value loans.

CONSUMER INSTALLMENT CREDIT

	1984	1985p	1985 Q3	1985 Q4p	1985 Oct.	1985 Nov.	1985 Dec.p
	Percent rate of growth, SAAR						
Change in outstandings--total	20.0	19.8	18.8	14.5	19.3	10.8	13
By type:							
Automobile credit	20.6	21.8	24.5	12.4	22.4	6.5	8
Revolving credit	23.9	22.7	14.1	22.4	22.2	27.9	16
All other[1]	17.5	16.5	15.8	12.4	14.8	6.0	16
	Billions of dollars, SAAR						
Change in outstandings--total	76.8	89.6	94.0	75.8	101.0	57.5	69
By type:							
Automobile credit	29.5	37.5	47.1	25.2	45.5	13.4	17
Revolving credit	19.6	21.5	15.1	24.7	24.5	31.4	18
All other[1]	27.8	30.5	31.9	25.9	31.0	12.7	34
By major holder:							
Commercial banks	40.4	38.9	29.3	32.6	34.4	37.7	26
Finance companies	9.3	24.5	41.6	18.0	37.7	6.6	10
All other	27.1	26.2	23.0	25.1	29.0	13.2	33
	Annual percentage rate						
Interest rates							
At commercial banks[2]							
New cars, 48 mos.	13.71	12.91	12.72	12.39	n.a.	12.39	n.a.
Personal, 24 mos.	16.47	15.94	15.84	15.61	n.a.	15.61	n.a.
Credit cards	18.77	18.70	18.62	18.57	n.a.	18.57	n.a.
At auto finance companies[3]							
New cars	14.62	11.98	10.72	11.40	9.97	11.71	12.52
Used cars	17.85	17.59	17.46	17.24	17.21	17.28	17.22

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

FHLMC and FNMA also issued large amounts of pass-throughs during the final quarter of 1985. As has been the case for some time, most Freddie/Fannie issues were swaps in which lenders trade their mortgages for FHLMC or FNMA securities representing ownership shares in pools of the same loans.

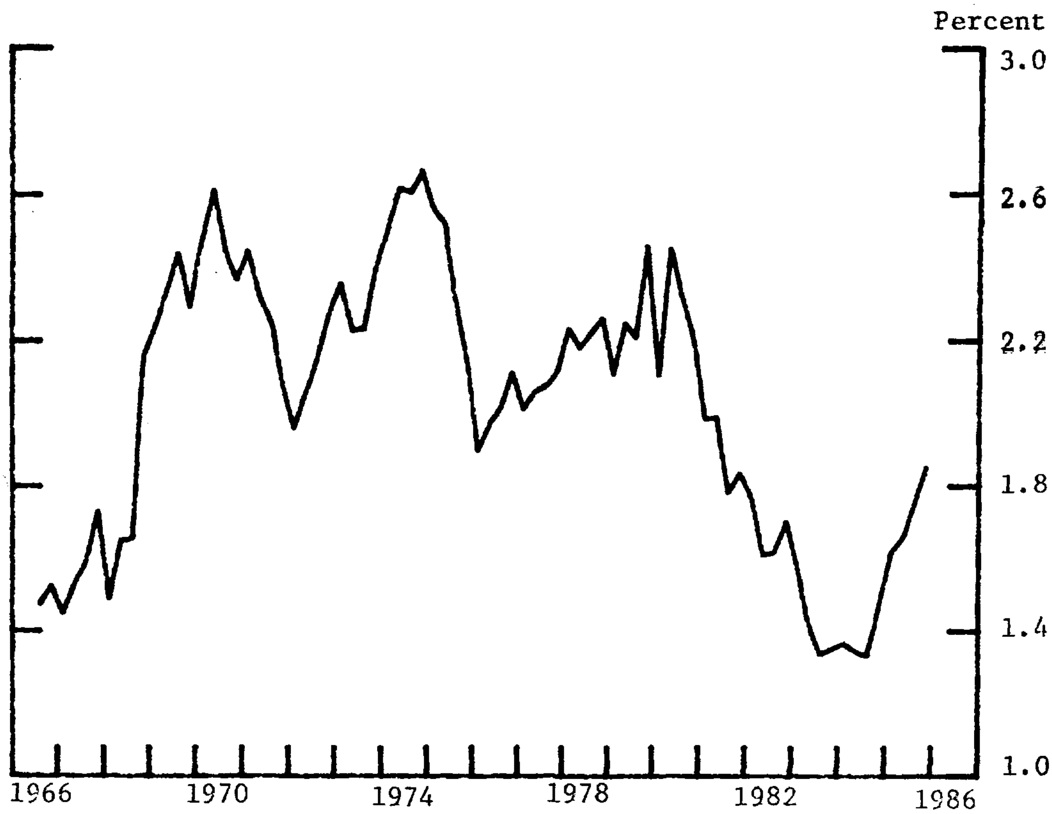
The continuing popularity of the mortgage swap programs is attributable in part to declining interest rates, which have made seasoned loans more attractive assets to sell because many of them now trade at or above par. Swaps are being used by mortgage holders to increase the market appeal of these loans further by adding the credit enhancement of a guarantee by Freddie Mac or Fannie Mae. In addition, some mortgage bankers are swapping mortgages for securities and then selling the securities, essentially using the swap programs as alternatives to outright loan sales to the agencies. A recent spur to swap activity has been a competition-induced reduction of 5 to 10 basis points in the fees charged by FNMA and FHLMC to guarantee their securities.

Consumer Installment Credit

Consumer installment credit is estimated to have risen at a 13 percent annual rate in December, a bit above the reduced November pace, and contributing to a gain for the full year of just under 20 percent. Revolving credit at commercial banks increased sharply in December, owing in part to aggressive promotion of this type of lending. With bank lending to consumers reportedly strong in January, and new reduced-rate financing programs in place at the captive auto finance companies, consumer credit growth likely quickened further in January.

Reflecting curtailment of incentive financing programs, total auto credit growth slowed to an average annual rate of about 7 percent in

AUTO LOANS DELINQUENT 30 DAYS OR MORE
AT AUTO FINANCE COMPANIES



November and December, but the increase was 22 percent for the year as a whole. The surge in auto debt last year was accompanied by a rise in car loan delinquencies at the three captives from about 1.45 percent of the number of loans outstanding in 1984-Q4 to about 1.85 percent in 1985-Q4; however, the latest reading is well below earlier peaks and even below the average of the past 20 years. Repossession rates edged up during 1985 but also were quite low relative to the past.

After a round of incentive plans ended in early October, the average interest rate charged on a new-car loan by the captive finance companies rebounded sharply from 8.9 percent in September to 12.5 percent in December, about where it was just prior to the late-August introduction of the programs. More recently, these companies have reinstated concessionary finance rates for cars that constitute about half their product line. The rate on a four-year loan at commercial banks in November was 12.4 percent.

A secondary market in auto loans consisting of securities backed by pools of seasoned loans began to develop during the past year. The first issue of such certificates, by a large bond underwriter on behalf of a commercial bank, was quite small and there were few further immediate moves into the field. However, in December GMAC offered about $525 million in certificates backed by a portfolio of its auto loans, and followed that with another $425 million package in January. GMAC has been pricing these certificates, whose expected maturities are just under two years, at about 65 basis points above two-year Treasuries. It expects to offer about $500 million each quarter.

INTERNATIONAL DEVELOPMENTS

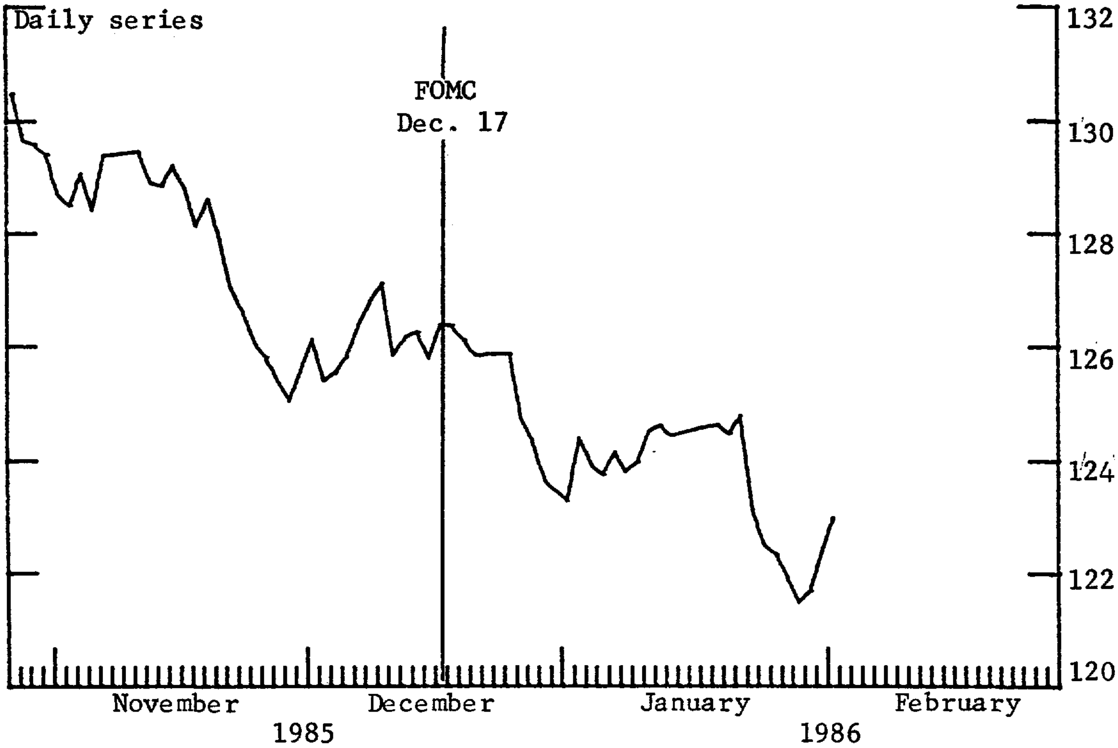
Foreign Exchange Markets

Since the last FOMC meeting, the weighted-average foreign-exchange value of the dollar has declined 2-1/2 percent, as depicted in Chart 1. This move brought the dollar's cumulative decline since the G-5 announcement on September 22 to 12-1/2 percent. During the intermeeting period, the dollar has displayed disparate movements against individual foreign currencies -- shown in the lower panel of Chart 1 -- appreciating 3-1/2 percent in terms of sterling, while declining 4 percent and 5 percent against the mark and yen, respectively.

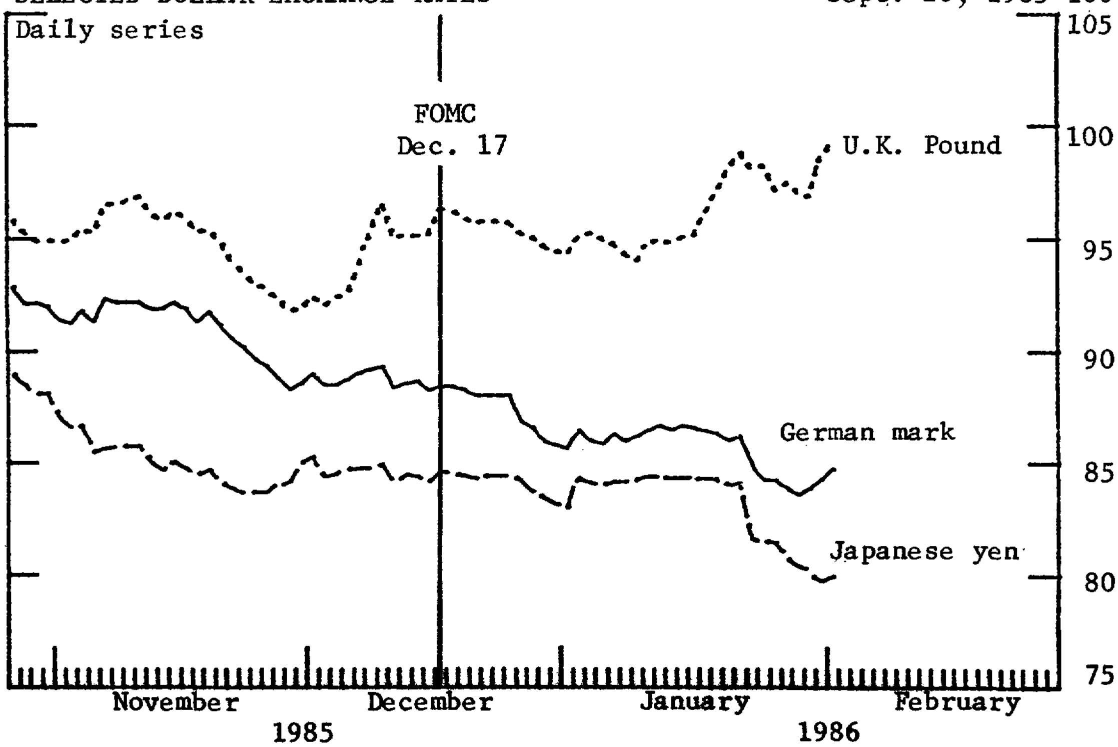
Changes in expectations about the likelihood of a U.S. or a Japanese discount rate cut were the dominant factors influencing the dollar during the intermeeting period. The dollar moved lower after mid-December in association with further declines in U.S. long-term interest rates as market participants reportedly assessed that U.S. monetary conditions were easing and that the Federal Reserve would soon lower its discount rate. The release in early January of stronger-than-anticipated U.S. economic statistics for December dampened expectations of a cut in the discount rate and the dollar firmed somewhat. Meanwhile, statements by Bank of Japan Governor Sumita indicating that he would like to see the yen stabilize, and a Japanese proposal that the G-5 undertake a concerted reduction in interest rates bolstered expectations of a cut in the Japanese discount rate. The Bank of Japan did lower its discount rate from 5.0 to 4.5 percent, effective January 30; the action had been so widely anticipated, however, that it already was incorporated in exchange rates. In late January, the dollar eased

Chart 1 Strictly Confidential (FR)
Class II - FOMC
2/5/86

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR March 1973=100



SELECTED DOLLAR EXCHANGE RATES Sept. 20, 1985=100



somewhat as the tone of official statements shifted to indicate that a further moderate depreciation in the dollar might be acceptable. In addition, some market participants reportedly conjectured that the Federal Reserve and, possibly, the Bundesbank would follow Japan's lead and lower their discount rates.

With respect to individual foreign currencies, sterling depreciated about 3-1/2 percent against the U.S. dollar during the intermeeting period in response to falling oil prices. Since the last FOMC, the price of North Sea Brent crude has dropped about $10, while the British government has indicated that it is unwilling to restrict production in concert with other oil-producing nations to shore up oil prices. Sterling's decline was interrupted briefly during the week of January 6 when the Bank of England boosted its money market dealing rates by 1-1/8 percentage points to 12-1/2 percent to counter the selling pressure on the pound.

Among the currencies of other major exporters of oil, the Venezuelan bolivar has depreciated about 21 percent in terms of the U.S. dollar during the intermeeting period. Despite the weakness in oil prices, the Mexican peso has firmed somewhat against the dollar in private markets, perhaps reflecting in part ongoing direct investment inflows from international automobile manufacturers under previous commitments, as well as continuing monetary restraint. The Norwegian krone has eased somewhat against the major European currencies, although it has appreciated vis-a-vis the dollar.

The Canadian dollar continued to weaken during the intermeeting period, depreciating 3 percent further against the U.S. dollar. The downward pressure on the Canadian dollar has been attributed to three factors; the perceived lack of progress in reducing the federal budget deficit, the expectation of a continued deterioration in Canada's trade and current account surpluses, and the assessment that domestic financial markets are still fragile. Canadian monetary authorities have responded by increasing central-bank lending rates. Since the last FOMC meeting, Canadian short-term interest rates have risen nearly 200 basis points.

. Furthermore, other measures were taken in support of the strained currencies. Belgium and Ireland raised official money market lending rates and Italy reinstituted credit and exchange controls and tightened monetary conditions.

In commodity markets, the dollar price of gold spurted to about $360 an ounce in mid-January in conjunction with increased tensions in the Middle East following the freeze on Libyan assets in the United States, official statements indicating that a coordinated reduction in interest rates would be proposed at the G-5 meeting, and reports of purchases of bullion by Japan to mint a commemorative coin. Since then, gold prices have retraced most of their rise and now stand at about $335 an ounce, as the drop in oil prices has led to a more favorable outlook for inflation.

U.S. International Financial Transactions

Private foreign purchases of U.S. securities were very large during October and November, at a time when the foreign exchange value of the dollar was declining. Net purchases of U.S. corporate bonds totaled almost $13 billion and net purchases of U.S. Treasuries were more than $5 billion. (See lines 2A and 3 of the Summary Table of U.S. International Transactions.)

During October there were also substantial capital inflows reported by banks which were only partially reversed in November. (See line 1.) Over half the net bank inflow during the two months was accounted for by a single U.S. bank owned by a foreign bank, which substantially restructured its balance sheet by selling almost all its claims on developing countries to its foreign parent. U.S. bank claims on public borrowers and other nonbanks in Latin America fell as a result of the asset sale, with a corresponding increase in exposure on the books of foreign banks.

For the first eleven months of 1985 as a whole, the largest increase in U.S. net capital flows occurred in the form of foreign private purchases of U.S. corporate securities; these net purchases totalled more than $40 billion and consisted almost entirely of Eurobonds. Bank holding companies were heavy issuers, accounting for about one-quarter of this total; the bulk of the bank issues were floating rate notes. As several large banks approached ceilings on the funds raised through the issue of mandatory convertible notes that could be counted as capital for regulatory purposes, the volume of new mandatory convertible notes fell from 1984 rates.

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

	1983	1984	1984				1985					
	Year	Year	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Sept.	Oct.	Nov.
Private Capital												
Banks												
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	13.4	21.7	12.7	0.7	9.6	-1.2	15.7	-0.9	8.1	-4.4	9.4	-3.5
Securities												
2. Private securities transactions, net	1.6	7.6	2.1	-0.3	0.3	5.6	7.0	4.9	10.0	3.5	4.3	9.7
a) foreign net purchases (+) of U.S. corporate bonds	2.2	13.8	0.5	0.6	2.6	10.1	10.6	6.7	10.3	4.0	4.5	8.4
b) foreign net purchases (+) of U.S. corporate stocks	6.4	-0.8	1.0	-0.1	-1.0	-0.7	-1.1	0.4	1.4	0.1	0.6	1.4
c) U.S. net purchases (-) of foreign securities	-7.0	-5.4	0.6	-0.8	-1.3	-3.8	-2.5	-2.2	-1.7	-0.6	-0.8	-0.1
3. Foreign net purchases (+) of U.S. Treasury obligations 1/	8.3	23.0	1.9	6.6	5.1	9.4	2.2	5.1	7.5	7.5	1.4	3.9
Official Capital												
4. Changes in foreign official reserve assets in U.S. (+ = increase)	5.2	2.6	-3.1	-0.7	-0.6	7.0	-10.6	7.9	2.5	-0.9	-2.0	1.5
a) By area												
G-10 countries (incl. Switz.)	6.4	3.1	2.3	-0.7	-0.8	2.2	-5.5	6.1	2.4	-2.1	-1.5	1.7
OPEC	-8.5	-5.4	-2.8	-2.5	-0.7	0.6	-1.6	-2.0	-2.0	-0.8	-0.5	-1.0
All other countries	7.3	4.9	-2.7	2.5	0.8	4.3	-3.5	3.9	2.1	1.9	*	0.8
b) By type												
U.S. Treasury securities	7.0	4.7	-0.3	-0.3	-0.6	5.8	-7.2	8.7	-0.1	-3.4	-3.3	-0.3
Other 2/	-1.7	-2.1	-2.8	-0.5	*	1.2	-3.5	-0.8	2.6	2.5	1.3	1.9
5. Changes in U.S. official reserve assets (+ = decrease)	-1.2	-3.1	-0.7	-0.6	-0.8	-1.1	-0.2	-0.4	-0.1	-0.2	-2.9	-0.3
Other transactions (Quarterly data)												
6. U.S. direct investment (-) abroad	-4.9	-4.5	-4.1	1.5	2.1	-4.0	0.7	-5.3	-6.1	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	2.1	6.7	5.6	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) 3/ 4/	-4.4	7.1	1.1	5.7	0.7	-0.4	-4.8	5.5	-3.4	n.a.	n.a.	n.a.
9. U.S. current account balance 4/	-46.0	-107.4	-17.5	-28.6	-32.3	-29.0	-23.4	-27.9	-34.1	n.a.	n.a.	n.a.
10. Statistical discrepancy 4/	16.7	30.5	4.3	6.4	10.7	9.0	11.3	4.4	10.0	n.a.	n.a.	n.a.
MEMO:												
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-67.2	-114.1	-24.6	-29.6	-29.0	-30.9	-23.5	-28.6	-33.1	n.a.	n.a.	n.a.

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.

Almost $9 billion (about one-quarter) of the Eurobonds issued by U.S. corporations in 1985 were foreign currency denominated or dual currency, up sharply from 1984, when foreign currency issues were $3 billion (14 percent). While it is possible that this increase reflects a shift in investor demand as a result of changing expectations about the exchange value of the dollar, it is also likely that, with the cost of hedging currency risk down on account of broadened swap markets, U.S. corporations are becoming increasingly willing to issue obligations not denominated in dollars. Virtually all foreign currency issues by U.S. corporations in 1985 involved swaps.

Information on the ultimate purchasers of Eurobonds issued by U.S. corporations in 1985 is not available; the reporting system usually indicates sales to the United Kingdom, the location of the intermediaries underwriting the issues.

Net sales of U.S. Treasury securities to private foreigners in the first eleven months of 1985 were at about the record rate reached in 1984. Of the $20 billion purchased by private foreigners, $17 billion was purchased by Japanese residents, up from $4.5 billion in 1984. Treasury issues specially targeted for foreigners amounted to only $1 billion of the total in 1985. Another specially targeted issue of up to $1 billion was announced for February 5, 1986.

Bank reported inflows were also substantial in the first eleven months of 1985, totalling almost $29 billion. (See line 1.) One major factor in these net inflows was the contraction in bankers acceptance business (BAs) done with foreign customers; many banks, under pressure to improve capital adequacy, cut back on BAs and other assets with low profit margins. Data available through September indicate that claims on foreigners declined by almost $7 billion as a result of the decline in BAs outstanding. Another factor in the net bank inflow was a $6 billion increase in liabilities to private nonbanks, particularly from Latin America; at least a couple of billion of this total probably represents the accumulation of interest on existing deposits, rather than new capital flight. In addition there were substantial net inflows from own foreign offices, reversing the large outflow that had occurred on the last day of 1984.

In another bank-related development, loan sales by U.S. banks to foreign banks expanded rapidly in 1985, and, because of reporting gaps, probably contributed to the large positive statistical discrepancy in the international accounts to the extent that foreign banks booked these claims on U.S. residents outside the United States. The rapid expansion of loan sales to foreign banks and the need for increased funding when these loans were booked at U.S. offices also probably was a factor in the increased borrowing of agencies and branches of foreign banks from their related foreign offices during 1985. (See the International Banking Data table, line 3a).

Foreign official assets in the United States were virtually unchanged in the first eleven months of 1985. A decline in holdings of the OPEC countries ($7 billion) was almost matched by increases elsewhere. Despite massive intervention sales of dollars by the G-10 countries in 1985, their holdings of official assets in the United States increased somewhat in the first eleven months of 1985. U.S. holdings of official reserve assets increased by almost $4 billion, largely as the result of intervention purchases of foreign currencies in October.

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1981	1982	1983	1984	1985					1986
	Dec.	Dec.	Dec.	Dec.	Mar.	June	Sept.	Nov.	Dec.	Jan. 3/
1. Net Claims of U.S. Banking Offices (excluding IBFs) on Own Foreign Offices	7.8	32.9	39.3	25.4	26.0	27.6	22.4	20.3	18.9	n.a.
2. Net Claims of U.S. Banking Offices on Own IBFs 1/	11.8	16.2	5.2	7.8	6.1	8.1	9.1	9.4	10.1	n.a.
3. Sum of lines 1 and 2 of which:	19.6	49.1	44.5	33.2	32.1	35.7	31.5	29.7	29.0	24.6
(a) U.S.-chartered banks	22.3	40.0	40.5	32.1	30.6	33.4	31.5	31.1	32.4	30.5
(b) Foreign-chartered banks	-2.6	9.1	4.0	1.1	1.6	2.2	*	-1.4	-3.4	-5.9
4. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	13.2	15.8	18.6	20.7	19.2	20.2	19.5	19.5	18.7	18.2
5. Eurodollar Holdings of U.S. Nonbank Residents 2/	95.5	112.6	124.3	117.5	118.9	109.5	114.6	110.5	112.0	113.7

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 January 20, 1986.
*/ Less than 50 million (+).
Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactionsaccounts. 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 byU.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.

U.S. Merchandise Trade

The merchandise trade deficit rose in the fourth quarter and brought the deficit for the year as a whole to a record level. The staff estimates that on a revised international transactions basis the fourth-quarter deficit was $145 billion, SAAR, and for 1985, the deficit was nearly $125 billion. These data are subject to revision.

The value of exports increased slightly in the fourth quarter from third-quarter levels. Agricultural exports picked up slightly, supported by renewed shipments of corn to the Soviet Union and increased exports of soybeans; U.S. exporters of soybeans were able to take advantage of shortages of Brazilian soybeans and supply third markets. For the year as a whole, the value of agricultural exports dropped by about 25 percent (about half in price and half in volume).

U.S. MERCHANDISE TRADE: Revised International Transactions Basis

	Year	1984	1985			
	1985e	Q4	Q1	Q2	Q3	Q4e
Value (Bil. $, SAAR)						
Exports	215	225.0	221.1	214.5	209.2	215
Agricultural	29	38.9	32.7	28.5	26.1	30
Nonagricultural	186	186.1	188.5	186.0	183.2	185
Imports	337	348.5	315.0	328.8	341.8	360
Oil	50	57.8	41.9	52.3	50.2	55
Nonoil	287	290.7	273.1	276.6	291.6	305
Trade Balance	-122	-123.5	-93.8	-114.3	-132.6	-145
Volume (Bil 82$, SAAR)						
Exports						
Agricultural	30	38.0	32.5	28.5	27.2	32
Nonagricultural	180	182.8	182.3	179.8	178.6	180
Imports						
Oil	59	65.9	48.9	60.9	61.0	65
Nonoil	291	288.5	277.7	283.0	296.9	308

e/ Staff estimate. Data are subject to possibly large revisions.

Both the value and volume of nonagricultural exports in the fourth quarter were at about the same level as recorded during the other three quarters of the year. The effect of the strong dollar on the price of U.S. goods offset the effect of a moderate rate of economic expansion abroad. During the year gradual declines in exports of machinery and industrial supplies were offset by small increases in exports of automotive products to Canada, aircraft, and other items.

Imports increased fairly strongly in the fourth quarter from the third-quarter level. Much of the increase was in automotive products, with notable increases also being recorded for consumer goods, capital goods and oil imports. The rise in value of these categories reflected higher prices as well as an increase in volume; prices of various imported manufacturers began to turn up in the second half of 1985. However, prices of industrial supplies and foods (except coffee) declined steadily through December. It was declining prices and a fairly flat volume of imports of these intermediate commodities that offset some of the upward movement of the imports of manufactured goods. Overall, the volume of nonoil imports in the fourth quarter of 1985 was about 7 percent higher than at the end of 1984; notwithstanding the recent rise in import prices of manufactured goods, nonoil import prices on average were no higher at the end of 1985 than at the end of 1984.

Oil imports in the fourth quarter rose in both price and volume (see the table below). The higher price of oil imports reflected the rise in world oil prices over the second half of last year. Since mid-December, spot prices for crude oil and petroleum products declined sharply, primarily as a result of an increase in Saudi Arabian production and a run-down in Saudi Arabian stocks. Iraq also increased sales. The price of North Sea crude oil, measured by the price of Brent blend crude, declined about $10 per barrel, and is now below $17 per barrel. In the United States, the price of a marginal barrel of crude oil, measured by the price of West Texas Intermediate crude, dropped about $11 per barrel. The decline in prices of petroleum products is reflected in changes in the netback prices of Saudi Arabian and Nigerian light crude oil, which declined by about $6 per barrel from mid-December to the end of January. The netback price is a calculation whereby the value of crude oil is imputed from the spot price of refined products.

OIL IMPORTS 1/

	Year	1984	1985			
	1985e	Q4	Q1	Q2	Q3	Q4e
Volume (mbd, SA)	5.2	5.62	4.34	5.30	5.34	5.7
Price ($/BBL)	26.35	27.59	26.43	27.01	25.78	26.25
Value (Bil. $, SAAR)	50.0	57.81	41.91	52.25	50.21	55.0

1/ International transactions basis.
e/ Staff estimate. Data are subject to possibly large revisions.

Economic Developments in Foreign Industrial Countries

Economic growth in the major foreign industrial countries remains moderate. Although growth in Japan has declined, economic activity in Germany and Canada continues to show signs of strength. Industrial production increased recently in France and Italy, but remains fairly weak. In the United Kingdom, industrial production has continued to grow. Inflation abroad generally continues to be moderate and has declined recently in France and the United Kingdom. Both Japan and Germany have consumer price inflation rates near 2 percent, while inflation in Canada and Italy has been somewhat higher. Meanwhile, 1985 trade and current account data showed record surpluses in both Japan and Germany through December, and the current account surplus widened in the United Kingdom. The trade surplus in Canada has declined while trade deficits in France and Italy have increased in the latest month for which there were data.

Individual Country Notes. In Japan, industrial production rose 0.7 percent (s.a.) in December after a decline of 1.1 percent the month before. Industrial production in the fourth quarter of 1985 was only 1.2 percent above its year-earlier level, a substantial slowing of growth from 1984. Retail sales increased 0.5 percent (s.a.) in December, although retail sales growth declined in the fourth quarter as a whole. New housing starts rose for the fourth consecutive month in December after falling in the five preceding months. New housing starts in 1985 were 4.2 percent above their year-earlier level.

The Tokyo consumer price index rose 1.6 percent during the twelve months ending in January, down from last year's inflation of 2.2 percent.

February 5, 1986

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

	Q4/Q4 1984	Q4/Q4 1985	1985 Q1	1985 Q2	1985 Q3	1985 Q4	1985 Aug.	1985 Sept.	1985 Oct.	1985 Nov.	1985 Dec.	Latest 3 months from year ago 2/
Canada												
GNP	4.3	n.a.	.9	1.0	1.6	n.a.	*	*	*	*	*	4.4
IP	4.4	n.a.	.2	.9	2.7	n.a.	-.3	-.1	.8	.8	n.a.	5.4
France												
GNP	1.7	n.a.	-.3	.9	.6	n.a.	*	*	*	*	*	1.1
IP	1.3	n.a.	-.8	.8	2.0	n.a.	.0	-1.5	.8	2.2	n.a.	1.3
Germany												
GNP	2.7	n.a.	-1.2	1.4	2.2	n.a.	*	*	*	*	*	3.2
IP	3.5	n.a.	-1.0	1.6	1.8	n.a.	-3.2	.6	3.1	-.2	n.a.	4.4
Italy												
GNP	1.7	n.a.	.9	.8	.2	n.a.	*	*	*	*	*	1.3
IP	1.8	n.a.	1.8	.3	-.7	n.a.	.4	2.2	-3.3	3.5	n.a.	.9
Japan												
GNP	5.7	n.a.	.4	1.4	.6	n.a.	*	*	*	*	*	4.7
IP	10.6	1.2	-.7	2.7	-.1	-.7	-1.3	-1.1	1.0	-1.1	.7	1.2
United Kingdom												
GNP	2.7	n.a.	.7	1.2	-.3	n.a.	*	*	*	*	*	3.3
IP	-.3	n.a.	2.4	2.1	-.3	n.a.	.3	2.0	.0	1.2	n.a.	6.3
United States												
GNP	4.7	2.5	.9	.3	.8	.6	*	*	*	*	*	2.5
IP	7.2	1.6	.5	.3	.5	.3	.9	-.1	-.6	.6	.7	1.6

1. Asterisks indicate that data are not available on a monthly basis.

2. For quarterly data, latest quarter from year ago.

February 5, 1986

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

	Q4/Q4 1984	Q4/Q4 1985	1984 Q3	1984 Q4	1985 Q1	1985 Q2	1985 Q3	1985 Q4	1985 Oct.	1985 Nov.	1985 Dec.	Jan.	Latest 3 months from year ago
Canada													
CPI	3.7	4.2	.9	.7	1.2	1.1	.9	.9	.3	.4	.5	n.a.	4.2
WPI	3.6	n.a.	.5	.3	1.0	.7	.2	n.a.	.3	.2	n.a.	n.a.	2.5
France													
CPI	6.8	4.8	1.7	1.4	1.4	1.8	.9	.6	.3	.2	.1	n.a.	4.8
WPI	10.5	-1.1	2.2	1.6	1.6	.9	-1.4	-2.1	-.5	-1.2	-.3	n.a.	-1.1
Germany													
CPI	2.1	1.8	.0	.7	1.1	.6	-.2	.3	.2	.2	.1	.2	1.6
WPI	1.3	-1.1	-1.0	.3	1.7	.3	-2.1	-.9	-.9	.2	-.5	n.a.	-1.1
Italy													
CPI	8.8	8.5	1.4	2.2	2.6	2.2	1.1	2.3	1.2	.7	.7	n.a.	8.5
WPI	8.9	n.a.	1.2	1.9	2.7	2.2	-.1	n.a.	.3	.1	n.a.	n.a.	6.0
Japan													
CPI	2.4	2.3	-.2	1.2	.6	.5	.1	1.0	1.1	-.9	.1	.5	1.9
WPI	.5	-3.7	.8	-.3	.4	-.7	-1.0	-2.4	-1.4	-.8	-.3	n.a.	-3.7
United Kingdom													
CPI	4.8	5.5	.9	1.2	1.3	3.4	.3	.5	.2	.3	.1	n.a.	5.5
WPI	6.1	5.1	.6	1.3	1.6	2.0	.5	.8	.2	.4	.2	n.a.	5.1
United States													
CPI (SA)	4.1	3.5	.9	.9	.8	1.0	.6	1.0	.3	.6	.4	n.a.	3.5
WPI (SA)	1.7	1.6	.0	.1	.2	.6	-.2	1.0	.9	.8	.4	n.a.	1.6

February 5, 1986

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

	1984	1985	1984		1985				1985			
			Q3	Q4	Q1	Q2	Q3	Q4	Sept.	Oct.	Nov.	Dec.
Canada												
Trade	15.7	n.a.	4.0	4.2	4.0	3.4	2.3	n.a.	1.3	1.2	.4	n.a.
Current account	1.9	n.a.	.7	.9	.5	.2	-1.1	n.a.	*	*	*	*
France												
Trade	-2.4	-2.6	.1	-.5	-1.1	-.4	-.7	-.4	-.3	.1	-.1	-.4
Current account	-.8	n.a.	.4	-.2	-.7	.6	.0	n.a.	*	*	*	*
Germany												
Trade	18.8	n.a.	5.0	6.3	4.5	6.2	6.9	n.a.	2.4	2.3	n.a.	n.a.
Current account (NSA) 2/	5.8	13.9	-.9	6.0	1.7	3.1	2.1	7.0	1.6	2.4	1.9	2.7
Italy												
Trade	-10.7	n.a.	-1.4	-4.2	-3.8	-3.7	-.3	n.a.	.1	-.6	-1.7	n.a.
Current account (NSA)	-2.9	n.a.	.7	-2.2	-2.9	n.a.	n.a.	n.a.	*	*	*	*
Japan												
Trade	44.1	56.1	9.9	13.7	11.5	13.1	13.7	17.8	4.4	5.2	6.4	6.2
Current account	34.9	49.7	7.2	11.7	9.4	12.1	12.0	16.1	4.0	4.5	5.6	6.0
United Kingdom												
Trade	-5.7	-2.5	-2.1	-1.6	-1.4	-.3	-.8	-.0	-.3	.0	-.2	.2
Current account	1.3	4.9	-.5	.5	-.4	1.7	1.6	2.0	.5	.6	.4	1.0
United States												
Trade 2/	-114.1	n.a.	-29.0	-30.9	-23.5	-28.6	-33.1	n.a.	-10.4	-12.4	n.a.	n.a.
Current account	-107.4	n.a.	-29.0	-31.8	-24.2	-27.7	-30.5	n.a.	*	*	*	*

1. The current account includes goods, services, and private and official transfers.
2. Annual or quarterly data are subject to revisions and therefore may not be consistent with quarterly or monthly data.
* -- monthly data are not published.

Japan's external surplus continued at record levels. For the calendar year 1985 the cumulative trade surplus was $56 billion compared to $44 billion in 1984.

As part of its effort to stimulate domestic demand, and in light of the recent strenghtening of the yen, the Bank of Japan cut its discount rate from 5 percent to 4-1/2 percent effective January 30. Recent data indicate that Japanese monetary growth exceeded somewhat the Bank of Japan's projected growth of 8 - 8.9 percent during the fourth quarter of last year. According to the Bank of Japan, this increase resulted from special factors, including porfolio shifts into recently liberalized large-denomination time deposits and a surge in corporate borrowing ahead of the December hike in the long-term prime lending rate. The rise in Japanese interest rates has since been largely reversed.

According to official reports, the budget proposal for FY 1986, unveiled in late December, will result in a reduction in the budget deficit in FY 1986 to 3.2 percent of GNP, from 3.7 percent last year. The budget provides for a 3 percent increase in General Account budget expenditures. Government expenditures net of debt service payments and local government revenue sharing will actually decline 1.2 billion yen. The Fiscal Investment and Loan Program, which is separate from the General Account Budget, is somewhat more expansionary, with planned increases of 6.2 percent in FY 1986 compared with a 1.2 percent decline in FY 1985. Taken together, the two budgets represent a slight degree of fiscal stimulus. No major tax reductions are planned for 1986.

Real GNP in Germany grew 2.5 percent in 1985, according to preliminary estimates. Growth in the fourth quarter implied by these estimates was about 4 percent (a.r.). Industrial production in the fourth quarter of last year was 3.7 percent above year-earlier levels. Production growth was especially strong in the capital goods sector, while the construction sector finished last year well below its level in late 1984. The unemployment rate remained at 9.2 percent (s.a.) in January, only slightly below the average rate of 9.3 percent for 1985. Employment increased slightly last year, and the number of unemployed declined.

The consumer price index in January was 1.4 percent above last year's index. For the year as a whole, the CPI rose 2.3 percent in 1985. Unit wage costs remained virtually constant in 1985. Import prices at year-end were 6.5 percent below their year-earlier levels. Wholesale and producers prices were essentially unchanged. Meanwhile, the current account surplus for 1985 was $13.9 billion, compared with $5.8 billion in 1984. The trade surplus in 1985 was $25.3 billion, following a surplus of $18.8 billion in 1984.

The pace of economic activity in France has increased in recent months. Industrial production rose by 2.2 percent (s.a.) in November following a 0.8 percent rise in October. On a year-over-year basis, industrial production showed an increase of 3.8 percent. The unemployment rate eased further in December to 10.1 percent (s.a.), 1/2 percentage point below its level in August.

Inflation has continued to decline. Consumer prices increased by only 0.1 percent (n.s.a.) in December. The year-over-year inflation rate eased to 4.7 percent, only slightly above the government's 4-1/2 percent inflation target for the year. Wholesale prices decreased by

0.3 percent (n.s.a.) in December, their seventh consecutive monthly decline. On a year-over-year basis, wholesale prices were down by 1.8 percent.

The trade deficit in December increased to $450 million (s.a.). For 1985 as a whole, the trade deficit was $2.6 billion, about unchanged from the previous year. Preliminary data suggest that the 1985 current account will show a small surplus following a small deficit in 1984.

Real GDP (average measure) in the United Kingdom fell 1.1 percent (s.a.a.r.) in the third quarter, largely reflecting a drop in real exports. More recent data on industrial production, however, suggest that this decline was only a temporary interruption in U.K. growth. After declining in mid-summer, the index of industrial production rose 3.2 percent (s.a.) during the three months ending in November to a level 7.1 percent above its year-earlier level.

Consumer price inflation in the United Kingdom has continued to decline. Retail prices rose only 0.6 percent (n.s.a.) between June and December, and at year end the twelve-month inflation rate was 5.7 percent. Nominal wage growth, however, continues to outpace price inflation; in November the twelve-month increase in average earnings was 8.6 percent. The U.K. trade and current accounts were in surplus in December, with the monthly current account surplus widening to $1 billion (s.a.). The trade deficit fell to $2.5 billion in 1985, from $5.7 billion in 1984. The current account surplus in 1985 tripled to $4.9 billion.

Gross domestic product in Canada increased 0.7 percent (s.a.) in November continuing the relatively strong growth shown throughout the year. Industrial production also increased 0.8 percent (s.a.) in November. The unemployment rate dropped to 10 percent in December, the lowest rate since April 1982, and nearly 3 percentage points below the peak reached in December 1982.

Inflation in Canada continued at a moderate pace. Consumer prices increased 0.5 percent in December and the twelve-month inflation rate rose slightly to 4.4 percent. The industry selling price increased 0.2 percent in November, bringing the twelve-month inflation rate in wholesale prices to 2.5 percent. Meanwhile, Canada's trade surplus dropped to $363 million in November from $1.2 billion in October. Exports dropped 8.5 percent while imports reached a new record level, growing nearly 9 percent. For the first 11 months, Canada's trade surplus stood at $11.7 billion compared with last year's $14.8 billion.

GDP in Italy rose 0.8 percent (s.a.a.r) in the third quarter of 1985, to a level 1.3 percent above its year-earlier level. In October and November, industrial production rose on average 0.5 percent (s.a.a.r.) to a level 1.4 percent above its average year-earlier level. Official government surveys conducted in October and November showed consumers' confidence at a fairly high level by the standards of the last three years.

The consumer price index rose .7 percent (s.a.) in December, bringing the twelve-month inflation rate to 8.6 percent. The wholesale price index rose .1 percent (s.a.) in November, resulting in a twelve-month inflation rate of 5.8 percent. The trade account showed a deficit of $1.7 billion in November. The deficit during the eleven months ending in November totalled $10.1 billion, about equal to the deficit over the comparable period last year.

On January 16, Treasury Minister Goria announced three measures designed to stem a large outflow of capital which began in December and January and that was associated with pressures on the exchange value of the lira. These measures were an effective increase in the yield on short-term securities, an imposition of a lira deposit requirement against exporters' receipts of foreign exchange, and a re-introduction of a ceiling on the growth of commercial bank credit. Goria said that a lack of faith in the Italian economy had caused an outflow of reserves of foreign exchange and these measures were meant expressly to discourage this outflow.

Economic Situation in Major Developing Countries. By the end of January 1986, oil exporting developing countries had seen the dollar price for their oil exports drop by about 20 percent from the average level of 1985. Among heavily indebted countries, Mexico and Nigeria will be hardest hit. At current prices, Mexico's oil export earnings would tend to fall by $2.4 billion from last year, while the drop in public sector revenues would lead to a loss of fiscal revenue of about 2 percent of GDP. Even at maximum production, the recent drop in oil prices would tend to reduce Nigeria's oil export receipts from about $11.3 billion in 1985 to about $9.5 billion in 1986. On December 31, Nigeria's president indicated that debt service payments in 1986 would be limited to no more than 30 percent of Nigeria's foreign exchange budget. However, even at current world oil prices, this limit would permit Nigeria to meet fully its current interest obligations in 1986. Venezuela's current account surplus would tend to decline by about $3 billion at current prices, but a small current account surplus would remain, and, with international reserves of $16 billion, the country could aborsb the effects of the decline in oil prices. Most of the other major developing countries will benefit from lower oil prices this year. Brazil is still a significant oil importer, but will also have to reconsider its longer-term domestic program for the production of alcohol and other high-cost substitutes for petroleum products. Moderate benefits are also expected in the Philippines where the economy remains generally depressed.

Individual Country Notes. Declining oil prices are cutting sharply into Mexico's export earnings and public sector revenues, leading to increased needs for external and domestic financing. Mexico's $4 billion current account surplus of 1984 disappeared in 1985 as peso overvaluation and domestic economic expansion in the first half of 1985 stimulated imports and impeded non-oil exports. Oil export earnings in 1985 were about $2 billion lower than in 1984, partly because the government acted slowly in reducing prices as the market weakened, triggering a temporary decline in the volume exported. At current prices and production levels, oil export earnings would fall a further $2.4 billion, while fiscal revenues would drop by about 2 percent of GDP. The lower oil earnings last year were offset by an easing of world interest rates and the lowering of spreads under the multi-year debt restructuring agreement. In 1985, the public sector deficit was 8.4 percent of GDP, 4.3 percentage points higher than the 4.1 percent target under the IMF program. The ballooning deficit stemmed from declining oil revenues (0.7 percent), higher-than-expected interest payments on the domestic debt (2.5 percent), and overspending in other areas (1.1 percent). Since last July, a substantial depreciation of the peso in real terms has been achieved, and the government has proposed a more austere budget. Prior to the recent drop in oil prices, Mexico had been seeking net new external financing for 1986 of $4 billion (of which $2.5 billion was to have been provided by commercial banks), to finance the 1986 current account deficit, to rebuild international reserves (which declined by about $2.5 billion in 1985), and to cover some private capital outflows. In light of recent oil price developments, Mexico's financing requirements will be higher. Negotiations with the IMF on a 1986 program have begun, and negotiations with the IBRD on an expanded borrowing program in support of specific structural reforms, starting with trade policy, are nearing completion.

On December 12, 1985, Nigeria announced that an IMF loan would not be sought, and that the measures contained in the 1986 budget plan would constitute a self-imposed stabilization plan. In his New Year's budget speech, the President announced measures to increase net revenues, including a sharp increase in unrealistically low domestic petroleum prices (which is expected to raise revenue equal to 1.5 percent of GDP), an additional levy of 30 percent on all categories of imports, and a reduction in subsidies to parastatals. Other budget measures are designed to encourage non-oil exports by providing import duty rebates on the raw materials and components used in the manufacture of exports, preferential import licenses for export activities, and retention for own-use of 25 percent of foreign exchange earnings by non-oil exporters.

For 1986, the President stated that external debt service would be limited to 30 percent of the foreign exchange budget, which--at about $2.9 billion--would be sufficient to finance Nigeria's current interest obligations, but which is far less than the $5-6 billion of total debt-service payments scheduled for 1986. In 1985, Nigeria's oil export revenue amounted to $11.3 billion and, at current prices and levels of production, would total about $9.5 billion in 1986.

Argentina is virtually self-sufficient in petroleum and will derive only minor indirect benefits from world oil price declines. The Argentine anti-inflationary program adopted last June has brought about a deepening of the recession that started in late 1984 and a decline in inflation. Consumer prices in the last five months of the year rose at an annual rate of 35 percent, almost as low as the monthly rate of increase recorded last June. Real GDP in the third quarter was 5 percent below a year earlier. The economic slowdown was accompanied by a decline in imports. In 1985, a $400 million decline in imports and a $400 million decrease in external interest payments were the main reason why the current account deficit narrowed by about $1 billion, to about $1.5 billion. Severe flooding in the main grain growing areas last November will lower 1986 export earnings by an estimated $500 million. The anti-inflationary program has achieved a considerable reduction in the public sector deficit and some reduction in central bank losses. But deviations from the IMF program occurred beginning in September and scheduled disbursements from the IMF and the commercial banks totaling about $2 billion cannot take place until an IMF waiver is granted.

Brazil met with its bank advisory committee in mid-January and made substantial progress toward an interim arrangement that would reschedule 1985 maturities and rollover 1986 maturities, as well as maintain short-term credit lines. Another meeting is scheduled for February 5 with the goal of reaching agreement by March 15. Externally, Brazil continues to run large trade surpluses in excess of $12 billion and is likely to continue to do so in 1986. A serious drought in Brazil will have effects that are largely offsetting with regard to the trade balance. Higher coffee export revenues from higher coffee prices and sales out of inventories should offset to a large extent higher grain imports. Brazil will also benefit from lower oil prices. Internally, inflation has accelerated, with consumer prices in January 1986 rising by a record 16.2 percent to a level 238 percent higher than in January 1985.

Although Peru continues to accumulate arrears to both commercial banks and the IMF, Peruvian officials have recently indicated that Peru may be considering a more conciliatory and flexible approach in its relations with its external creditors. Peru recently made a small payment of SDR 1.7 million against its arrears to the IMF--its first payment to the Fund since early September--but Peru still has arrears to the IMF of more than SDR 65 million. Peruvian officials in January also indicated, for the first time, that Peru may be willing to accept an IMF team visit for what is normally an annual review of the country's economic policies and prospects, viz., the Article IV consultation. Peru's interest arrears to commercial banks are about $400 million, are growing by about $28 million a month, and--according to a government announcement on February 2--new interest rate ceilings have been set on short-term working capital debts of 1-1/4 percentage points above LIBOR and 1 percentage point over prime.

Petroleum accounts for only about 10 percent of Colombia's exports, while coffee accounts for about one half. Thus, the effect on Colombian exports of the current weakness of oil prices is being more than offset in the short run by the sharp strengthening of coffee prices during December and January. A large increase in receipts from coffee exports is expected to provide Colombia with foreign exchange to add to reserves and to amortize external debt (possibly ahead of schedule).

The domestic economic outlook for Venezuela has again weakened in view of the falling price of petroleum, which accounts for about 90 to

95 percent of its export revenue. Assuming an export level of 1.4 million barrels per day and continuation of recent oil prices, oil export earnings would drop about $2.3 billion from their $14 billion level in 1985. However, with international reserves of $15.8 billion (including gold holdings), Venezuela initially could absorb the effects of the decline in oil prices. Venezuela is expected to sign at long last the agreement to reschedule $21.2 billion of its external public sector debt the week of February 24, 1986.

The IMF Board on December 20, 1985, approved the completion by the Philippines of the Second Review of the 18-month December 1984 stand-by arrangement. This allowed the Philippines to draw the third and fourth tranches of the arrangement (totaling SDR 212 million) on December 27 and cleared the way for the second disbursement on January 8, 1986, of $175 million from the commercial banks' $925 million new money loan--$400 million having been disbursed earlier in August. On January 10, 1986, the Philippines signed a rescheduling agreement for $2.9 billion in external debt to commercial banks owed by seven public sector institutions, out of some $5.8 billion in external debt that is to be rescheduled this year. While lower oil prices will be of some assistance to the Philippine balance of payments and economy this year, possibly reducing the imported oil costs by about 1 percent of GDP, other major forces are expected to keep the economy depressed.