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May 14, 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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Tables



Charts

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 | Apr. | 05-02-86 | 117.2 | 0.3 | 1.5 | 1.7 |
| Unemployment rate (%)[1] | Apr. | 05-02-86 | 7.1 | 7.2 | 6.7 | 7.3 |
| Insured unemployment rate (%)[1] | Dec. | 03-13-86 | 3.0 | 2.8 | 2.8 | 2.8 |
| Nonfarm employment, payroll (mil.) | Apr. | 05-02-86 | 100.0 | 2.5 | 2.2 | 3.0 |
| Manufacturing | Apr. | 05-02-86 | 19.4 | -1.7 | -1.7 | -.5 |
| Nonmanufacturing | Apr. | 05-02-86 | 80.7 | 3.5 | 3.1 | 3.9 |
| Private nonfarm: | | | | | | |
| Average weekly hours (hr.)[1] | Apr. | 05-02-86 | 35.0 | 35.0 | 35.2 | 35.0 |
| Hourly earnings ($)[1] | Apr. | 05-02-86 | 8.74 | 8.74 | 8.67 | 8.54 |
| Manufacturing: | | | | | | |
| Average weekly hours (hr.)[1] | Apr. | 05-02-86 | 40.6 | 40.7 | 41.0 | 40.2 |
| Unit labor cost (1967=100) | Mar. | 04-29-86 | 82.7 | 2.9 | -4.3 | -4.6 |
| Industrial production (1977=100) | Mar. | 04-15-86 | 125.1 | -5.7 | -4.1 | .9 |
| Consumer goods | Mar. | 04-15-86 | 122.7 | -7.8 | -4.8 | 2.4 |
| Business equipment | Mar. | 04-15-86 | 140.2 | -11.0 | -3.4 | .0 |
| Defense & space equipment | Mar. | 04-15-86 | 177.4 | 7.5 | -7.3 | 5.0 |
| Materials | Mar. | 04-15-86 | 115.0 | -4.2 | -3.1 | -.4 |
| Consumer prices all items (1967=100) | Mar. | 04-22-86 | 326.3 | -5.1 | -2.0 | 2.2 |
| All items, excluding food & energy | Mar. | 04-22-86 | 323.8 | 4.5 | 4.0 | 4.1 |
| Food | Mar. | 04-22-86 | 314.1 | 1.1 | -1.4 | 1.8 |
| Producer prices: (1967=100) | | | | | | |
| Finished goods | Mar. | 04-11-86 | 288.6 | -12.8 | -13.0 | -1.2 |
| Intermediate materials, nonfood | Mar. | 04-11-86 | 316. | -15.0 | -12.4 | -2.6 |
| Crude foodstuffs & feedstuffs | Mar. | 04-11-86 | 222.9 | -11.7 | -28.0 | -7.7 |
| Personal income ($ bil.)[2] | Mar. | 04-11-86 | 3,406.5 | 2.1 | 2.6 | 4.6 |
| | | | | (Not at annual rates) | | |
| Mfgrs. new orders dur. goods ($ bil.) | Mar. | 04-30-86 | 105.6 | -2.1 | -1.8 | 6.1 |
| Capital goods industries | Mar. | 04-30-86 | 37.9 | 4.8 | .4 | 13.2 |
| Nondefense | Mar. | 04-30-86 | 27.4 | -5.2 | -10.3 | .7 |
| Defense | Mar. | 04-30-86 | 10.4 | 45.1 | 46.1 | 67.4 |
| Inventories to sales ratio:[1] | | | | | | |
| Manufacturing and trade, total | Mar. | 05-14-86 | 1.40 | 1.37 | 1.35 | 1.38 |
| Manufacturing | Mar. | 04-30-86 | 1.46 | 1.42 | 1.42 | 1.47 |
| Trade | Mar. | 05-14-86 | 1.35 | 1.33 | 1.29 | 1.29 |
| Ratio: Mfgrs.' durable goods inventories to unfilled orders[1] | Mar. | 04-30-86 | .523 | .525 | .536 | .554 |
| Retail sales, total ($ bil.) | Apr. | 05-13-86 | 116.8 | .5 | -.5 | 2.2 |
| GAF[3] | Apr. | 05-13-86 | 26.1 | .2 | 3.3 | 6.5 |
| Auto sales, total (mil. units.)[2] | Apr. | 05-05-86 | 11.1 | 14.2 | -3.3 | 1.0 |
| Domestic models | Apr. | 05-05-86 | 8.0 | 15.9 | -7.6 | -7.5 |
| Foreign models | Apr. | 05-05-86 | 3.1 | 10.0 | 10.1 | 32.5 |
| Plant and equipment expen.[4] | | | | | | |
| Total nonfarm business | 1986 | 04-16-86 | 395.13 | — | — | 2.3 |
| Manufacturing | 1986 | 04-16-86 | 151.84 | — | — | -.1 |
| Nonmanufacturing | 1986 | 04-16-86 | 243.28 | — | — | -4.3 |
| Housing starts, private (thous.)[2] | Mar. | 04-16-86 | 194.9 | -2.4 | 3.6 | 5.4 |
| Leading indicators (1967=100) | Mar. | 04-29-86 | 176.6 | .5 | 1.4 | 5.4 |

1. Actual data used in lieu of percent changes for earlier periods.
2. At annual rates.
3. Excludes mail order houses.
4. Planned-Commerce for January through March 1986 survey.

Economic activity in the aggregate appears to be expanding gradually, but with marked contrasts across sectors and geographical regions. Lower interest rates are spurring strong gains in purchases of new homes, and the underlying determinants of consumer spending appear favorable. At the same time, however, the industrial sector remains relatively weak, owing in part to sharp cutbacks in oil drilling. Aggregate price measures have declined further, reflecting plummeting prices for petroleum products, while nominal wage increases have been restrained.

## Industrial Production

The index of industrial production apparently edged up in April, after declines in February and March, as small gains in motor vehicle assemblies and steel output offset a further plunge in oil and gas well drilling. Over the first four months of the year, total industrial production declined. The sharp cutback in auto assemblies in March contributed importantly to the weakness, but production of business equipment, excluding motor vehicles, also has been weak in recent months, reflecting continued import pressures and weak order levels.

Although auto assemblies were up slightly in April, automakers intend to cut production during the second quarter as a whole. Using seasonal factors developed for the index of industrial production, current assembly plans call for cars to be built at a 7.9 million unit annual rate in the second quarter, down from an 8.3 million unit pace in the first quarter. The Commerce Department's estimate of auto production, which incorporates alternative seasonal adjustment factors, places planned auto assemblies at a 7.4 million unit annual rate in the second quarter, compared with an 8.9 million unit rate during the first three months of this year. The sharp drop in the Commerce Department's estimate of auto assemblies should have a substantial downward effect on real GNP growth in the second quarter, reducing it by roughly 1-1/2 tp 2 percentage points at an annual rate.

With declines in output widespread, capacity utilization in total industry dropped 0.6 percentage point in March to 79.4 percent, its lowest level since December 1983. Utilization rates in manufacturing and mining dropped 0.6 and 0.9 percentage point respectively in March, while the rate for utilities edged down. In April, overall capacity utilization apparently remained about unchanged.

Employment and Unemployment

Nonfarm employment, as measured by the establishment survey, continued to expand in April, but, as in the first quarter, job gains were unbalanced across industries. In recent months, the service-producing sector has accounted for much of the overall growth, adding more than 900,000 jobs since December. Hiring at construction sites also has picked up this year, reflecting the boom in housing activity and increased highway construction. In manufacturing, however, widespread employment losses took place in recent months in both durable and nondurable goods industries, and the factory workweek slipped from the very high levels reported at the end of last year. Employment in oil and gas extraction, after drifting downward throughout 1985, plummeted during the first four months of this year as firms adjusted drilling activity to lower oil prices. Since

## CHANGES IN EMPLOYMENT[1]

(Thousands of employees; based on seasonally adjusted data)

| | 1984 | 1985 | 1985 Q3 | 1985 Q4 | 1986 Q1 | 1986 Feb. | 1986 Mar. | 1986 Apr. |
|---|---|---|---|---|---|---|---|---|
| | --Average monthly changes-- | | | | | | | |
| Nonfarm payroll employment[2] | 327 | 250 | 248 | 290 | 249 | 160 | 178 | 206 |
| Strike adjusted | 329 | 248 | 254 | 289 | 242 | 160 | 189 | 203 |
| Mining | 1 | -2 | -4 | -3 | -17 | -18 | -27 | -36 |
| Oil and gas extraction | 1 | -2 | -1 | -4 | -16 | -18 | -24 | -34 |
| Manufacturing | 52 | -14 | -40 | 51 | -15 | -8 | -50 | -27 |
| Durable | 45 | -14 | -37 | 28 | -18 | -14 | -47 | -10 |
| Nondurable | 7 | 0 | -3 | 23 | 3 | 6 | -3 | -17 |
| Construction | 29 | 25 | 28 | 16 | 33 | -23 | -13 | 84 |
| Trade | 106 | 72 | 50 | 69 | 111 | 93 | 93 | 56 |
| Finance, insurance and real estate | 17 | 24 | 27 | 27 | 30 | 33 | 28 | 47 |
| Services | 89 | 100 | 100 | 98 | 98 | 52 | 152 | 83 |
| Total government | 17 | 36 | 80 | 20 | 9 | 44 | -9 | 2 |
| Private nonfarm production workers | 253 | 173 | 148 | 231 | 190 | 103 | 122 | 183 |
| Manufacturing production workers | 33 | -16 | -27 | 44 | -15 | -6 | -41 | -8 |
| Total employment[3] | 269 | 163 | 306 | 229 | 194 | -394 | 227 | 104 |
| Nonagricultural | 265 | 183 | 347 | 184 | 149 | -190 | 38 | 167 |

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 Q3 | 1985 Q4 | 1986 Q1 | 1986 Feb. | 1986 Mar. | 1986 Apr. |
|---|---|---|---|---|---|---|---|---|
| Civilian, 16 years and older | 7.5 | 7.2 | 7.2 | 7.0 | 7.1 | 7.3 | 7.2 | 7.1 |
| Teenagers | 18.9 | 18.6 | 18.3 | 19.0 | 18.5 | 19.0 | 18.2 | 19.6 |
| 20-24 years old | 11.5 | 11.0 | 11.0 | 10.8 | 10.6 | 10.8 | 10.6 | 10.9 |
| Men, 25 years and older | 5.7 | 5.3 | 5.3 | 5.2 | 5.3 | 5.5 | 5.5 | 5.2 |
| Women, 25 years and older | 6.0 | 5.9 | 5.9 | 5.5 | 5.7 | 5.9 | 5.9 | 5.8 |
| White | 6.5 | 6.2 | 6.2 | 6.0 | 6.1 | 6.4 | 6.2 | 6.1 |
| Black | 15.9 | 15.1 | 14.8 | 15.1 | 14.6 | 14.8 | 14.7 | 14.8 |
| Fulltime workers | 7.2 | 6.9 | 6.9 | 6.7 | 6.7 | 6.9 | 6.9 | 6.7 |
| Memo: | | | | | | | | |
| Total national[1] | 7.4 | 7.1 | 7.0 | 6.9 | 7.0 | 7.2 | 7.1 | 7.0 |

1. Includes resident Armed Forces as employed.

January of this year, nearly 20 percent of the jobs in this sector have been lost.

The unemployment rate, which stood at 7.1 percent in April, has shown no improvement from the levels that prevailed in late 1985. Although jobless rates in most states were little changed in the first quarter, there were signs of deteriorating labor market conditions in those states most closely tied to the oil and gas industry.

Autos

Domestic auto sales continue to be influenced by changes in the sales terms offered by manufacturers. In late March, GM announced list price increases averaging about 3 percent, possibly in response to higher prices for imported cars or perhaps to window-dress future incentive programs by allowing for larger discounts from list prices. Ford and Chrysler declined to follow this strategy for cars, but did raise list prices for some other vehicles. In mid-April, when most of the early spring incentives were due to expire, the major domestic automakers launched a new series of sales incentives, followed by some additional shaving of finance rates around the end of the month.

Reflecting the efforts by consumers to beat GM's announced price increases and the enticements of the incentive programs, sales of domestic cars rose to an 8.0 million unit annual rate in April from their sluggish 6.9 million unit pace in the previous month. However, this sales pace still fell a little short of assemblies in April, further increasing the already-bloated level of auto inventories.

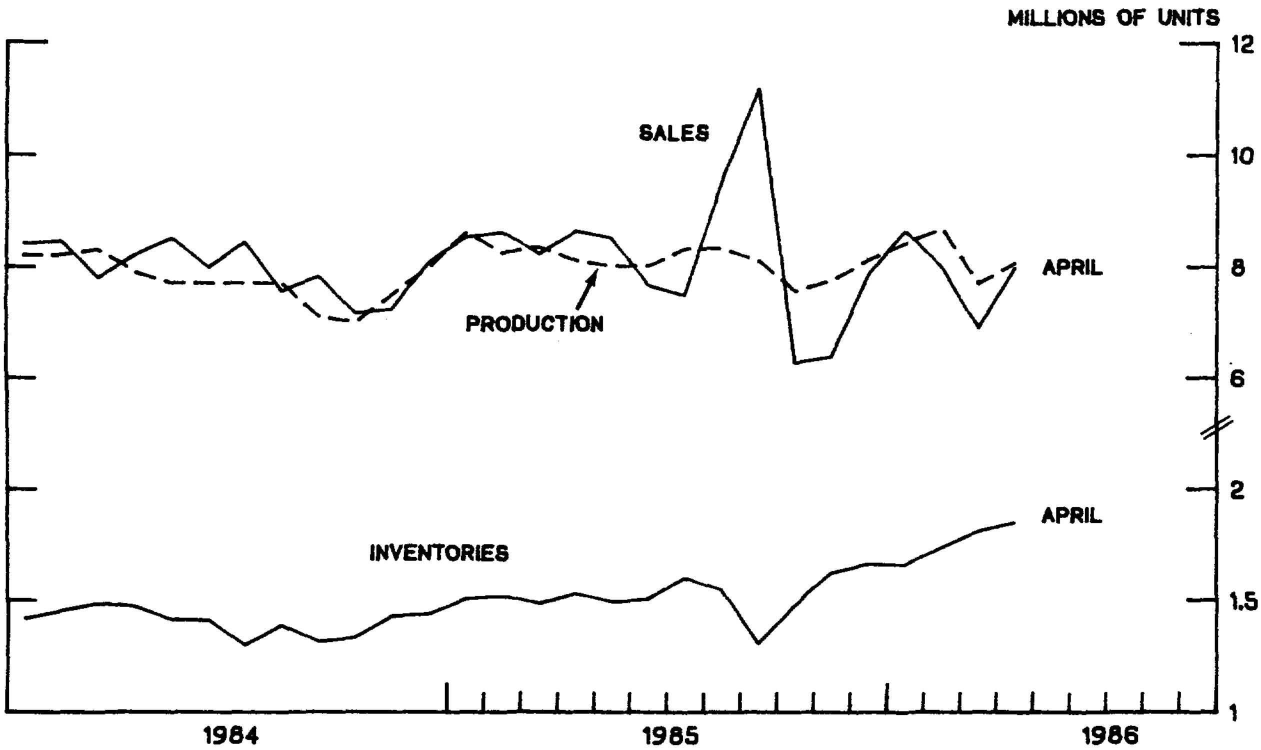
Sales of foreign cars were at a 3.1 million unit annual rate in April, compared with the 2.8 million unit average pace of sales during

AUTO SALES, PRODUCTION, AND INVENTORIES
(millions of units at an annual rate, FRB seasonals)

| | 1985 | | 1986 | 1986 | | | |
|---|---|---|---|---|---|---|---|
| | Q3 | Q4 | Q1 | Jan. | Feb. | Mar. | Apr. |
| Total auto sales[1] | 12.3 | 10.2 | 10.7 | 11.4 | 10.8 | 9.7 | 11.1 |
| Domestic | 9.4 | 6.8 | 7.8 | 8.6 | 8.0 | 6.9 | 8.0 |
| Imported | 2.9 | 3.4 | 2.8 | 2.8 | 2.8 | 2.8 | 3.1 |
| Domestic production | 8.2 | 7.8 | 8.3 | 8.4 | 8.7 | 7.7 | 8.1 |
| Dealers' stocks | 1.31 | 1.67 | 1.81 | 1.66 | 1.74 | 1.81 | 1.85 |
| Days' supply[2] | 43 | 75 | 71 | 59 | 67 | 81 | 71 |

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.

THE MARKET FOR DOMESTIC AUTOMOBILES
(SEASONALLY ADJUSTED, ANNUAL RATES)



the first quarter of this year. An increase in sales of Japanese cars during April, the first month of the new quota year, accounted for most of the rise.

Personal Consumption and Income

Recent consumer data generally have shown strong gains in income, wealth, and spending. Personal consumption expenditures, in real terms, rose more than 4 percent at an annual rate in the first quarter of 1986 after almost no growth in the fourth quarter of last year. Although outlays for durable goods were little changed, on balance, in the first quarter, real spending for nondurables surged ahead at almost an 8 percent annual rate, and expenditures on services posted a sizable gain. In April, the preliminary estimate of retail sales for goods excluding autos fell back from its March pace. Outlays for general merchandise were up more than 1 percent in April, continuing the substantial gains posted in previous months, while spending declined for food and household durables.

Disposable personal income in constant dollars advanced 5.6 percent in the first quarter, after little growth in the second half of 1985. Declines in consumer prices in February and March, coupled with moderate gains in nominal personal income, have accounted for most of the recent improvement in real income. With total personal consumption expenditures increasing less than disposable income in the first quarter, the saving rate rose to 4.3 percent from 4.0 percent in the final three months of 1985.

PERSONAL INCOME AND EXPENDITURES
(Based on seasonally adjusted data)

| | | 1985 | | 1986 | 1986 | | |
|---|---|---|---|---|---|---|---|
| | 1985 | Q3 | Q4 | Q1 | Jan. | Feb. | Mar. |
| | - - Percentage changes at annual rates[1] - - | | | | | | |
| Total Personal Income | | | | | | | |
| Nominal | 5.3 | 2.3 | 6.9 | 5.3 | .8 | 5.0 | 2.1 |
| Real[2] | 2.0 | .1 | 2.5 | 4.2[e] | -2.4 | 10.3 | 4.2[e] |
| Disposable Personal Income | | | | | | | |
| Nominal | 4.5 | -2.5 | 6.7 | 6.9 | 4.4 | 5.8 | 3.1 |
| Real | 1.3 | -4.5 | 2.3 | 5.6 | 1.4 | 10.8 | 4.9[e] |
| Expenditures | | | | | | | |
| Nominal | 6.2 | 6.8 | 4.5 | 5.5 | -4.6 | 5.4 | 4.2 |
| Real | 3.0 | 4.6 | .1 | 4.3 | -7.6 | 10.4 | 6.2[e] |
| | - - Changes in billions of dollars[3] - - | | | | | | |
| Total personal income | 14.7 | 9.8 | 24.8 | 7.4 | 2.2 | 14.1 | 5.9 |
| Wages and salaries | 10.1 | 7.6 | 13.7 | 7.1 | 4.8 | 6.9 | 9.6 |
| Private | 7.8 | 5.8 | 10.8 | 5.9 | 4.6 | 5.3 | 7.8 |
| Manufacturing | 1.3 | .8 | 3.2 | -.4 | -1.0 | -2.2 | 1.9 |
| Other income | 6.1 | 2.7 | 12.0 | 1.9 | 1.[illegible] | 7.6 | -3.2 |
| Disposable personal income | 11.2 | 6.8 | 21.5 | 10.6 | 10.5 | 13.9 | 7.4 |
| Expenditures | 13.9 | 22.1 | 11.1 | 3.7 | -10.2 | 11.9 | 9.3 |
| Durables | 1.7 | 13.7 | -7.1 | -6.2 | -4.2 | -4.8 | -9.6 |
| Nondurables | 3.8 | 4.4 | 4.0 | 5.0 | .4 | 1.1 | 13.6 |
| Services | 8.3 | 4.0 | 14.2 | 4.8 | -6.4 | 15.6 | 5.3 |
| Personal saving rate (percent) | 4.6 | 3.7 | 4.0 | 4.3 | 4.3 | 4.3 | 4.2 |

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--BEA estimate prior to release of March CPI.

RETAIL SALES
(Seasonally adjusted percentage change)

| | 1985 | | 1986 | 1986 | | |
|---|---|---|---|---|---|---|
| | Q3 | Q4 | Q1 | Feb. | Mar. | Apr. |
| Total sales | 2.2 | -.8 | 1.0 | -.1 | -.9 | .5 |
| Previous estimate[1] | | | 1.2 | .1 | -.8 | -- |
| (REAL)[2] | 2.2 | -1.6 | 1.3 | .8 | .5 | -- |
| Previous estimate[1] | | | -- | 1.2 | .6 | -- |
| Total less automotive group, nonconsumer stores, and gasoline stations | 1.2 | 1.4 | 1.2 | .5 | .7 | -.8 |
| Previous estimate[1] | | | 1.3 | .7 | .6 | -- |
| GAF[3] | 1.5 | 1.6 | 1.3 | 1.4 | 1.6 | .2 |
| Durable | 4.3 | -3.6 | 1.7 | -.5 | -2.2 | 2.8 |
| Automotive group | 6.1 | -8.1 | .9 | -1.1 | -4.6 | 4.1 |
| Furniture and appliances | 2.1 | 4.3 | 1.0 | .0 | 1.3 | -1.6 |
| Other durable goods | .9 | 1.5 | 6.3 | 1.3 | 19.2 | -17.6 |
| Nondurable | .9 | 1.0 | .6 | .1 | -.1 | -.8 |
| Apparel | 1.9 | 1.6 | 1.2 | 1.4 | 2.1 | .0 |
| Food | 1.0 | 1.7 | 1.3 | -.3 | .6 | -1.6 |
| General merchandise[4] | 1.0 | .4 | 1.5 | 2.1 | 1.5 | 1.1 |
| Gasoline stations | -.7 | .2 | -4.5 | -2.8 | -7.1 | -2.3 |

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.

Not only have households enjoyed stronger real income growth, but household balance sheets, on the whole, have improved in recent months. A strengthening in the prices of existing houses and the continuing boom in stock and bond markets have contributed to increases in household wealth. In addition, although some indicators of debt service problems, such as installment loan delinquency rates, have moved up, both lower interest rates on closed-end installment debt and the ability to refinance mortgage debt at lower rates are reducing payment burdens somewhat.

Apparently responding to these favorable factors, both the Michigan Survey Research Center and the Conference Board reported extremely high buying plans in their most recent surveys. An exceptionally large proportion of consumers, citing lower interest rates, viewed this as a good time to buy autos and homes. And almost half of the households surveyed reported that their financial situations had improved during the past year; not since the 1960s have consumers' assessments of their own financial progress been this favorable for so long a period of time. Detail in the Michigan survey also suggests that some consumers may be attempting to buy in advance of higher prices for imports; this seems to be affecting demand for imported cars and electronic goods. Nevertheless, fewer consumers than at any time since 1966 commented about the erosion of living standards due to inflation.

## Business Fixed Investment

Real outlays for business fixed investment fell sharply in the first quarter. Overall, first-quarter spending for equipment declined at nearly an 18 percent annual rate, about reversing a large fourth-quarter rise. This recent volatility probably reflects two special factors that shifted spending from the first quarter into the fourth quarter of last year. First, IBM accelerated initial deliveries of its Sierra computer, apparently to improve 1985 earnings. Second, and more generally, fear of adverse tax changes for equipment purchased in 1986 likely prompted firms to move planned spending into late 1985.

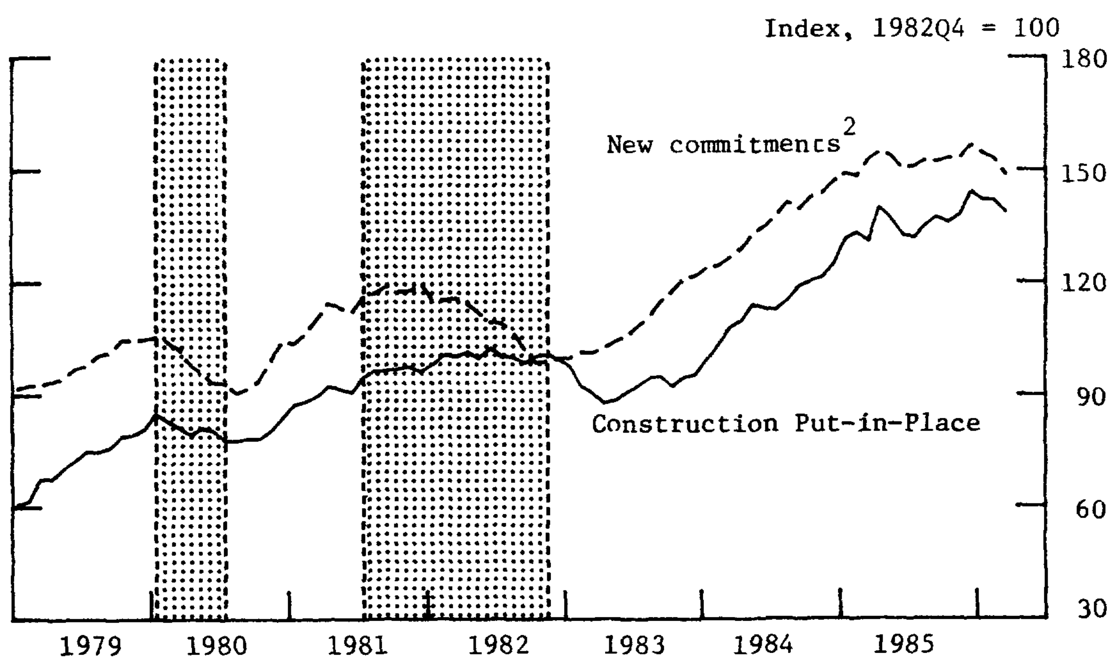
In the case of nonresidential structures, first-quarter real spending was depressed by a 40 percent (annual rate) plunge in drilling activity, a contraction that apparently has continued. In contrast, the remaining categories of nonresidential structures posted a small advance on balance, led in large part by gains in the "other commercial" sector (primarily stores and warehouses). The first-quarter retrenchment in equipment purchases was reflected in a sudden plunge in shipments of nondefense capital goods in January. With the increases posted in subsequent months, shipments by March had recovered to a level 3-3/4 percent above the quarterly average, suggesting a single bounceback in second-quarter equipment outlays.

Looking further ahead, new orders for nondefense capital goods have been lackluster, while new commitments for nonresidential construction have edged off recently, probably reflecting excess capacity in the industrial and office sectors. More generally, fear of adverse tax changes for fixed investment probably will continue to restrain spending. Recent capital spending surveys, reflecting these concerns as well as the contraction in the energy sector, point to no more than modest growth in outlays for the year as a whole. Although firms outside of the oil-producing sector have strengthened their 1986 spending plans since last fall, these gains have been offset by expectations of sharply reduced outlays in petroleum and mining. The most bearish of the surveys--conducted by

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

| | 1985 Q3 | 1985 Q4 | 1986 Q1 | 1986 Jan. | 1986 Feb. | 1986 Mar. | 1986 Apr. |
|---|---|---|---|---|---|---|---|
| **Producers' durable equipment** | | | | | | | |
| Nondefense capital goods | | | | | | | |
| Shipments | .2 | 3.2 | -4.7 | -10.6 | 5.0 | 3.2 | -- |
| Excluding office & store mach. | 1.9 | 3.7 | -2.2 | -8.6 | 4.7 | 1.9 | -- |
| Office and store machinery | -7.4 | .5 | -17.5 | -21.7 | 6.7 | 11.6 | -- |
| Orders | 5.6 | .0 | -3.1 | -19.7 | 17.7 | -5.2 | -- |
| Excluding office & store mach. | 5.7 | 3.2 | -3.5 | -19.3 | 7.2 | -2.1 | -- |
| Office and store machinery | 5.3 | -16.8 | -.3 | -23.0 | 121.7 | -20.0 | -- |
| Sales of heavy-weight trucks (thousands of units, A.R.) | 264 | 303 | 262 | 275 | 253 | 259 | -- |
| **Nonresidential structures** | | | | | | | |
| Nonresidential construction | -1.1 | .5 | .8 | -.9 | .1 | -2.1 | -- |
| Commercial building | -.3 | 4.0 | 2.2 | -.2 | -1.5 | -.9 | -- |
| Office | -1.7 | .7 | 1.1 | -1.2 | -2.5 | .1 | -- |
| Other commercial | 1.4 | 7.7 | 3.4 | .8 | -.4 | -2.0 | -- |
| Industrial building | -5.8 | 6.9 | -5.7 | -9.3 | 3.2 | -11.1 | -- |
| Rotary drilling rigs in use | .7 | -10.2 | -21.0 | -4.6 | -15.1 | -17.5 | -18.0 |

NONRESIDENTIAL CONSTRUCTION AND NEW COMMITMENTS[1]




1. Source F.W. Dodge and Census.
2. Six-month moving average (sum of contracts and permits).

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

| | 1985 Q3 | 1985 Q4 | 1986 Q1 | 1986 Jan. | 1986 Feb.r | 1986 Mar.p |
|---|---|---|---|---|---|---|
| Book Value Basis: | | | | | | |
| Total | -5.6 | 17.6 | 18.4 | 21.8 | 2.5 | 30.7 |
| Manufacturing | -6.6 | -8.6 | -10.0 | -18.3 | -13.5 | 1.6 |
| Wholesale | -2.1 | 6.1 | 4.3 | 8.2 | -.8 | 5.5 |
| Retail | 3.1 | 20.1 | 24.1 | 32.0 | 16.7 | 23.6 |
| Automotive | -6.8 | 19.9 | 15.4 | 14.7 | 10.0 | 21.6 |
| Ex. auto | 9.9 | .2 | 8.7 | 17.3 | 6.7 | 2.0 |
| Constant Dollar Basis: | | | | | | |
| Total | 1.5 | 14.6 | -- | 25.7 | 16.4 | -- |
| Manufacturing | -4.0 | -10.5 | -- | -22.8 | -8.0 | -- |
| Wholesale | 3.3 | 4.5 | -- | 5.7 | 4.6 | -- |
| Retail | 2.2 | 20.5 | -- | 42.8 | 19.7 | -- |
| Automotive | -5.7 | 19.9 | -- | 18.9 | 16.5 | -- |
| Ex. auto | 7.9 | .7 | -- | 24.0 | 3.3 | -- |

INVENTORIES RELATIVE TO SALES[1]

| | Cyclical Reference Points[2] 81 low | Cyclical Reference Points[2] 82 high | 1985 Q3 | 1985 Q4 | 1986 Q1 | 1986 Jan. | 1986 Feb.r | 1986 Mar.p |
|---|---|---|---|---|---|---|---|---|
| Book Value Basis: | | | | | | | | |
| Total | 1.39 | 1.53 | 1.36 | 1.36 | 1.38 | 1.35 | 1.37 | 1.40 |
| Manufacturing | 1.60 | 1.77 | 1.46 | 1.42 | 1.43 | 1.41 | 1.42 | 1.46 |
| Wholesale | 1.06 | 1.28 | 1.18 | 1.18 | 1.20 | 1.18 | 1.20 | 1.22 |
| Retail | 1.37 | 1.46 | 1.37 | 1.43 | 1.47 | 1.43 | 1.45 | 1.48 |
| Automotive | 1.57 | 1.90 | 1.34 | 1.65 | 1.79 | 1.65 | 1.70 | 1.85 |
| Ex. Auto | 1.31 | 1.37 | 1.39 | 1.37 | 1.37 | 1.37 | 1.37 | 1.37 |
| Constant Dollar Basis: | | | | | | | | |
| Total | 1.58 | 1.72 | 1.53 | 1.54 | -- | 1.54 | 1.54 | -- |
| Manufacturing | 1.88 | 2.04 | 1.76 | 1.72 | -- | 1.72 | 1.72 | -- |
| Wholesale | 1.26 | 1.45 | 1.31 | 1.31 | -- | 1.30 | 1.32 | -- |
| Retail | 1.38 | 1.49 | 1.37 | 1.45 | -- | 1.46 | 1.47 | -- |
| Automotive | 1.54 | 1.90 | 1.15 | 1.51 | -- | 1.52 | 1.60 | -- |
| Ex. auto | 1.31 | 1.41 | 1.44 | 1.43 | -- | 1.45 | 1.44 | -- |

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.

McGraw-Hill in March and April--indicated a 1/2 percent decline in nominal expenditures this year, which implies further declines in spending over the rest of 1986. In contrast, the latest Merrill Lynch survey, reported a planned increase of 3 percent in 1986 spending, about in line with the earlier Commerce Department survey. Given the low first-quarter level of outlays, these plans imply moderate spending gains by the end of 1986. Because none of these three surveys has a distinctly better track record than the others in predicting actual spending, their differing implications underscore the considerable uncertainty about investment spending over the rest of this year.

Housing

The pace of new residential construction remained vigorous during March as private housing starts registered a 1.95 million unit annual rate. Single-family starts were about unchanged from the previous month's high level while multifamily starts dropped 7 percent from their advanced February rate. For the first quarter as a whole, total housing starts were up 12 percent from the previous three-month period, and rose in all regions except the South. The dip in housing starts in the South is attributable in part to earlier overbuilding as well as to economic problems in some of the oil-producing areas. Indeed, rental vacancy rates in the South rose to a record 9.5 percent in the first quarter, and remain well above those in other regions of the U.S. Nationally, newly-issued residential building permits picked up by 2 percent in March and were up 6 percent for the first quarter--rising in all regions except the South.

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

| | 1985 | | 1986 | 1986 | | |
|---|---|---|---|---|---|---|
| | Annual | Q4 | Q1 | Jan. | Feb. | Mar.[1] |
| All units | | | | | | |
| Permits | 1.73 | 1.74 | 1.85 | 1.91 | 1.80 | 1.85 |
| Starts | 1.74 | 1.77 | 1.99 | 2.03 | 2.00 | 1.95 |
| Single-family units | | | | | | |
| Permits | .95 | .95 | 1.06 | 1.09 | 1.02 | 1.05 |
| Starts | 1.07 | 1.07 | 1.25 | 1.34 | 1.20 | 1.21 |
| Sales | | | | | | |
| New homes | .69 | .70 | .78 | .74 | .71 | .90 |
| Existing homes | 3.22 | 3.50 | 3.27 | 3.30 | 3.27 | 3.23 |
| Multifamily units | | | | | | |
| Permits | .77 | .79 | .80 | .81 | .78 | .80 |
| Starts | .67 | .70 | .74 | .70 | .79 | .74 |
| Mobile home shipments | .28 | .29 | n.a. | .28 | .27 | n.a. |

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

Sales of new single-family homes jumped in March to the highest level in the 23-year history of the series. The robust first-quarter sales pace left the inventory of unsold homes at its lowest level in over a year and a half. In contrast to new homes, sales of existing homes showed no response through March to the falloff in mortgage interest rates. Sales were unchanged from February's pace and 7 percent below the high fourth-quarter pace.

In many cases, consumers have responded to lower interest rates by purchasing higher quality homes. Although average new home prices increased 9 percent over the year ended in the first quarter of 1986, the constant-quality new home price index rose only 2.5 percent during this period. The average sales price of existing homes also rose 9 percent in the year ended in March.

Business Inventories

The business inventory picture has changed little this year, apart from the buildup in auto dealers' stocks. In the manufacturing sector, inventories declined in the first quarter, as they have since early 1985; except for some special categories, however, such as petroleum and the volatile aircraft series, recent changes in manufacturers' inventories have been relatively moderate. Overall, the evidence suggests that, with goods prices flat, sales still sluggish, and materials in ready supply, manufacturers have no desire to boost stocks. Nonauto trade stocks rose moderately early this year, and stock-sales ratios were little changed.

Federal Government

Real federal purchases declined at a 32 percent annual rate in the first quarter, reflecting a marked slowdown in Commodity Credit Corporation

(CCC) acquisitions of agricultural inventories and a decline in defense spending. The pattern of CCC purchases in recent quarters largely reflects problems in the agricultural sector. Late last year, when a huge crop harvest was depressing market prices, financially-strapped farmers turned to the CCC in extraordinary numbers for loans to finance inventories. (In the National Income Accounts, these loans are counted as part of federal purchases.) First-quarter CCC loan activity, although still substantial, was at a much slower pace than in the fourth quarter. To a considerable extent, the fluctuations in CCC stockpiling in recent quarters have been mirrored by opposite and largely offsetting changes in private farm inventories, and thus have had little net effect on real GNP.

First-quarter defense purchases were reduced by slower than scheduled deliveries of some big ticket items, such as the B-1 bomber, and delays in the delivery of space equipment related to the Challenger shuttle disaster. Spending for research and development services also declined. It should be noted that preliminary NIPA defense estimates were based on actual federal outlay data for only January and February. The more recent March figures show some bounceback in defense outlays.

On May 1, the Senate passed a budget resolution that would reduce the fiscal 1987 deficit (based on the economic assumptions in the Congressional Budget Office baseline) to the $144 billion limit mandated in the Gramm-Rudman-Hollings Act. Compared with the administration's February budget, the Senate resolution calls for $7 billion more in 1987 tax increases and $7 billion less in 1987 nondefense cuts. The Senate budget also would provide $19 billion less in new fiscal 1987 defense budget authority,

REAL FEDERAL PURCHASES
(Billions of 1982 dollars, SAAR)

| | 1985 Q1 | 1985 Q2 | 1985 Q3 | 1985 Q4 | 1986 Q1 |
|---|---|---|---|---|---|
| Total purchases | 304.3 | 305.9 | 331.1 | 349.0 | 316.7 |
| Nondefense purchases | 77.6 | 74.3 | 87.9 | 107.7 | 79.7 |
| Commodity Credit Corporation | 3.8 | .2 | 13.0 | 33.7 | 6.7 |
| Other nondefense purchases | 73.8 | 74.1 | 74.9 | 74.0 | 73.0 |
| Defense purchases | 226.7 | 231.5 | 243.3 | 241.3 | 237.0 |
| Durable goods | 67.9 | 69.6 | 76.5 | 72.4 | 71.7 |
| Research and development | 23.4 | 24.1 | 25.3 | 27.2 | 24.9 |
| Other defense | 135.4 | 137.8 | 141.5 | 141.7 | 140.4 |
| Memo: | | | | | |
| Real GNP[1] | 3.7 | 1.1 | 3.0 | .7 | 3.2 |
| Real GNP excluding CCC[1] | 3.5 | 1.5 | 1.6 | -1.6 | 6.4 |
| Real GNP excluding CCC and private farm inventories[1] | 3.2 | 1.4 | 2.5 | .8 | 3.6 |

1. Percent change from previous quarter at annual rates.

SENATE-PASSED BUDGET RESOLUTION
(Fiscal years, billions of dollars)

| | 1987 | 1988 | 1989 |
|---|---|---|---|
| Baseline deficit[1] | 182.7 | 166.8 | 143.9 |
| Proposed changes:[2] | | | |
| Revenue increases | -13.2 | -20.2 | -20.6 |
| Defense cuts | -2.0 | -4.6 | -5.7 |
| Nondefense cuts | -22.3 | -29.3 | -37.4 |
| Net interest | -1.2 | -2.6 | -8.1 |
| Total changes | -38.7 | -56.7 | -71.8 |
| Senate resolution deficit | 144.0 | 110.1 | 72.1 |

1. Estimated by CBO based on its February baseline economic assumptions and updated (in March) technical estimates.
2. Sign on changes denotes direction of effect on deficit.

although outlay estimates are essentially the same as in the administration budget owing to projections of higher rates of spending out of existing budget authority.

On May 8, the House Budget Committee also approved a budget plan that is similar in many respects to the Senate plan. The principal difference is a cut in defense outlays that is $6 billion larger, but there also are some differences in the composition and size of nondefense cuts; revenue proposals are about the same. Action on this proposal by the full House is expected later this week.

In other Congressional action, the Senate Finance Committee has approved a comprehensive tax reform package, which is scheduled to be considered by the full Senate during June; the House approved a somewhat different reform package last December. Both packages would lower marginal individual and corporate income tax rates and eliminate various tax preferences and loopholes that currently narrow the tax base. The bills also would shift tax burdens from individuals to corporations, with a somewhat greater shift in the House bill. Differences between the House and Senate bills will have to be reconciled in a Senate-House conference before a final bill is enacted.

State and Local Sector

Real outlays for goods and services in the state and local sector rose 2.4 percent in the first quarter, about the same as the growth over the four quarters of last year. Most of the increase was in spending for construction; real outlays for compensation rose only slightly.

Although the sector as a whole expanded during the first quarter, some states, especially those dependent on agricultural and energy-related sources of revenue, are experiencing hardships. Oil-producing states have faced shrinking revenues from severance taxes based on the quantity or value of extracted natural resources. A rough estimate indicates that a $10 drop in the price of oil, about what has occurred so far this year, has cost most of these states 5 to 10 percent of total expected revenue. Secondary effects on energy-related community businesses and personal income are likely to reduce revenues further. In addition, the weakness in farm income and related spillover effects on agricultural-related businesses continue to affect many agricultural states.

It appears that most of the states facing erosion on their budget positions are rapidly making adjustments, either through budget cuts or tax increases. Seventeen states already have reduced fiscal 1986 expenditures from planned levels (in particular, Texas, Oklahoma, and North Dakota have cut spending substantially), while other states are reducing budgets for fiscal 1987. In addition, more than 40 states are planning some sort of limitation on salary increases to employees, several are limiting hiring, and a few states are likely to begin furloughing state employees later this year.

Some states also are undertaking alternative measures to deal with revenue shortfalls. Alaska and Wyoming are transferring funds from their reserve accounts, while other states are planning tax increases. A recent canvas indicates that 12 states are planning to raise taxes in fiscal 1987, while only 4 are planning reductions. As in recent years, the preference seems to be for increases in sales and excise taxes, especially for fuel and tobacco, and reductions in income taxes.

Prices

Major price indexes continued to fall in March, led by a further drop in prices for petroleum products. The consumer price index for all urban consumers fell 0.4 percent for the second month, and producer prices of finished goods were down more than one percent. During the first quarter of this year, the CPI and PPI fell at annual rates of about 2 and 12-1/2 percent, respectively.

Retail prices for both gasoline and fuel oil dropped further in March, reflecting the continued passthrough of lower crude oil costs. The prices of both products fell almost 20 percent in the first three months of this year, and private survey data indicate that pump prices declined significantly further in April. However, in the volatile spot market, prices have turned up recently in response to tight near-term supplies of refinery products and increased demand.

Food prices also helped to hold down inflation rates in the first quarter. They edged up at the consumer level in March, after a sharp February decline, but are down on balance so far this year. Recent price movements for agricultural commodities suggest that the PPI for crude foods probably declined in April for the fifth consecutive month, but may turn up in May.

Increases in prices of imported goods have picked up recently, in response to the substantial depreciation of the dollar over the past year. As measured by the BLS index, the prices of nonfuel imports rose 3.4 percent (not annualized) in the three months ended in March. So far, however, the higher import prices do not appear to have had much effect

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

| | Relative Importance Dec. 1985 | 1985 | 1985 Q3 | 1985 Q4 | 1986 Q1 | 1986 Feb. | 1986 Mar. |
|---|---|---|---|---|---|---|---|
| | | | --Annual rate-- | | | --Monthly rate-- | |
| All items[2] | 100.0 | 3.8 | 2.4 | 5.3 | -1.9 | -.4 | -.4 |
| Food | 18.5 | 2.7 | 2.1 | 5.9 | -1.4 | -.7 | .1 |
| Energy | 11.3 | 1.8 | -3.2 | 3.3 | -34.2 | -3.8 | -6.5 |
| All items less food and energy[3] | 70.2 | 4.4 | 3.4 | 5.4 | 4.1 | .2 | .4 |
| Commodities[3] | 25.9 | 2.1 | 1.1 | 3.6 | .3 | -.1 | -.1 |
| Services[3] | 44.4 | 5.7 | 4.8 | 6.5 | 6.5 | .4 | .6 |
| Memorandum: | | | | | | | |
| CPI-W[4] | 100.0 | 3.6 | 2.0 | 5.2 | -2.7 | -.5 | -.6 |

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. 1985 | 1985 | 1985 Q3 | 1985 Q4 | 1986 Q1 | 1986 Feb. | 1986 Mar. |
|---|---|---|---|---|---|---|---|
| | | | --Annual rate-- | | | --Monthly rate-- | |
| Finished goods | 100.0 | 1.8 | -2.4 | 9.2 | -12.4 | -1.6 | -1.1 |
| Consumer foods | 24.5 | .3 | -2.9 | 15.0 | -6.6 | -1.6 | .3 |
| Consumer energy | 12.5 | .0 | -11.3 | 22.2 | -68.0 | -9.4 | -13.4 |
| Other consumer goods | 40.3 | 2.7 | .0 | 4.5 | 2.7 | -.1 | .8 |
| Capital equipment | 22.7 | 2.7 | -.9 | 5.3 | .9 | .1 | .3 |
| Intermediate materials[2] | 95.3 | -.1 | -1.3 | 2.7 | -11.8 | -1.4 | -1.3 |
| Exc. energy | 79.6 | -.2 | -.7 | -.3 | -.9 | -.2 | .0 |
| Crude food materials | 52.5 | -6.4 | -20.6 | 47.0 | -25.2 | -3.6 | -1.0 |
| Crude energy | 31.6 | -4.3 | -5.9 | -2.0 | -51.1 | -8.2 | -8.9 |
| Other crude materials | 15.9 | -4.5 | -4.4 | 1.0 | -3.2 | -3.0 | 2.6 |

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

on the pricing behavior of domestic producers or on price trends at the retail level. In the CPI, the price index for commodities excluding food and energy edged down for the second month in March, while in the PPI, the prices of capital equipment were little changed, on net, in the first quarter of this year.

The CPI for services excluding energy picked up in March, with large increases for rents, auto insurance, and medical services. This index was up 6-1/2 percent at an annual rate in the first quarter, a bit faster than the average rate of increase over the past two years.

Wages and Labor Costs

Available measures of labor costs provide differing indications of the current rate of wage inflation, but all point to continued restraint so far this year. The hourly earnings index (HEI) was unchanged in April and rose only 0.8 percent at an annual rate in the first four months of this year. In contrast, a more comprehensive measure of wages, the employment cost index (ECI) continues to show wage increases in the 4 percent range, primarily reflecting larger increases for nonproduction and supervisory workers excluded from the HEI. Advances in the ECI measure of hourly compensation costs, which includes employer costs for employee benefits as well as wages and salaries, decelerated by about 1/2 percentage point over the past 12 months, largely reflecting employers' efforts to reduce insurance and pension costs.

In the union sector, wage adjustments for workers covered by major union settlements have continued to be particularly small. These lower union wage adjustments in recent years, coupled with somewhat larger increases

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

| | 1984 | 1985 | 1985 Q3 | 1985 Q4 | 1986 Q1 | 1986 Year to date |
|---|---|---|---|---|---|---|
| Hourly earnings index, wages of production workers[1] | | | | | | First four months |
| Total private nonfarm | 3.1 | 3.0 | 2.0 | 3.3 | 2.4 | .8 |
| Manufacturing | 3.3 | 3.3 | 2.0 | 2.3 | 3.0 | 2.3 |
| Nonmanufacturing | 3.0 | 2.9 | 2.0 | 3.8 | 2.1 | .2 |
| Employment cost index, wages and salaries of all persons[2] | | | | | | 1985 Q1 to 1986 Q1 |
| Total | 4.1 | 4.1 | 5.3 | 2.3 | 3.9 | 3.9 |
| By occupation: | | | | | | |
| White collar | 4.4 | 4.9 | 5.9 | 3.2 | 4.1 | 4.5 |
| Blue collar | 3.6 | 3.4 | 4.7 | 1.0 | 3.7 | 3.4 |
| Service workers | 6.2 | 2.3 | 6.3 | 1.0 | 4.5 | 3.4 |
| By bargaining status: | | | | | | |
| Union | 3.4 | 3.1 | 3.6 | 1.9 | 2.9 | 3.2 |
| Nonunion | 4.5 | 4.6 | 6.0 | 2.3 | 4.5 | 4.3 |
| Employment cost index, compensation of all persons[2] | | | | | | |
| Total | 4.9 | 3.9 | 5.2 | 2.2 | 4.5 | 3.8 |
| Major collective bargaining agreements | | | | | | First three months |
| First-year wage adjustments | 2.4 | 2.3 | -- | -- | -- | .8 |
| Total effective wage change | 3.7 | 3.3 | -- | -- | -- | 2.4 |
| Labor costs and productivity, all persons[1] | | | | | | 1985 Q1 to 1986 Q1 |
| Compensation per hour | 3.8 | 3.7 | 2.8 | 3.2 | 2.4 | 3.1 |
| Output per hour | .8 | -.6 | .4 | -4.1 | 3.4 | .0 |
| Unit labor costs | 3.0 | 4.3 | 2.4 | 7.6 | -1.0 | 3.1 |

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 the nonunion sector, have reversed about one-half of the widening in the union-nonunion wage differential that occurred between 1976 and 1982.

Although compensation trends have been generally favorable, unit labor costs have been rising at a somewhat faster pace than earlier in this expansion, largely owing to sluggish productivity performance. Output per hour was up nearly 3-1/2 percent in the first quarter of this year, but this rise did not quite offset the sharp drop in output per hour in the fourth quarter. Indeed, productivity has been essentially flat over the past year and a half. As a result, all of the recent increases in compensation per hour have been passed directly through into higher unit labor costs, a marked contrast to the offset provided by rapid productivity growth during the earlier stage of this business expansion.

III-T-1

SELECTED FINANCIAL MARKET QUOTATIONS[1]

(Percent)

| | 1982/1983 | 1984 | 1985 | 1986 | | Change from: | |
|---|---|---|---|---|---|---|---|
| | Cyclical lows | Highs | March highs | FOMC Apr. 1 | May 13 | 1985 highs | FOMC Apr. 1 |
| **Short-term rates** | | | | | | | |
| Federal funds[2] | 8.46 | 11.63 | 8.58 | 7.36 | 6.87 | -1.71 | -.49 |
| Treasury bills[3] | | | | | | | |
| 3-month | 7.08 | 10.67 | 8.80 | 6.33 | 6.09 | -2.71 | -.24 |
| 6-month | 7.62 | 10.77 | 9.13 | 6.32 | 6.10 | -3.03 | -.22 |
| 1-year | 7.73 | 11.13 | 9.25 | 6.30 | 6.20 | -3.05 | -.10 |
| Commercial paper | | | | | | | |
| 1-month | 8.00 | 11.42 | 8.94 | 7.23 | 6.74 | -2.20 | -.49 |
| 3-month | 7.97 | 11.35 | 9.12 | 7.04 | 6.61 | -2.51 | -.43 |
| Large negotiable CDs[3] | | | | | | | |
| 1-month | 8.08 | 11.52 | 8.89 | 7.12 | 6.69 | -2.20 | -.43 |
| 3-month | 8.12 | 11.79 | 9.29 | 7.00 | 6.67 | -2.62 | -.33 |
| 6-month | 8.20 | 12.30 | 9.92 | 6.92 | 6.67 | -3.25 | -.25 |
| Eurodollar deposits[4] | | | | | | | |
| 1-month | 8.68 | 11.89 | 8.89 | 7.34 | 6.83 | -2.06 | -.51 |
| 3-month | 8.71 | 12.20 | 9.58 | 7.23 | 6.74 | -2.84 | -.49 |
| Bank prime rate | 10.50 | 13.00 | 10.50 | 9.00 | 8.50 | -2.00 | -.50 |
| Treasury bill futures | | | | | | | |
| June 1986 contract | | | 10.58 | 5.94 | 6.03 | -4.55 | .09 |
| Sept. 1986 contract | | | 10.74 | 5.84 | 5.83 | -4.91 | -.01 |
| **Intermediate- and long-term rates** | | | | | | | |
| U.S. Treasury (constant maturity) | | | | | | | |
| 3-year | 9.33 | 13.49 | 11.22 | 7.01 | 7.18 | -4.04 | .17 |
| 10-year | 10.12 | 13.99 | 12.02 | 7.37 | 7.63 | -4.39 | .26 |
| 30-year | 10.27 | 13.94 | 11.97 | 7.47 | 7.42 | -4.55 | -.05 |
| Municipal revenue[5] (Bond Buyer index) | 9.21 | 11.44 | 10.25 | 7.69 | 7.76 | -2.49 | .07 |
| Corporate--A utility Recently offered | 11.64 | 15.30 | 13.23 | 9.14 | 9.39 | -3.84 | .25 |
| Home mortgage rates[6] | | | | | | | |
| S&L fixed-rate | 12.55 | 14.68 | 13.29 | 10.10 | 10.00 | -3.29 | -.10 |
| S&L ARM, 1-yr. | n.a. | 12.31 | 11.14 | 8.67 | 8.59 | -2.55 | -.08 |

| | 1983 | 1984 | 1985 | 1986 | | Percent change from: | |
|---|---|---|---|---|---|---|---|
| | Highs | Lows | March highs | FOMC Apr. 1 | May 13 | 1985 high | FOMC Apr. 1 |
| **Stock prices** | | | | | | | |
| Dow-Jones Industrial | 1287.20 | 1086.57 | 1553.10 | 1790.11 | 1785.34 | 14.95 | -.27 |
| NYSE Composite | 99.63 | 85.13 | 121.90 | 135.86 | 136.35 | 11.85 | .36 |
| AMEX Composite | 249.03 | 187.16 | 246.13 | 267.43 | 273.41 | 11.08 | 2.24 |
| NASDAQ (OTC) | 328.91 | 225.30 | 325.16 | 374.15 | 386.66 | 18.91 | 3.34 |

1. One-day quotes except as noted.
2. Averages for two-week reserve maintenance period closest to date shown. Last observation is average to date for the maintenance period ending May 7, 1986.
3. Secondary market.
4. Averages for statement week closest to date shown.
5. One-day quotes for preceding Thursday.
6. One-day quotes for preceding Friday.
e--estimate

The powerful securities market rally continued into mid-April before faltering somewhat. Interest rates fell during the first part of the intermeeting period as market participants viewed the economy as expanding sluggishly and inflation prospects as favorable, and expectations of another reduction in the discount rate became widespread. The discount rate was cut by 1/2 percentage point on April 18. A backup in rates occurred thereafter, however, in association with a sharp fall in the value of the dollar and an uptick in oil prices, events that reportedly led traders to reevaluate prospects for further easing steps by the System. Most long-term interest rates are near their levels of the last FOMC meeting, while intermediate-term rates have risen, and short rates are lower by 1/4 to 1/2 percentage point.

The monetary aggregates grew briskly in April as more rapid declines in security yields than in deposit rates boosted inflows to the more liquid components. M1 soared farther above its 1986 range; this strength, combined with accelerated growth in money fund shares, MMDAs, and savings deposits, pushed M2 up into its target range for the first time this year. M3 remained near the center of its target range, with flatness in its non-M2 component damping its expansion relative to the narrow aggregates.

Borrowing activity has mushroomed in the past few months; although it is somewhat difficult to measure the net flows at this point, expansion of domestic nonfinancial debt probably is picking up this quarter after a substantial slowing earlier in the year. Corporate bond issuance has continued to break records--despite a smaller volume of share retirements in connection with mergers and other corporate restructurings, and a stepped-up pace of new equity issuance in response to record stock prices--as firms call older,

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

| | 1984:Q4 to 1985:Q4 | 1985 Q4 | 1986 Q1 | 1986 Feb. | 1986 Mar. | 1986 Apr.pe | Growth from Q4 1985 to Apr. 1986pe |
|---|---|---|---|---|---|---|---|
| | — Percentage change at annual rates — | | | | | | |
| 1. M1 | 11.9 | 10.7 | 7.7 | 7.5 | 13.9 | 14 | 10 |
| 2. M2 | 8.6 | 6.0 | 4.2 | 3.6 | 6.3 | 13 | 6-1/4 |
| 3. M3 | 7.7 | 6.4 | 7.3 | 6.1 | 6.6 | 10 | 7-3/4 |
| | | | | | | | Levels in billions of dollars Mar. 1986 |
| Selected components | | | | | | | |
| 4. Currency | 7.5 | 7.4 | 7.5 | 7.0 | 6.9 | 4 | 173.9 |
| 5. Demand deposits | 8.6 | 7.7 | 3.0 | 0.9 | 17.8 | 11 | 273.1 |
| 6. Other checkable deposits | 22.3 | 18.8 | 15.0 | 17.3 | 13.8 | 29 | 185.2 |
| 7. M2 minus M1[2] | 7.6 | 4.6 | 3.1 | 2.3 | 3.9 | 13 | 1952.0 |
| 8. Overnight RPs and Eurodollars, NSA | 18.7 | 24.2 | 3.0 | -7.1 | -35.5 | 2 | 65.6 |
| 9. General purpose and broker/dealer money market mutual fund shares, NSA | 9.3 | 0.9 | 11.1 | 22.3 | 35.1 | 36 | 186.3 |
| 10. Commercial banks | 9.1 | 5.2 | 7.1 | 2.8 | 6.9 | 6 | 854.8 |
| 11. Savings deposits, SA, plus MMDAs, NSA[3] | 19.0 | 11.1 | 8.7 | 1.3 | 10.4 | 14 | 465.9 |
| 12. Small time deposits | -0.6 | -1.6 | 5.2 | 4.7 | 2.8 | -3 | 388.9 |
| 13. Thrift institutions | 5.1 | 1.4 | 4.4 | 6.3 | 6.7 | 7 | 867.1 |
| 14. Savings deposits, SA, plus MMDAs, NSA[3] | 13.7 | 7.4 | 1.3 | 3.7 | 6.7 | 13 | 361.4 |
| 15. Small time deposits | -0.4 | -2.9 | 6.6 | 8.2 | 6.7 | 3 | 505.7 |
| 16. M3 minus M2[4] | 3.8 | 8.0 | 19.8 | 15.9 | 7.4 | -1 | 667.7 |
| 17. Large time deposits | 5.7 | 10.8 | 15.5 | 8.8 | -1.9 | 4 | 450.4 |
| 18. At commercial banks, net[5] | 5.1 | 14.1 | 18.5 | 7.0 | -17.7 | 0 | 287.1 |
| 19. At thrift institutions | 6.8 | 5.2 | 10.0 | 11.4 | 27.1 | 13 | 163.3 |
| 20. Institution-only money market mutual fund shares, NSA | 11.1 | 3.1 | 26.8 | 7.1 | 44.3 | 67 | 70.2 |
| 21. Term RPs, NSA | -4.4 | 39.2 | 47.2 | 31.5 | 18.8 | -30 | 71.4 |
| 22. Term Eurodollars, NSA | -4.0 | -6.0 | 2.5 | 40.7 | 24.2 | -13 | 80.9 |
| | — Average monthly change in billions of dollars — | | | | | | |
| MEMORANDA: | | | | | | | |
| 23. Managed liabilities at commercial banks (24+25) | 2.3 | 6.4 | 7.6 | 2.9 | 4.9 | -10 | 484.2 |
| 24. Large time deposits, gross | 1.0 | 2.3 | 3.3 | 2.4 | -4.2 | -1 | 347.6 |
| 25. Nondeposit funds | 1.3 | 4.1 | 4.3 | 0.5 | 9.1 | -9 | 136.6 |
| 26. Net due to related foreign institutions, NSA | 0.3 | 0.8 | 2.4 | -0.4 | 1.5 | -7 | -19.5 |
| 27. Other[6] | 1.0 | 3.3 | 1.9 | 0.9 | 7.7 | -1 | 156.2 |
| 28. U.S. government deposits at commercial banks[7] | 0.2 | 0.9 | -0.6 | 2.1 | -5.4 | 1 | 15.7 |

1. Quarterly growth rates are computed on a quarterly average basis. Dollar amounts shown under memoranda for quarterly changes are calculated on an end-month-of-quarter basis.
2. Nontransactions M2 is seasonally adjusted as a whole.
3. Growth rates are for savings deposits, seasonally adjusted, plus money market deposit accounts (MMDAs), not seasonally adjusted. Commercial bank savings deposits excluding MMDAs increased during March and April 1986 at rates of 5.8 percent and 10 percent, respectively. At thrift institutions, savings deposits excluding MMDAs increased during March and April 1986 at rates of 8.7 percent and 24 percent, respectively.
4. The non-M2 component of M3 is seasonally adjusted as a whole.
5. Net of large-denomination time deposits held by money market mutual funds and thrift institutions.
6. 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.
7. Consists of Treasury demand deposits and note balances at commercial banks.
pe--preliminary estimate

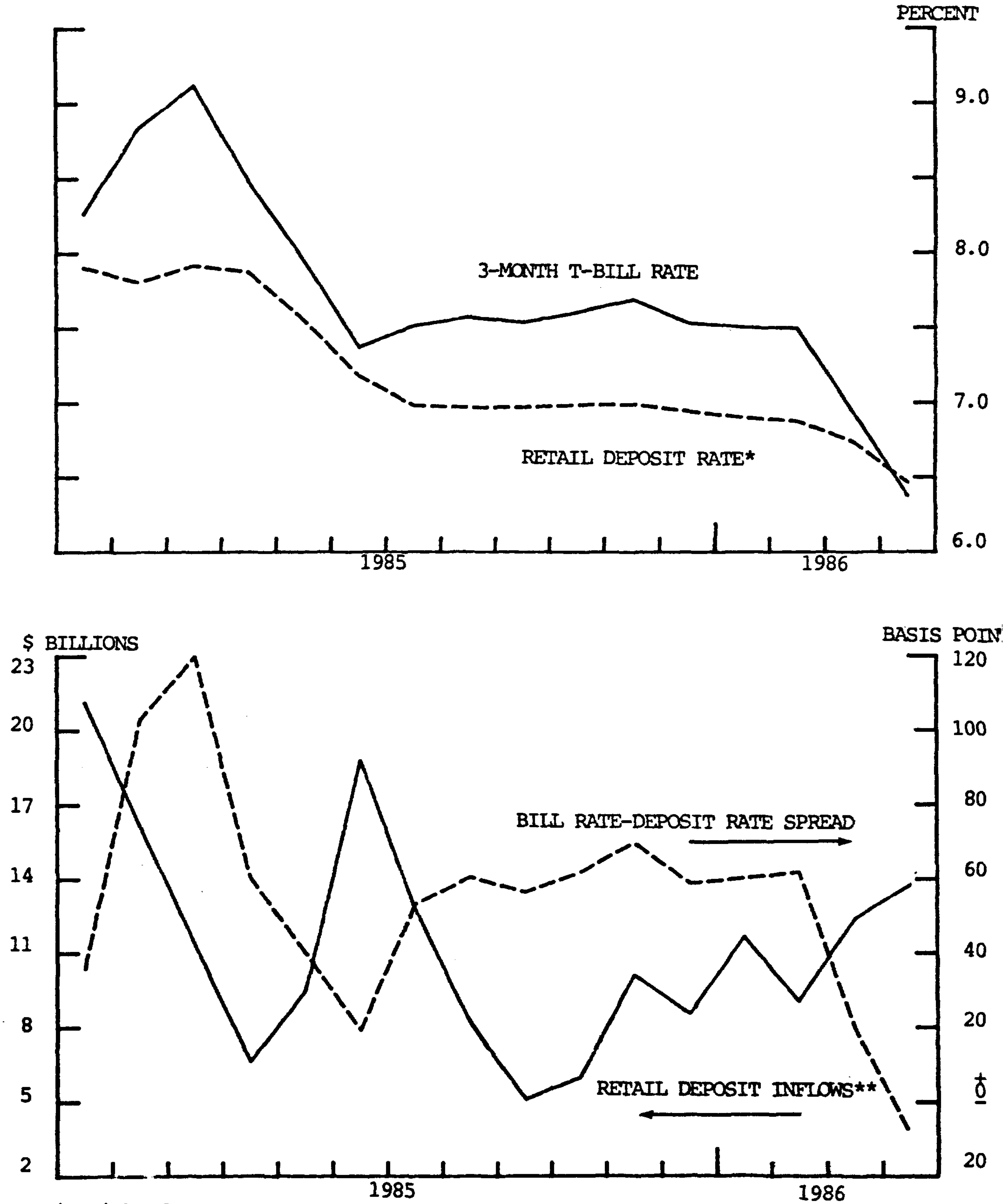
higher-rate bonds and repay short-term debt. The municipal bond market has recovered from its worst fears of tax reform, and issuance of tax-exempt bonds in April exceeded the average monthly rate of every past year but 1985. Activity is hectic in the residential mortgage market, with a torrent of refinancing applications reportedly delaying closings in many real estate transactions; available evidence suggests that overall household sector debt growth is being restrained by a slowing in consumer installment credit expansion. The Treasury has increased its borrowing sharply in the second quarter on a seasonally adjusted basis, after drawing down high year-end cash balances in the first quarter.

Monetary Aggregates and Bank Credit

M1 rose in April at about a 14 percent annual rate for the second consecutive month, raising this aggregate farther above its 3-to-8 percent target range for 1986. The sustained strength in narrow money last month resulted primarily from an acceleration of other checkable deposits (OCDs). Growth in currency and demand deposits moderated, though demand deposits advanced at a still rapid 11 percent clip. Recent declines in market interest rates undoubtedly have contributed importantly to the acceleration in M1 over the past two months. M1 also likely was boosted a bit by larger federal tax refunds this April than in recent years.

M2 grew at a 13 percent annual rate in April, its fastest pace since June of last year. After sluggish growth in the first quarter, this surge pushed M2 just above the lower limit of its 1986 target cone of 6 to 9 percent.

MONTHLY INFLOWS TO RETAIL INTEREST-BEARING DEPOSITS
AND MARKET-BANK RATE SPREADS




* Weighted average rate on OCDs, MMDAs, savings deposits, and small time deposits at banks.

** Inflows to OCDs, MMDAs, savings deposits, and small time deposits at all depository institutions.

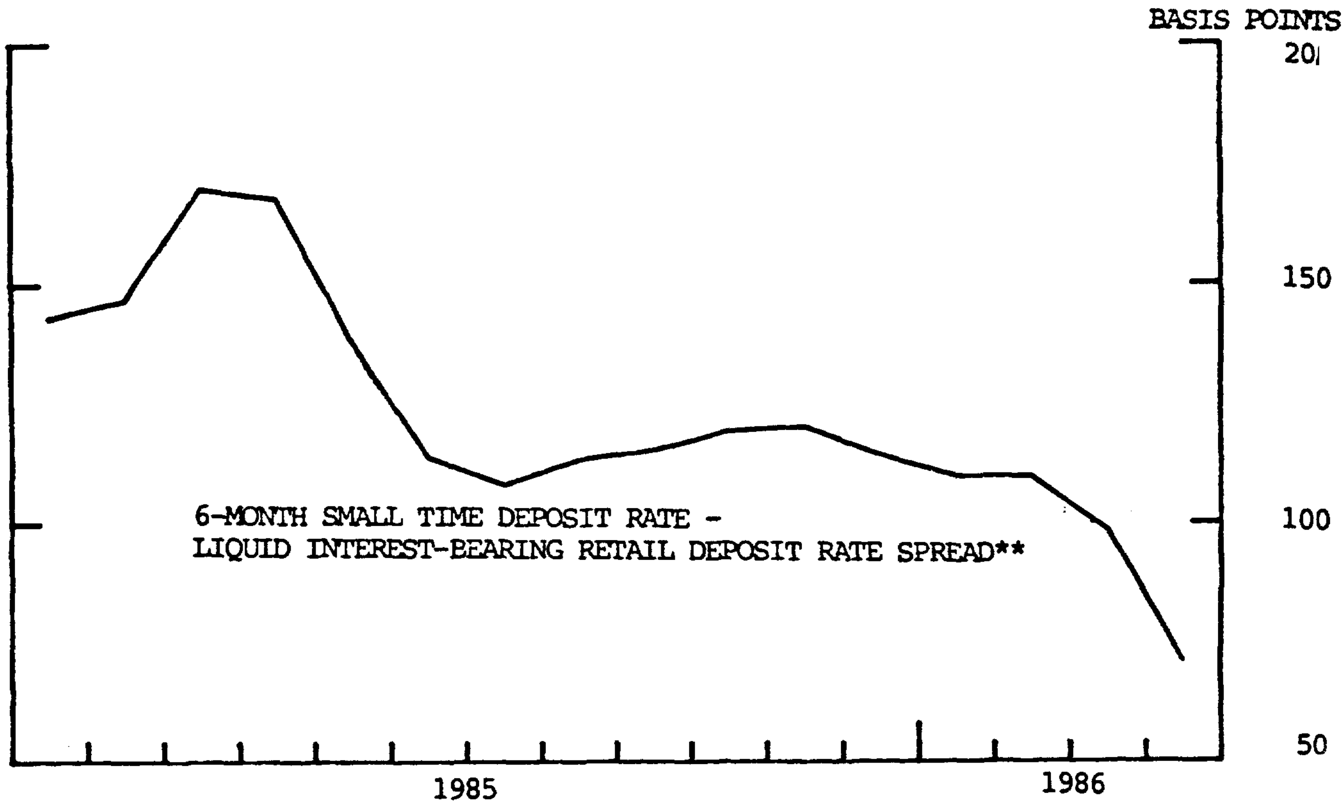
That M2, even after the April surge, has recorded comparatively slow growth may reflect in part the influence of rising investor interest in stock and, especially, bond mutual funds. Net sales of these funds have broken records month after month.

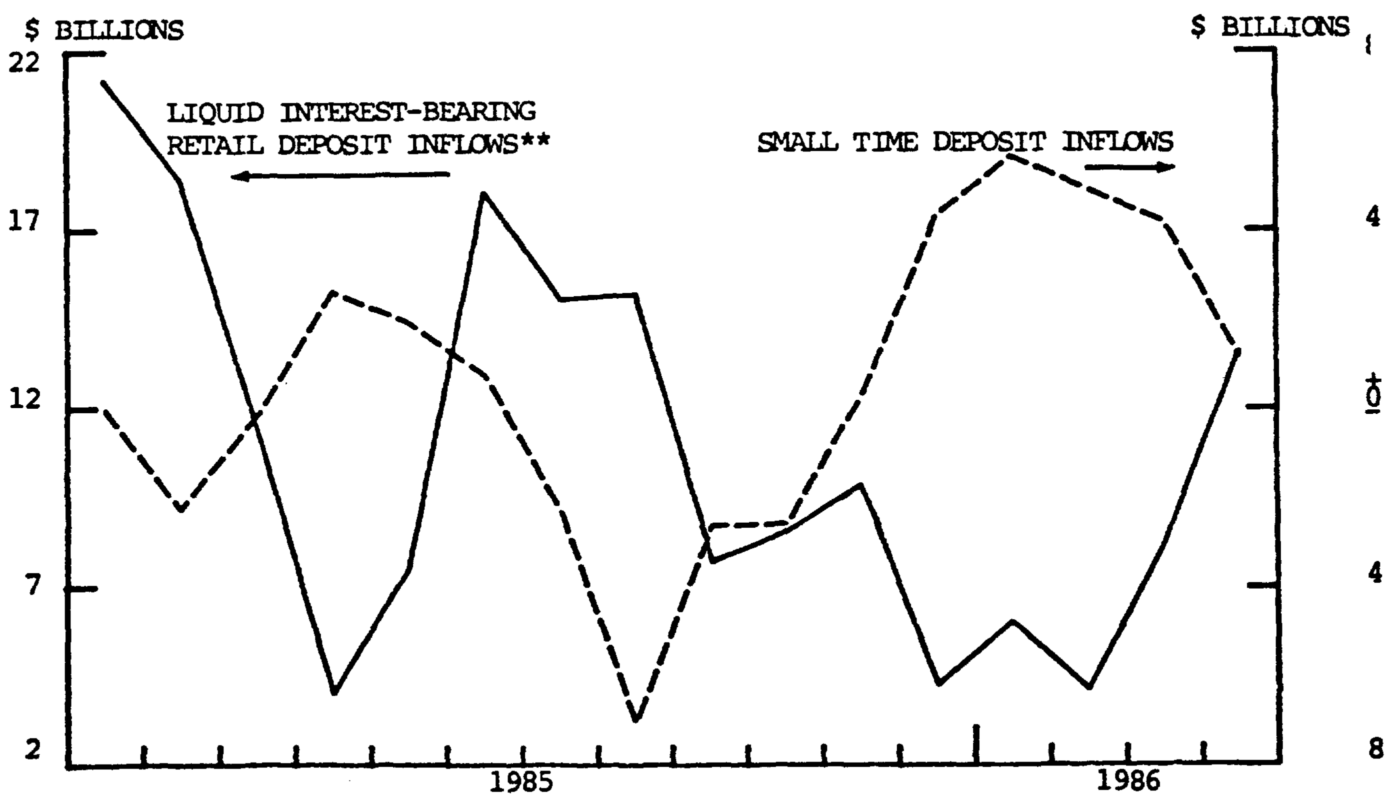
The nontransaction component of M2 in April was boosted by inflows to liquid retail accounts. Tax refunds may have contributed to these inflows, but the more important factor would appear to be interest rates. Savings deposits grew at their fastest monthly rate since late 1982 (when a temporary bulge was created by heavy competition among institutions for funds in anticipation of the introduction of MMDAs). Ceilings on passbook savings rates were removed on April 1, but in the prevailing environment depository institutions generally did not move to raise their rates.[1] Nonetheless, the bulk of the increase in savings deposits likely reflects narrowing yield spreads between savings deposits and alternative instruments.

Indeed, the acceleration of consumer-type deposits as a whole over the past two months is consistent with changes in yield relationships. Offering rates on these deposits have not matched the sharp drop in market rates, resulting in narrower, and in some instances even negative, spreads. The chart depicts the spread of market rates (represented by the 3-month Treasury bill rate) over a weighted average of rates offered by commercial banks on OCDs, MMDAs, savings deposits, and small time deposits, along with the inflows into the sum of these accounts at all depository institutions. Inflows to these deposits clearly have been inversely related to the rate spread.

1. Reports from the Reserve Bank contact group indicate that few depository institutions responded to the ceiling removal by offering higher rates, and a scattering of institutions actually lowered savings rates. Share accounts at credit unions, which are included in savings deposits but were unaffected by removal of the passbook rate ceiling, accounted for a disproportionate amount of the increase in savings deposits in April.

MONTHLY BANK RATE SPREADS AND DEPOSIT INFLOWS*




* Spreads are for rates offered at commercial banks and are calculated from FR 2042 data, except for April, which is estimated using data from the Bank Rate Monitor. Inflows are to all depository institutions.

** Liquid interest-bearing retail deposits consist of OCDs, MMDAs, and Savings deposits. The rate on these deposits is a weighted-average rate.

Rate spreads also appear to be influencing the relative growth rates of components of the aggregates. The top panel of the chart shows the spread at commercial banks between the 6-month small time deposit rate and a weighted average rate on Super NOW accounts, savings accounts, and MMDAs. Again, the responsiveness of deposit growth to rate spreads is apparent in the lower panel; with small time deposit rates having adjusted comparatively rapidly to downward movements in market rates in the recent period, funds have moved toward the more liquid deposit categories.

M3 expanded at a 10 percent annual rate in April, with all of its growth in its M2 component. Increases in institution-only money funds and large time deposits issued by thrifts were balanced by runoffs of large time deposits and term RPs and Eurodollar deposits at commercial banks. With strong core deposit inflows outstripping bank credit growth in April, commercial banks further reduced their managed liabilities by advancing about $7 billion to their foreign offices.

The weaker bank credit growth in April resulted from a deceleration in loans and and a continued run-off of security holdings. Banks apparently have been taking advantage of much higher securities prices to realize capital gains by selling some of their U.S. government securities. Holdings of tax-exempt securities also have continued to decline, but they still remain above the average level of last December, when banks were in the process of acquiring a large volume of tax-exempt securities amid uncertainty about 1986 tax reform. Real estate loans again showed strong growth in April. Security loans, however, fell off sharply after an extraordinary surge in March, and consumer loans decelerated.

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 |
|---|---|---|---|---|---|---|---|---|
| | | Q3 | Q4 | Q1 | Feb. | Mar. | Apr.p | Aprilp |
| | | Commercial Bank Credit | | | | | | |
| 1. | Total loans and securities at banks | 8.6 | 11.8 | 9.7 | 4.1 | 9.5 | 2.0 | 1944.8 |
| 2. | Securities | 12.4 | 19.6 | 3.0 | 4.0 | -19.0 | -12.0 | 444.0 |
| 3. | U.S. government securities | 9.0 | -3.5 | -4.0 | 28.1 | -12.4 | -14.3 | 264.8 |
| 4. | Other securities | 18.8 | 61.3 | 13.8 | -29.7 | -28.6 | -8.6 | 179.2 |
| 5. | Total loans | 7.4 | 9.4 | 11.8 | 4.2 | 18.4 | 6.3 | 1500.8 |
| 6. | Business loans | 2.4 | 5.5 | 6.6 | 2.7 | 16.5 | 5.0 | 504.2 |
| 7. | Security loans | -18.0 | 5.2 | 99.2 | -36.2 | 186.6 | -47.2 | 46.4 |
| 8. | Real estate loans | 11.2 | 13.0 | 11.7 | 12.4 | 14.2 | 13.5 | 440.5 |
| 9. | Consumer loans | 11.1 | 8.8 | 11.6 | 12.0 | 10.3 | 7.7 | 296.7 |
| 10. | Other loans | 12.3 | 13.5 | 8.1 | -11.3 | 9.1 | 4.5 | 213.0 |
| | | Short- and Intermediate-Term Business Credit | | | | | | |
| 11. | Business loans net of bankers acceptances | 2.2 | 5.0 | 6.9 | 3.4 | 16.4 | 4.8 | 500.2 |
| 12. | Loans at foreign branches[2] | -4.1 | -2.1 | -41.5 | -68.8 | -53.0 | -97.1 | 15.9 |
| 13. | Sum of lines 11 & 12 | 1.9 | 4.7 | 5.1 | 0.7 | 14.1 | 1.2 | 516.1 |
| 14. | Commercial paper issued by nonfinancial firms[3] | -1.5 | 55.5 | -14.4 | -2.7 | -27.4 | -40.7 | 82.6 |
| 15. | Sums of lines 13 & 14 | 1.6 | 11.4 | 2.1 | 0.4 | 7.6 | -4.6 | 598.7 |
| 16. | Bankers acceptances: U.S. trade related[4,5] | -6.7 | -31.7 | -9.8 | -3.7 | -18.6 | n.a. | 31.7 (Mar) |
| 17. | Line 15 plus bankers acceptances: U.S. trade related | 1.0 | 9.0 | 1.6 | 0.2 | 6.5 | n.a. | 632.8 (Mar) |
| 18. | Finance company loans to business[4] | 3.1 | 19.2 | n.a. | 16.5 | n.a. | n.a. | 155.2 (Feb) |
| 19. | Total short- and intermediate-term business credit (sum of lines 17 & 18) | 1.5 | 10.9 | n.a. | 3.4 | n.a. | n.a. | 784.6 (Feb) |

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.

Business Finance

Gross public bond offerings of nonfinancial firms, both here and abroad, set records in April for the third consecutive month. The torrid pace of bond issuance in part reflects corporate efforts to lengthen the maturity of liabilities. More than half of new domestic issues in April were for at least 20 years, and more than 40 percent of Euromarket issuance was fixed-rate debt of at least 10 years' maturity. In addition, outstanding loans and short-term market paper probably contracted in April, as bank business loan growth slowed and nonfinancial commercial paper fell at a 40 percent annual rate.

Gross bond borrowing has been partly offset by retirements of existing higher-coupon issues. Salomon Brothers estimates that $7 billion of nonconvertible debt was called by nonfinancial firms in the first quarter, and another $5 billion in April; this compares with about $8 billion for all of last year, itself a very high total. About half the calls have been by utilities, generally under standard bond indentures allowing debt to be refunded after five years at a small premium above par. A few industrial firms have used "cash calls;" because the debt they are retiring is nonrefundable, that is, protected from calls financed by new debt with a lower coupon, these firms have had to use cash generated from asset sales, stock sales, or accumulated earnings. Even taking account of the stepped-up level of retirements, though, the pace of net bond borrowing appears to have increased greatly, as suggested by the table on page III-11.[1]

1. A large share—estimated at 40 to 50 percent—of the net increase is accounted for by firms that have recently participated in mergers, LBOs, or share repurchases.

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

| | 1984 | 1985 | 1985 | 1986 | | | |
|---|---|---|---|---|---|---|---|
| | Year | Year | Q4 | Q1p | Feb.p | Mar.p | Apr.p |
| Corporate securities - total[1] | 9.90 | 16.12 | 19.29 | 27.78 | 28.14 | 33.40 | 40.35 |
| Public offerings in U.S. | 8.02 | 12.97 | 14.86 | 23.76 | 23.90 | 29.90 | 33.00 |
| Stocks--total[2] | 1.89 | 2.96 | 3.32 | 4.19 | 4.36 | 4.80 | 5.50 |
| Nonfinancial | 1.08 | 1.61 | 1.81 | 2.11 | 2.44 | 1.90 | 2.40 |
| Utility | .22 | .37 | .38 | .54 | .74 | .40 | .20 |
| Industrial | .86 | 1.24 | 1.43 | 1.57 | 1.70 | 1.50 | 2.20 |
| Financial | .81 | 1.35 | 1.51 | 2.08 | 1.92 | 2.90 | 3.10 |
| Bonds--total[1] | 6.13 | 10.01 | 11.54 | 19.57 | 19.54 | 25.10 | 27.50 |
| By industry | | | | | | | |
| Nonfinancial | 2.80 | 5.21 | 6.04 | 10.02 | 9.28 | 14.02 | 17.60 |
| Utility | .87 | 1.51 | 2.28 | 3.32 | 4.11 | 4.38 | 7.10 |
| Industrial | 1.93 | 3.70 | 3.76 | 6.70 | 5.17 | 9.64 | 10.50 |
| Financial | 3.33 | 4.80 | 5.50 | 9.55 | 10.26 | 11.08 | 9.90 |
| By quality[3] | | | | | | | |
| Aaa and Aa | 1.87 | 2.37 | 2.67 | 5.60 | 7.03 | 6.57 | 9.10 |
| A and Baa | 2.11 | 4.58 | 5.20 | 7.75 | 8.08 | 10.28 | 9.10 |
| Less than Baa | 1.09 | 1.42 | 1.72 | 2.74 | 1.03 | 3.28 | 5.80 |
| No rating (or unknown) | .25 | .34 | .39 | .33 | .44 | .31 | |
| Memo items: | | | | | | | |
| Equity based bonds[4] | .63 | .70 | .38 | 1.17 | .90 | 1.43 | 1.73 |
| Mortgage-backed bonds | .81 | 1.30 | 1.56 | 3.15 | 2.96 | 4.66 | 3.20 |
| Variable-rate notes | .72 | .87 | .56 | .24 | .10 | .70 | .15 |
| Bonds sold abroad - total | 1.88 | 3.15 | 4.43 | 4.02 | 4.24 | 3.50 | 7.35 |
| Nonfinancial | .84 | 1.26 | 1.73 | 2.04 | 2.56 | 2.15 | 4.05 |
| Financial | 1.06 | 1.89 | 2.70 | 1.98 | 1.68 | 1.35 | 3.30 |

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.

NET INCREASE IN TAXABLE CORPORATE BONDS OF NONFINANCIAL CORPORATIONS
(billions of dollars, seasonally adjusted annual rates)

| | 1985 | 1986 (Jan. - Apr.) |
|---|---|---|
| New issues | 112 | 208 |
| Estimated retirements | 44 | 87 |
| Net increase | 68 | 121 |

As the volume of bond issues has ballooned, the spread between the Board's recently offered utility rate index and the yield on 30-year Treasuries has widened to well above its 1985 average. Some of this widening may reflect revised investor valuations of the call options retained by debt issuers. Some issuers have responded by offering securities with tighter call and refunding provisions.

Businesses also have maintained a lively pace of issuance of new shares and equity-linked debt in association with the strong stock market, while merger and buyout activity and stock repurchases have slowed appreciably since the end of last year. The preliminary GNP accounts for the first quarter suggest an improvement in economic profits and aggregate after-tax retained earnings probably more than offset stock retirements.

Treasury and Federally Sponsored Agency Financing

The staff is projecting a combined federal deficit for the current quarter of $23 billion, a seasonally small deficit because of the large tax collections in April. The Treasury is expected to borrow about $46 billion this quarter to finance this deficit and to add $14 billion to its cash balance. (Technical factors--in particular float and accrued interest--are expected to absorb $9 billion.)

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

| | 1986 | | | | |
|---|---|---|---|---|---|
| | Q1 | Q2[f] | Mar. | Apr[p]. | May[e] |
| **Treasury financing** | | | | | |
| Combined surplus/deficit(-) | -61.2 | -23.0 | -30.1 | 9.2 | -36.2 |
| Means of financing deficit: | | | | | |
| Net cash borrowing from the public | 37.1 | 46.2 | 8.4 | 14.3 | 23.0 |
| Marketable borrowings/ repayments(-) | 35.3 | 36.7 | 8.9 | 9.0 | 21.1 |
| Bills | -6.7 | 1.7 | -4.3 | .5 | 7.8 |
| Coupons | 42.0 | 35.0 | 13.2 | 8.5 | 13.3 |
| Nonmarketable | 1.8 | 9.5 | -.5 | 5.3 | 1.9 |
| Decrease in the cash balance | 18.7 | -14.1 | 14.1 | -22.2 | 14.4 |
| Memo: Cash balance at end of period | 12.2 | 26.4 | 12.2 | 34.4 | 20.0 |
| Other[2] | 5.4 | -9.1 | 7.6 | -1.3 | -1.2 |
| **Federally sponsored credit agencies, net cash borrowing[3]** | -0.4 | 2.3 | 1.8 | 2.0 | 0.2 |
| FHLBs | 0.3 | 5.6 | 2.0 | 1.9 | 1.7 |
| FNMA | -1.5 | -4.4 | -.8 | -.4 | -2.0 |
| Farm Credit Banks | -2.9 | -2.0 | -.3 | -.7 | -.5 |
| FHLMC | 2.4 | 1.5 | .6 | .5 | .5 |
| SLMA | 1.3 | 1.6 | .3 | .7 | .5 |

f--staff forecast p--preliminary e--staff estimate
1. Data reported on a not seasonally adjusted, payment basis.
2. Includes checks issued less checks paid, accrued items and other transactions.
3. Excludes mortgage pass-through securities issued by FNMA and FHLMC.

At its mid-quarter refunding last week, the Treasury issued $27 billion of new securities, evenly distributed among 3-, 10-, and 30-year instruments, to raise $12.8 billion of net new funds.[1] Much market commentary before the auctions was focused on whether, in light of the weakness of the dollar, foreign demand would be strong at prevailing interest rates. In fact, foreign investors' orders reportedly were substantial, particularly for the 30-year bonds.

Borrowing by the federally sponsored credit agencies has been light thus far in the second quarter, after a net paydown of outstanding debt in the first quarter. Fannie Mae's borrowing requirements have been reduced somewhat by heavy mortgage refinancings, which tend to reduce temporarily the mortgage loans held by Fannie Mae.[2] The reduction in the debt of the Farm Credit Banks apparently is associated with weak demand for new credit by the agricultural sector.

Borrowing by the Home Loan Banks has surged thus far in the second quarter as the demand by S&Ls for advances--especially longer-term advances--has picked up. The Banks seek to match the durations of their assets and liabilities; thus, larger than normal portions of their recent borrowing have carried maturities in the range of 7 to 10 years. The interest rate spread over Treasury securities on these longer-term issues has been in excess of 50 basis points, compared with the spreads of 25 or

---

1. The Treasury appreciably boosted the sizes of the 10- and 30-year issues compared with recent refundings, because of its decision no longer to offer 20-year bonds. This security never was popular with investors, and this lack of of interest was reflected in a higher rate--typically 10 to 20 basis points more than the 30-year issue.
2. Borrowing by Fannie Mae may fall sharply in the months ahead, owing to its recently announced plan to sell $10 billion of older mortgages from its portfolio. The exact timing of the sale was not specified, nor was the use of the proceeds.

30 points that the Home Loan Banks normally paid on such securities in the past. The spreads were boosted primarily because of the large size of the issues. Also, investors may be concerned about the role the Home Loan Banks are expected to play in financing the FSLIC.[1]

Tax-Exempt Markets

Issuance of tax-exempt bonds has accelerated since early in the year. Offerings in April totaled more than $12 billion, up from $8 billion in March. The surge in issuance of short-term securities in April reflected the large annual spring financing by New York State; this year the financing raised $3.5 billion, $800 million less than in the two prior springs. Nearly half of the volume in longer-term markets so far this year has been refunding bonds, as governmental units seek to replace high-cost debt at lower interest rates. Public utilities have accounted for a large share of the refunding, but states and localities also are refinancing public-purpose bonds.

The stepped-up pace of tax-exempt issuance, and continuing uncertainty about the treatment of municipal securities in any tax-reform legislation passed this year, evidently have put upward pressure on yields. The ratio of yields on tax-exempt general obligation bonds to yields on Treasuries of comparable maturity neared its 1969 record in mid-April, and the Bond Buyer revenue bond index exceeded Treasury bond yields throughout

1. Under the current proposal, the FSLIC Funding Facility would be formed with an initial capitalization of $3 billion from the Federal Home Loan Banks; the Funding Facility also would raise $10 to $15 billion through long-term debt securities. The Facility would purchase about $2 billion of long-term Treasury zero coupon securities, which should be sufficient to pay off the principal of the Facility's initial debt issuance. The interest on the debt securities would be paid from the FSLIC's annual income.

the intermeeting period.[1] Municipal-corporate yield ratios have risen as well, though not to record levels.

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

| | 1985 | 1985 | | 1986 | | |
|---|---|---|---|---|---|---|
| | Year | Q3 | Q4 | Q1P | MarP | AprP |
| Total | 19.82 | 16.29 | 37.69 | 4.92 | 8.52 | 16.20 |
| Short-term | 1.97 | 2.67 | .91 | .63 | .49 | 4.00 |
| Long-term | 17.85 | 13.62 | 36.78 | 4.29 | 8.03 | 12.20 |
| Refundings[2] | 4.84 | 4.20 | 9.40 | 2.34 | 5.44 | 4.36 |
| New capital | 13.00 | 9.42 | 27.38 | 1.95 | 2.59 | 7.84 |
| Total housing[3] | 2.11 | 2.32 | 2.64 | 0.0 | 0.0 | --- |
| Single-family | .98 | 1.15 | .99 | 0.0 | 0.0 | --- |

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

Issuance of municipal securities began to recover from tax-reform concerns in March, as bond counsels approved covenants in accord with the requirements of the House tax-reform bill (H.R. 3838).[2] A further boost to the market came in mid-March, when the House, Senate, and Treasury agreed to put off the effective date of several key restrictions on public-purpose bonds until September 1, or until final passage of tax-reform legislation, whichever comes first. A few days later, trading in municipal securities markets came to a virtual standstill when Senator Packwood proposed including

1. The 1969 peak of this ratio reflected at least in part Treasury and Congressional efforts to restrict IDBs and arbitrage bonds, and a threat to include municipal-bond interest in an alternative minimum tax.
2. The tax-exempt market also has begun to see a trickle of private-purpose bonds. Most of these have been current refundings, i.e., offerings of bonds whose proceeds will be used to refund outstanding bonds within 30 days; sales of these bonds would retain tax-exempt status under H.R. 3838.

all tax-exempt interest income under an expanded personal minimum tax. Within a week, however, the full Senate Finance Committee rejected such a provision. Participants in municipal markets gained additional confidence in April, as the difficulties of the Senate Finance Committee in shaping an acceptable plan seemed to doom tax reform altogether. This optimism continued despite Finance Committee approval of a draft plan.

The Finance Committee plan would preserve much of the tax-exempt market; however, it would impose curbs on arbitrage and advance refundings, and it retains the scheduled phase-out of single-family housing bonds and small-issue industrial development bonds (IDBs). The plan is less restrictive than H.R. 3838: while H.R. 3838 would retain small-issue IDBs, the Finance Committee plan allows a more generous definition of public-purpose bonds and retains banks' tax deduction for 80 percent of the interest costs of holding tax-exempt securities. The final form of any tax legislation will not be decided for several months, however, and many investors remain wary.

Residential Mortgage Markets

Refinancing has continued to surge. Fully one-third of FHA home loan applications in April were for refinancing, and refinancings in the conventional loan market also appear to have experienced a sharp pickup. Refinancing earlier this year likely did not result in large withdrawals of equity from the underlying property, judging from the slowing in net residential mortgage debt growth to an 8.5 percent annual rate in the first quarter.

Widespread refinancing has not yet shown up in available data on thrift institutions lending activity, which do not go beyond March. Loan retirements of $10.5 billion (SA) in March actually were down slightly at

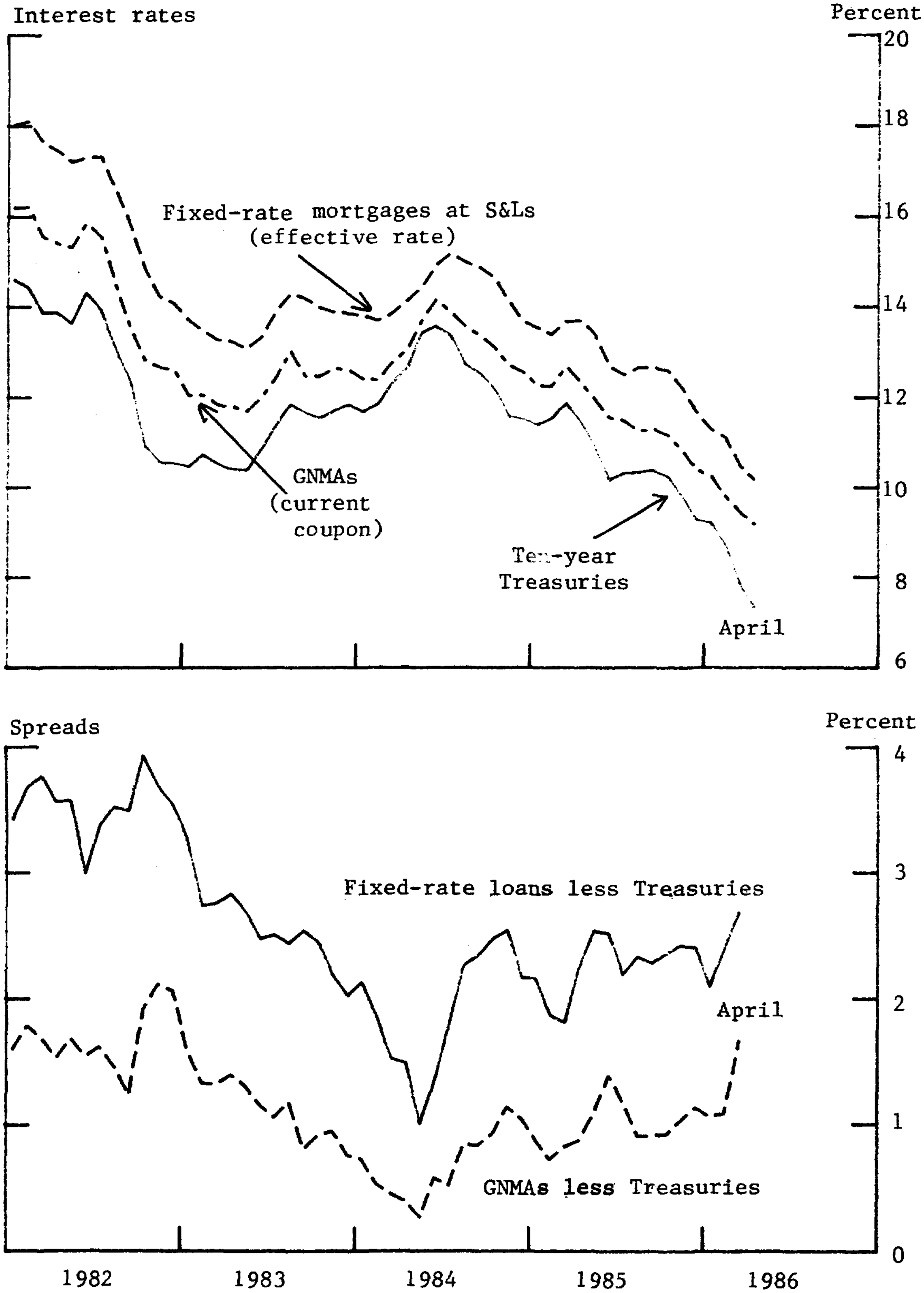
S&Ls from their February pace, and loan originations declined in each of the first three months of 1986. However, there is a substantial time lag between loan applications and closings--and reports indicate that this lag is lengthening because of the crush of applications--so it may be that the pickup in mortgage borrowing will not be reflected in the data until the second quarter.

Vigorous activity is suggested by more current data on thrift institution liabilities. Thrift institutions augmented stepped-up growth in core deposits in April by boosting managed liabilities. Over the past two months large CD issuance at thrifts has proceeded at the fastest pace since 1984, and advances surged by $4 billion in April. Staff at the FHLBB report that the demand for advances was widespread geographically and appeared to be linked to both actual and anticipated increases in assets.[1]

Mortgage interest rates are little changed on balance since the last FOMC meeting. Despite a spread of 140 basis points in favor of adjustable-rate mortgages, most homebuyers have been opting for the security of fixed-rate financing, with rates on these instruments at their lowest levels in seven years. Only 29 percent of conventionally financed home purchases in early April involved adjustable-rate financing, and market sources indicate that an even smaller percentage of the recent refinancing volume carries adjustable rates. Issuance of mortgage pass-through securities accelerated to a record pace in April; roughly 60 percent of the heavy volume of these

1. Some of this borrowing may be in response to prospective liability-based capital requirements for FSLIC-insured institutions. A FHLBB proposal, now out for public comment, would impose a 6 percent capital requirement on incremental liability growth after the third quarter of 1986, but allow a 6-year phase-in of the capital requirement on then-existing liabilities.

HOME MORTGAGE FINANCING
Monthly averages



instruments in the first quarter was linked to newly originated mortgages, about the proportion of the past two years.

Mortgage rates in the primary and secondary markets have not fallen nearly as much in recent months as have Treasury yields of comparable maturity. Some lag in the adjustment of mortgage rates is normal, but other factors also are contributing to the widened spread. Increased investor concern regarding the risk of mortgage prepayments, given the recent prepayment volume and greater interest rate volatility, appears to account for some of the recent widening of spreads over Treasuries observed on both current-coupon and premium-coupon mortgage pass-throughs. In addition, a record volume of new issues of mortgage securities has been marketed in recent months, and the market may well expect an even larger supply to follow.

Consumer Installment Credit

Growth in consumer installment credit outstanding has slowed markedly, to an 8 percent annual rate in March. New-car sales dropped in March, after manufacturers shifted to less attractive financing programs. Growth in auto credit was about unchanged for the quarter as a whole, however, and it was a slowing in other categories that accounted for the bulk of the deceleration in total credit. Data for consumer loans at commercial banks suggest a continuation of more moderate growth in April, but the swings in market share between banks and captive finance companies argue for some caution in interpreting these numbers.

A combination of aggresive lending and economic weakness in certain areas seems to be resulting in increasing problems of credit quality. Consumer loan delinquencies at auto finance companies have continued to

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

| Period | Total | GNMAs | FHLMCs | FNMAs | Memo: FNMA and FHLMC swap issues |
|---|---|---|---|---|---|
| 1985-Q1 | 6.4 | 2.7 | 2.4 | 1.3 | 3.0 |
| Q2 | 7.5 | 3.3 | 2.8 | 1.5 | 3.3 |
| Q3 | 10.4 | 4.1 | 3.8 | 2.5 | 4.7 |
| Q4 r | 11.8 | 5.2 | 3.9 | 2.7 | 4.9 |
| 1986-Q1 p | 12.3 | 5.1 | 4.1 | 3.1 | 5.3 |
| 1985-Oct. | 11.1 | 5.8 | 3.1 | 2.2 | 3.8 |
| Nov. | 11.2 | 5.3 | 3.4 | 2.5 | 4.3 |
| Dec. r | 13.2 | 4.5 | 5.3 | 3.4 | 6.7 |
| 1986-Jan. r | 12.3 | 5.3 | 3.0 | 4.0 | 5.4 |
| Feb. | 12.4 | 5.0 | 4.4 | 3.0 | 6.0 |
| Mar. r | 12.2 | 5.1 | 4.9 | 2.3 | 4.3 |
| Apr. p | 13.9 | 6.0 | 5.1 | 2.8 | 5.7 |

p--preliminary. r--revised.

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

| | Mortgage transactions | | Net change in mortgage assets[1] | | |
|---|---|---|---|---|---|
| | Originations (1) | Sales (2) | Total (3) | Mortgage loans (4) | Mortgage-backed securities (5) |
| 1985-July r | 14.9 | 10.6 | 2.4 | 4.7 | -2.3 |
| Aug. r | 16.0 | 7.9 | 6.6 | 5.1 | 1.5 |
| Sept. r | 17.0 | 10.0 | 9.5 | 4.0 | 5.5 |
| Oct. r | 19.5 | 13.0 | 4.9 | 6.4 | -1.5 |
| Nov. r | 18.6 | 13.1 | 3.7 | 3.1 | .6 |
| Dec. r | 20.2 | 11.2 | 5.0 | 4.9 | .1 |
| 1986-Jan. r | 18.4 | 9.3 | 5.4 | 2.9 | 2.6 |
| Feb. r | 17.8 | 9.8 | 3.1 | 2.2 | .9 |
| Mar. p | 16.3 | 12.6 | 2.7 | 2.7 | 0 |

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

increase, rising in March to 2.13 percent, the highest level in nearly five years. However, the uptrend began from an unusually low level, so that this indicator still is not much above the midpoint of its historical range. Data on delinquency rates on consumer loans at commercial banks are not yet available for the first quarter, but anecdotal evidence would suggest that such rates, especially for credit cards, have maintained an upward trend. The rising credit card delinquencies are not surprising, given the aggressive marketing techniques employed over the past couple of years; the consequent pickup in charge-offs was to a considerable extent predictable, and most banks evidently are finding the interest margins adequate to absorb the losses. Some notes of caution are being sounded, but there is to date no sign of a pullback by lenders.

CONSUMER INSTALLMENT CREDIT

| | 1984 | 1985 | 1985 Q4 | 1986 Q1 | 1986 Jan. | 1986 Feb.r | 1986 Mar.p |
|---|---|---|---|---|---|---|---|
| | -------- Percent rate of growth, SAAR -------- | | | | | | |
| Change in outstandings--total | 20.6 | 18.0 | 14.5 | 12.2 | 17.2 | 11.1 | 8.1 |
| By type: | | | | | | | |
| Automobile credit | 18.7 | 19.3 | 15.8 | 15.4 | 24.3 | 15.3 | 6.1 |
| Revolving credit | 25.7 | 20.1 | 15.6 | 13.2 | 14.1 | 10.4 | 14.6 |
| All other[1] | 19.7 | 15.6 | 12.6 | 8.6 | 11.9 | 7.3 | 6.5 |
| | ---------- Billions of dollars, SAAR ---------- | | | | | | |
| Change in outstandings--total | 77.3 | 81.5 | 74.7 | 65.5 | 91.9 | 60.1 | 44.6 |
| By type: | | | | | | | |
| Automobile credit | 27.2 | 33.4 | 31.3 | 31.8 | 50.2 | 32.2 | 13.1 |
| Revolving credit | 20.1 | 19.8 | 17.8 | 15.6 | 16.6 | 12.5 | 17.6 |
| All other[1] | 30.0 | 28.4 | 25.6 | 18.1 | 25.1 | 15.4 | 13.9 |
| By major holder: | | | | | | | |
| Commercial banks | 39.8 | 31.6 | 29.0 | 18.4 | 29.5 | 17.0 | 8.6 |
| Finance companies | 10.0 | 24.0 | 20.7 | 29.3 | 43.5 | 27.4 | 17.1 |
| All other | 27.6 | 25.9 | 25.0 | 17.8 | 18.9 | 15.7 | 18.9 |
| | ----------- Annual percentage rate ----------- | | | | | | |
| Interest rates | | | | | | | |
| At commercial banks[2] | | | | | | | |
| New cars, 48 mos. | 13.71 | 12.91 | 12.39 | 12.29 | n.a. | 12.29 | n.a. |
| Personal, 24 mos. | 16.47 | 15.94 | 15.61 | 15.52 | n.a. | 15.52 | n.a. |
| Credit cards | 18.77 | 18.70 | 18.57 | 18.48 | n.a. | 18.48 | n.a. |
| At auto finance companies[3] | | | | | | | |
| New cars | 14.62 | 11.98 | 11.40 | 10.07 | 9.99 | 9.70 | 10.51 |
| Used cars | 17.85 | 17.59 | 17.24 | 16.66 | 16.60 | 16.74 | 16.63 |

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.
r--revised.

Foreign Exchange Markets

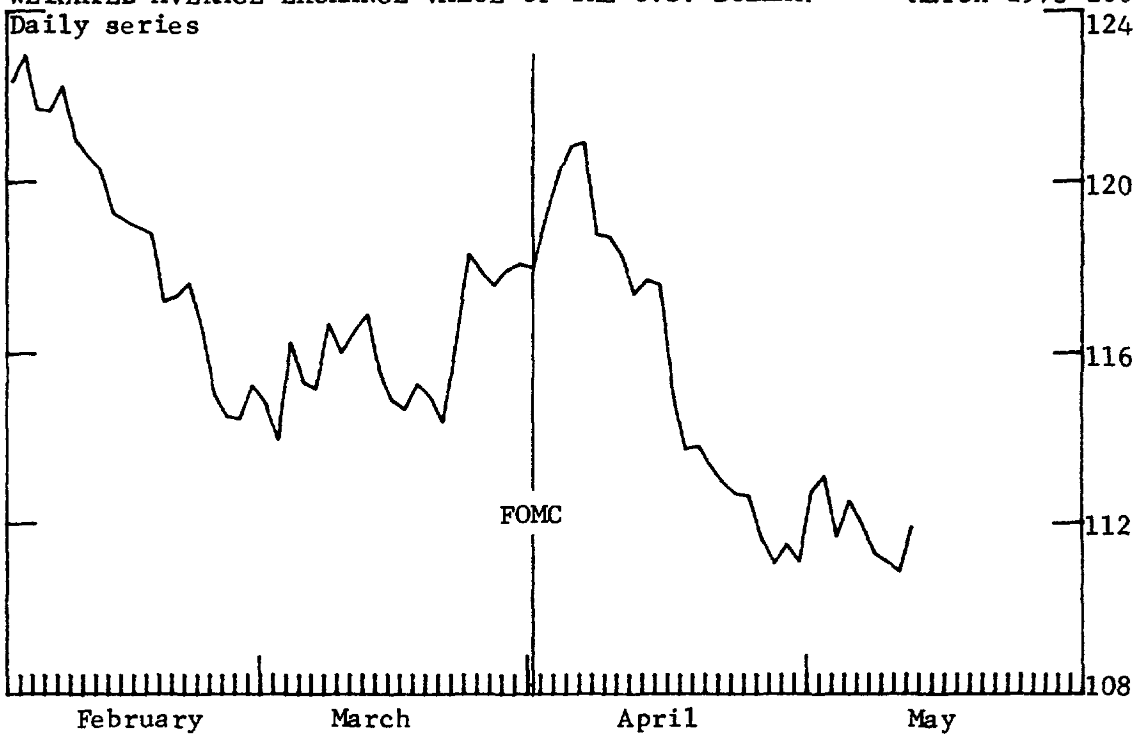
Since the April 1 FOMC meeting, the foreign-exchange value of the dollar has declined by about 5½ percent on a weighted-average basis. Developments have been dominated by market participants' attempts to discern the policies of the G-5 countries toward the foreign exchange market, especially in connection with the Tokyo Summit in early May. Attention during the first part of the intermeeting period was directed particularly at the dollar's value against the mark, but in recent weeks attention has shifted to the yen. Since the previous meeting, the dollar has fallen by about 6½ percent against the mark, with most of that decline coming in mid-April; against the yen the dollar has declined by 8½ percent. There was little net change in the differential between U.S. interest rates and a weighted average of foreign interest rates -- both short and long-term -- during the period.

During the first week of April, the dollar gained about 2 percent on a weighted-average basis, as market participants reportedly took the view that G-5 officials were no longer favoring a lower dollar. Key elements in this view were various statements, primarily by Japanese officials, to the effect that the dollar may have fallen far enough and limited but visible dollar purchases by the Bank of Japan. At this time the dollar was supported by a marked firming of oil prices as well.

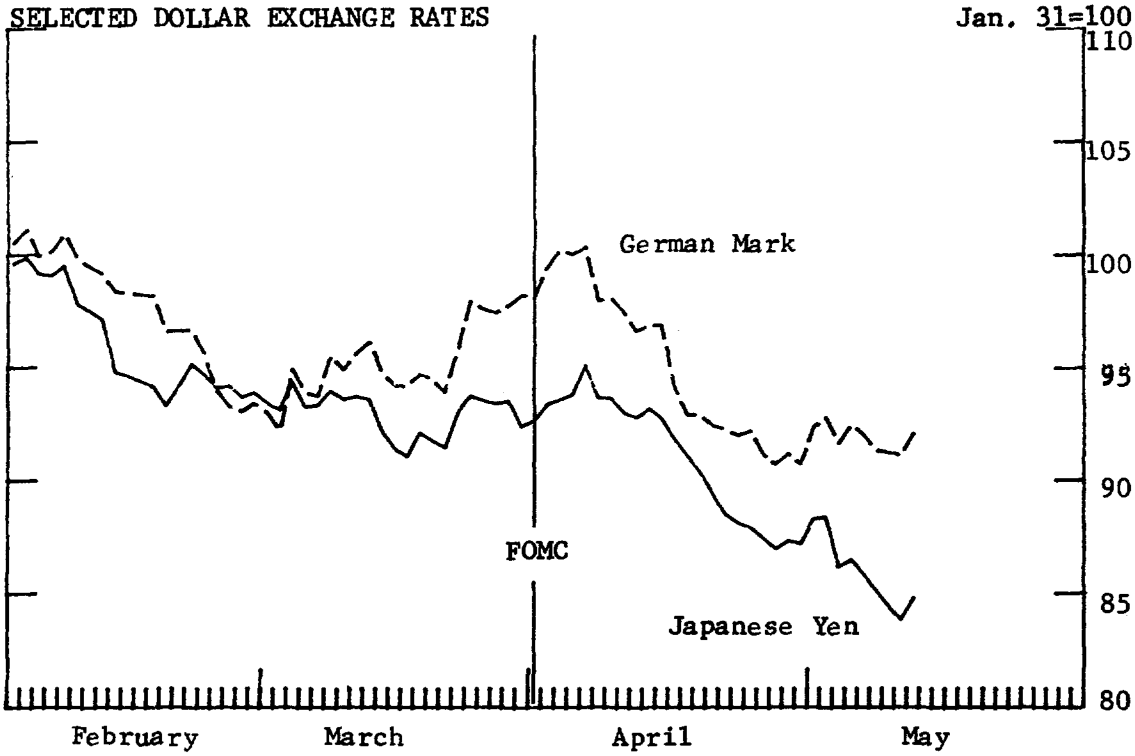
Also during the first week of April, the French franc came under very heavy selling pressure within the European Monetary System. On April 6, the EMS countries announced a new alignment of central exchange

Chart 1 Strictly Confidential (FR)
Class II-FOMC
5/14/86

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




SELECTED DOLLAR EXCHANGE RATES Jan. 31=100



rates in which the French franc was devalued against the mark by about 6 percent. Changes in EMS central exchange rates in the April 6 realignment are summarized in Table 1. In the weeks following the realignment, both France and Italy relaxed some capital controls and reduced official central bank lending rates.

Table 1.
Percentage Changes in Central Exchange Rates in
April 6 EMS Realignment

| | |
|---|---|
| Germany | 3 |
| Netherlands | 3 |
| Denmark | 1 |
| Belgium | 1 |
| Italy | 0 |
| Ireland | 0 |
| France | -3 |

In mid-April, downward pressure on the dollar resumed, gaining impetus in part from various statements by foreign officials that seemed to suggest that G-5 authorities might take additional coordinated actions to lower the dollar's value. A modest package of measures designed to stimulate the Japanese economy (but notably not including a cut in the discount rate) and the relative steadiness of German short-term interest rates -- together with some disappointing U.S. economic data and continued declines in U.S. interest rates -- were factors in a strong shift in market sentiment away from the dollar. The dollar declined steadily in mid-month, falling particularly steeply against the mark and eventually reaching a five-year low of about 2.16 marks per dollar in the last week of April. Although the dollar's rate of decline against the mark slowed by the end of the month, upward pressure on the yen continued strongly throughout the second half of April.

The dollar's downward trend was interrupted in the week before the Tokyo Summit as trading was very light and market participants awaited new developments. Following the summit declaration on international economic policy on May 6, the dollar resumed its decline, again mainly against the yen. Market participants reportedly concluded from the summit declaration and other statements by officials that Japanese and German hopes for joint action to slow the dollar's decline had not been met. The dollar/yen rate reached a post-war low below 160 yen per dollar in trading on May 12.

U.S. International Financial Transactions

Substantial net capital inflows during the first quarter, the counterpart of continued large trade and current account deficits, took the form of substantial foreign purchases of U.S. corporate stocks and bonds, continued heavy purchases of U.S. Treasury securities, and large bank-reported inflows. These inflows were offset in part by unusually heavy purchases of foreign securities by U.S. residents, particularly in March.

Foreign purchases of U.S. corporate stocks totalled a record $6 billion during the first quarter (see line 2b in the Summary Table on U.S. International Transactions). This rate was 50 percent higher than the brisk fourth-quarter pace, as investors abroad apparently were attracted by the surge in the U.S. stock market.

Private foreign purchases of U.S. corporate bonds slowed noticeably from an extremely rapid fourth-quarter pace, but remained above the average quarterly rate for 1985 (line 2a). New Eurobonds issued by U.S. corporations accelerated in April, totalling over $7 billion through the fourth week of the month. The pickup in April took place as yields on longer-term instruments dipped close to or below 7 percent, and accompanied a very large volume of domestic issues. A growing proportion of the issues in the Euromarkets was in longer-term maturities (10 years or more) at fixed rates. About one-third of the new issues in March and April were denominated in terms of foreign currency (largely Swiss francs and yen), but in most cases the bonds were issued in conjunction with swap arrangements that eliminated the foreign currency exposure of the U.S. issuers.

U.S. net purchases of foreign securities (line 2c) totalled more than $6 billion during the first quarter, nearly double the previous high quarterly rate. About one-third of the total was in foreign stocks, including sizeable purchases of Japanese stocks. The remaining two-thirds was in bonds, reflecting, in part, a pickup in dollar-denominated bond issues floated in the U.S. market by foreign borrowers. A sizeable proportion of U.S. purchases of bonds abroad apparently was denominated in foreign currency, although firm data on this breakdown is not available. As further evidence of a possible growing willingness on the part of U.S. investors to acquire foreign-currency-denominated securities, U.S. bank holding companies and other corporations have begun to float sizeable non-dollar security issues in the U.S. market this year. During January-April, $1.2 billion equivalent was issued, denominated largely in Australian dollars, at relatively high nominal interest rates.

Foreign purchases of U.S. Treasury securities (line 3) continued to be heavy in the first quarter, but about half of the total was accounted for by large purchases by the World Bank in March. Most of the rest was recorded as sales to residents of the United Kingdom and Canada. Sales recorded to Japanese residents fell to about $1/2 billion in the first quarter, down sharply from a fourth-quarter total of $5 billion, repeating a pattern of first-quarter declines observed during the past two years. Independent survey data suggest that total Japanese purchases of foreign securities (largely dollar denominated) remained strong during the first quarter suggesting that Japanese investors shifted from Treasury securities to Eurodollar bonds and U.S. corporate stocks during the period. Total Japanese purchases of foreign securities apparently accelerated in April.

Foreign official reserve holdings in the United States (line 4) rose moderately in the first quarter. The increase was largely in the form of Treasury securities purchased by several major industrial countries.

U.S. banks recorded a substantial net inflow in the first quarter, most of it in January (line 1 in the Summary Table). As indicated in the International Banking Data Table (line 3a), a sizeable portion of the inflow reflected a continued reduction in net claims of the U.S offices of U.S. chartered banks on their foreign branches. This flow appears to have been reversed in April, in association with the increase in the growth of domestic core deposits relative to a slowing in the growth of loans and securities at banks.

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

| | 1984 Year | 1985 Year | 1985 Q2 | 1985 Q3 | 1985 Q4 | 1986 Q1 | 1986 Jan. | 1986 Feb. | 1986 Mar. |
|---|---|---|---|---|---|---|---|---|---|
| **Private Capital** | | | | | | | | | |
| Banks | | | | | | | | | |
| 1. Change in net foreign positions of banking offices in the U.S. (+ = inflow) | 20.6 | 31.3 | -0.2 | 11.5 | 5.2 | 11.1 | 10.4 | 1.3 | -0.5 |
| Securities | | | | | | | | | |
| 2. Private securities transactions, net | 7.7 | 42.9 | 4.9 | 10.0 | 21.1 | 12.8 | 4.9 | 4.4 | 3.6 |
| a) foreign net purchases (+) of U.S. corporate bonds | 13.7 | 46.0 | 6.7 | 10.3 | 18.4 | 12.9 | 3.3 | 4.4 | 5.2 |
| b) foreign net purchases (+) of U.S. corporate stocks | -0.9 | 4.9 | 0.5 | 1.4 | 4.1 | 6.1 | 1.6 | 1.8 | 2.8 |
| c) U.S. net purchases (-) of foreign securities | -5.0 | -8.0 | -2.3 | -1.6 | -1.4 | -6.1 | 0.1 | -1.7 | -4.4 |
| 3. Foreign net purchases (+) of U.S. Treasury obligations 1/ | 23.1 | 20.5 | 5.1 | 7.5 | 5.7 | 8.4 | -0.7 | 1.4 | 7.7 |
| **Official Capital** | | | | | | | | | |
| 4. Changes in foreign official reserve assets in U.S. (+ = increase) | 2.6 | -1.8 | 7.9 | 2.5 | -1.6 | 2.3 | 2.0 | -0.2 | 0.5 |
| a) By area | | | | | | | | | |
| G-10 countries (incl. Switz.) | 3.1 | -0.4 | 6.0 | 2.4 | -3.3 | 3.9 | 2.1 | 1.4 | 0.4 |
| OPEC | -5.4 | -6.7 | -2.1 | -2.0 | -1.0 | 1.3 | 1.1 | 0.7 | - - |
| All other countries | 4.9 | 5.2 | 3.9 | 2.1 | 2.7 | -2.8 | -1.2 | -2.2 | |
| b) By type | | | | | | | | | |
| U.S. Treasury securities | 4.7 | -0.5 | 8.7 | -0.1 | -2.0 | 3.3 | 0.4 | 1.7 | 1.1 |
| Other 2/ | -2.1 | -1.3 | -0.8 | 2.6 | 0.4 | -0.9 | 1.6 | -1.9 | -0.6 |
| 5. Changes in U.S. official reserve assets (+ = decrease) | -3.1 | -3.9 | -0.4 | -0.1 | -3.1 | -0.1 | 0.1 | -0.1 | -0.1 |
| **Other transactions** (Quarterly data) | | | | | | | | | |
| 6. U.S. direct investment (-) abroad | -4.5 | -19.1 | -5.1 | -7.1 | -8.7 | n.a. | n.a. | n.a. | n.a. |
| 7. Foreign direct investment (+) in U.S. | 22.5 | 16.3 | 6.7 | 6.0 | 1.5 | n.a. | n.a. | n.a. | n.a. |
| 8. Other capital flows (+ = inflow) 3/ 4/ | 8.0 | -1.2 | 4.9 | -8.5 | 6.1 | n.a. | n.a. | n.a. | n.a. |
| 9. U.S. current account balance 4/ | -107.4 | -117.7 | -27.6 | -29.3 | -36.6 | n.a. | n.a. | n.a. | n.a. |
| 10. Statistical discrepancy 4/ | 30.5 | 32.7 | 3.8 | 7.5 | 10.4 | n.a. | n.a. | n.a. | n.a. |
| **MEMO:** | | | | | | | | | |
| U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted) | -114.1 | -124.3 | -28.5 | -33.0 | -39.5 | -35e | 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.

INTERNATIONAL BANKING DATA
(Billions of dollars)

| | 1981 | 1982 | 1983 | 1984 | 1985 | | | | 1986 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Dec. | Dec. | Dec. | Dec. | Mar. | June | Sept. | Dec. | Mar. | Apr. 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 | 18.9 | 21.0 | 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 | 10.1 | 1.0 | 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 | 29.0 | 22.0 | 29.3 |
| (a) U.S.-chartered banks | 22.3 | 40.0 | 40.5 | 32.1 | 30.6 | 33.4 | 31.5 | 32.4 | 27.1 | 31.1 |
| (b) Foreign-chartered banks | -2.6 | 9.1 | 4.0 | 1.1 | 1.6 | 2.2 | * | -3.4 | -5.1 | -1.8 |
| 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 | 18.7 | 17.6 | 16.7 |
| 5. Eurodollar Holdings of U.S. Nonbank Residents 2/ | 95.5 | 112.6 | 124.3 | 117.5 | 118.9 | 110.3 | 114.1 | 112.4 | 115.8 | 114.8 |

1. Corresponds to net claims of international banking facilities (IBFs) on all foreign residents, including all banks whether related or not, and all nonbanks.
2. Include terms and overnight Eurodollars held by money market mutual funds.
3. Through April 28, 1986.
*/ Less than 50 million (±).
Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactions accounts. Line 1 is an estimate constructed as the residual of line 3 minus line 2. Line 2 is data for the last Wednesday of the month for the sample of monthly IBF reporters. Line 3 is an average of daily data reported to the Federal Reserve by U.S. banking offices. Line 4 is an average of daily data. Line 5 is the month-end value for data through September 1983. For dates after September 1983, the overnight portion is an average of daily data and the term portion is an average of Wednesday data.

U.S. Merchandise Trade

Revised U.S. merchandise trade figures for January and February and very preliminary data for March suggest that on a balance-of-payments basis the merchandise trade deficit in the first quarter was smaller than in the fourth quarter of last year as exports rose somewhat and oil imports declined substantially.

The rise in exports in the first quarter appears to come largely from machinery (particularly broadcasting equipment and to a lesser extent construction equipment and business machines) as well as aircraft and consumer goods. For all nonagricultural exports as a group, the first-quarter increase was almost entirely in volume; prices of nonagricultural exports rose on average by less than one-half percent.

U.S. MERCHANDISE TRADE 1/

| | Year | 1985 | | | | 1986 |
|---|---|---|---|---|---|---|
| | 1985 | Q1 | Q2 | Q3 | Q4 | Q1e |
| Value (Bil. $, SAAR) | | | | | | |
| Exports | 214.0 | 220.8 | 214.1 | 209.1 | 211.9 | 220 |
| Agricultural | 29.2 | 32.8 | 28.6 | 26.1 | 29.3 | 28 |
| Nonagricultural | 184.8 | 187.9 | 185.5 | 183.0 | 182.6 | 192 |
| Imports | 338.3 | 314.3 | 328.1 | 340.9 | 369.9 | 362 |
| Oil | 50.4 | 41.8 | 52.2 | 50.1 | 57.4 | 42 |
| Nonoil | 287.9 | 272.4 | 275.9 | 290.8 | 312.5 | 320 |
| Trade Balance | -124.3 | -93.5 | -113.9 | -131.8 | -157.9 | -142 |
| Volume (Bil 82$, SAAR) | | | | | | |
| Exports | | | | | | |
| Agricultural | 30.1 | 32.6 | 28.6 | 27.2 | 31.8 | 30 |
| Nonagricultural | 179.3 | 181.8 | 179.3 | 178.4 | 177.6 | 185 |
| Imports | | | | | | |
| Oil | 59.8 | 48.8 | 60.9 | 60.9 | 68.5 | 58 |
| Nonoil | 292.5 | 277.0 | 282.3 | 296.1 | 314.4 | 322 |

1/ As published in the balance-of-payments accounts.
e/ Staff estimate. Data are subject to possibly large revisions.

The value of agricultural exports was at nearly the same level as in the fourth quarter. Prices of various export commodities rose somewhat, especially corn, tobacco and oilseeds with a smaller price increase for soybeans. The volume of agricultural exports declined a bit despite continued Soviet purchases of corn and record Soviet purchases of soybeans. Demand for U.S. agricultural commodities continued to be affected by ample competing foreign supplies and U.S. prices that were not competitive in world markets. Later this year U.S. price supports for various farm crops will be lowered significantly reflecting provisions of the 1985 farm bill.

The value of imports appears to have declined moderately in the first quarter. A sharp drop in oil imports was offset by increases in other import categories. These data are preliminary and are subject to revision.

Both the price and volume of imported oil dropped in the first quarter. It is estimated that the average price of imported oil dropped from $26.30 per barrel in December (on a balance-of-payments basis) to about $18 per barrel in March in response to developments in world markets. The volume of oil imported declined moderately from fourth-quarter rates; in the fourth quarter the volume of imports rose as stocks of fuel oil were replenished.

OIL IMPORTS 1/

| | Year | 1984 | 1985 | | | | 1986 |
|---|---|---|---|---|---|---|---|
| | 1985 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1e |
| Volume (mbd, SA) | 5.24 | 5.62 | 4.34 | 5.30 | 5.34 | 5.99 | 5.2 |
| Price ($/BBL) | 26.37 | 27.59 | 26.43 | 27.01 | 25.77 | 26.29 | 21.75 |
| Value (Bil. $, SAAR) | 50.40 | 57.81 | 41.84 | 52.19 | 50.14 | 57.41 | 42.0 |

1/ As published in the balance-of-payments accounts.
e/ Staff estimate. Data are subject to possibly large revisions.

The increase in nonoil imports in the first quarter was spread among various categories including machinery, consumer goods and items such as gold and coffee; part of that rise in value appears to be in prices. As measured by the BLS index, prices of nonoil imports rose 3.4 percent (not an annual rate) in the three-month period ending in March following a 2.3 percent increase during the fourth quarter. Import price developments sampled by BLS tend to lead changes in unit values measured by recorded merchandise trade data (and implied in the tables above).

Foreign Economic Developments. The pace of economic activity in foreign industrial countries has been slow in recent months with the level of industrial production so far this year generally below the fourth quarter of last year. This recent weakness has been most pronounced in Japan, where production levels in the first quarter fell to a level only 1 percent above the first quarter of last year. In Germany, where industrial production also declined in the first quarter, the level remained 3.5 percent above a year earlier.

Inflation abroad is slowing further under the influence of lower oil prices and a weaker dollar. Consumer price inflation was lower in the first quarter than in the previous quarter in most countries. Monthly rates for March and April, where available, were very low in all countries. In Germany, the monthly cost of living index in April was below its year-earlier level for the first time in 27 years.

First-quarter external surpluses continued at record levels in Japan and Germany. Both countries' trade and current account surpluses in the first quarter were approximately equal to their fourth-quarter rates and substantially higher than a year ago.

Individual Country Notes. In Japan, recent data on industrial production suggest a continuation of the substantial slowing of the pace of output growth that emerged in 1985. Industrial production fell by 0.6 percent (s.a.) in March after a slight increase in February, so that the average level of the index for the first quarter was below that of the previous quarter and just 1.1 percent above its year-earlier level. Reflecting this slowing of industrial growth, new private sector machinery orders (s.a.) declined for the second consecutive month by 2.4

May 14, 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 Q2 | 1985 Q3 | 1985 Q4 | 1986 Q1 | 1985 Nov. | 1985 Dec. | 1985 Jan. | 1985 Feb. | 1985 Mar. | Latest 3 months from year ago 2/ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Canada** | | | | | | | | | | | | |
| GNP | 4.3 | 4.9 | .8 | 1.7 | 1.3 | n.a. | * | * | * | * | * | 4.9 |
| IP | 4.4 | 5.0 | .9 | 2.7 | 1.1 | n.a. | .4 | .6 | -.7 | .7 | n.a. | 4.7 |
| **France** | | | | | | | | | | | | |
| GNP | 1.6 | 2.0 | 1.0 | .6 | .6 | n.a. | * | * | * | * | * | 2.0 |
| IP | 1.8 | 1.5 | .5 | 2.0 | .0 | n.a. | 2.2 | -3.6 | -.8 | 1.5 | n.a. | 1.5 |
| **Germany** | | | | | | | | | | | | |
| GNP | 3.0 | 2.4 | 1.7 | 1.7 | -.1 | n.a. | * | * | * | * | * | 2.4 |
| IP | 3.5 | 3.4 | 1.8 | 2.1 | .4 | -.8 | -.7 | -3.4 | 2.7 | -1.3 | -.3 | 3.5 |
| **Italy** | | | | | | | | | | | | |
| GNP | 2.9 | 2.3 | 1.4 | .3 | .6 | n.a. | * | * | * | * | * | 2.3 |
| IP | 2.1 | 1.0 | .4 | -1.1 | .2 | n.a. | 3.8 | -3.9 | 2.0 | 2.5 | n.a. | 1.7 |
| **Japan** | | | | | | | | | | | | |
| GNP | 5.7 | 4.4 | 1.4 | .7 | 1.7 | n.a. | * | * | * | * | * | 4.4 |
| IP | 10.6 | 1.2 | 2.7 | -.1 | -.7 | -.7 | -1.1 | .6 | -.6 | .1 | -.6 | 1.1 |
| **United Kingdom** | | | | | | | | | | | | |
| GNP | 2.6 | 2.8 | 1.4 | -.2 | .5 | n.a. | * | * | * | * | * | 2.8 |
| IP | -.5 | 4.9 | 1.8 | .0 | .2 | n.a. | 1.5 | -2.1 | .7 | 1.7 | n.a. | 3.3 |
| **United States** | | | | | | | | | | | | |
| GNP | 4.7 | 2.1 | .3 | .8 | .2 | .8 | * | * | * | * | * | 2.0 |
| IP | 7.2 | 1.8 | .3 | .5 | .5 | .3 | .8 | .8 | .2 | -.7 | -.5 | 1.6 |

1. Asterisk indicates that monthly data are not available.

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

May 14, 1986

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

| | Q4/Q4 1984 | Q4/Q4 1985 | 1984 Q4 | 1985 Q1 | 1985 Q2 | 1985 Q3 | 1985 Q4 | 1986 Q1 | 1986 Jan. | 1986 Feb. | 1986 Mar. | 1986 Apr. | Latest 3 months from year ago |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Canada** | | | | | | | | | | | | | |
| CPI | 3.7 | 4.2 | .7 | 1.2 | 1.1 | .9 | .9 | 1.2 | .5 | .4 | .2 | n.a. | 4.2 |
| WPI | 3.6 | 2.8 | .3 | 1.0 | .7 | .2 | .8 | n.a. | .8 | -.2 | n.a. | n.a. | 3.0 |
| **France** | | | | | | | | | | | | | |
| CPI | 6.8 | 4.8 | 1.4 | 1.4 | 1.8 | .9 | .6 | .1 | .1 | -.2 | .3 | n.a. | 3.6 |
| WPI | 10.5 | -1.2 | 1.6 | 1.6 | .9 | -1.4 | -2.2 | n.a. | n.a. | n.a. | n.a. | n.a. | -1.2 |
| **Germany** | | | | | | | | | | | | | |
| CPI | 2.1 | 1.8 | .7 | 1.1 | .6 | -.2 | .3 | .0 | .2 | -.2 | -.2 | .0 | .2 |
| WPI | 1.3 | -1.1 | .3 | 1.7 | .3 | -2.1 | -.9 | -2.1 | -.1 | -2.2 | -1.0 | -.4 | -6.5 |
| **Italy** | | | | | | | | | | | | | |
| CPI | 8.8 | 8.5 | 2.2 | 2.6 | 2.2 | 1.1 | 2.3 | 1.8 | .5 | .7 | .4 | .2 | 7.1 |
| WPI | 8.9 | 5.9 | 1.9 | 2.7 | 2.2 | -.1 | .9 | -.5 | .3 | -1.3 | -.7 | n.a. | 2.5 |
| **Japan** | | | | | | | | | | | | | |
| CPI | 2.4 | 2.3 | 1.2 | .6 | .5 | .1 | 1.0 | -.1 | .5 | -.3 | -.5 | .5 | 1.5 |
| WPI | .5 | -3.7 | -.3 | .4 | -.7 | -1.0 | -2.4 | -2.4 | -.2 | -1.5 | -2.2 | n.a. | -6.4 |
| **United Kingdom** | | | | | | | | | | | | | |
| CPI | 4.8 | 5.5 | 1.2 | 1.3 | 3.4 | .3 | .5 | .7 | .2 | .4 | .1 | n.a. | 4.9 |
| WPI | 6.1 | 5.2 | 1.3 | 1.6 | 2.0 | .5 | .9 | 1.5 | .6 | .4 | .6 | .8 | 4.8 |
| **United States** | | | | | | | | | | | | | |
| CPI (SA) | 3.9 | 3.6 | .8 | .9 | 1.0 | .6 | 1.1 | .4 | .3 | -.4 | -.4 | n.a. | 3.1 |
| WPI (SA) | 1.7 | 1.6 | .1 | .1 | .6 | -.2 | 1.1 | -1.4 | -.7 | -1.6 | -1.1 | n.a. | .1 |

May 14, 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 | | | | 1986 | 1985 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Dec. | Jan. | Feb. | Mar. |
| **Canada** | | | | | | | | | | | | |
| Trade | 15.7 | 12.2 | 4.2 | 4.0 | 3.4 | 2.3 | 2.5 | 1.8 | .9 | .8 | .1 | .9 |
| Current account | 1.9 | -1.4 | .9 | .5 | .2 | -1.1 | -.9 | n.a. | * | * | * | * |
| **France** | | | | | | | | | | | | |
| Trade | -2.4 | -2.5 | -.5 | -1.1 | -.4 | -.7 | -.3 | .1 | -.3 | .5 | .0 | -.4 |
| Current account | -.8 | .5 | -.2 | -.6 | .5 | .0 | .6 | n.a. | * | * | * | * |
| **Germany** | | | | | | | | | | | | |
| Trade (NSA) | 18.7 | 25.4 | 7.2 | 4.2 | 6.0 | 6.1 | 9.1 | 9.5 | 3.1 | 2.9 | 2.9 | 3.7 |
| Current account (NSA) | 5.9 | 13.9 | 6.0 | 1.7 | 3.1 | 2.1 | 7.0 | 6.9 | 2.7 | 1.8 | 2.9 | 2.1 |
| **Italy** | | | | | | | | | | | | |
| Trade | -10.9 | -13.0 | -3.1 | -3.8 | -3.9 | -1.3 | -4.0 | -3.1 | -.6 | -1.6 | -.7 | -.7 |
| Current account (NSA) | -2.9 | n.a. | -2.2 | -2.9 | -2.4 | n.a. | n.a. | n.a. | * | * | * | * |
| **Japan** | | | | | | | | | | | | |
| Trade | 44.1 | 56.1 | 13.2 | 11.5 | 13.1 | 14.1 | 17.3 | 17.5 | 6.2 | 6.0 | 5.3 | 6.2 |
| Current account 2/ | 35.0 | 49.3 | 11.3 | 9.4 | 12.2 | 12.1 | 15.6 | 15.6 | 5.9 | 5.5 | 4.4 | 5.6 |
| **United Kingdom** | | | | | | | | | | | | |
| Trade | -5.3 | -2.7 | -1.6 | -1.4 | -.3 | -.6 | -.3 | -2.0 | -.0 | .2 | -.5 | -1.7 |
| Current account | .9 | 4.0 | .5 | -.4 | 1.7 | 1.5 | 1.3 | 1.2 | .7 | 1.6 | .4 | -.8 |
| **United States** | | | | | | | | | | | | |
| Trade 2/ | -114.1 | -124.3 | -30.9 | -23.4 | -28.5 | -33.0 | -39.5 | n.a. | * | * | * | * |
| Current account | -107.4 | -117.7 | -31.8 | -24.2 | -27.6 | -29.3 | -36.6 | n.a. | * | * | * | * |

1. The current account includes goods, services, and private and official transfers.
Asterisk indicates that monthly data are not available.
2. Annual data are subject to revisions and therefore may not be consistent with quarterly and/or monthly data.

percent in March. There is also cumulative evidence of weakness in other sectors of the economy. Retail sales (s.a.) fell 5 percent in February and rose 3 percent in March. New housing starts (s.a.) declined for the second consecutive month in March. Growth in export volume has slowed substantially in recent months, and in March and April, the export volume index was below its year-earlier level. As the table below shows, the slowing of growth in export volume, which started in early 1985, has been dramatic compared with the strong growth experienced in 1984.

GROWTH IN EXPORT VOLUME
(percent change from year earlier)

| | Q1 | Q2 | Q3 | Q4 |
|---|---|---|---|---|
| 1984 | 16.1 | 16.0 | 13.9 | 15.8 |
| 1985 | 6.9 | 6.8 | 4.0 | 1.9 |
| 1986 | 1.0 | | | |
| Jan. | 2.3 | | | |
| Feb. | 0.1 | | | |
| Mar. | -2.1 | | | |
| Apr. | -0.3 | | | |

Inflation is slowing from its already low rate. The Tokyo consumer price index rose 1.2 percent during the 12 months ending in April. Wholesale prices in March were more than 8 percent below their year-earlier level, reflecting the recent sharp appreciation of the yen and the drop in oil import prices.

Although the demands of Japanese trade unions were quite moderate during this spring's wage negotiations, the outcomes were still below union demands. For the third consecutive year, the unions gained only modestly in terms of wages and hours. The private sector wage increase averaged 5.1 percent, only slightly above the increases of the previous two years, and the government provided only vague promises to shorten the work week. Pressure for a lower wage settlement this year primarily stemmed from the impact of the rapid appreciation of the yen on export-oriented industries, including the traditionally pace-setting sectors in wage negotiations such as the metal-working industries.

External surpluses continued at record rates. In the first three months of the year, the current account surplus was $62 billion (s.a.a.r.), little changed from the fourth quarter of 1985. The trade balance in the first quarter was $70 billion (s.a.a.r.).

As part of its ongoing efforts to stimulate domestic demand, and in light of the continued strengthening of the yen, the Bank of Japan lowered its discount rate from 4 to 3-1/2 percent on April 21. This was the third discount rate reduction in four months.

In other actions, Prime Minister Nakasone announced the recommendations of a specially appointed panel to study structural adjustments required to reduce Japan's dependence on export-led growth. The Maekawa Report recommended substantial changes in the Japanese economy over the medium term, including a reduction in working hours, growth in wages, abolition of the tax-free savings system on small accounts, improved market access, and more flexible implementation of fiscal policy. No timetable for implementation has been announced, and some domestic opposition has emerged to the Maekawa Report. In association with the Report, Japanese authorities announced a package of specific short-term measures to stimulate domestic demand. These measures include an acceleration of planned public works expenditure, temporary reduction in retail prices of electricity and gas, and promotion of housing and utilities investment.

Industrial production in Germany fell by 1.3 percent in February and by 0.3 percent in March. The average first-quarter result was nearly 1 percent below the fourth quarter and 3.5 percent above a year ago. The construction sector continues to hold down overall production data. Building activity in the first quarter was 8 percent (s.a.) below its fourth-quarter level. New order volumes in the first quarter were almost 2 percent below fourth-quarter levels as domestic orders remained sluggish and foreign orders dropped sharply in March. The most recent business climate survey reports a slight deterioration from a month ago in the respondents' outlook over the next six months, but continuing confidence in growth over the next five years. The rate of unemployment in April was 9.1 percent, only slightly lower than last year's average. Employment, however, has continued to increase.

The cost of living index in April was 0.1 percent below April of last year, marking the first year-on-year decline since June 1959. Through April, the index this year has declined at an annual rate of about 1 percent. Import prices in March were 18 percent below March 1985. Wholesale and producers prices are also below a year ago. Excluding energy prices, the cost of living index in March was 1.8 percent above March 1985. Another component that has contributed to the fall in the cost of living is food prices, which were 1.1 percent below last year in March. This reflects both the decline in prices of imported food, especially in D-mark terms, and a decline in the prices of domestic agricultural products.

The first-quarter trade surplus was $9.5 billion (n.s.a.) compared with $4.2 billion in last year's first quarter. The corresponding results for the current account were $6.9 billion (n.s.a.) compared with $1.7 billion last year. This continued high level of the trade surplus is due primarily to price effects. In constant prices, the trade surplus has declined from its peak in the second quarter of last year, and the most recent data on foreign orders suggest that this decline is continuing.

In France, industrial production increased by 1.5 percent (s.a.) in February, but was unchanged from its year-earlier level. The unemployment rate rose by 0.1 percentage point in March to 10.6 percent (s.a.), only slightly below the record high level of last January. The inflation rate has continued to moderate. Consumer prices rose by only 0.3 percent (n.s.a.) in March as the year-over-year inflation rate eased to 3 percent, not far above the new government's year-end inflation target of 2.3 percent.

The trade balance in March moved into deficit by $370 million (s.a.). However, for the first quarter, trade was in surplus by $100 million, only the second quarterly trade surplus in seven years.

The new government of Prime Minister Chirac has begun to implement its economic program. In conjunction with the devaluation of the franc within the EMS in early April, a partial lifting of exchange controls and price regulations was announced. The government outlined a program of extensive denationalization, to be carried out over a four-year period. Supplemental budget measures for 1986 involved relatively minor tax and expenditure adjustments, leaving the expected budget deficit unchanged at slightly below 3 percent of GDP. The newly announced monetary goal of holding M3 growth in 1986 below 5 percent is consistent with the previous government's target range of 3 to 5 percent growth in M3. The Chirac government also indicated its intention to introduce legislation increasing the autonomy of the Bank of France.

Economic activity in the United Kingdom continues to expand at a moderate rate, although the rate of growth appears to be somewhat slower than that experienced last year. Industrial production rose 1.7 percent (s.a.) in February, reversing its sharp December decline, after January had seen only a slight increase. Preliminary data indicate that consumption was flat in the first quarter, although it is thought that difficulties in seasonal adjustment may have obscured underlying growth.

Inflation in the United Kingdom continues to be moderate. Retail prices rose only 0.1 percent (n.s.a.) in March, lowering the 12-month inflation rate to 4.2 percent. The trade deficit in the first quarter of 1986 was $7.8 billion (s.a.a.r.) and the current account surplus was $5.0 billion (s.a.a.r.). This compares with a trade deficit of $1.2 billion and a current account surplus of $5.2 billion (s.a.a.r.) in the previous quarter. Nearly all of the deterioration in the trade balance occurred in March, when falling oil export revenues and rising imports led to the largest monthly trade deficit on record.

The Bank of England lowered its official lending rates by 1 percentage point in two steps in April. Major U.K. clearing banks announced similar reductions in their base lending rates, now at 10.5 percent. On April 29, Chancellor of the Exchequer Nigel Lawson announced that the government will permit the creation of a sterling commercial paper market. Permission to act as underwriters in this market will initially be granted only to U.K.-licensed banks, although U.S. investment banks will be allowed to seek special permission to operate in this market from the Bank of England.

Economic expansion continued in Canada in early 1986. The index of gross domestic product increased 0.6 percent (s.a.) in February, bringing the 12-month growth rate to 5.4 percent. The increase was broadly based among service-producing and goods-producing industries. The index of industrial production increased 0.7 percent in February, reversing the January decline. Meanwhile, the unemployment rate remained at 9.6 percent in April, unchanged from March, which was the lowest value in four years.

Inflation has continued to be moderate in 1986. Consumer prices rose 4.1 percent in the 12 months ending in March, about the same percentage change as during 1985. In addition, Canada's industrial product price index in February was only 2.9 percent above its year-earlier level. Canada's trade surplus fell sharply in February to $0.1 billion, the smallest monthly surplus since September 1981. Falling oil prices and slow auto sales in the United States resulted in a drop in the value of merchandise exports; there was a 40 percent reduction in export revenues from crude petroleum and coal. Meanwhile, imports reached a new record.

Short-term money market rates declined on balance over the past few weeks. Chartered banks cut their prime lending rates by 50 basis points, to 10.75 percent. This was the fourth cut in the prime rate since peaking at 13 percent in mid-February.

In Italy, real GDP increased 2.3 percent from the fourth quarter of 1984 to the fourth quarter 1985. Growth of exports was particularly strong at 7.8 percent in that period. Industrial production in January and February averaged only 0.6 percent above what it had been in January and February 1985. The unemployment rate rose to 11.5 percent in the first quarter, a post-War record figure.

The consumer price index rose 0.2 percent (s.a.) in April, bringing the 12-month inflation rate to 6.5 percent, the lowest such figure in more than 13 years. The wholesale price index in February dropped 1.3 percent (s.a.), bringing the 12-month rate of increase of wholesale prices to 2.5 percent. This drop resulted primarily from falling energy prices.

The trade deficit in the first quarter was $3.1 billion, compared with a deficit of $3.8 billion a year ago. Lower energy prices were largely responsible for the improvement.

On April 24, Italian authorities lowered the discount rate from 14 to 13 percent. This is the second time in as many months that the discount rate has been lowered. The April auction of Treasury bills was fully subscribed, as investors have responded to lowered inflation expectations. As the ceilings on commercial bank lending that were put into effect in January as a part of the package to support the lira are due to expire in June, commercial banks have already begun to lower their prime lending rates.

The Netherlands government anticipates a decline of about $4.5 billion in its 1987 revenues derived from natural gas production owing to the general decline in energy prices, reduced export volume, and the decline in the dollar. (Gas revenues are received by the Treasury with a lag of about one year.) The cabinet has approved a $3.7 billion package of spending cuts and tax increases in response; however, if no further action beyond the approved package is taken, the budget deficit would rise from about 6-1/2 percent of GNP in 1986 to about 7-1/2 percent in 1987.

Economic Situation in Major Developing Countries. Several major borrowing countries are encountering difficulties in fiscal management and containment of inflation as they attempt to maintain an adequate degree of macroeconomic discipline. Argentina probably missed some of the first quarter performance criteria of its IMF program, jeopardizing an IMF drawing and a disbursement from commercial banks. Prices and wages have begun to rise at a somewhat faster pace than they did immediately following introduction of the Austral Plan. In Brazil, prices remain steady two months into its stabilization program, but signs of overheating may now be appearing. Mexico's 1986 financing plans continue to be complicated by the fall in world oil prices; a trip by Mexico's Finance Secretary to Japan failed to generate commitments for new external financing. On April 23, the President of Venezuela invoked the contingency clause of Venezuela's rescheduling agreement with commercial banks, allowing a reconsideration of terms in the event of a change in the country's economic situation (in this case, the continued weakness in world oil markets). In Peru, the Garcia government has made a number of conciliatory gestures to its external creditors, including token payments against its arrears to the IMF, the U.S. government, and--for the first time--commercial banks.

Individual Country Notes. Reports from Argentina suggest that Argentina failed to meet some of the first-quarter performance criteria of its twice-revised IMF program. Such a failure could jeopardize the disbursement of the last drawing of SDR 235 million under the IMF agreement and of the remaining $600 million under the $4.2 billion loan from foreign commercial banks signed last summer. The government continued the partial relaxation of the freeze of prices, wages, and exchange rates introduced in June 1985. On the basis of adjustments in early April, public and private sector workers are likely to receive wage increases for the rest of the year in the 18-25 percent range. Public sector prices were increased by an average of 5 percent and the government announced that they would be increased each month in the future by an average of 2 percent. Also, a mini-devaluation policy was announced, under which the official austral price of the dollar has been increased by 6-1/4 percent in three steps since April 7. The CPI rose by 4.6 percent in March and by 4.7 percent in April--an annual rate of nearly 60 percent--while wholesale prices rose by 3 percent in April following a 1.4 percent increase in March. In the previous eight months, the average monthly rate of increase was 2.9 percent for the CPI and 0.5 percent for wholesale prices. In response to the increase in inflation, in early May the central bank tightened monetary conditions by increasing reserve requirements for commercial banks and resumed selling central bank paper in the market.

In late April, Argentina and its bank advisory committee agreed on a 180-day rollover of $3.9 billion of dollar-denominated bonds and promissory notes coming due over the next four years and an estimated $2.8 billion of other public and private sector debts coming due this year. A more permanent arrangement is to be negotiated this summer in the context of Argentina's overall financing program for 1986.

As a result of the price freeze instituted in Brazil on February 28 as part of an anti-inflationary program, prices dropped by 0.1 percent in March. Preliminary reports indicate that prices rose by about 0.5

percent in April. However, there are indications that the economy is overheating because of strong consumer and government demand, and shortages of various goods have been reported. Surveys indicate that wage settlements have tended to be higher than the minimum set by the government package and this is likely to contribute further to strong consumer demand. In March, the monetary base grew by 36 percent and M1 grew by 75 percent. This surge in money growth may be largely due to a new willingness to hold money balances in a period of expected price stability. Real GDP is now expected to grow by 7 percent in 1986, as compared with earlier forecasts in the 4-5 percent range. In 1985, real GDP grew by 8.3 percent. On the external side, the trade balance remained strong with a surplus estimated at $3.7 billion in the first four months of 1986 compared with a surplus of $2.9 billion in the year-earlier period.

In late April, Mexico's Finance Secretary Silva-Herzog travelled to Japan seeking financing of up to $1 billion for an oil pipeline and refinery expansion project, a steel mill expansion, and an export promotion project that would be co-financed by the World Bank. He noted that, as a result of the oil price decline and the appreciation of the yen against the dollar, Japan would save about $1 billion this year on its oil purchases from Mexico. However, he did not obtain any commitment.

Mexico is refraining from approaching its creditor banks with a firm proposal for 1986 financing until negotiations are concluded with the IMF for an expected two-year program and with the World Bank for a

$500 million trade policy loan that would be conditional on new steps to liberalize imports.

Since last November, when ceilings on bank lending were imposed, domestic credit conditions in Mexico have been very tight and business firms have brought back funds from abroad to meet local obligations. This has helped to bolster international reserves and to narrow the gap between the controlled and free-market exchange rates. On May 12, the gap was 2.9 percent. As the gap narrowed, the rate of crawl of the peso in the controlled market has slowed somewhat. In April, it averaged 1 peso per day, after reaching a peak of 1.26 pesos per day in February. On May 12, the peso price of the dollar in the controlled market was 137 percent higher than a year earlier. In April, the CPI rose by 5.2 percent, and was 71 percent higher than a year earlier.

On February 26, 1986, Venezuela signed its long-delayed $21.2 billion rescheduling agreement with commercial banks. As part of that agreement, Venezuela was given additional time to make amortization payments of about $900 million originally scheduled to be due in 1985 and 1986. An additional downpayment by the government of $750 million is expected to be made this summer. On April 23, citing the continued weakness in world oil markets, the President of Venezuela invoked the "contingency clause" of Venezuela's rescheduling agreement that allows it to ask for reconsideration of terms in the event of a change in the country's economic situation. This probably means that Venezuela will request a rescheduling of public-sector principal payments scheduled for 1987 and 1988. Separately, the Venezuelan government may attempt to stretch out further the repayment of private sector debt.

The IMF team that visited the Philippines in April made some progress toward negotiating a new 18-month stand-by arrangement. The current stand-by arrangement--scheduled to run to June 13, 1986--has become inoperative. One problem area in the negotiations is the size of the budget deficit. The Philippine government would like to maintain its current fiscal stance through the end of 1986. The IMF staff argues that a large deficit will tend to keep interest rates high and discourage investment, and is seeking remedial actions under the stand-by arrangement to reduce the deficit, which the Fund staff believes could reach 5-1/4 percent of GDP in 1986 compared to 1-1/4 percent of GDP in 1985. At present, it is expected that negotiations might be completed in time for the IMF Board to approve a new stand-by for the Philippines in August or September. Recent positive developments include a net inflow of capital in January-April, which has reportedly increased international reserves by about $400 million to $1.5 billion, low inflation with prices in March only 3-1/2 percent above a year ago, and a decline in the world oil price that is expected to reduce Philippine oil import costs by about $500 million in 1986. On April 15, the country's creditor banks approved an extension, from June 30, 1986 to December 31, 1986, of the $925 million new money credit facility; $350 million of the facility still remains to be disbursed.

In the last four weeks, Peru has made a number of conciliatory gestures towards its external creditors. First, the Garcia government made its first substantial payment (SDR 30 million) to the IMF since August 1985, and it gave firm assurance that Peru's arrears to the Fund (now about SDR 100 million) would be eliminated by August 15. Because of this assurance, the IMF Executive Board decided not to declare Peru ineligible to use IMF resources, but to invoke that penalty automatically unless Peru eliminates all arrears by August 15. Second, Peru made its first interest payment ($18 million) to commercial banks on its medium- and long-term public sector debt since June 1985. This was the first payment made by the Garcia administration, which took office in July 1985. Peru's interest arrears on these debts were about $490 million at the end of April. The government has indicated that it will present to the bank advisory committee in early June a formal proposal for rescheduling these debts. Finally, Peru made its first payment to the U.S. government ($15 million) since September 1985. This payment was sufficient to lift restrictions on disbursements of U.S. bilateral assistance that are automatically imposed under U.S. law whenever debt-service payments to certain U.S. government agencies are overdue by more than one year. These restrictions will again go into effect in June if no further payments are made.