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Confidential (FR) Class III FOMC

August 13, 1986

RECENT DEVELOPMENTS

Prepared for the Federal Open Market Committee

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

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DOMESTIC NONFINANCIAL DEVELOPMENTS

SELECTED DOMESTIC NONFINANCIAL DATA
(Seasonally adjusted)

	Latest data			Percent change from		
	Period	Release date	Data	Preceding period	Three periods earlier	Year earlier
				(At annual rates)		
Civilian labor force	July	08-01-86	118.1	-.4	2.9	2.4
Unemployment rate (%)[1]	July	08-01-86	6.9	7.1	7.1	7.3
Insured unemployment rate (%)[1]	Mar.	06-13-86	2.9	2.8	3.0	2.9
Nonfarm employment, payroll (mil.)	July	08-01-86	100.3	4.7	1.9	2.6
Manufacturing	July	08-01-86	19.1	-1.4	-2.6	-.8
Nonmanufacturing	July	08-01-86	81.1	6.1	2.9	3.5
Private nonfarm:						
Average weekly hours (hr.)[1]	July	08-01-86	34.6	34.7	34.8	34.8
Hourly earnings ($)[1]	July	08-01-86	8.73	8.75	8.72	8.55
Manufacturing:						
Average weekly hours (hr.)[1]	July	08-01-86	40.6	40.6	40.7	40.4
Unit labor cost (1967=100)	June	07-31-86	81.4	-2.9	-7.7	-4.7
Industrial production (1977=100)	June	07-15-86	124.1	-5.8	-1.0	-.2
Consumer goods	June	07-15-86	123.7	-1.0	4.2	2.8
Business equipment	June	07-15-86	138.0	-13.8	-3.2	-1.9
Defense & space equipment	June	07-15-86	179.7	1.3	2.7	3.6
Materials	June	07-15-86	113.4	-5.3	-2.1	-.8
Consumer prices all items (1967=100)	June	07-23-86	327.5	5.5	1.5	1.8
All items, excluding food & energy	June	07-23-86	326.3	3.7	3.1	4.0
Food	June	07-23-86	316.7	1.1	3.3	2.5
Producer prices: (1967=100)						
Finished goods	June	07-11-86	288.5	-.4	-.1	-1.7
Intermediate materials, nonfood	June	07-11-86	312.2	.4	-4.8	-3.9
Crude foodstuffs & feedstuffs	June	07-11-86	223.2	-9.1	.5	-3.2
Personal income ($ bil.)[2]	June	07-23-86	3,479.2	1.2	4.0	5.3
				(Not at annual rates)		
Mfgrs. new orders dur. goods ($ bil.)	June	07-31-86	102.7	.1	-1.9	-3.8
Capital goods industries	June	07-31-86	33.8	-2.3	-8.7	-13.9
Nondefense	June	07-31-86	26.5	1.3	-.2	-5.4
Defense	June	07-31-86	7.3	-13.4	-30.1	-35.0
Inventories to sales ratio:[1]						
Manufacturing and trade, total	May	07-16-86	1.39	1.37	1.37	1.36
Manufacturing	June	07-31-86	1.44	1.42	1.42	1.46
Trade	May	07-16-86	1.35	1.33	1.33	1.27
Ratio: Mfgrs.' durable goods inventories to unfilled orders[1]	June	07-31-86	.528	.528	.524	.550
Retail sales, total ($ bil.)	July	08-13-86	118.7	.1	.8	3.6
GAF[3]	July	08-13-86	26.6	.4	1.8	8.6
Auto sales, total (mil. units.)[2]	July	08-12-86	10.9	-3.8	-1.6	4.8
Domestic models	July	08-05-86	7.6	-9.3	-5.2	0.9
Foreign models	July	08-12-86	3.3	11.3	7.7	15.2
Housing starts, private (thous.)[2]	June	07-17-86	1,845	-.8	-5.9	9.0
Leading indicators (1967=100)	June	07-31-86	178.6	.3	1.5	6.5

1. Actual data used in lieu of percent changes for earlier periods.
2. At annual rates.
3. Excludes mail order houses.

Incoming indicators have continued to suggest a sluggish and uneven pattern of economic activity. The service and construction sectors continue to benefit from strong demand on the part of households, but manufacturing still is contracting under the pressure of declining business investment and strong foreign competition. Wage gains appear to be moderating gradually, and--apart from the recent energy market developments--price inflation has remained in check.

Industrial Production

The index of industrial production fell 0.5 percent in June--about half of the decline being strike related. Since reaching its most recent peak in January, the index has dropped 2 percent; one-half percentage point of the decline is attributable to the plunge in drilling activity; but cutbacks in production of business equipment and durable materials also have contributed significantly.

Preliminary indicators suggest that the downtrend in production continued in July. Automobile assemblies were down 400,000 units (annual rate) last month, and drilling activity was reduced further, albeit, as in June, by a smaller amount than earlier in the year. More generally, the July labor market report indicates that production probably declined in many durable goods industries. By contrast, output of metals and paper rose last month, and the settlement of the strike against AT&T probably boosted production of communication equipment.

Capacity utilization declined 0.6 percentage point in June to 78.3 percent. Since reaching its most recent peak in July 1984, utilization has fallen 4 percentage points, with much of the decline occurring during the first half of this year. The drop in operating rates this year has been concentrated in the durable manufacturing and mining industries.

Employment and Unemployment

Nonfarm employment, as measured by the establishment survey, rose 390,000 last month; about 150,000 of this increase reflected striking workers returning to their jobs at AT&T and Alcoa. Led by large gains in retail trade and services, the number of jobs in the private service-producing sector grew about 240,000 (strike adjusted). In addition, construction employment rebounded in July, more than retracing a June decline. Manufacturing employment, however, continued to fall; cutbacks of more than 50,000 jobs (strike adjusted) last month brought the cumulative decline since January to 175,000.

The civilian unemployment rate declined 0.2 percentage point in July to 6.9 percent, toward the lower end of the range that has prevailed over the past year. Much of the improved labor market situation reflected higher employment levels for adult women. The teenage unemployment rate also showed an unusually large drop in July. However, the unemployment rate for adult men has been essentially unchanged for several months, likely reflecting the weak performance of the goods-producing sector.

Personal Income and Consumption

Real income growth and consumer spending have shown considerable strength this year. Owing in part to sharp declines in energy prices and a substantial boost to farm income from government subsidy payments, disposable personal income, in real terms, rose at an annual rate of nearly 7 percent in the first half.

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

	1985	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June	1986 July
	—Average monthly changes—							
Nonfarm payroll employment[2]	230	229	261	191	127	135	-54	389
Strike adjusted	229	235	260	184	181	134	114	241
Manufacturing	-18	-31	30	-11	-37	-44	-56	-23
Strike adjusted	-17	-22	24	-13	-25	-46	-16	-53
Construction	21	19	20	17	34	2	-35	53
Trade	65	50	55	79	31	68	-21	87
Finance and services	122	131	123	98	159	132	182	160
Total government	38	59	31	23	1	9	-19	19
Private nonfarm production workers	159	137	191	135	99	94	-48	331
Manufacturing production workers	-18	-25	24	-13	-24	-35	-36	-15
Total employment[3]	163	306	229	194e	295	218	563	209
Nonagricultural	183	347	184	149e	335	280	558	261

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.
e--Adjusted by the FRB to eliminate distortions caused by the introduction of revised population estimates.

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

	1985	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June	1986 July
Civilian, 16 years and older	7.2	7.2	7.0	7.1	7.2	7.3	7.1	6.9
Teenagers	18.6	18.3	19.0	18.5	19.2	19.0	19.1	17.5
20-24 years old	11.0	11.0	10.8	10.6	11.1	11.7	10.7	10.8
Men, 25 years and older	5.3	5.3	5.2	5.3	5.4	5.4	5.5	5.5
Women, 25 years and older	5.9	5.9	5.5	5.7	5.7	5.7	5.7	5.4
White	6.2	6.2	6.0	6.1	6.2	6.2	6.1	6.0
Black	15.1	14.8	15.1	14.6	14.9	14.8	15.1	14.0
Fulltime workers	6.9	6.9	6.7	6.7	6.8	7.0	6.7	6.6
Memo:								
Total national[1]	7.1	7.0	6.9	7.0	7.1	7.2	7.0	6.8

1. Includes resident Armed Forces as employed.

PERSONAL INCOME AND EXPENDITURES
(Percent changes at annual rates)[1]

	1984	1985	1985 Q3	1985 Q4	1986 Q1	1986 Q2
Current dollars						
Total personal income	8.4	6.1	3.0	7.4	6.0	5.6
Private wages and salaries	8.8	6.3	4.7	7.5	6.5	1.9
Manufacturing	8.3	3.9	3.0	6.0	2.6	-2.1
Farm income[2]	31.5	29.2	21.6	29.4	24.4	39.1
Disposable personal income	8.0	5.6	-1.4	7.3	7.6	6.2
Real	4.2	1.9	-4.0	2.6	6.5	7.2
Constant dollars						
Personal consumption expenditures	3.6	3.5	5.3	1.7	3.6	5.9
Durables	8.8	6.2	23.8	-11.1	-1.8	14.8
Motor vehicles and parts	6.7	3.7	48.9	-32.8	-8.4	21.3
Furn. and household equip.	9.6	9.2	6.5	15.1	4.0	10.2
Other durables	12.5	6.1	4.1	7.5	2.0	8.7
Nondurables	2.2	2.0	1.2	1.6	6.5	7.1
Clothing and shoes	4.0	3.2	1.1	2.8	14.0	8.4
Gasoline and oil	.6	1.5	.4	3.4	2.1	40.0
Food	2.0	2.0	.5	-.2	5.6	1.9
Services	3.3	3.9	3.2	6.0	3.2	2.5
Memo:						
Personal saving rate (percent)[3]	6.5	4.6	4.2	4.4	5.0	5.2

1. Annual figures are from the fourth quarter of preceding year to fourth quarter of year indicated.
2. Level, billions of dollars.
3. Annual figures are based on averages of quarterly data.

RETAIL SALES
(Seasonally adjusted percentage change)

	1985	1986		1986		
	Q4	Q1	Q2	May	June	July
Total sales	-.8	1.2	1.1	.8	-.1	.1
Previous estimate[1]			1.1	.7	.2	—
(REAL)[2]	-1.5	1.5	2.3	.5	-.2	—
Previous estimate[1]			2.3	.4	.0	—
Total less automotive group, nonconsumer stores, and gasoline stations	1.4	1.3	1.4	.7	.4	.7
Previous estimate[1]			1.3	.6	.0	—
GAF[3]	1.6	1.4	2.7	.1	1.3	.4
Durable	-3.6	2.0	3.2	1.5	-.7	-.1
Automotive group	-8.1	1.1	3.8	3.1	-1.3	-1.7
Furniture and appliances	4.3	1.0	4.2	2.7	1.9	1.6
Other durable goods	1.5	.1	1.5	2.9	-2.1	2.0
Nondurable	1.0	.7	-.2	.4	.3	.2
Apparel	1.6	1.6	3.7	.1	2.2	-.2
Food	1.7	1.4	-.5	.4	.5	.8
General merchandise[4]	.4	1.4	1.6	-.9	.5	.0
Gasoline stations	.2	-4.4	-11.5	1.1	-.6	-2.6

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

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

	1985		1986		1986		
	Q3	Q4	Q1	Q2	May	June	July
Total auto sales[1]	12.3	10.2	10.7	11.2	11.3	11.3	10.9
Domestic	9.4	6.8	7.8	8.2	8.2	8.3	7.6
Imported	2.9	3.4	2.8	3.0	3.1	3.0	3.3
Domestic production	8.2	7.8	8.3	7.9	7.6	8.0	7.6
Dealers' stocks	1.31	1.67	1.81	1.80	1.81	1.80	1.76
Days' supply[2]	43	75	71	68	68	66	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.

Consumer spending rose at nearly a 5 percent annual rate over the first half of the year, with substantial gains in spending for a broad range of goods. Outlays for furniture, other household durables, and apparel were particularly robust, and auto sales spurted in late spring in response to enhanced financing incentives. In addition, gasoline usage surged, as pump prices fell.

In July, retail sales excluding automotive outlets, gasoline stations and hardware stores (the "retail control" grouping) rose 0.7 percent from an upward revised June level. Sales remained particularly strong at furniture and appliance stores. In the auto market, total car sales slipped to a 10.9 million unit rate in July, as a drop in sales of domestic models more than offset a strong increase in foreign auto sales.

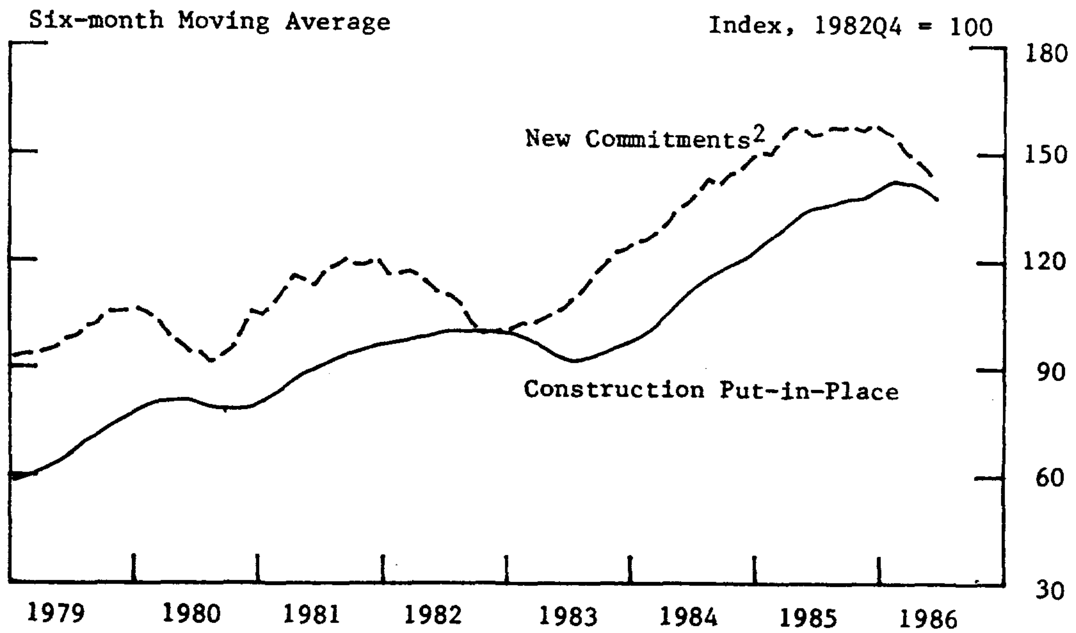
Business Fixed Investment

After falling sharply in the first quarter, real business fixed investment declined 2-1/2 percent at an annual rate in the second quarter. The weakness was centered on the nonresidential structures component, which fell at an estimated 35 percent annual rate. A portion of this drop stems from the sharp curtailment of activity related to petroleum drilling, but declines also occurred in commercial and industrial construction. The decline in commercial spending probably reflected both the record-high vacancy rates in most of the country and the widespread anticipation that Congress will restrict the tax preferences given to investment in these structures. Spending for industrial buildings has been weak, in part, owing to excess capacity throughout the economy. New commitments for nonresidential construction have fallen sharply since late last year,

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

	1985	1986		1986			
	Q4	Q1	Q2	Apr.	May	June	July
Producers' durable equipment							
Nondefense capital goods							
Shipments	3.2	-5.8	2.5	.2	-2.8	2.5	--
Excluding office & store mach.	3.7	-3.6	1.0	.6	-3.0	.2	--
Office and store machinery	.5	-17.5	11.7	-2.2	-1.7	16.1	--
Orders	.0	-4.8	-.8	-1.4	-.1	1.3	--
Excluding office & store mach.	3.2	-4.8	-1.8	.1	-2.8	-1.8	--
Office and store machinery	-16.8	-4.7	5.1	-10.8	19.2	19.4	--
Sales of heavy-weight trucks (thousands of units, A.R.)	303	262	273	195	321	304	--
Nonresidential structures							
Nonresidential construction	2.2	1.0	-6.0	.1	-2.8	-1.0	--
Commercial building	4.3	1.9	-8.3	-1.3	-4.5	-1.2	--
Office	1.1	-.8	-6.7	-1.0	-4.6	-.8	--
Other commercial	8.0	4.9	-10.0	-1.7	-4.3	-1.6	--
Industrial building	3.4	-6.2	-8.8	9.5	-6.4	-3.6	--
Rotary drilling rigs in use	-10.2	-21.0	-40.3	-18.0	-13.2	-9.9	-3.2

NONRESIDENTIAL CONSTRUCTION AND NEW COMMITMENTS[1]



1. Sum of contracts (from F.W. Dodge) and permits (from Census).
2. Includes only the building components of nonresidential construction, i.e., industrial, commercial, institutional, and hotels and motels.

suggesting that outlays likely will retreat further during the third quarter.

In contrast to structures, outlays for equipment rose substantially in the second quarter, led by a rebound in spending for office and computing equipment. However, this gain only partly reversed a sharp decline in the first quarter and near-term indicators suggest little prospect of a significant pickup in demand. New orders for nondefense capital goods fell for three consecutive months before posting a small gain in June. Although bookings for office and computing equipment, which account for almost 20 percent of total equipment spending, rose markedly in May and June, these gains were from the lowest quarterly level in the past three years, and anecdotal evidence suggests continued caution in spending for computers.

Housing

Residential investment expenditures increased sharply in the second quarter, propelled by the rise in both starts and sales through early spring. However, indicators have softened recently. Multifamily starts fell sharply in May and were little changed in June. The lower pace of multifamily construction partly reflects high vacancy rates; additional factors include concerns among investors regarding the impact of tax reform on the yield to rental housing and a lessening effect from the tax-exempt funds raised last year by state and local governments.

In the single-family sector, starts in the second quarter remained in the 1-1/4 million unit range, but sales of new and existing houses fell back in May and June from the exceptionally high levels recorded earlier in the year. The falloff in house sales in recent months may be partly attributable to a backup of mortgage rates of more than three-fourths of a percentage point (on fixed-rate loans) between April and June. Though rates edged down slightly since mid-June, they are still about 1/2 percentage point above their spring low.

In the second quarter, the average price of new single-family houses sold was 12 percent higher than a year earlier. Adjusting for quality improvements and changes in the regional mix of sales, however, average prices were up about 5 percent. Regionally, the largest price increases were registered in the strong housing markets of the Northeast, where prices rose sharply for both new and existing houses.

Business Inventories

Business inventory investment apparently slowed markedly in the second quarter, especially in the trade sector. Auto inventories were reduced slightly after a large run-up in the preceding half year. In addition, the available data for nonauto trade inventories point to a sharp slowing in the rate of accumulation. After rising $18 billion in the first quarter, these constant-dollar stocks were nearly unchanged, on balance, in April and May.

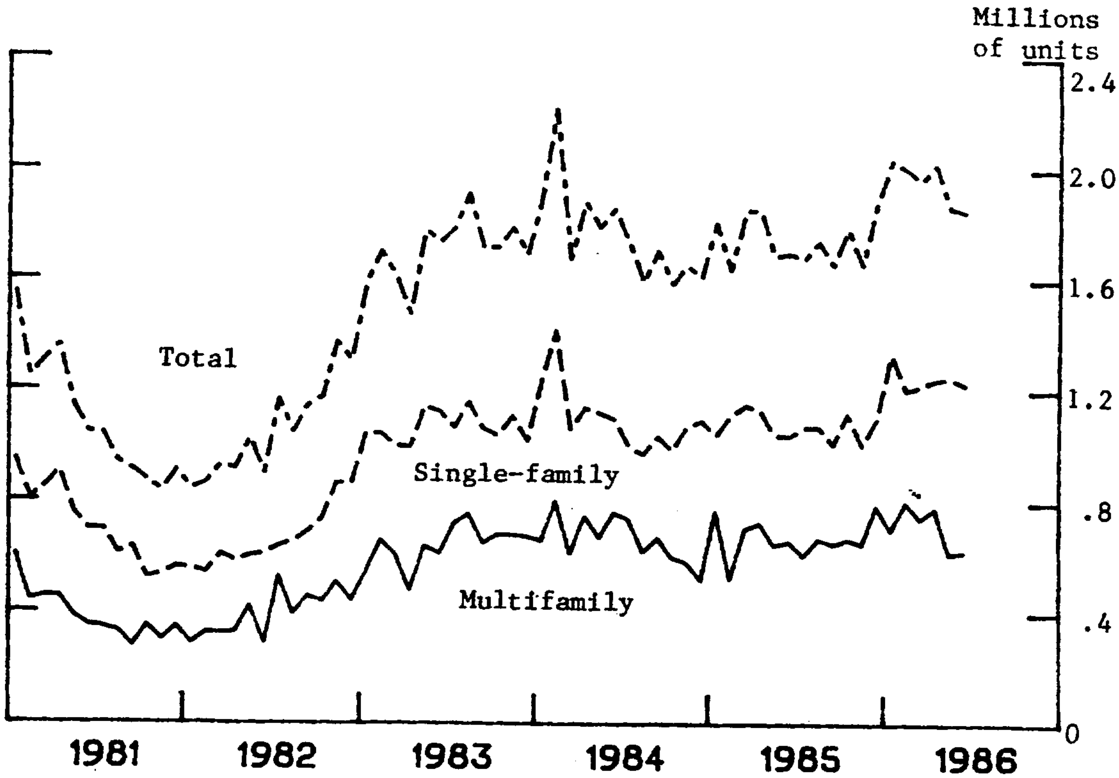
In the manufacturing sector, constant-dollar stocks apparently changed little in the second quarter. The liquidation of the past year has held the stock-sales ratio at a relatively low level despite the sluggish performance of factory shipments.

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

	1985 Annual	1985 Q4	1986 Q1	1986 Q2	1986 Apr.	1986 May	1986 June[1]
All units							
Permits	1.73	1.74	1.83	1.81	1.89	1.79	1.75
Starts	1.74	1.77	2.00	1.91	2.02	1.86	1.85
Single-family units							
Permits	.96	.96	1.05	1.11	1.14	1.09	1.09
Starts	1.07	1.07	1.25	1.24	1.24	1.25	1.22
Sales							
New homes	.69	.70	.80	.79	.88	.78	.70
Existing homes	3.22	3.50	3.26	3.48	3.57	3.45	3.41
Multifamily units							
Permits	.78	.78	.79	.70	.75	.70	.66
Starts	.67	.70	.75	.67	.78	.61	.62
Mobile home shipments	.28	.29	.26	n.a.	.25	.24	n.a.

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

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



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

	1985	1986		1986		
	Q4	Q1	Q2	Apr.	May[r]	June[p]
Book Value Basis:						
Total	17.6	20.1	—	5.1	-23.1	--
Manufacturing	-8.6	-9.3	-5.2	-2.6	-12.1	-1.1
Wholesale	6.1	4.5	7.4	.3	5.1	16.8
Retail	20.1	24.9	—	7.3	-16.1	--
Automotive	19.9	15.1	—	-6.0	-9.9	--
Ex. auto	.2	9.8	—	13.3	-6.1	--
Constant Dollar Basis:						
Total	11.0	29.8	—	25.8	-42.6	—
Manufacturing	-10.5	-5.3	—	9.5	-7.0	—
Wholesale	3.6	6.8	—	1.6	-1.8	—
Retail	17.8	28.3	—	14.7	-33.8	—
Automotive	15.9	17.2	—	1.0	-20.0	—
Ex. auto	1.9	11.0	—	13.7	-13.8	—

INVENTORIES RELATIVE TO SALES[1]

	Cyclical Reference Points[2]		1985	1986		1986		
Book Value Basis:	81 low	82 high	Q4	Q1	Q2	Apr.	May[r]	June[p]
Total	1.39	1.53	1.36	1.38	—	1.37	1.39	--
Manufacturing	1.60	1.77	1.42	1.43	1.43	1.42	1.44	1.44
Wholesale	1.06	1.28	1.18	1.20	1.24	1.20	1.25	1.24
Retail	1.37	1.46	1.43	1.47	--	1.46	1.44	--
Automotive	1.57	1.90	1.65	1.78	--	1.72	1.66	—
Ex. Auto	1.31	1.37	1.37	1.38	—	1.39	1.38	--

1. Ratio of end-of-period inventories to average monthly sales for the period. Constant dollar ratios are not available as BEA has not yet completed revision to constant dollar sales data.
2. Highs and lows are specific to each series and are not necessarily coincidental.
r—Revised estimates.
p—Preliminary estimates.

The Federal Government

Increased spending on defense and farm subsidies helped push total federal expenditures up $38 billion in the second quarter. Federal spending has been particularly variable over the past year, largely because of unevenness in spending for defense and farm programs. The volatility in defense spending is largely attributable to discrete jumps in the delivery rates of major new procurement items. For example, deliveries of B1 bombers and M1 tanks increased during the second quarter, and the first MX missiles were delivered. Current production schedules suggest some further increases in delivery rates in the near term and a leveling off thereafter. In addition, this year's farm program authorized advance income payments to farmers, which produced a surge in subsidy payments in the second quarter. On the revenue side, the slow growth of receipts during the first and second quarters reflects the sluggishness of taxable incomes and the disappearance of windfall profits tax revenues because of falling oil prices.

Action on the budget, though considerably behind the schedule specified in the Gramm-Rudman-Hollings Act, has picked up in recent weeks. The House, where appropriations bills originate, has passed 6 of the 13 regular appropriations bills; the Senate, however, has not yet acted on any of these bills. The Senate has passed a bill to increase the debt ceiling; this bill includes an amendment that would restore the automatic mechanism to cut outlays--ruled unconstitutional by the Supreme Court. There is, however, substantial opposition to this amendment in the House, and a short-term extension of the debt ceiling may be required

CHANGES IN SELECTED FEDERAL RECEIPT AND EXPENDITURE CATEGORIES
(NIA basis, change from previous quarter in billions of dollars)

	1985		1986	
	Q3	Q4	Q1	Q2
Expenditures				
Purchases	20.0	20.0	-25.2	9.1
Defense purchases	10.4	2.6	-1.6	11.0
Commodity Credit Corporation	9.1	17.3	-23.1	-2.9
Other nondefense purchases	.6	.1	-.5	.9
Subsidies	-7.3	6.0	-3.1	17.9
Payments to farmers	-7.8	5.7	-3.1	17.8
Other	.5	.3	.0	.1
Other expenditures (transfers, grants, and net interest)	6.8	7.3	6.4	11.1
Total expenditures	19.5	33.3	-21.9	38.1
Memo: Farm and defense expenditures	11.7	25.6	-27.8	25.9
Revenues				
Personal tax payments	33.0	6.0	-5.3	1.2
Corporate profits tax accruals	6.9	.4	-6.0	--
Indirect business tax accruals	-5.3	2.0	-3.3	-2.2
Social insurance contributions	2.2	4.8	8.8	1.2
Total revenues	36.8	13.2	-5.8	--

while this issue is debated. In addition, a conference committee is working to reconcile the Senate and House versions of the tax reform bill. Consideration of reconciliation legislation in the House and Senate that would cut the deficit about $9 billion in 1987 and $24 billion over three years has been postponed until Congress reconvenes from its Labor Day recess.

The administration and the CBO recently released new estimates of their economic and budget projections for FY 1986 through 1991; these are discussed in an appendix.

<u>State and Local Government Sector</u>

State and local government spending strengthened in the second quarter, but employment gains have slowed and fiscal positions of states generally have weakened somewhat. Real outlays advanced 7-3/4 percent at an annual rate in the second quarter versus a gain of 2-1/2 percent in the first quarter. Most of the second-quarter increase was attributable to a surge in construction spending in May. Monthly employment gains have been averaging 8,500 during the past four months, less than half as much as during the first quarter of this year and substantially below the pace in 1985.

Indicators of state fiscal positions point to some further deterioration for the sector as a whole. For fiscal year 1986, 18 states reduced planned general-funds outlays, and 9 already have sliced planned fiscal 1987 expenditures; a few states are expecting to spend less in 1987 than they did in 1986. One early estimate of state finances indicates that the general funds cash balance for the states as a whole will be close to zero in fiscal 1987.

Prices

Recent patterns of price change have reflected the gyrations in energy prices, with the consumer price index for all urban consumers up 1/2 percent in June and the producer price index for finished goods unchanged. Over the first half of this year, the CPI declined slightly and the PPI substantially, owing largely to the sharp decline in petroleum product prices.

A June pickup in energy prices at the consumer level reflected advances for gasoline, electricity, and natural gas, which more than offset continued declines for fuel oil. Retail prices of gasoline tend to respond fairly quickly to changes in spot prices of petroleum and refinery products; these prices weakened considerably in domestic and world markets after mid-June, but have responded to the recent OPEC agreement with sharp climbs. Prices of service fuels, however, have adjusted more slowly to the lower price level for petroleum products.

Food prices also had a restraining influence on the CPI in the first half, rising at an average annual rate of only 1.0 percent. In June, food prices in the CPI edged up 0.1 percent, as fresh fruit and vegetable prices turned down, largely offsetting advances for meats, poultry, and other categories.

At the farm level, crop and livestock prices have followed widely divergent patterns in recent months. Declines in crop output this year, partly stemming from policy-induced reductions in acres planted, probably

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

	Relative Importance Dec. 1985	1985	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June
			-Annual rate-			-Monthly rate-	
All items[2]	100.0	3.8	5.3	-1.9	1.5	.2	.5
Food	18.5	2.7	5.9	-1.4	3.4	.4	.1
Energy	11.3	1.8	3.3	-34.2	-12.5	.3	2.3
All items less food and energy	70.2	4.4	5.4	4.1	3.1	.1	.3
Commodities	25.9	2.1	3.6	.3	-.5	-.1	.1
Services	44.4	5.7	6.5	6.5	5.2	.2	.4
Memorandum:							
CPI-W[3]	100.0	3.6	5.2	-2.7	1.0	.2	.5

1. Changes are from final month of preceding period to final month of period indicated.
2. Official index for all urban consumers.
3. Index for urban wage earners and clerical workers.

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

	Relative Importance Dec. 1985	1985	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June
			-Annual rate-			-Monthly rate-	
Finished goods	100.0	1.8	9.2	-12.4	-.1	.6	.0
Consumer foods	24.5	.5	16.0	-7.5	5.3	1.1	.0
Consumer energy	12.5	-.3	20.7	-67.6	-23.5	2.7	-.6
Other consumer goods	40.3	2.7	4.4	2.9	1.4	.2	.0
Capital equipment	22.7	2.7	5.6	.7	1.9	.1	.1
Intermediate materials[2]	95.3	-.1	2.9	-11.9	-4.7	-.3	.0
Exc. energy	79.6	-.1	.0	-1.2	-1.2	.0	.0
Crude food materials	52.5	-6.4	47.0	-25.2	.5	4.1	-.8
Crude energy	31.6	-4.9	-4.0	-50.1	-35.5	.2	-3.0
Other crude materials	15.9	-4.3	1.5	-3.7	10.5	.2	1.1

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

will not be large enough to make a serious dent in the huge stockpiles that have hung over the market for the past two years. Consequently, with price support levels for the major crops being reduced substantially in an effort to boost exports, crop prices have fallen sharply. Livestock prices, in contrast, have strengthened substantially in recent months especially for hogs and poultry. Poultry output has been affected, probably temporarily, by the drought in the Southeast, and a cyclical contraction in the hog sector has limited marketings.

Excluding food and energy items, the CPI rose 0.3 percent in June, after rising only fractionally in May. Prices of commodities less food and energy edged up 0.1 percent, as further declines for used cars and apparel nearly offset increases for new cars and other items. Recent price hikes for new cars, including both domestic and imported models, have raised that index to a level about 4-1/2 percent above a year earlier. By contrast, used car prices have declined at about a 7 percent rate so far this year.

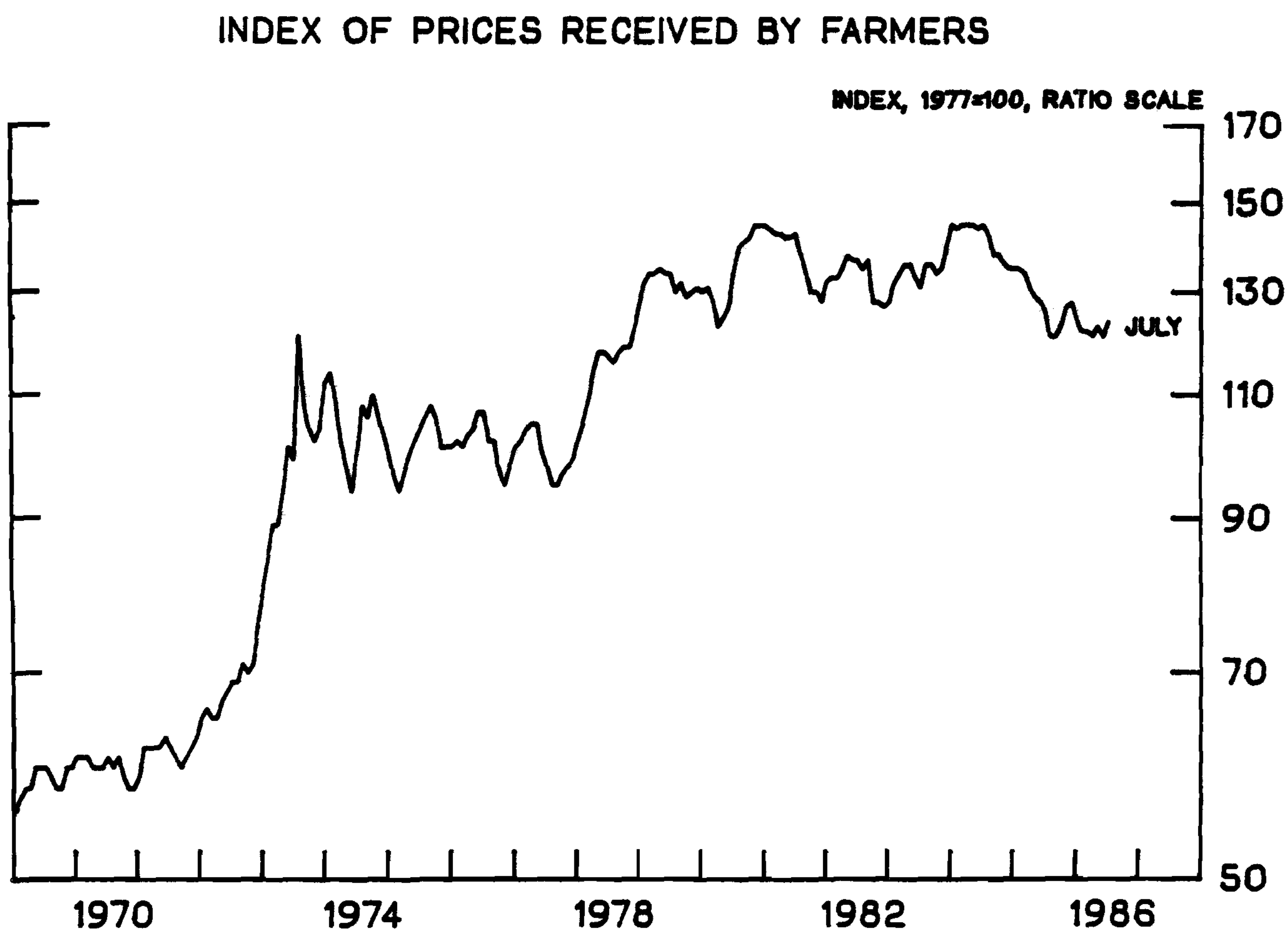
Prices of nonenergy services rose 0.4 percent in June. Price increases for auto insurance and medical care remained large, and a scheduled rise in local access charges boosted the cost of telephone service. Compared with June 1985, nonenergy service prices were up 5-3/4 percent, similar to the previous twelve-month pace.

According to the BLS, prices of imported consumer goods other than autos rose 4 percent (not annual rate) over the first six months of 1986 and 7 percent over the past 12 months. Although import prices have spurted for consumer goods such as tape recorders, photographic equipment,

INDICATORS OF U.S. AGRICULTURAL PRODUCTION[1]

Commodity (unit)	1985	Projected 1986	Projected Percent change
Crop production:			
Corn (billions of bushels)	8.87	8.32	-6.2
Wheat (billions of bushels)	2.43	2.16	-11.1
Soybeans (billions of bushels)	2.10	1.98	-5.7
Cotton (millions of bales)	13.4	10.7	-20.1
Meat production:			
Beef (billions of pounds)	23.6	23.7	.4
Pork (billions of pounds)	14.7	14.2	-3.4
Poultry (billions of pounds)	16.9	17.9	5.9
Total meat and poultry[2]	56.0	56.6	1.1
Livestock inventories:			
Cattle (millions of animals, July 1)	116.3	112.2	-3.5
Cattle on feed, July 1	9.7	8.9	-8.2
Hogs and pigs (millions of animals, June 1)	52.3	48.8	-6.7

1. All data are from the U.S. Agriculture Department. Crop production estimates are based on conditions as of August 1. Projections of meat production are from USDA's supply-demand estimates of August 12. The inventory data are actual, rather than projected, and are based on midyear surveys.
2. Includes some items not shown separately.



INDEX OF PRICES RECEIVED BY FARMERS[1]
(Percent change)

	Q4 to Q4			1985	1986		1986		
	1983	1984	1985	Q4	Q1	Q2	May	June	July
Total	6.8	.0	-7.6	2.7	-2.6	-.8	1.7	-1.6	2.5
Livestock	-1.2	2.7	-3.8	6.2	-2.4	-2.3	3.1	1.5	6.8
Crops	18.5	-3.2	-12.0	-.9	-2.6	.6	.0	-4.4	-3.7

1. Not seasonally adjusted. Changes over periods larger than one quarter are measured from final quarter of preceding period to final quarter of period indicated.

watches, and optical goods, much of the increase apparently is being absorbed by domestic distributors.

In the capital equipment area, prices of domestically-produced goods have shown little change over the past year, while according to the BLS survey, import prices of a wide range of machinery and equipment rose at double-digit rates in the year ending in June 1986. Prices of intermediate materials, less food and energy, have continued to show little change, on balance, over the past year and a half. By contrast, prices of crude nonfood materials, less energy, were up in June as well as over the first half of this year, after declining during most of 1984 and 1985. This index shows prices rising for such items as domestic logs, wastepaper, and scrap metal.

Wages and Labor Costs

Available measures of labor costs provide different indications of the current rate of wage inflation, but all point to continued restraint so far this year. The hourly earnings index was little changed July, after rising at a 2-1/4 percent rate in the first half of this year. In contrast, the wage and salary component of the employment cost index, a more comprehensive measure, continues to show wage increases close to 4 percent, primarily reflecting relatively large increases for nonproduction and supervisory workers who are excluded from the hourly earnings index. The ECI measure of overall hourly compensation, which includes employer costs as well as wages and salaries, also has been rising at just under a 4 percent rate, as moderation in the growth of fringe benefits has accompanied the deceleration in wages.

The unionized sector continues to be a source of wage restraint. In the first half of 1986, effective wage change was less than 3 percent, most of which reflected wage adjustments negotiated under prior contracts; COLA payments were nearly nonexistent in the first half of this year. In general, settlements this year have been far less generous than the contracts they replaced. New settlements for the 1 million private industry workers bargaining so far this year averaged just 1.2 percent in the first contract year and 1.9 percent annually over the life of the contract, exclusive of lump-sum payments and COLAs. Much of the deceleration in average first-year adjustments can be explained by the large number of workers not receiving a wage increase. More than 40 percent of workers covered by new settlements so far this year accepted initial wage cuts or freezes, the highest percentage since 1982. However, 30 percent of workers negotiating new settlements in the first half of this year will receive lump-sum payments in lieu of wage increases. These payments, which averaged about 3 percent of salary in 1985, currently are excluded from straight-time measures such as the hourly earning index and the wage and salary component of the ECI, but are included as part of total hourly compensation.

Along with favorable compensation trends, there has been some improvement in productivity growth. Output per hour in the nonfarm business sector has risen 1.1 percent over the past year, compared with just 0.2 percent over the preceding four quarters.

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

	1984	1985	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 Year to date
Hourly earnings index, wages of production workers[1]							First seven months
Total private nonfarm	2.9	3.0	2.4	3.2	2.7	1.8	1.3
Manufacturing	3.4	3.3	2.5	2.4	2.3	2.4	1.5
Nonmanufacturing	2.7	2.9	2.4	3.5	2.8	1.6	1.1
Employment cost index, compensation of all persons[2]							1985 Q2 to 1986 Q2
Total	4.9	3.9	5.2	2.2	4.5	3.1	3.8
By occupation:							
White collar	5.1	4.8	5.5	3.1	4.7	3.7	4.2
Blue collar	4.2	3.2	4.0	1.3	4.2	1.9	2.9
Service workers	6.6	3.0	6.5	2.2	4.4	.6	3.4
By bargaining status:							
Union	4.3	2.6	3.2	1.9	4.2	.9	2.5
Nonunion	5.2	4.6	5.9	2.2	4.8	3.8	4.2
Employment cost index, wage and salaries of all persons[2]							
Total	4.1	4.1	5.3	2.3	3.9	3.5	3.7
Major collective bargaining agreements[3]							First six months
First-year wage adjustments	2.4	2.3	--	--	--	--	1.2
Total effective wage change	3.7	3.3	--	--	--	--	2.6
Labor costs and productivity, all persons[1]							1985 Q2 to 1986 Q2
Compensation per hour	4.3	3.9	3.2	3.7	3.1	2.2	3.1
Output per hour	1.0	0.2	2.2	-3.5	4.3	1.7	1.1
Unit labor costs	3.2	3.7	1.0	7.4	-1.2	0.5	1.9

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.
3. Agreements covering 1,000 or more workers; not seasonally adjusted.

APPENDIX *

ADMINISTRATION AND CONGRESSIONAL BUDGET OFFICE

BUDGET UPDATES

Official projections of economic and budget prospects were updated last week with the release of the administration's Mid-Session Review of the 1987 Budget and the Congressional Budget Office's The Economic and Budget Outlook: An Update. These reports take into account the legislative, economic, technical estimating and policy developments that have occurred since the FY1987 budget was submitted last February. Based on these developments, both the administration and the CBO have revised their estimate of the fiscal 1986 deficit upward; they have made revisions in opposite directions for 1987 but both agencies have lowered their deficit projections for the years beyond 1987.

Most of the revisions to the economic assumptions of the administration and CBO, shown in table 1, merely incorporate recent developments--the greater-than-expected deceleration of inflation, lower interest rates, and slow real growth--into the 1986 and 1987 forecast. The contours of the longer-run forecast are about unchanged from February, with the exceptions of somewhat slower real growth and slightly lower interest rates now being projected by CBO. The negative effect of lower inflation and real growth on tax revenues is, however, offset in the CBO assumption by an upward revision in the share of GNP that is subject to personal and corporate taxes. Both the administration and CBO continue to be optimistic about the continuation of the recovery; but the overall outlook of the administration forecast is more optimistic, including a substantially higher growth rate of potential output implicit in its real growth and employment projections, and a steeper downtrend in inflation and interest rates.

The revised administration and CBO current services or baseline budget projections are summarized in table 2. Current services and baseline projections are estimates of the revenues and spending that would occur if no policy changes were made. Most taxes and spending for entitlements are projected on the basis of current law tax rates and spending formulas. Nondefense discretionary spending is projected at the level that would maintain real program services. The administration usually includes defense spending at the level specified in its most recent policy proposal. However, for the Mid-Session Review the administration has reduced the budget authority assumed for 1987 to the level specified in the FY1987 congressional budget resolution, but it assumes that after 1987 budget authority grows at the 3 percent real growth specified in the February budget (and in the FY1986 congressional budget resolution that was adopted by Congress in August 1985). The CBO, on the other hand, usually includes defense at a level that reflects congressional policy. In its February projections, the CBO rejected the defense spending path specified in the FY1986 budget resolution because of the subsequent enactment of the Gramm-Rudman Deficit Reduction Act.

* Prepared by Wolf Ramm, Senior Economist, Government Finance Section, Division of Research and Statistics.

It interpreted congressional intent as specifying zero real growth of defense appropriations. This assumption was retained in the August update.

As the table shows, a sharp decline in the current services deficit is now being projected by both the CBO and the administration--from $224 or $230 billion in 1986 to less than $70 billion in 1991. The decline is steeper than that projected in the February budget documents and is in marked contrast to the steady or rising deficits that were being projected last August (see the memo lines of the table). The downward revisions of the long-range deficit projections since last August are partly the result of spending restraint--including a scaling back of the proposed size of the defense build-up--and minor revenue increases that have been adopted by Congress and the administration over the past year. In addition, favorable economic developments, primarily lower interest rates and inflation, have cut the growth of outlays.

The sources of the revisions to the February deficit estimates are summarized in table 3. The administration's estimate of the FY1986 deficit was revised up because of higher than expected defense spend-out rates, major technical reestimates of farm price support and FDIC and FSLIC deposit insurance payments, and the lower than expected growth of taxable incomes. In the years beyond 1986 the deficit is smaller primarily because lower inflation reduced proposed defense spending and because of nondefense spending cuts and tax increases that were enacted in the Comprehensive Omnibus Reconciliation Act of 1985 (COBRA). The CBO also has revised its 1986 deficit estimate because of weak income growth and high farm and deposit insurance payments. In the out years, CBO adjustments to the defense baseline are much smaller than the administration's, apparently taking the lower inflation assumption into account only for pay estimates. On the other hand, the CBO made larger deficit adjustments based on revised economic assumptions; the share of taxable income in national income is assumed to be greater than in the February report and assumed interest rates are a bit lower. CBO technical reestimates about offset the effect of COBRA on the deficit projection in the years beyond FY1986.

Table 4 summarizes the additional deficit-reducing actions that have been proposed by the administration in the Mid-Session Review and by Congress in its FY1987 Budget Resolution. The admininistration estimates that its proposed initiatives would be sufficient to hold the deficit below the GrammRudman targets. However, many economic forecasts current in the private sector would imply higher deficits and there has been substantial resistance in Congress to many of the administration's deficit cutting proposals. On the other hand, congressional policy, when reestimated by the CBO, also exceeds the Gramm-Rudman targets.

It should be noted that the Gramm-Rudman sequester report which is due on August 20 will be based on a different baseline concept than the administration and CBO estimates discussed above. The Gramm-Rudman tax and spending estimates will be based only on currently enacted legislation. If new appropriations for a program or agency are not yet enacted, appropriation levels from the previous year would be assumed (none of the 1987 appropriation bills have yet cleared Congress); that is, there would be no adjustment for maintaining real program services as in the CBO baseline and administration current services budget, nor would defense be estimated at proposed policy levels. The CBO estimates that the 1987 deficit computed on a Gramm-Rudman basis would be about $173 billion and OMB officials have indicated that their estimates will probably be between $160 and $170 billion. A reconciliation bill that would cut about $9 billion from these estimates will be considered by the House and Senate in early September. This bill would go a long way toward bringing the deficit estimate down toward the $154 billion 1987 trigger for a sequester under Gramm-Rudman (the sequester process is triggered when the estimated deficit exceeds the $144 billion deficit target by more than $10 billion).

Table 1
Administration and Congressional Budget Office Economic Assumptions
(calendar years, percent)

	1986	1987	1988	1989	1990	1991
Real GNP (year to year)						
Administration (August)	2.9	4.0	4.1	3.9	3.6	3.5
Administration (February)	3.4	4.0	4.0	3.9	3.6	3.5
CBO (August)	2.8	3.4	3.2	3.2	3.1	3.0
CBO (February)	3.2	3.1	3.3	3.5	3.5	3.2
GNP deflator (year to year)						
Administration (August)	2.6	3.3	3.7	3.3	2.8	2.1
Administration (February	3.5	4.2	3.7	3.3	2.8	2.1
CBO (August)	2.7	3.3	4.1	4.1	4.1	4.1
CBO (February)	3.6	4.1	4.1	4.1	4.1	4.1
Civilian unemployment rate (annual average)						
Administration (August)	7.0	6.6	6.4	6.2	5.9	5.7
Administration (February)	6.8	6.6	6.4	6.2	5.9	5.7
CBO (August)	7.0	6.7	6.4	6.3	6.1	6.0
CBO (February)	6.7	6.7	6.5	6.3	6.1	6.0
Three-month Treasury bill rate (annual average)						
Administration (August)	6.2	6.2	5.6	5.1	4.5	4.0
Administration (February)	7.3	6.5	5.6	4.8	4.3	4.0
CBO (August)	6.2	6.4	6.3	6.0	5.7	5.3
CBO (February)	6.8	6.7	6.4	6.1	5.7	5.4

Table 2
Administration Current Services and Congressional Budget Office
Baseline Budget Projections
(Fiscal years, billions of dollars)

	1986	1987	1988	1989	1990	1991
Receipts:						
Administration	765	828	914	983	1050	1111
CBO	767	828	915	987	1067	1148
Outlays:						
Administration	995	999	1054	1099	1140	1175
CBO	991	1012	1065	1113	1162	1217
Deficit:						
Administration	230	172	140	116	91	64
CBO	224	184	150	127	96	69
Memo:						
Recent deficit projections:						
Administration current services:						
February 1986	206	182	150	139	126	104
August 1985	243	253	256	244	238	n.a.
CBO baseline:						
February 1986	208	181	165	144	120	104
August 1985	212	229	243	264	285	n.a.

Note: Detail may not add to totals because of rounding.

Table 3
Revisions to Baseline Deficit Projections
(Fiscal years, billions of dollars)

	1986	1987	1988	1989	1990	1991
Administration:						
Current services deficit in February	205.6	181.8	150.0	138.9	126.3	103.9
Effect on deficit of:						
National defense	5.6	-2.8	-4.6	-10.3	-19.2	-26.2
Enacted policy	-.1	-8.3	-3.4	-7.6	-10.9	-11.1
Economic assumptions	10.5	6.3	.3	-8.4	-6.8	-4.1
Technical reestimates	8.6	-5.5	-2.0	3.4	1.4	1.6
Updated current services deficit in Mid-session Review	230.2	171.5	140.3	116.0	90.7	64.1
Congressional Budget Office:						
Baseline deficit in February	208	181	165	144	120	104
Effect on deficit of:						
Enacted policy	-5	-12	-10	-13	-15	-16
Economic assumptions	7	3	-12	-17	-25	-35
Technical reestimates	14	12	7	12	15	16
Updated baseline deficit in August Budget Outlook	224	184	150	127	96	69

Note: Detail may not add to totals because of rounding.

Table 4
Proposed Administration and Congressional Policy
(Fiscal years, billions of dollars)

	1987	1988	1989	1990	1991
Administration:					
Current services deficit	171.5	140.3	116.0	90.7	64.1
Revenue increases	3.6	4.6	4.4	2.8	2.7
Outlay cuts	24.0	38.2	50.5	64.8	68.8
Deficit on a policy basis	143.9	97.5	61.1	23.0	-7.4
Congressional Budget Resolution:					
CBO baseline deficit	184	150	127		
Revenue increases[1]	6	6	7		
Outlay cuts[1]	17	26	36		
Deficit on a policy basis	161	118	84		
Memo:					
Gramm-Rudman deficit target	144	108	72	36	0

Note: Detail may not add to totals because of rounding.

1. As reestimated by the CBO in the August Budget Outlook.

DOMESTIC FINANCIAL DEVELOPMENTS

III-T-1
SELECTED FINANCIAL MARKET QUOTATIONS[1]
(Percent)

	1984	1985	1986			Change from:	
	Highs	March highs	April Lows	FOMC July 9	Aug. 12	April Lows	FOMC July 9
Short-term rates							
Federal funds[2]	11.63	8.58	6.95	6.69	6.35	-0.60	-0.34
Treasury bills[3]							
3-month	10.67	8.80	5.77	5.88	5.61	-0.16	-0.27
6-month	10.77	9.13	5.81	5.90	5.59	-0.22	-0.31
1-year	11.13	9.25	5.79	5.94	5.69	-0.10	-0.25
Commercial paper							
1-month	11.42	8.94	6.42	6.65	6.19	-0.23	-0.46
3-month	11.35	9.12	6.30	6.51	6.09	-0.21	-0.42
Large negotiable CDs[3]							
1-month	11.52	8.89	6.51	6.61	6.10	-0.41	-0.51
3-month	11.79	9.29	6.39	6.45	6.08	-0.31	-0.37
6-month	12.30	9.92	6.35	6.44	6.06	-0.29	-0.38
Eurodollar deposits[4]							
1-month	11.89	8.89	6.59	6.84	6.36	-0.23	-0.48
3-month	12.20	9.58	6.55	6.65	6.38	-0.17	-0.27
Bank prime rate	13.00	10.50	8.50	8.50	8.00	-0.50	-0.50
Treasury bill futures							
Sept. 1986 contract		10.74	5.16	5.60	5.44	0.28	-0.16
Dec. 1986 contract			5.27	5.59	5.35	0.08	-0.24
Intermediate- and long-term rates							
U.S. Treasury (constant maturity)							
3-year	13.49	11.22	6.49	6.93	6.60	0.11	-0.33
10-year	13.99	12.02	6.98	7.31	7.23	0.25	-0.08
30-year	13.94	11.97	7.14	7.15	7.34	0.20	0.19
Municipal revenue[5]							
(Bond Buyer index)	11.44	10.25	7.55	7.91	7.97	0.42	0.06
Corporate--A utility							
Recently offered	15.30	13.23	9.15	9.54e	9.55e	0.40	0.01
Home mortgage rates[6]							
S&L fixed-rate	14.68	13.29	9.86	10.59	10.40	0.54	-0.19
S&L ARM, 1-yr.	12.31	11.14	8.41	8.57	8.44	0.03	-0.13

	1984	1985	1986	1986		Percent change from:	
	Lows	March Lows	Record Highs	FOMC July 9	Aug. 12	Record Highs	FOMC July 9
Stock prices							
Dow-Jones Industrial	1086.57	1247.35	1909.03	1826.07	1835.49	-3.85	0.52
NYSE Composite	85.13	102.46	145.15	139.55	140.02	-3.53	0.34
AMEX Composite	187.16	222.28	285.19	273.71	267.89	-6.07	-2.13
NASDAQ (OTC)	225.30	276.18	411.16	393.39	373.29	-9.21	-5.11

1. One-day quotes except as noted.
2. Averages for two-week reserve maintenance period closest to date shown. Last observation is the average to date for the maintenance period ending August 13, 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 discount rate was cut from 6-1/2 to 6 percent shortly after the July FOMC meeting, but other interest rates have not registered comparable declines. Yields on 3- to 6-month money market instruments generally have eased around one-fourth to three-eighths percentage point, while bond yields are mostly unchanged to a bit higher over the intermeeting period. The discount rate change had been widely anticipated, but several other factors also worked to hold up market rates. Until recent days when rumors have circulated about discussions of new coordinated actions, the failure of other central banks to match the July discount rate move and the weakness of the dollar--along with the stress placed by U.S. officials on the role of foreign demand in bolstering growth here--seemed to dim hopes of further Federal Reserve easing steps. In addition, the OPEC oil supply initiative, coming on the heels of a larger-than-expected June CPI increase, emphasized the importance of energy prices in recent disinflation and had a moderate, bearish effect on the fixed-income markets.

A pickup in the growth of M2 and M3 in July moved these aggregates to the upper portions of their annual target ranges. Growth of the broader aggregates was given considerable impetus by a surge in overnight RPs associated with record acquisitions of U.S. government securities by commercial banks. M1 continued to grow rapidly, with strong increases in demand deposits and other checkable deposits.

Apart from a drop-off in Treasury borrowing on a seasonally adjusted basis, aggregate credit growth appears to be well maintained in the current quarter. Net borrowing by nonfinancial firms slowed in July as the use of short-term credit was weak and bond issuance receded from the torrid pace

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

	1984:Q4 to 1985:Q4	1986 Q1	1986 Q2	1986 May	1986 June	1986 July[pe]	Growth from Q4 1985 to July 1986[pe]
	------ Percentage change at annual rates ------						
1. M1	11.9	7.7	15.8	23.4	14.6	17	13-1/2
2. M2	8.6	4.3	10.4	12.4	9.5	13	8-1/2
3. M3	7.6	7.4	8.0	5.6	6.5	13	8-1/2
							Levels in billions of dollars June 1986
Selected components							
4. Currency	7.5	7.5	6.2	9.6	5.5	6	176.6
5. Demand deposits	8.6	3.0	15.2	25.7	14.1	14	284.9
6. Other checkable deposits	22.3	15.0	25.8	32.9	24.0	30	199.0
7. M2 minus M1[2]	7.6	3.2	8.7	8.8	7.8	11	2002.2
8. Overnight RPs and Eurodollars, NSA	18.9	3.0	-7.1	3.6	-55.4	99	64.0
9. General purpose and broker/dealer money market mutual fund shares, NSA	9.3	10.9	27.8	12.5	26.7	15	197.7
10. Commercial banks	9.1	7.2	5.8	4.3	7.5	6	867.9
11. Savings deposits, SA, plus MMDAs, NSA[3]	19.0	8.7	13.2	15.8	21.4	16	486.1
12. Small time deposits	-0.6	5.3	-3.1	-9.6	-9.7	-6	381.8
13. Thrift institutions	5.1	4.3	7.4	6.3	7.4	7	883.4
14. Savings deposits, SA, plus MMDAs, NSA[3]	13.7	1.3	13.8	21.4	24.5	18	379.3
15. Small time deposits	-0.4	6.6	2.8	-4.5	-5.2	-2	504.1
16. M3 minus M2[4]	3.7	20.3	-1.5	-20.8	-5.5	16	653.6
17. Large time deposits	5.7	15.6	-1.8	-15.4	-2.4	3	445.4
18. At commercial banks, net[5]	5.1	18.5	-8.7	-23.4	-2.6	0	280.8
19. At thrift institutions	6.8	10.0	11.0	-0.7	-2.2	9	164.6
20. Institution-only money market mutual fund shares, NSA	11.1	26.8	39.2	32.4	-17.3	40	75.0
21. Term RPs, NSA	-4.6	44.1	-13.2	-17.5	-44.3	-4	65.2
22. Term Eurodollars, NSA	-4.9	7.7	-1.5	-40.0	-10.7	-11	77.6
	-- Average monthly change in billions of dollars --						
MEMORANDA:							
23. Managed liabilities at commercial banks (24+25)	2.3	7.7	-5.8	-5.3	-3.7	0	469.2
24. Large time deposits, gross	1.0	3.4	-2.6	-6.5	-0.6	-1	339.8
25. Nondeposit funds	1.3	4.3	-3.2	1.2	-3.1	1	129.4
26. Net due to related foreign institutions, NSA	0.3	2.4	-1.6	4.1	-2.0	-6	-24.3
27. Other[6]	1.0	2.0	-1.7	-2.9	-1.1	8	153.7
28. U.S. government deposits at commercial banks[7]	0.2	-0.6	0.9	3.9	-2.8	-4	18.5

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 June and July 1986 at rates of 17.7 percent and 23 percent, respectively. At thrift institutions, savings deposits excluding MMDAs increased during June and July 1986 at rates of 29.1 percent and 23 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

in the spring. Fragmentary data on the household sector suggest that the growth of home mortgage debt is continuing at a rapid rate, but that growth of installment loans may be slowing further. Meanwhile, however, state and local government borrowing has soared once again, with bonds being rushed to market ahead of proposed new restrictions that could become effective on September 1, depending on developments in the tax reform arena.

Monetary Aggregates and Bank Credit

M2 accelerated in July to a 13 percent annual rate of growth, owing largely to a surge in the issuance of overnight RPs, apparently to finance massive acquisitions of Treasury securities by large commercial banks in late June and early July. Among other M2 components, relative interest rate movements again favored the more liquid items. Yields on money market mutual fund shares have lagged the decline in market rates, leading to strong inflows into these instruments. The same is true of savings deposits and MMDAs, which rose rapidly while runoffs of small time deposits extended into July. Since late 1984, the share of small time accounts in M2 has drifted down almost 5 percentage points to 33 percent; in contrast, the share of liquid interest-bearing instruments (including OCDs, savings deposits, MMDAs, and MMMFs) has risen over the same period from 43 percent to almost 48 percent of M2.

The continued rapid growth of M1 obviously has been a significant part of the shift toward liquid monetary assets. Growth of M1 in July, at an annual rate of 17 percent, was only a little below the change between March and June. The expansion was paced by continued strong inflows to OCDs as yield spreads between OCDs and less liquid alternatives were

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

	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June	1986 July^p	Levels in bil. of dollars July^p
	---------- Commercial Bank Credit ----------						
1. Total loans and securities at banks	11.5	9.3	3.9	5.9	3.8	11.7	1982.9
2. Securities	19.9	2.0	4.9	10.4	6.3	28.8	469.4
3. U.S. government securities	-3.5	-5.3	7.9	18.2	3.1	40.2	284.0
4. Other securities	62.5	12.8	0.7	-1.3	11.2	11.8	185.4
5. Total loans	8.9	11.6	3.6	4.6	3.0	6.5	1513.5
6. Business loans	6.0	5.3	2.1	-2.6	4.7	0.5	508.9
7. Security loans	4.0	101.7	-62.0	-40.1	-98.5	62.1	44.7
8. Real estate loans	12.6	13.0	13.4	15.5	11.6	13.3	455.7
9. Consumer loans	8.5	11.0	6.7	7.6	5.9	4.7	305.7
10. Other loans	10.2	7.3	-1.6	4.8	-0.6	-2.4	198.4
	---------- Short- and Intermediate-Term Business Credit ----------						
11. Business loans net of bankers acceptances	6.0	5.2	1.0	-3.8	3.6	1.2	504.0
12. Loans at foreign branches[2]	-16.5	0.0	-21.5	-26.1	-26.7	-20.5	17.3
13. Sum of lines 11 & 12	5.2	5.1	0.2	-4.4	2.5	0.2	521.3
14. Commercial paper issued by nonfinancial firms[3]	55.5	-14.4	-10.3	-2.9	13.1	-23.0	81.7
15. Sums of lines 13 & 14	11.8	2.1	-1.2	-4.2	4.0	-3.0	603.0
16. Bankers acceptances: U.S. trade related[4,5]	-30.8	-6.2	16.3	18.8	25.8	n.a.	33.2 (Jun)
17. Line 15 plus bankers acceptances: U.S. trade related	9.5	1.7	-0.4	-3.0	5.1	n.a.	637.7 (Jun)
18. Finance company loans to business[4]	19.2	16.4	3.8	-2.3	-2.3	n.a.	158.5 (Jun)
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	11.3	4.5	0.5	-2.0	3.8	n.a.	796.3 (Jun)

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.

squeezed to their narrowest levels since the introduction of nationwide NOW accounts; for example, at commercial banks rates on 6-month small time accounts were less than 75 basis points above Super NOW rates late in July, compared with around 150 basis points in the latter part of 1985. Growth of demand deposits remained strong in July.

M3 rose at an annual rate of 13 percent in July, the highest monthly figure this year. A sharp rebound in the non-M2 component contributed to the increase. Inflows to institution-only money funds bulged in July, reflecting the lagging adjustment of their yields to the decline in market rates. Substantial issuance of large time deposits by thrifts also was an important factor, as institutions regulated by the FHLBB sought to bolster their liability base in light of a proposal for higher capital requirements that would restrain their future growth. Commercial banks as a group did not rely on CDs, but the flatness hides a continued runoff at banks under pressure from problems in the energy industry and other troubled sectors.

Business loan demand has been quite weak in recent months, but overall bank credit picked up in July owing to the buildup in holdings of U.S. government securities. Banks continued to acquire other securities, perhaps to take advantage of attractive yields on tax-exempt issues. Real estate loans again increased briskly in July while consumer loans continued to grow relatively slowly, owing in part to the competition from captive auto finance companies. The volatile securities loan category bounced up in July, adding a bit to total asset accumulation.

Business Finance

Overall short-term credit use by nonfinancial firms has remained weak. Business loans at commercial banks, including loans from offshore

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

	1985	1986				
	Year	Q1	Q2p	May p	June p	July p
Corporate securities - total[1]	16.09	27.86	30.62	22.09	28.93	24.09
Public offerings in U.S.	12.94	23.84	26.46	19.89	26.00	21.00
Stocks—total[2]	2.96	4.46	5.74	6.60	5.00	4.20
Nonfinancial	1.61	2.20	2.97	3.62	2.60	2.60
Utility	.37	.65	.48	.79	.30	.60
Industrial	1.24	1.55	2.49	2.83	2.30	2.00
Financial	1.35	2.26	2.77	2.98	2.40	1.60
Bonds—total[1]	9.99	19.38	20.72	13.29	21.00	16.80
Nonfinancial	5.21	9.99	12.24	8.56	10.50	8.65
Utility	1.51	3.30	4.30	2.85	3.00	2.40
Industrial	3.70	6.69	7.94	5.71	7.50	6.25
Financial	4.78	9.39	8.48	4.73	10.50	8.15
By quality[3]						
Aaa and Aa	2.35	5.45	6.32	2.68	7.15	3.35
A and Baa	4.58	7.72	6.16	3.98	5.05	4.55
Less than Baa	1.42	2.75	4.65	3.69	4.50	4.35
No rating (or unknown)	.34	.30	.36	.48	.35	.55
Memo items:						
Equity-based bonds[4]	.70	1.16	1.26	1.29	.72	1.09
Mortgage-backed bonds	1.30	3.16	3.23	2.46	3.95	4.00
Variable-rate notes	.87	.33	.56	.16	1.17	.97
Bonds sold abroad - total	3.15	4.02	4.16	2.20	2.93	3.09
Nonfinancial	1.26	2.04	2.07	1.39	.77	1.03
Financial	1.89	1.98	2.09	.81	2.16	2.06

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.

branches of U.S. banks, were flat in July and commercial paper of nonfinancial firms resumed its decline after an uptick in June. Although firms are still borrowing to finance mergers and restructurings, the slack demand for short-term credit reflects the limited need for external capital to finance inventories and fixed investment. Short-term borrowing might have been even weaker recently if bond yields had not backed up from their April lows and encouraged some deferral of long-term financings.

Although still heavy by historical standards, bond offerings of nonfinancial firms have tapered off from the tremendous pace earlier in the year. With the higher level of long-term interest rates, moreover, the proportion of nonfinancial corporate bonds with maturities of 20 years or longer has contracted--to 35 percent of domestic issuance in July versus the peak of 50 percent in the first quarter. (Interest rates on intermediate-term bonds have increased less than those at the long end of the market.) The market has remained receptive to low-rated or unrated bonds, and these issues represented about 35 percent of the total domestic corporate bond volume in July, compared with about 20 percent in the first quarter.[1]

Most major stock price indexes have declined as much as 9 percent since hitting record highs at the beginning of July. The gross issuance of new equity has tapered off with the decline in stock prices; the July volume was the lowest since January. Initial public offerings of new

1. Holders of some existing low-rated issues fared poorly last month when LTV declared bankruptcy. A total of $2.2 billion of bonds, much reportedly held by mutual funds specializing in high-yield bonds, went into default simultaneously as a result of this bankruptcy. The bonds had not been issued in connection with recent mergers, but rather were mostly debt of operating companies that was outstanding when the firms were acquired by LTV.

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

	1986					
	Q2	Q3[e]	June	July[p]	Aug.[e]	Sep.[e]
Treasury financing[5]						
Combined surplus/deficit(-)	-30.5	-57.9	-1.0	-24.4	-28.0	-5.5
Means of financing deficit:						
Net cash borrowing from the public	50.8	52.3	18.5	15.2	17.5	19.6
Marketable borrowings/ repayments(-)	39.8	47.8	16.3	12.4	16.6	18.8
Bills	3.5	11.8	1.8	4.1	2.3	5.4
Coupons	36.3	36.0	14.5	8.3	14.3	13.4
Nonmarketable	11.0	4.5	2.2	2.8	0.9	0.8
Decrease in the cash balance	-12.4	.4	-11.8	3.8	11.3	-14.7
Memo: Cash balance at end of period	24.6	24.2	24.6	20.8	9.5	24.2
Other[2]	-7.9	5.2	-5.7	5.4	-.8	0.6
Federally sponsored credit agencies, net cash borrowing[3,4]	4.8	5.1	1.5	2.3	1.1	1.7
FHLBs	6.8	6.0	2.8	2.3	2.0	1.7
FNMA	.1	.0	-.1	.1	-.4	0.3
Farm Credit Banks	-2.5	-2.2	-1.2	-0.6	-1.0	-0.6
FHLMC	-0.5	0.3	.0	0.2	0.1	*
SLMA	0.9	1.0	.0	0.3	0.4	.3

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.
4. Second quarter numbers are based on both preliminary data and staff estimates.
5. Third quarter estimates are based on the assumption that the Congress will pass a temporary increase in the debt ceiling before its Labor Day recess. This increase should allow the Treasury to borrow in the market with only minor disruptions in its normal schedule.

equity also have slowed sharply, with the July volume only about 20 percent of the amount brought to market in the second quarter. Enormous amounts of outstanding stock still are being absorbed in mergers, buyouts, and restructurings, and net equity issuance has remained deeply negative—accounting for the bulk of business borrowing needs.

Treasury and Sponsored Agency Financing

The staff is projecting a combined federal budget deficit for the current quarter of $58 billion, bringing the estimated deficit for fiscal year 1986 to $225 billion. This projection is about in line with the recent budget outlook published by the Congressional Budget Office, but it is about $5 billion below the estimate of the Administration. The lower estimate of the staff compared with the Administration reflects both higher receipts and lower expenditures in several categories. In financing the deficit this quarter, the Treasury is expected to borrow about $48 billion in the market and to draw down its cash balance slightly. Nonmarketable borrowing will provide $4-1/2 billion of financing—considerably less than in other recent quarters, partly because the amount of securities sold to state and local governments has weakened. As the yields on tax-exempt securities have increased relative to Treasury rates (many tax-exempt securities recently have carried higher yields than Treasury issues), state and local authorities have been able to invest the proceeds in market instruments until they are needed, without violating arbitrage restrictions.[1]

1. When the proceeds of an advance refunding bond are invested in Treasury securities, the new bonds are backed by the revenues of the particular project being financed or by the state and local government, and the old bonds are backed by the Treasury security. In technical terms, the old bonds are said to be defeased. When the proceeds of an advance refunding are invested in a non-Treasury security, the old bond continues to be backed by the revenues from the particular project or by the state and local government, while the new bonds are backed by the escrowed market security purchased with its proceeds. In these cases, the revenue or government backing for the securities crosses over to the new issue when the old bond is retired.

The Treasury's financing activities have been disrupted this quarter because of the statutory debt ceiling. The current ceiling was reached on August 1, and the Treasury began to rely on the $15 billion borrowing authority of the Federal Financing Bank, issuing FFB debt to government trust accounts and redeeming nonmarketable securites. The resultant room will be close to exhausted, however, when the Treasury raises $13-3/4 billion, net, with the settlement of the midquarter refunding on August 15. Already the Treasury has paid down bills to ensure that the refunding could be held. At this point, it appears as though the Congress plans to pass a temporary increase in the debt ceiling before its Labor Day recess and to consider a permanent increase and other budget matters when it reconvenes. Absent a temporary increase, the Treasury is expected to have sufficient cash to maintain operations through the month of August but would be unable to cover its large expenditures (such as social security benefits) in early September before the Congress reconvenes.

Borrowing by the federally sponsored credit agencies in the third quarter is estimated to be only slightly higher than in the preceding quarter, with the Federal Home Loan Banks again more than accounting for the net issuance. The FHLBs have sold large amounts of debt since March as the demand for advances by thrift institutions generally has been strong. Fannie Mae's outstanding debt has been flat recently as the firm has been raising funds by selling older, fixed-rate mortgages from its portfolio. The Farm Credit Banks continue to pay down debt as their loan portfolios shrink.

In the past few months, gross issuance by the FHLBs and FNMA has been heavy in the 7- to 10-year maturity range; under this pressure, the spread between rates on 10-year sponsored agency securities and Treasury securities has widened to about 75 basis points from roughly 30 basis points earlier in the year. In contrast, spreads on securities with shorter maturities (5 years and under) have changed only slightly. Rate spreads over Treasuries on the securities of the Farm Credit Banks also have been about unchanged in recent weeks, despite the publication of negative financial results for the second quarter.

Tax-Exempt Securities Markets

Issuance of tax-exempt bonds increased sharply in July and is likely to rise even further in August. The July volume reached nearly $20 billion, the largest amount for any month except during the fourth quarter of last year. The surge this summer, like the one last fall, represents an effort on the part of issuers to beat regulatory deadlines. Also, tax-exempt bond volume in both periods was boosted by a large volume of refunding issues as the rates on tax-exempt bonds were quite low compared with those issued earlier in the decade. However, unlike the rush last year—which involved primarily private-purpose debt—the current surge in gross issuance is composed almost entirely of public-purpose offerings.

In mid-March, congressional and Treasury leaders postponed to September 1 the effective date on public-purpose bond restrictions contained in the House tax reform bill (H.R. 3838). State and local governments are coming to market now in an effort to avoid restrictions that, if legislation along the lines of H.R. 3838 were enacted, would tighten arbitrage restrictions, require that the proceeds of bond sales be spent more quickly, and further limit the amount of funds that could benefit private entities in a public financing.

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

	1985 Year	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June	1986 July[p]
Total	19.82	37.69	4.79	14.88	13.47	15.44	24.30
Short-term[1]	1.97	.91	.64	2.58	.21	3.70	4.70
Long-term	17.85	36.78	4.15	12.30	13.26	11.74	19.60
Refundings[2]	4.84	9.40	2.15	5.05	6.11	3.54	7.30
New capital	13.00	27.38	2.00	7.25	7.15	8.20	12.30
Total housing	2.11	2.64	.05	.33	.15	.55	.39

p--preliminary.
1. Does not include tax-exempt commercial paper.
2. Includes all refunding bonds, not just advance refundings.

The recent surge in bond volume has occurred in the face of continued uncertainty among investors about the future tax status of municipal securities issued this year, as well as the tax situation for the investors themselves. The ratio of tax-exempt to taxable yields has declined somewhat in recent weeks, however, as investor interest reportedly has been piqued by the possibility that such attractive rates may not be available after September 1.

Hampered by tax reform, and because tax-exempt rates are not much different from taxable rates, a number of governmental units have marketed private-purpose issues with taxable yields. The state of Illinois, the Alaska Housing Finance Corporation, and two governmental agencies in Louisiana sold private-purpose taxable debt, and agencies in at least four other states are planning similar taxable bond sales. Such issues totaled about $300 million in July and will exceed that amount in August.

Mortgage Markets

Total mortgage debt outstanding is estimated to have expanded at a seasonally adjusted annual rate of 10 percent during the second quarter, about the same as the upward revised pace of the previous three-month period. A surge in lending for single-family dwellings contributed to a rebound in residential debt growth, while a decline in mortgage debt secured by farms and a slowing in construction of commercial properties led to a falloff in nonresidential debt growth. Growth of residential mortgage debt in the first half of the year probably was restrained some by the volume of mortgage refinancings. These transactions apparently have involved little net debt expansion, for it appears that most homeowners have not used refinancing as a vehicle for tapping much existing equity in their homes; at the same time, the delays in other transactions caused by the surge in refinancings have cut into net credit growth for home purchases.

The pooling of mortgage loans into pass-through securities has continued at a remarkable pace in the past few months. In the second quarter, more than 60 percent of the net change in residential loans was in the federally related mortgage pool category. New issues of pass-through securities carrying a payment guarantee by GNMA, FHLMC, or FNMA totaled almost $50 billion in June and July--equal to nearly half of last year's volume. Issuance of these securities has been stimulated by the robust pace of loan originations during the spring as well as by the renewed dominance of the fixed-rate home mortgage. Thrift institutions have acquired a large amount of mortgage-backed securities because of their liquidity and their acceptance as collateral for borrowing.

The rate of growth in residential mortgage debt may well reach a peak in the current quarter. At FSLIC-insured thrifts, new commitments to originate mortgage loans in June appear to have leveled off. Weekly HUD surveys of large mortgage companies indicate a moderation in the number

NET CHANGE IN MORTGAGE DEBT OUTSTANDING

	1984	1985	1985 Q3	1985 Q4	1986 Q1 r	1986 Q2 p
	Percent rate of growth, SAAR					
By Type of Debt						
Total mortgage debt	12.0	11.6	11.8	12.3	10.1	10.2
Residential	11.4	12.0	12.9	12.8	9.5	11.8
Nonresidential	13.6	10.5	8.6	10.8	11.7	5.6
	Billions of dollars, SAAR					
By Type of Holder						
Total mortgage debt	218	236	253	270	228	236
S&Ls and savings banks	83	54	72	51	15	27
Commercial banks	46	49	57	56	53	57
Federal and related agencies	11	8	1	3	-5	-10
Mortgage pools[1]	47	83	88	108	115	125
All other	31	42	35	52	51	37

1. Pools backing pass-through securities guaranteed by the Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Farmers Home Administration.
r--revised. p--preliminary.

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	11.8	5.2	3.9	2.7	4.9
1986-Q1	12.6	5.1	4.4	3.1	5.3
Q2 p	19.5	7.0	7.8	4.7	8.3
1986-Apr.	15.3	6.9	5.6	2.8	5.8
May	17.7	5.9	7.4	4.5	8.7
June p	25.4	8.2	10.4	6.8	10.5
July p	23.6	8.6	8.9	6.1	n.a.

p--preliminary.

(NSA) of home loan applications received during July. While these data evidently reflect in large part a slowdown in refinancing requests, they also are consistent with the plateauing of single-family housing starts since February and the recent slackening in the pace of home sales.

Costs of credit in the primary mortgage market have declined somewhat during the intermeeting period. For conventional home mortgages at S&Ls, average interest rates on commitments for 30-year, fixed-rate loans have come down by 20 basis points since early July--but at 10.4 percent are still one-half percentage point above their spring lows. Initial rates on one-year ARMs have subsided by a smaller amount.

Reflecting the relatively narrow spreads between fixed- and variable-rate credit, as well as the level of mortgage rates, ARMs continue to account for a small share of new lending. At major lenders in early July, only 22 percent of conventional loans closed for the purchase of a single-family home carried adjustable rates, compared with about half during 1985.

Consumer Installment Credit

Growth of consumer installment credit in June slowed to an annual rate of 11 percent, and growth in the first half of the year averaged about 12 percent. Compared with last year's experience, the expansion of consumer credit this year clearly has moderated, reflecting some slackening in the growth of nominal consumer expenditures, a reduced proportion of outlays for durable goods, and probably expanding repayments on debt incurred in prior years. In addition, a reduction in the average maturity of new-auto loans at finance companies from 52 months in December to 49-1/2 months in June is boosting monthly repayments and thereby

CONSUMER INSTALLMENT CREDIT

	1984	1985	1986 Q1	1986 Q2p	1986 Apr.	1986 May r	1986 June p
	Percent rate of growth, SAAR						
Change in outstandings--total	20.6	18.0	11.8	11.9	10.6	13.9	10.8
By type:							
Automobile credit	18.7	19.3	15.3	15.6	8.1	17.5	20.4
Revolving credit	25.7	20.1	13.0	8.8	12.9	10.7	2.7
All other[1]	19.7	15.6	7.9	10.0	11.8	12.2	5.8
	Billions of dollars, SAAR						
Change in outstandings--total	77.3	81.5	63.4	65.6	58.5	77.5	60.9
By type:							
Automobile credit	27.2	33.4	31.5	33.3	17.4	37.8	44.8
Revolving credit	20.1	19.8	15.3	10.8	15.7	13.2	3.4
All other[1]	30.0	28.4	16.5	21.5	25.3	26.4	12.8
By major holder:							
Commercial banks	39.8	31.6	17.5	18.0	27.9	14.2	11.9
Finance companies	10.0	24.0	29.3	30.0	15.7	29.3	45.1
All other	27.6	25.9	16.6	17.6	14.9	34.0	3.8
	Annual percentage rate						
Interest rates							
At commercial banks[2]							
New cars, 48 mos.	13.71	12.91	12.29	11.45	n.a.	11.45	n.a.
Personal, 24 mos.	16.47	15.94	15.52	14.89	n.a.	14.89	n.a.
Credit cards	18.77	18.70	18.48	18.32	n.a.	18.32	n.a.
At auto finance companies[3]							
New cars	14.62	11.98	10.07	9.80	10.55	9.49	9.35
Used cars	17.85	17.59	16.66	16.43	16.67	16.56	16.06

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.
r--revised.
p--preliminary.

damping the growth rate of total consumer installment credit. For July, a reduction in auto sales and a further slowdown in consumer loan growth at large commercial banks suggests continued deceleration in consumer installment credit.

Several offerings were made during June and July of pass-through securities collateralized by automobile credit receivables, including a $755 million issue by GMAC. Other offerings by Chrysler Financial Corporation, Nissan Motors Acceptance Corporation, and Empire Savings of America amounted to a total of $628 million. These offerings typically include generous recourse provisions. Initial yields on the securities ranged from 7.42 percent on the Chrysler issue (rated AAA) to 8.04 percent on the most recent GMAC issue (rated AA+). The outstanding amount of such securities in late July was about $3.7 billion.[1]

The average delinquency rate on finance company auto loans declined to 1.94 percent in the second quarter from 2.01 percent in the first quarter of 1986, after moving up fairly rapidly from mid-1984 through early 1986. In recent quarters, the finance company auto loan delinquency rate has been near the midpoint of the historical range for this series.

1. The installment debt series has yet to be restructured to reflect the emergence of this channel of credit provision; the data on consumer loans currently are tabulated in such a way that the credit is attributed to the institution selling the receivables rather than to the buyer of the security.

INTERNATIONAL DEVELOPMENTS

Foreign Exchange Markets

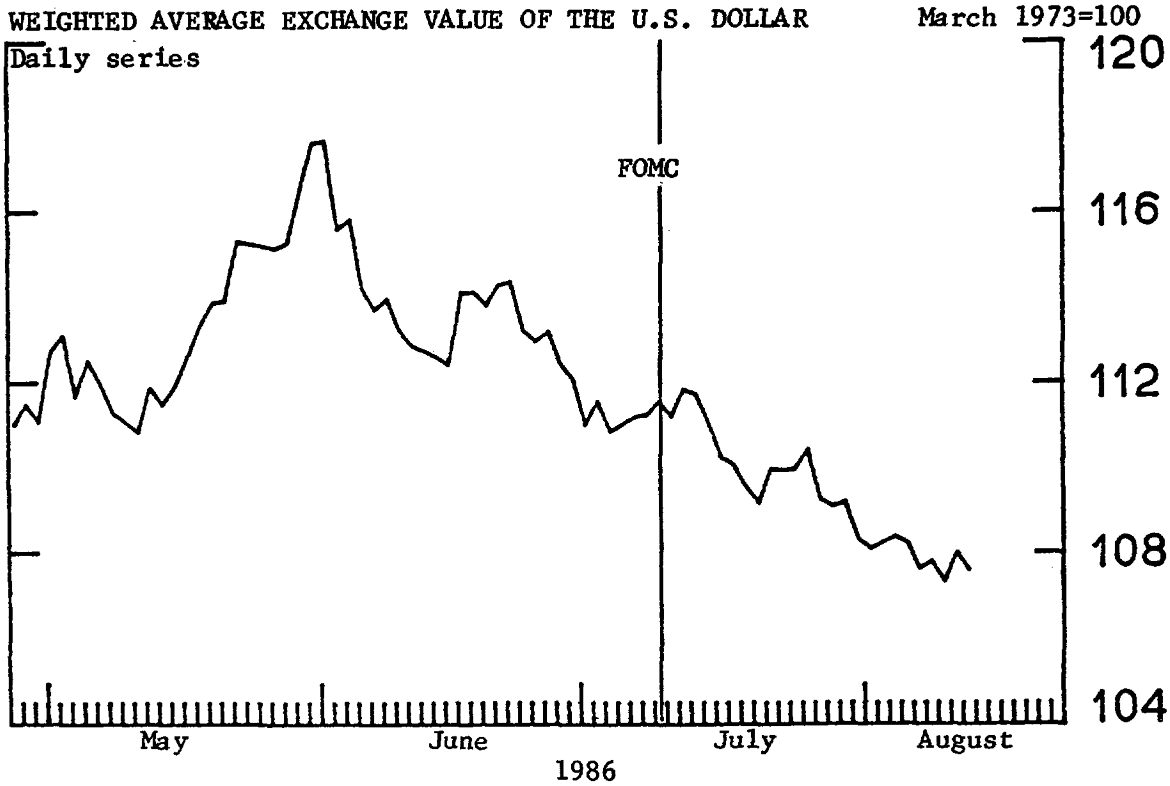
Since the last FOMC meeting, the weighted-average foreign exchange value of the dollar has declined nearly 3 percent, as shown in the upper panel of the chart. Lackluster U.S. economic statistics together with the Federal Reserve's unilateral reduction in its discount rate on July 10 contributed to the view that U.S. monetary authorities were willing to accept a lower dollar, partly to prod German and Japanese policymakers to stimulate their economies. This perception was reinforced by remarks of U.S. officials indicating that further dollar depreciation was needed to redress the trade imbalance. Statements by the Japanese and German finance ministers favoring a consolidation of exchange rates near current levels provided only temporary support for the dollar.

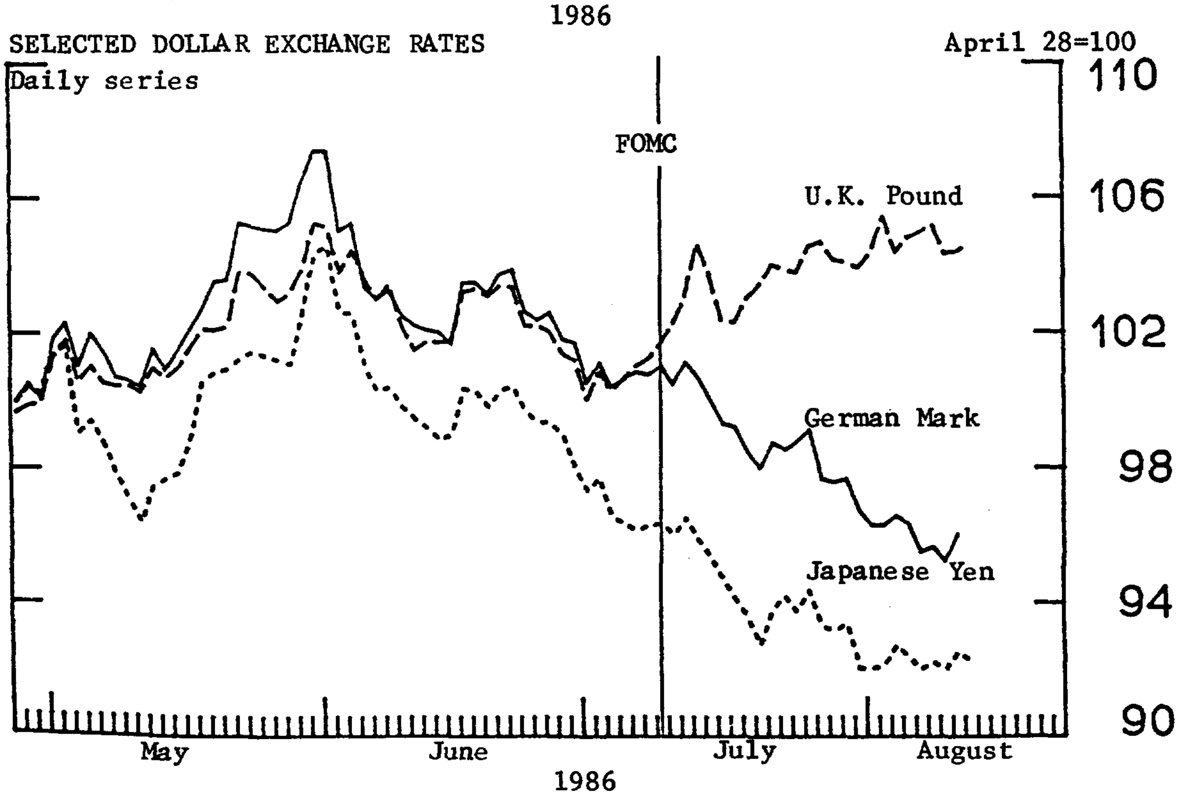
Short-term interest rates abroad were little changed during the intermeeting period, while comparable U.S. interest rates declined by about 40 basis points. At the long end of the maturity spectrum, the differentials between U.S. and German and Japanese interest rates on balance were about unchanged.

On a bilateral basis, the dollar displayed diverse movements against the major currencies, as illustrated in the lower panel of the chart. During the intermeeting period the dollar's value depreciated 4-3/4 percent in terms of the mark and 3-1/2 percent vis-a-vis the yen, as incoming data for Germany suggested a rebound in second-quarter growth, while the outlook for economic activity in Japan remained weak.

Chart 1

8/13/86





. Sterling fell 3 percent in terms of the dollar and nearly 6 percent on a multilateral trade-weighted basis. Further declines in oil prices early in the intermeeting period and waning political support for the Conservative government prompted heavy selling pressure on the pound. Sterling recovered somewhat along with oil prices following the announcement of an interim agreement on production quotas by OPEC.

Within the EMS, the mark's divergence below parity with the French franc narrowed abruptly to about 1/4 percent from the level of near 2 percent that had prevailed from the realignment on April 6 until early July. Several factors may have motivated this movement in cross-rates: the general tendency of the mark to appreciate against the other currencies in the exchange rate system when the dollar depreciates; the brightening of growth prospects in Germany; and political frictions between French President Mitterand and the Chirac government over privitization decrees. In other EMS developments, Irish authorities devalued the Irish pound by 8 percent within the exchange rate system on August 2 in an attempt to restore Ireland's competitive position vis-a-vis the United Kingdom, its major trading partner; Ireland's loss of competitiveness had stemmed from the sharp depreciation of sterling against the EMS currencies.

•

Meanwhile, Australian authorities

raised the rediscount rate -- from a level of 14.7 percent to 18 percent -- and introduced a package liberalizing direct foreign investment into Australia as well as withdrawing previously announced withholding taxes on interest earned by non-residents.

U.S. International Financial Transactions

Foreign official reserve assets in the United States increased sharply in the second quarter. (See line 4 of the U.S. International Transactions table.) These increases were concentrated at the G-10 countries and Switzerland and reflected large scale official purchases of dollars to slow the appreciation of foreign currencies against the dollar in recent months. Preliminary information indicates that there were substantial increases in July as well. For the first half of 1986, investment of official holdings in U.S. Treasury securities more than matched the increase in official reserves.

In contrast, private foreign purchases of U.S. Treasury securities (line 3) were relatively small in the second quarter. In particular, Treasury (TIC) data show that Japanese net private purchases fell to virtually zero in the first half of 1986, from $17 billion in 1985. These data, reported by securities dealers in the United States, appear inconsistent with market commentary which has focused on the large role of Japanese-based securities dealers at recent Treasury auctions.

While one cannot rule out the possibility of reporting errors in the TIC system, this does not appear the most likely explanation. Virtually all major securities dealers, both U.S. and Japanese-based, reported the same pattern for the first six months of 1986: large purchases and sales of Treasury securities by Japanese residents, with little net change in holdings. It appears that the major Japanese securities firms, in their efforts to become primary U.S. government securities dealers, have been very active bidders at recent auctions, but have not sold Treasuries net to Japanese residents or other foreigners. Despite the lack of Japanese private net purchases, total sales of

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

	1984 Year	1985 Year	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 Apr.	1986 May	1986 June
Private Capital									
Banks									
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	20.6	33.6	11.4	7.7	9.3	-5.6	-6.6	3.7	-2.7
Securities									
2. Private securities transactions, net	7.7	42.9	10.0	21.1	12.6	21.4	5.9	9.8	5.7
a) foreign net purchases (+) of U.S. corporate bonds	13.7	46.0	10.2	18.4	12.6	16.1	5.0	7.2	3.8
b) foreign net purchases (+) of U.S. corporate stocks	-0.9	4.8	1.4	4.0	6.1	6.9	3.6	2.7	0.5
c) U.S. net purchases (-) of foreign securities	-5.0	-7.9	-1.6	-1.4	-6.1	-1.5	-2.7	-0.1	1.3
3. Foreign net purchases (+) of U.S. Treasury obligations 1/	23.1	20.1	7.8	4.9	7.8	2.3	3.0	-1.0	0.3
Official Capital									
4. Changes in foreign official reserve assets in U.S. (+ = increase)	2.4	-2.0	2.2	-1.5	2.2	13.2	8.0	1.6	3.6
a) By area									
G-10 countries (incl. Switz.)	3.1	-0.4	2.4	-3.3	3.9	10.9	6.7	1.5	2.8
OPEC	-5.6	-7.0	-2.3	-1.0	1.3	-2.6	-0.2	-0.8	-1.6
All other countries	4.9	5.3	2.1	2.9	-3.0	4.8	1.5	0.8	2.5
b) By type									
U.S. Treasury securities	4.7	-0.9	0.4	-2.0	3.3	14.0	6.9	3.8	3.3
Other 2/	-2.3	-1.1	1.8	0.5	-1.1	-0.8	1.1	-2.2	0.4
5. Changes in U.S. official reserve assets (+ = decrease)	-3.1	-3.9	-0.1	-3.1	-0.1	-0.0	0.1	-0.2	0.1
Other transactions (Quarterly data)									
6. U.S. direct investment (-) abroad	-3.9	-18.8	-6.2	-10.1	-10.1	n.a.	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	25.4	17.9	6.1	2.4	1.3	n.a.	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) 3/ 4/	6.8	6.6	-1.5	9.0	5.1	n.a.	n.a.	n.a.	n.a.
9. U.S. current account balance 4/	-106.5	-117.7	-28.5	-33.7	-33.7	n.a.	n.a.	n.a.	n.a.
10. Statistical discrepancy 4/	27.3	23.0	-1.3	5.1	2.9	n.a.	n.a.	n.a.	n.a.
MEMO:									
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-112.5	-124.4	-31.7	-37.4	-36.6	n.a.	-12.9	-11.6	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.

Treasury securities to foreigners, official and private, were $27 billion in the first half of 1986, greater than the amount reported for all of 1985.

Net capital inflows reported through other securities transactions (line 2) continued at very high levels in the second quarter. Foreign purchases of U.S. corporate bonds totaled $16 billion on a payments basis (line 2a). However new issues of Eurobonds by U.S. corporations dropped sharply after April and have remained relatively low through July while domestic bond issuance by U.S. corporations dropped less sharply. Apparently Eurobond dealers were caught with large inventories of unsold bonds when interest rates reversed their downward trend in April. Foreign net purchases of U.S. corporate stock (line 2b) remained at record levels in the second quarter. On the other hand, U.S. purchases of foreign securities (line 2c) declined from the very strong first quarter rate.

Participation of U.S firms in the newly developing Euro-commercial paper market appears to be expanding. Several U.S. corporations have arranged substantial borrowing programs, although until recently amounts outstanding appear to have been modest. This situation may change however, in the wake of an apparently successful new program for GMAC; GMAC placed about $.5 billion by early July and dealers speculate that its outstanding may increase to as much as $2.5 billion this year. Overall data on commercial paper and other short-term borrowing by U.S. corporations are not collected through the same channels as other securities transactions; they will be available only with substantial lags and aggregated with other capital flows (line 8).

Net bank reported capital flows (line 1) continued to reverse directions from month to month; in June there was an outflow of $2.7 billion. In July, as indicated on the International Banking Data table, line 3, net outflows to related foreign offices and IBFs amounted to over $6 billion, reflecting continued strong core deposit growth relative to loan demand at commercial banks.

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1981 Dec.	1982 Dec.	1983 Dec.	1984 Dec.	1985 Dec.	1986 Mar.	1986 Apr.	1986 May	1986 June	1986 July 3/
1. Net Claims of U.S. Banking Offices (excluding IBFs) on Own Foreign Offices	7.8	32.9	39.3	25.4	18.9	21.0	17.5	18.2	18.7	n.a.
2. Net Claims of U.S. Banking Offices on Own IBFs 1/	11.8	16.2	5.2	7.8	10.1	1.0	11.4	6.5	8.1	n.a.
3. Sum of lines 1 and 2 of which:	19.6	49.1	44.5	33.2	29.0	22.0	28.9	24.7	26.8	33.1
(a) U.S.-chartered banks	22.3	40.0	40.5	32.1	32.4	27.1	30.9	30.0	31.1	34.8
(b) Foreign-chartered banks	-2.6	9.1	4.0	1.1	-3.4	-5.1	-2.0	-5.3	-4.3	-1.7
4. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	13.2	15.8	18.6	20.7	18.7	17.6	18.1	18.0	17.7	17.9
5. Eurodollar Holdings of U.S. Nonbank Residents 2/	95.5	112.6	124.3	117.6	112.1	118.2	116.9	116.1	117.3	116.5

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 July 28, 1983.
*/ 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

Commerce Department figures on U.S. merchandise trade through June showed (in column 8 of the table below) that the deficit in June was as large as in May on an unrevised basis. The staff estimates that after all the revisions are made and the data are adjusted to a balance-of-payments basis (column 7), the value of the trade deficit in the second quarter will be about the same as was recorded in the first quarter.

U.S. Merchandise Trade
Billions of dollars, annual rates

	Balance-of-payments basis, seasonally adjusted							Census Balance Unrevised, NSA
	Exports			Imports				
	Total	Agr.	Nonagr.	Total	Oil	Nonoil	Balance	CIF Value 1/
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Years								
1984	220	38	182	332	57	275	-112	-123
1985	215	30	185	339	51	288	-124	-149
Quarters								
1984 - 4	224	37	187	341	57	283	-117	-108
1985 - 1	221	33	188	322	42	280	-100	-125
2	216	30	186	337	55	282	-121	-152
3	210	28	183	337	50	287	-127	-153
4	211	29	182	360	57	304	-149	-164
1986 - 1	214	28	186	361	40	321	-146	-174
2	215e	25e	190e	360*e	30*e	330*e	-145*e	-162
Months								
1986-Apr	216e	26e	190e	371e	28e	343e	-155e	-145
May	211e	23e	188e	351e	33e	318e	-140e	-171
Jun	215e	25e	190e	355*e	30*e	325*e	-140*e	-170

1/ Unrevised data. Range of revisions for monthly data:
Exports: ± 15 billion.
Imports: ± 50 billion.
Balance: ± 65 billion.

e/ FR staff estimate.

*/ Import figures are based on data for April-May and projections for June.

The value of total exports in the second quarter is estimated to be about unchanged from first-quarter levels. However, a substantial increase in exports of gold masked declines in agricultural exports and in most categories of nonagricultural trade. Excluding gold exports, the volume of nonagricultural exports is estimated to have declined by 1 percent in the second quarter. Gold exports, nearly $10 billion AR in the second quarter, were largely to Japan to be used in the minting of a commemorative gold coin. The gold was imported into the United States over the past six months.

On the import side, the estimates of second-quarter developments are more tentative because of the size of potential data revisions. A decline in the value of oil imports resulted from a more than 35 percent drop in the price of oil that was partly offset by a 20 percent increase in the volume imported (from a low first-quarter average) as inventories were rebuilt. See the table below. Uncertainties regarding world oil prices continue to result in wide swings in imports from quarter to quarter.

OIL IMPORTS*

	Year	1985				1986	
	1985	Q1	Q2	Q3	Q4	Q1	Q2e
Value (Bil. $, SAAR)	50.53	41.61	54.53	49.49	56.48	40.06	30.00e
Price ($/BBL)	26.40	26.67	26.92	25.74	26.30	21.56	13.50e
Volume (mbd, SA)	5.24	4.27	5.55	5.27	5.88	5.09	6.30e

*/ As published in the balance-of-payments accounts.
e/ FR staff estimate.

Nonoil imports are estimated to have risen in value in the second quarter. About half of the increase resulted from rising import prices. On a fixed-weight basis, the price of nonoil imports increased at a 5-1/2 percent rate in the second quarter, the third quarter in a row of such increases. This rise in the index for all nonoil imports occurred in spite of continuing declines being recorded for prices of industrial supplies (which account for 20 percent of nonoil imports). The strongest price rises were recorded for various manufactured goods, particularly general industrial machinery (other than computers), electric machinery and telecommunication equipment, photographic equipment and passenger cars. For the volume of nonoil imports, the estimated 1-1/2 percent increase in the second quarter was spread among various trade categories (machinery, aircraft, passenger cars, consumer goods and gold) and came from various geographic areas (Japan, Western Europe, Latin America, and the newly industrialized countries in the Far East).

Foreign Economic Developments. Recent data provide continued evidence of generally weak economic activity in most of the foreign industrial countries. Industrial production in Japan grew only 1.1 percent (s.a.a.r.) in the second quarter. In the most recent months for which data are available, industrial production fell in France, the United Kingdom, Canada, and Italy. German industrial production picked up somewhat in the second quarter, but it only retraced its first quarter decline. French GDP grew 2.2 percent (s.a.a.r.) in the first half.

Inflation abroad continues to moderate. In recent months, consumer prices have declined in Japan, Germany and the United Kingdom. In France, Canada, and Italy inflation has slowed to levels which are extremely low by recent historical standards.

Japan and Germany continue to experience record trade surpluses, and France and Italy have narrowed their trade deficits. In contrast, the United Kingdom and Canada experienced deteriorating trade balances in recent months.

Individual Country Notes. In Japan, the pace of economic activity remained sluggish in the second quarter. Industrial production (s.a.) increased 0.5 percent in June, after having risen 0.3 percent in May and having remained unchanged in April. In the second quarter, industrial production on average was slightly above its first quarter level but 0.6 percent below its year-earlier level. In May, new private sector orders of machinery (s.a.) declined 2.7 percent, while new housing starts (s.a.) increased 4.7 percent after having declined in the three previous months. In the first quarter, the consumer sector provided the principal stimulus to growth, but the preliminary indications of

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

	Q4/Q4 1984	Q4/Q4 1985	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 Feb.	1986 Mar.	1986 Apr.	1986 May	1986 June	Latest 3 months from year ago 2/
Canada												
GDP	5.4	3.9	.8	1.8	.6	n.a.	*	*	*	*	*	3.6
IP	4.4	5.3	2.3	1.4	-.3	n.a.	.7	-3.2	3.1	-2.0	n.a.	3.5
France												
GNP	1.4	2.2	1.0	.6	.0	1.1	*	*	*	*	*	2.7
IP	1.8	1.5	1.5	.0	-1.2	n.a.	.8	.0	3.8	-5.1	n.a.	.8
Germany												
GNP	3.0	2.4	1.7	-.1	-1.7	n.a.	*	*	*	*	*	1.6
IP	3.5	3.4	2.1	.4	-1.1	1.1	-1.3	-1.0	3.6	-3.3	2.7	2.6
Italy												
GNP	2.7	2.3	.3	.6	1.5	n.a.	*	*	*	*	*	3.8
IP	2.1	1.0	-1.1	.2	2.8	n.a.	2.8	3.1	1.5	-6.7	n.a.	3.4
Japan												
GNP	5.7	4.0	.7	1.4	-.5	n.a.	*	*	*	*	*	3.0
IP	10.6	.9	-.1	-.9	.2	.3	.2	-.2	.0	.3	.5	-.6
United Kingdom												
GNP	2.6	2.7	-.3	.5	.7	n.a.	*	*	*	*	*	2.5
IP	-.4	4.7	-.1	-.1	.5	-.9	1.4	-.1	.4	-1.8	-1.2	-.6
United States												
GNP	4.6	2.9	1.0	.5	.9	.3	*	*	*	*	*	2.7
IP	7.2	1.8	.5	.5	.1	-.7	-.9	-1.0	.6	-.4	-.5	.4

1. Asterisk indicates that monthly data are not available.
2. For quarterly data, latest quarter from year ago.

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

	Q4/Q4 1984	Q4/Q4 1985	1985				1986		1986				Latest 3 months from year ago
			Q1	Q2	Q3	Q4	Q1	Q2	Apr.	May	June	July	
Canada													
CPI	3.7	4.2	1.2	1.1	.9	.9	1.2	.8	.2	.5	.2	n.a.	3.9
WPI	4.0	2.3	1.2	.5	-.0	.6	.9	-.9	-.2	-.7	.0	n.a.	.6
France													
CPI	6.8	4.8	1.4	1.8	.9	.6	.1	.7	.4	.2	.3	.1	2.2
WPI	10.5	-1.2	1.6	.9	-1.4	-2.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-1.2
Germany													
CPI	2.1	1.8	1.1	.6	-.2	.3	.0	-.3	-.1	.0	.2	-.5	-.3
WPI	1.3	-1.1	1.7	.3	-2.1	-.9	-2.1	-2.6	-.4	-.9	-.9	-2.1	-8.1
Italy													
CPI	8.8	8.5	2.6	2.2	1.1	2.3	1.8	1.1	.3	.4	.4	.0	6.2
WPI	8.9	5.9	2.7	2.2	-.1	.9	-.5	-1.8	-.4	-.7	.0	n.a.	-1.4
Japan													
CPI	2.4	2.3	.6	.5	.1	1.0	-.1	.0	.5	.3	-.8	-.3	.6
WPI	.5	-3.7	.4	-.7	-1.0	-2.4	-2.4	-4.2	-1.4	-1.0	-.7	n.a.	-9.6
United Kingdom													
CPI	4.8	5.5	1.3	3.4	.3	.5	.7	1.3	1.0	.2	-.1	n.a.	2.8
WPI	6.1	5.2	1.6	2.0	.5	.9	1.4	1.6	.8	.3	.0	.1	4.5
United States													
CPI (SA)	4.1	3.5	.8	1.0	.6	1.1	.4	-.4	-.3	.2	.5	n.a.	1.6
WPI (SA)	1.7	1.6	.1	.6	-.2	1.1	-1.5	-1.4	-.6	.6	-.0	n.a.	-2.0

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

	1984	1985	1985				1986		1986			
			Q1	Q2	Q3	Q4	Q1	Q2	Mar.	Apr.	May	June
Canada												
Trade	16.0	12.8	4.0	3.3	2.6	2.9	1.7	n.a.	.9	.8	.6	n.a.
Current account	1.9	-.8	.8	.2	-1.1	-.7	-2.1	n.a.	*	*	*	*
France												
Trade	-2.4	-2.6	-1.1	-.4	-.8	-.4	.1	-1.1	-.4	-.7	-.3	-.2
Current account	-.8	.9	-.6	.5	.0	1.0	1.1	n.a.	*	*	*	*
Germany												
Trade (NSA)	18.7	25.4	4.2	6.0	6.1	9.1	9.5	12.5	3.7	4.4	3.6	4.4
Current account (NSA)	5.9	13.9	1.7	3.1	2.1	7.0	6.8	8.2	2.1	3.6	2.7	1.9
Italy												
Trade	-11.0	-11.9	-3.7	-3.8	-1.3	-3.1	-3.0	.0	-.7	-.3	.1	.2
Current account (NSA)	-2.8	-6.1	-2.8	-2.4	-.4	-.4	n.a.	n.a.	*	*	*	*
Japan												
Trade	44.1	56.1	11.5	13.1	14.1	17.3	17.4	22.4	6.2	7.2	8.4	6.9
Current account 2/	35.0	49.3	9.4	12.2	12.1	15.6	15.5	21.8	5.6	7.4	7.8	6.7
United Kingdom												
Trade	-5.5	-2.5	-1.4	-.2	-.6	-.3	-2.0	-2.3	-1.8	-.4	-1.0	-.9
Current account	1.3	5.2	.1	2.0	2.0	1.1	.7	.8	-1.0	.7	.1	.1
United States												
Trade 2/	-112.5	-124.4	-25.0	-30.4	-31.7	-37.4	-36.6	n.a.	*	*	*	*
Current account	-106.5	-117.7	-26.1	-29.4	-28.5	-33.7	-33.7	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.

consumer demand in the second quarter are mixed. Retail sales (s.a.) rose 0.4 percent in April but fell 0.3 percent in May. The unemployment rate was unchanged in June at 2.7 percent. A Bank of Japan survey of investment intentions released in May suggests a substantial slowing of investment. Real investment grew 9 percent in FY 1985, but it is projected to grow only 4.3 percent in FY 1986.

Japanese consumer prices have been declining in recent months. The Tokyo consumer price index (n.s.a.) fell 0.8 percent in June and 0.3 percent in July, bringing the index to a level 0.2 percent below that of a year ago. Wholesale prices have continued to decline, and the overall wholesale price index fell a record 10.1 percent in June from its year-ago level. The sharp decline in wholesale prices in June was mainly the result of reductions in the prices of electric power and gas, reflecting the yen's appreciation and falling world crude oil prices.

External surpluses remain at record levels. In the first half of the year, the cumulative current account and trade surpluses were $74.7 billion (s.a.a.r.) and $79.6 billion (s.a.a.r.) respectively. Trade volumes continue to decline in response to the yen's sharp appreciation since last year. In June, the export volume index declined 2.3 percent from its year-earlier level, the fourth consecutive monthly decline. Import volume has increased in recent months, rising 31.9 percent between June 1985 and June 1986. Import volume growth is not expected to continue at this pace, however, because the June figure reflects sizable imports of gold for the minting of coins commemorating the sixtieth year of Emperor Hirohito's reign.

In the July 6 general parliamentary elections, Prime Minister Nakasone's Liberal Democratic Party (LDP) won a landslide victory, gaining 304 out of 512 seats in the upper house. The margin of victory was viewed as a personal triumph for Prime Minister Nakasone. Nakasone appointed Kiichi Miyazawa, a long-time advocate of greater monetary and fiscal stimulation, as Minister of Finance. It is unclear whether Miyazawa's appointment signals a major shift in the government's willingness to provide fiscal stimulus. On the one hand, it is increasingly likely that the government will propose a record 3 billion yen supplementary budget this fall to stimulate domestic demand. On the other hand, the government's initial requests for the FY 1987 budget indicate a desire to continue its program of fiscal austerity.

Industrial production in Germany rose 2.7 percent (s.a.) in June. With the substantial downward revision of the May figure, the level of production in the second quarter was only 1.1 percent above that of the first quarter and 2.6 percent above its level of a year ago. The rate of unemployment (s.a.) remained at 9 percent in July. In an unusually early report, an official of the Finance Ministry put second quarter real GNP growth at 3 percent above the same quarter of last year. This would imply a strong rebound from the first quarter slump.

Consumer prices fell another 0.5 percent (n.s.a) in July to a level 0.5 percent below July of last year. The index has fallen at an annual rate of 1.3 percent in the first seven months of this year. Import prices in June were 21 percent below their year-earlier level. In July, wholesale were 8.7 percent (n.s.a.) below their level in July 1985.

This year's cumulative trade and current account surpluses continue at record rates. In the first half of the year, the cumulative current account surplus has been $30 billion (a.r.), compared with $9.6 billion (a.r) in the same period of last year. These large and growing external surpluses are primarily due to Germany's improving terms of trade.

The pace of real economic activity in France slowed in the first quarter and picked up in the second quarter. Revised data show that real GDP (s.a.) did not grow at all in the first quarter, but it grew 4.5 percent (s.a.a.r.) in the second quarter. The unemployment rate has remained at a record high of 10.7 percent from April through June. Industrial production fell by 5.1 percent (s.a.) in May and was 1.5 percent below its year-earlier level. However, the government statistical institute attributed the sharp decline in this index to the unusually large number of national holidays in May. Early indicators point to a recovery in industrial production in June, especially in the automobile industry and in the semi-finished goods sector.

The inflation rate continues to be low. Consumer prices increased only 0.2 percent (n.s.a.) in July following a 0.3 percent rise in June. The year-over-year consumer price inflation rate in July was 2 percent, already below the government's inflation target for the end of this year.

The trade deficit narrowed in June. For the first half of this year, the trade deficit rate was about $2.1 billion (s.a.a.r.), down from the $2.9 billion deficit rate in the first half of last year.

On July 31, Parliament adopted the conservative government's privatization bill, which sets conditions for the sale of 65 state-owned banks, insurance companies, and industrial concerns during the next five years.

In the United Kingdom, recent data give a somewhat mixed picture about the strength of economic activity. Industrial production declined by 1.2 percent (s.a.) in June and was 1.3 percent below its year-earlier level. The unemployment rate increased by 0.1 percentage point in June to 13.1 percent. However, retail sales volume rose by a strong 3.5 percent (s.a.) in June according to provisional figures, a 6.1 percent increase on a year-over-year basis.

Retail price inflation has continued to moderate. The retail price index declined by 0.1 percent (n.s.a.) in June, bringing the year-over-year inflation rate down to 2.5 percent. Other measures of inflationary pressure present a less favorable picture. Producer prices in July were 4.4 percent above their year-earlier level, and average earnings in May were up by 7.2 percent on a year-over-year basis.

The trade deficit continued at a high level in June, while the current account remained in slight surplus. In the first half of this year, the cumulative trade deficit was $8.8 billion (s.a.a.r.), substantially greater than the $3.1 billion deficit in the same period last year. The current account was in surplus by $3.2 billion (s.a.a.r.) in the first half of 1986, only slightly below the $4.1 billion current account surplus in the first half of 1985.

Growth in real gross domestic product slowed in Canada to 2.3 percent (s.a.a.r.), in the first quarter of 1986, after having grown 3.8

percent on average in 1985. Were it not for a large build-up in inventories, real GDP would have declined. More recently, industrial production fell 2 percent (s.a.) in May, reversing part of April's sharp increase. Furthermore, the unemployment rate rose 0.4 percent (s.a.) in July, reaching 9.9 percent. Inflation continues to be moderate. Consumer prices increased 3.7 percent (n.s.a.) over the twelve-month period ending in June. The industrial product price index was unchanged in June, bringing the 12-month increase to 0.3 percent (n.s.a.).

Latest data confirm a sharp deterioration in Canada's external position. Exports fell 6.3 percent (s.a.) in May, but imports fell only 4.4 percent. This brings the cumulative merchandise trade surplus to \$7.5 billion (s.a.a.r.) in May, well below the rate of \$15.9 billion (s.a.a.r.) for the comparable period last year.

In Italy, industrial production rose 1.5 percent (s.a.) in April and fell by 6.7 percent in May, to a level below what it had been in May 1985. In June, the official government survey showed consumer confidence in the general state of the economy at a record high. The unemployment rate in April was 11.3 percent, slightly lower than it was in January.

The consumer price index was unchanged in July, lowering the twelve-month inflation rate to 5.9 percent (s.a.), the lowest such figure since 1973. The wholesale price index dropped 0.7 percent (n.s.a.) in May and was unchanged in June, leaving this index 1.8 percent below its year-earlier level.

During the first six months of 1986, the trade deficit was $5.9 billion (s.a.a.r.), compared with a deficit of $15 billion (s.a.a.r.) in the first six months of 1985.

On August 8, Bettino Craxi's new coalition government received a vote of confidence from the Chamber of Deputies, ending the political crisis that had lasted for 40 days. Craxi agreed to relinquish control of the coalition to the Christian Democrats in the spring of 1987. The Ministers of Treasury and Finance are unchanged, and the new government is not expected to institute any substantially different economic policies from those of the old.

Economic Situation in Major Developing Countries. On July 22, Mexico signed a letter of intent for an 18-month IMF stand-by arrangement. Brazil announced measures designed to restrain domestic demand and to encourage the holding of longer-term securities. Venezuela's Congress approved legislation establishing a fund to facilitate private sector reschedulings. After foreign banks objected strongly to the terms of the fund, Finance Minister Azpurua said that the government will propose to Congress that the fund be abolished. In Argentina, talks on a new stand-by arrangement with the IMF are expected to begin later in August. IMF Board consideration of Ecuador's new stand-by arrangement has been delayed until Ecuador takes prior actions. A new IMF stand-by arrangement for the Philippines received tentative approval.

Individual Country Notes. On July 22, Mexican Finance Secretary Petricioli signed a letter of intent in support of an 18-month IMF stand-by arrangement for SDR 1.4 billion. The program calls for a reduction of the public sector deficit by 3 percent of GDP through (a) improved tax collection and the elimination of some deductions, (b) increases in public sector prices, and (c) a reduction in public sector expenditures. It calls for a recovery of GDP growth, which is expected to be negative in 1986, and for new initiatives in privatization, trade liberalization, and encouraging foreign direct investment. The program includes two contingency mechanisms for additional financing, one in case the economic recovery fails to materialize, the other in case oil export prices average less than $9 per barrel for a calendar quarter within the first nine months of the program. (External financing would be reduced should oil export prices average more than $14 per barrel for a calendar quarter within the first nine months of the program.) The program envisages 18-month external financing of about $12 billion, of which the commercial banks would be asked to provide about $6 billion in new money ($3.5 billion in 1986 and $2.5 billion in 1987 as envisaged by the IMF staff). Formal IMF approval of the stand-by arrangement is planned for September. A bridging loan from the monetary authorities of a number of developed and developing countries and commercial banks is under negotiation.

In July, the CPI rose by 5 percent, after a 6.4 percent rise in June, to a level 86 percent above July 1985. Beginning June 9, deposit interest rates were increased five times by a total of 7.5-12.25 percentage points. After mid-July, the sale of Treasury bills to the highest bidder was resumed, reversing the practice, instituted last October, of announcing in advance the rate at which the bills would be sold and letting the market determine the volume. In line with its commitments to the IMF, the government, in early August, raised sharply Mexico City public transport fares and fuel prices. Since June, the daily rate of crawl of the peso price of the dollar in the controlled market has been accelerated. This price rose by about 10 percent in July, compared with less than 7 percent per month in the second quarter. Negotiations on Mexico's accession to GATT were completed in July. Mexico is expected to sign the protocol of accession in mid-August and to become a full member by September.

The Brazilian government announced on July 23 measures designed to restrain domestic demand and to encourage the holding of longer-term securities. Surcharges (some of which were characterized as compulsory loans) were imposed on gasoline, fuel alcohol, cars, airline tickets, and the purchase of foreign exchange for travel. Among other measures, certain withholding taxes will be substantially increased on short-term securities and decreased on long-term securities.

The surcharge measures were presented in the context of financing a new development plan that will emphasize spending on social welfare, transport, and energy. However, it appears that the main purpose was to raise revenues (an estimated 1.8 percent of GDP) and to adjust prices upward for a select number of goods in short supply under the price freeze. Longer-term CD rates are reported to have dropped by about 6 percentage points (from 32-33 percent) in response to the change in the taxation of financial assets. The spread between the official and market exchange rates increased by 15 percent to about 75 percent in the week following the announcement of the measures.

Consumer prices rose 1.3 percent in June, and now have risen 3.4 percent since the introduction of the February 28 anti-inflation plan. Brazil's trade surplus was $6.2 billion in the first half of 1986 compared with $5.4 billion in the same period a year earlier.

Creditor banks are in the process of signing the $31 billion rescheduling/rollover package for 1985-86 that Brazil and its advisory committee agreed to on March 1. Participation by banks holding 90-95 percent of the debt, which is necessary for the package to become effective, will hinge on Brazil compensating creditors for losses surrounding the intervention of three Brazilian banks in late 1985. As of August 8, between 75 and 85 percent of the banks had signed. The termination date of the March 1 commitment to Brazil from the advisory committee has been extended from August 15 to September 5.

On July 29, Brazil and Argentina signed an agreement establishing a program for economic integration and cooperation. The purpose of the agreement is to increase bilateral trade and investment. The various agreements are to be implemented gradually.

On July 2, Venezuela's Congress approved legislation establishing the Exchange Compensation Fund (FOCOCAM) to coordinate rescheduling of \$3.6 billion of \$6.9 billion in registered private sector external debt. FOCOCAM would collect bolivars from private sector debtors that wished to retain access to a preferential dollar rate for debt repayment. In exchange, the creditors would receive 15-year, dollar-denominated bonds paying a maximum of 5 percent interest. On July 17, the preferential rate available for repayment under the plan was changed to 7.5 bolivars/\$ from 4.3 bolivars/\$. Foreign banks have objected strongly to the changes in private debt repayment, and a special session of the Venezuelan Congress will meet this month to review the legislation. Finance Minister Azpurua said on August 12 that the government will propose liquidation of FOCOCAM to the Congress, but it is unclear what, if anything, the government will put in its place.

In Argentina, talks with the IMF on a new stand-by arrangement are likely to begin later in August. Argentina waited to begin negotiations until the outcome of Mexico's negotiations with the IMF was known. Consumer prices rose 6.8 percent in July. Inflation has escalated since the beginning of the year, and through seven months of 1986 has been 33 percent. The government in its 1986 budget assumed inflation of 28 percent for the entire year. Publicity surrounding publication of the July CPI increase rekindled inflationary expectations. The interbank interest rate rose to 8.1 percent per month on August 11, up about 2.5 percentage points per month from two weeks earlier. Since the end of July, the monthly interest rates on regulated 30-day loans and deposits also have been raised two percentage points to 7 and 5.5 percent, respectively. The mini-devaluations of the austral were stepped up. However, the spread between the austral price of the dollar in the parallel market and the official rate, which since July 1 had been virtually eliminated, increased to 10.8 percent on August 12.

IMF Board consideration of a one-year, SDR 75 million stand-by arrangement and SDR 40 million Compensatory Financing Facility (CFF) for Ecuador, which had been scheduled for August 4, was postponed because the government failed to take prior actions involving devaluation of the exchange rate, lowering minimum denominations of certificates of deposit, and liberalization of import licensing agreements. The CFF for Ecuador would be the first facility for an OPEC member based on an export shortfall that is due to low oil prices. Ecuador has received commitments for about $180 million for a commercial bank oil export financing facility (originally planned for $150-200 million).

Peru has recently significantly expanded its restrictions on servicing its external debt. For the first time, the government banned debt service payments on private sector external debt. Foreign currency remittances associated with foreign direct investment were also limited. In addition, existing restrictions on debt servicing of public sector medium- and long-term debt were extended for an indefinite period. The only debts that Peru will continue to service are short-term trade credits (about $100 million in such credits are currently outstanding) and debts owed to those creditors that are still willing to provide net new credit to Peru: i.e., the World Bank, the Inter-American Development Bank, and some Paris Club governments.

Peruvian officials announced that they plan to pay only about $35 million of the $186 million in arrears that they owe to the IMF by August 15. The IMF Executive Board decided in May that if Peru did not eliminate its arrears to the Fund by August 15 Peru would lose its eligibility to use IMF resources. All of these actions by Peru were taken in the context of a deteriorating trade balance. At the end of March, Peru had $2 billion in gross foreign exchange reserves with an additional 2.5 million ounces in gold reserves. Since that time Peru is reported to have lost about $300 million in reserves.

Nigeria is preparing to inaugurate a second-tier foreign exchange market on or before October 1. The government has indicated that transactions for most goods and services (official debt service will continue to be converted at the official rate) will be channeled through the second-tier market. On August 5, in anticipation of the opening of the second-tier market, the government announced that Nigerians could hold and trade foreign exchange on the parallel market. The official and second-tier rates are expected to be unified within 12 months. In anticipation of a unified rate, the government has been adjusting the official rate downward in small increments on an almost daily basis. Since June, the naira has been devalued from $0.85 to $0.75.

Although the government has consistently opposed a formal IMF stand-by arrangement with drawings, it may be working toward an alternative arrangement with quantitative targets and performance criteria that it could "sell" domestically. Adoption of an IMF program could open the way for a $400 million World Bank loan (which would be used to supply foreign exchange to the second-tier market), and commercial banks and Paris Club reschedulings. The banks have already agreed to defer principal payments until October 1, but Nigeria has asked for new money as part of a comprehensive rescheduling package.

Early this month, the Philippines and an IMF mission in Manila reached tentative agreement on a new 18-month, SDR 189 million stand-by arrangement and an SDR 224 million Compensatory Financing Facility (CFF). Prior to Board approval, the government will produce a program for reforming insolvent government financial institutions and commit itself to a timetable for continuing the process of liberalizing imports. If the reform plan for the government financial institutions is approved by the World Bank and the entire program is given the green light by the IMF Management in mid-September, the Fund Board is expected to approve the program in October.