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Confidential (FR) Class III FOMC

September 17, 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	Aug.	09-05-86	118.2	1.1	1.8	2.5
Unemployment rate (%)[1]	Aug.	09-05-86	6.8	6.9	7.3	7.1
Insured unemployment rate (%)[1]	Mar.	06-13-86	2.9	2.8	3.0	2.9
Nonfarm employment, payroll (mil.)	Aug.	09-05-86	100.3	2.4	1.6	2.5
Manufacturing	Aug.	09-05-86	19.1	1.2	-1.4	-.6
Nonmanufacturing	Aug.	09-05-86	81.2	2.7	2.3	3.2
Private nonfarm:						
Average weekly hours (hr.)[1]	Aug.	09-05-86	34.8	34.7	34.8	34.9
Hourly earnings ($)[1]	Aug.	09-05-86	8.76	8.72	8.73	8.59
Manufacturing:						
Average weekly hours (hr.)[1]	Aug.	09-05-86	40.8	40.6	40.7	40.6
Unit labor cost (1967=100)	July	08-28-86	80.9	-7.4	-4.4	-4.7
Industrial production (1977=100)	Aug.	09-16-86	124.8	1.9	1.9	.3
Consumer goods	Aug.	09-16-86	125.1	2.9	2.6	3.5
Business equipment	Aug.	09-16-86	137.9	3.5	.0	-2.2
Defense & space equipment	Aug.	09-16-86	182.2	16.7	9.4	5.1
Materials	Aug.	09-16-86	113.1	-2.1	.4	-.7
Consumer prices all items (1967=100)	July	08-21-86	327.6	.4	2.7	1.6
All items, excluding food & energy	July	08-21-86	327.5	4.4	3.1	4.1
Food	July	08-21-86	319.5	10.6	5.7	3.3
Producer prices: (1967=100)						
Finished goods	Aug.	09-12-86	288.2	3.8	-.6	-1.8
Intermediate materials, nonfood	Aug.	09-12-86	309.5	-1.9	-3.3	-4.5
Crude foodstuffs & feedstuffs	Aug.	09-12-86	236.5	29.6	20.6	6.7
Personal income ($ bil.)[2]	July	08-20-86	3,502.5	5.5	1.6	5.6
				(Not at annual rates)		
Mfgrs. new orders dur. goods ($ bil.)	July	09-02-86	106.9	4.1	3.0	2.4
Capital goods industries	July	09-02-86	37.9	12.5	15.9	4.4
Nondefense	July	09-02-86	27.4	3.6	4.6	2.6
Defense	July	09-02-86	10.5	44.7	61.4	9.4
Inventories to sales ratio:[1]						
Manufacturing and trade, total	July	09-15-86	1.38	1.38	1.37	1.38
Manufacturing	July	09-02-86	1.43	1.44	1.42	1.47
Trade	July	09-15-86	1.34	1.34	1.33	1.30
Ratio: Mfgrs.' durable goods inventories to unfilled orders[1]	July	09-02-86	.525	.529	.527	.547
Retail sales, total ($ bil.)	Aug.	09-12-86	120.2	.8	1.3	3.4
GAF[3]	Aug.	09-12-86	26.6	.3	1.1	6.5
Auto sales, total (mil. units.)[2]	Aug.	09-04-86	12.2	12.3	8.7	-1.0
Domestic models	Aug.	09-04-86	8.9	17.9	8.8	-6.3
Foreign models	Aug.	09-04-86	3.3	-.3	8.3	17.0
Plant and equipment expen.[4]						
Total nonfarm business	1986	09-11-86	379.59	—	—	-1.9
Manufacturing	1986	09-11-86	144.01	—	—	6.2
Nonmanufacturing	1986	09-11-86	235.58	—	—	.8
Housing starts, private (thous.)[2]	Aug.	09-17-86	1,822	.4	-1.7	4.9
Leading indicators (1967=100)	July	08-28-86	179.4	1.1	.6	6.0

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

Recent economic indicators point to a moderate pickup in growth in the current quarter. Payroll employment continued to expand in August, with gains widespread by industry. Consumer spending has continued to increase rapidly, and construction of single-family houses has been well maintained. Capital outlays, however, have remained soft--especially those for new structures. Although some price measures have been affected by recent developments in energy and food markets, the underlying rate of inflation appears little changed from the moderate pace observed over the past year.

Industrial Production and Capacity Utilization

Industrial production edged up an estimated 0.1 percent in August, and revised data for the preceding two months indicate somewhat stronger industrial activity than estimated earlier. In particular, total industrial production for June was revised from a 0.3 percent decline to no change, and July output from a 0.1 percent drop to a rise of 0.3 percent. In July and August, gains in output were especially large for defense and space equipment; in addition, production of business equipment, consumer goods, and construction supplies posted solid advances.

As part of the staff's ongoing review of its statistical series, the index of industrial production has been revised back to January 1984. For 1984 and 1985, the revised data indicate slightly less growth in the total index than previously estimated: a rise of 11.2 percent in 1984 (instead of 11.5 percent), and an increase of 2.0 percent during 1985 (instead of 2.2 percent). In contrast, the revisions for the first seven months of 1986 indicate somewhat stronger industrial activity than previously estimated: a cumulative decline of 1.1 percent for the period, instead of 2.1 percent.

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

	1986 Q1	1986 Q2	1986 June	1986 July	1986 Aug.
	--Annual rate--		--Monthly rate--		
Total index	1.2	-2.1	.0	.3	.1
Products	1.4	-1.0	-.1	.5	.4
Final products	.0	-2.8	-.5	.6	.4
Consumer goods	2.7	4.5	.0	.5	.2
Durable	2.3	-1.1	.5	1.4	-.6
Nondurable	2.9	6.4	-.2	.2	.5
Equipment	-2.9	-10.5	-1.1	.8	.6
Business	.6	-6.6	-1.2	1.0	.3
Defense and space	.6	2.3	.2	.8	1.4
Oil and gas drilling	-52.5	-86.7	-10.2	-4.1	4.0
Intermediate products	6.2	5.4	1.2	.1	.3
Construction supplies	10.1	2.2	.5	.1	.6
Materials	.8	-3.9	.2	.0	-.2
Durable goods	-.4	-6.8	-.5	.5	.0
Nondurable goods	6.5	4.0	1.0	.3	.9
Energy materials	-1.7	-5.3	1.0	-1.1	-1.8

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

	1978-80 High	1982 Low	1967-85 Avg.	1984 High	1986 June	1986 July	1986 Aug.
Total industry	86.9	69.5	81.7	81.8	78.9	79.1	79.0
Manufacturing	86.5	68.0	80.6	81.3	79.1	79.5	79.6
Durable	86.3	63.7	78.7	79.8	75.7	76.1	76.0
Nondurable	87.0	74.4	83.5	84.3	84.3	84.6	84.9
Mining	95.2	76.9	87.7	86.6	75.3	73.8	72.8
Utilities	88.5	78.0	87.9	85.8	80.6	80.0	78.7
Industrial materials	89.1	68.4	82.5	82.9	78.2	78.1	77.9
Metal materials	93.6	45.7	78.4	70.8	63.5	64.1	63.6
Paper materials	97.3	79.9	91.4	98.6	96.1	95.6	n.a.
Chemical materials	87.9	63.3	80.8	78.5	80.3	80.2	n.a.

Capacity utilization in manufacturing, mining, and utilities fell 0.1 percentage point in August to 79.0 percent. This level is about the same as the rate for the three preceding months, but 1.6 percentage points lower than a year earlier. The overall decrease in August was related to a further drop in utilization in the mining industry and to a weather-related decline in electricity generation; the operating rate in manufacturing edged up 0.1 percentage point in August.

Employment and Unemployment

Employment continued to expand in August: total nonfarm payroll employment rose 240,000 after adjusting for strike activity, somewhat better than the average pace so far this year. Although hiring at service-producing establishments accounted for about two-thirds of the overall increase, the manufacturing sector registered a strike-adjusted gain of nearly 40,000 jobs—the first such increase since January. The largest increases occurred in transportation equipment and chemicals, but a number of other industries reported increases as well. In addition, manufacturers lengthened work schedules last month, with the factory workweek rising 0.2 hours to 40.8 hours—its highest level since January. Elsewhere, construction employment was up 55,000 in August, apparently reflecting the strong activity in the housing sector. The number of jobs in oil and gas extraction slipped another 10,000 last month, bringing the cumulative job loss over the past year to more than 150,000.

The civilian unemployment rate fell to 6.8 percent in August, nearly 1/2 percentage point below the second-quarter average. In general, most demographic groups have experienced some decline in joblessness this

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

	1985	1985 Q4	1986 Q1	1986 Q2	1986 June	1986 July	1986 Aug.
	—Average monthly changes—						
Nonfarm payroll employment[2]	230	261	191	120	-75	279	202
Strike adjusted	229	260	184	174	93	134	244
Manufacturing	-18	30	-11	-40	-66	-19	19
Durable	-16	13	-14	-37	-71	-13	1
Nondurable	-2	17	3	-3	5	-6	18
Manufacturing Strike adjusted	-17	24	-13	-29	-26	-46	37
Construction	21	20	17	36	-27	34	55
Trade	65	55	79	35	-10	75	45
Finance and services	122	123	98	159	182	150	107
Total government	38	31	23	-6	-38	-62	28
Private nonfarm production workers	159	191	135	102	-38	308	134
Manufacturing production workers	-18	24	-13	-27	-46	-16	21
Total employment[3]	163	229	194[e]	295	563	209	273
Nonagricultural	183	184	149[e]	335	558	261	338

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 Q4	1986 Q1	1986 Q2	1986 June	1986 July	1986 Aug.
Civilian, 16 years and older	7.2	7.0	7.1	7.2	7.1	6.9	6.8
Teenagers	18.6	19.0	18.5	19.2	19.1	17.5	17.7
20-24 years old	11.0	10.8	10.6	11.1	10.7	10.8	10.2
Men, 25 years and older	5.3	5.2	5.3	5.4	5.5	5.5	5.3
Women, 25 years and older	5.9	5.5	5.7	5.7	5.7	5.4	5.4
White	6.2	6.0	6.1	6.2	6.1	6.0	5.8
Black	15.1	15.1	14.6	14.9	15.1	14.0	14.6
Fulltime workers	6.9	6.7	6.7	6.8	6.7	6.6	6.4
Memo:							
Total national[1]	7.1	6.9	7.0	7.1	7.0	6.8	6.7

1. Includes resident Armed Forces as employed.

year; only the unemployment rate for adult men has not dropped, on balance, from its level at the end of last year.

Personal Consumption and Income

Real consumption spending rose at a 6-1/2 percent annual rate in the second quarter--one of the highest growth rates reported in the current expansion, and strength continues to be evident in the third quarter. Real purchases in July were well above their second-quarter level, and advance information on August retail sales suggests that real spending rose again last month. Outlays for durable goods other than autos, which had been strong earlier in the year, dropped back in August; however, general merchandisers posted another solid gain.

Growth in disposable personal income, which had been quite robust throughout much of the first half of this year, slowed in June and July, and the personal saving rate dropped to 4.0 and 4.2 respectively in those months--well below the first-half average of 5.1 percent.

Despite some slowing in income growth, indexes of consumer attitudes have remained at fairly high levels. Perceptions of personal financial situations as reported to the Michigan survey are at levels comparable to earlier cyclical highs. Respondents believe that it continues to be a good time to buy a house or a car. However, attitudes about near-term economic conditions turned down somewhat in August. The rate of inflation expected over a 12-month horizon has moved up from 3-3/4 percent earlier this year to 4.3 percent in August.

Autos

Sales of new domestic cars rose sharply in the last 10 days of August to a 10.6 million unit annual rate, and soared to a 17 million unit rate

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

	1984	1985	1985 Q4	1986 Q1	1986 Q2	1986 July/Q2
Current dollars						
Total personal income	8.4	6.1	7.4	6.0	6.4	2.8
Private wages and salaries	8.8	6.3	7.5	6.5	2.3	2.1
Manufacturing	8.3	3.9	6.0	2.6	-1.4	-2.3
Farm income[2]	31.5	29.2	29.4	24.4	40.9	27.5[3]
Disposable personal income	8.0	5.6	7.3	7.6	6.5	1.7
Constant dollars						
Disposable personal income	4.2	1.9	2.6	6.5	7.4	-1.3e
Personal consumption expenditures	3.6	3.5	1.7	3.6	6.5	4.5e
Durables	8.8	6.2	-11.1	-1.8	16.4	.4e
Motor vehicles and parts	6.7	3.7	-32.8	-8.4	21.6	—
Other durables	10.5	8.2	12.4	3.6	12.6	—
Nondurables	2.2	2.0	1.6	6.5	8.4	5.5e
Clothing and shoes	4.0	3.2	2.8	14.0	14.4	—
Gasoline and oil	.6	1.5	3.4	2.1	41.1	—
Food	2.0	2.0	-.2	5.6	2.6	—
Services	3.3	3.9	6.0	3.2	2.4	5.0e
Memo:						
Personal saving rate (percent)	6.3	5.1	4.4	5.0	5.1	4.2[3]

e--Estimated by Board staff.
1. Annual figures are from the fourth quarter of preceding year to fourth quarter of year indicated.
2. Level, billions of dollars.
3. July level.

RETAIL SALES
(Seasonally adjusted percentage change)

	1985	1986		1986		
	Q4	Q1	Q2	June	July	Aug.
Total sales	-.8	1.2	1.2	.2	.3	.8
Total less automotive group, nonconsumer stores, and gasoline stations	1.4	1.2	1.4	.4	.5	.2
GAF[2]	1.6	1.4	2.7	.5	.4	.3
Durable	-3.6	2.0	3.5	.1	.6	1.8
Automotive group	-8.2	1.1	4.2	-.2	-.3	3.2
Furniture and appliances	4.3	1.0	4.2	1.9	2.0	-.4
Other durable goods	1.5	.1	1.8	-1.2	2.5	-.9
Nondurable	1.0	.7	-.2	.3	.0	.1
Apparel	1.6	1.6	3.9	-.5	-.5	.1
Food	1.8	1.4	-.4	.7	.5	-.1
General merchandise[3]	.4	1.4	1.5	.3	.1	.7
Gasoline stations	.0	-4.4	-11.5	-.6	-2.7	-1.8

1. BCD series 59. Data are available approximately 3 weeks following the retail sales release.
2. General merchandise, apparel, furniture and appliance stores.
3. General merchandise excludes mail order nonstores; mail order sales also are excluded in the GAF grouping.

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

	1985		1986		1986		
	Q3	Q4	Q1	Q2	June	July	Aug.
Total auto sales[1]	12.3	10.2	10.7	11.2	11.3	10.9	12.2
Domestic	9.4	6.8	7.8	8.2	8.3	7.6	8.9
Imported	2.9	3.4	2.8	3.0	3.0	3.3	3.3
Domestic production	8.2	7.8	8.3	7.9	8.0	7.6	7.0
Dealers' stocks	1.31	1.67	1.81	1.80	1.80	1.76	1.65
Days' supply[2]	43	75	71	68	66	71	57
Total light truck sales[3]	4.6	4.4	4.1	4.6	4.6	4.8	4.9
Domestic	3.8	3.6	3.3	3.7	3.8	3.7	4.2
Imported[4]	.8	.8	.8	.9	.8	1.1	.7

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.
3. Trucks having gross weight 10,000 pounds or less.
4. About 1 percent of imported trucks have gross weight above 10,000 pounds.

in the first 10 days of September. The surge reflected an enthusiatic response by consumer to automakers' latest round of incentive programs.[1] However, the incentives are scheduled to expire early in October with the introduction of the new model year, and some "payback" of the current heightened pace of sales is likely to occur in the fall.

As an additional measure to liquidate excessive inventories, General Motors scaled back production from earlier plans, mostly by lengthening plant closings during the usual model changeover. As a result, auto production in August fell to a 7 million unit annual rate from the 7.6 million pace in July. However, assembly schedules indicate that automakers plan to produce cars at a relatively high 8.2 million unit rate in September.[2]

Sales of foreign cars have been strong in recent months, reaching a 3.3 million unit annual rate in both July and August. Moreover, sales of light trucks also picked up in August, and are expected to rise further in September. Many domestic and foreign trucks are currently covered by sales incentive programs.

Business Fixed Investment

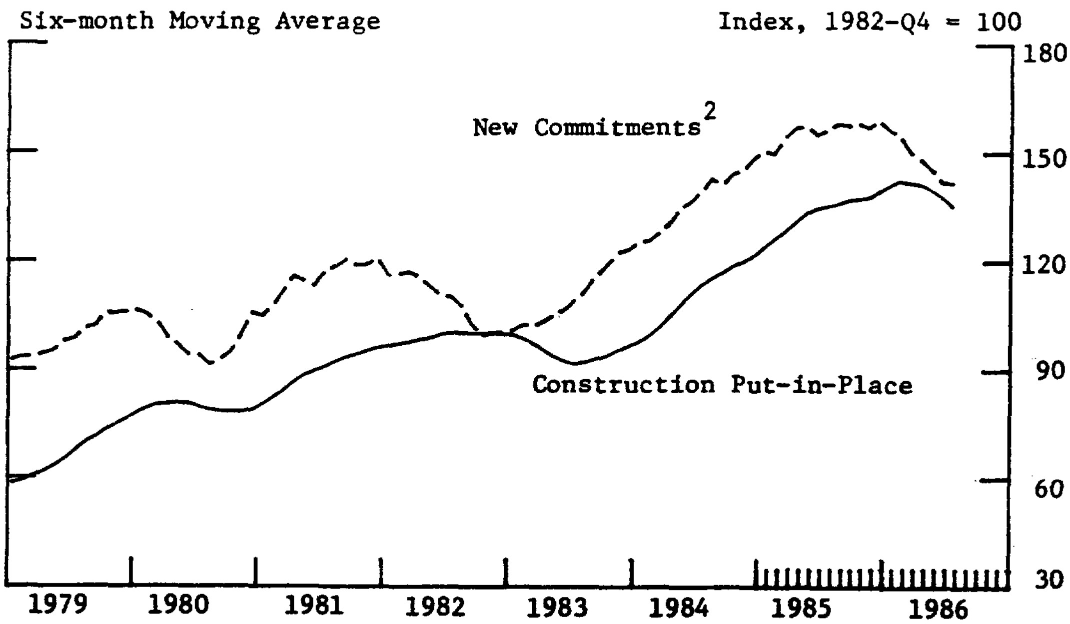
Business fixed investment remained sluggish through July, with continued weakness in nonresidential construction. The value of nonresidential

1. In the latest GM program, interest rates are 2.9 percent on the 36-month loans and 4.8 percent on the more popular 48-month loans, compared with 5.9 percent and 8.9 percent rates in the earlier GM program. Commercial bank rates on four-year auto loans were in the range of 11 percent during August.
2. All figures are based on FRB seasonals. Although monthly production patterns differ when BEA's seasonals are used, the average production rates over July and August show similar declines from their second-quarter levels on both seasonal bases.

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

	1985 Q4	1986 Q1	1986 Q2	1986 June	1986 July	1986 Aug.
Producers' durable equipment						
Nondefense capital goods						
Shipments	3.2	-5.8	2.5	2.5	.4	--
Excluding office & store mach.	3.7	-3.6	1.0	.1	1.9	--
Office and store machinery	.5	-17.5	11.6	16.0	-7.0	--
Orders	.0	-4.8	-.9	1.1	3.6	--
Excluding office & store mach.	3.2	-4.8	-1.9	-2.1	3.1	--
Office and store machinery	-16.8	-4.7	5.3	19.9	6.2	--
Sales of heavy-weight trucks (thousands of units, A.R.)	303	262	273	304	261	268
Nonresidential structures						
Nonresidential construction	2.2	1.0	-5.6	-.3	-.6	--
Commercial building	4.3	1.9	-7.8	-.2	-1.5	--
Office	1.1	-.8	-6.6	-.6	-3.4	--
Other commercial	8.0	4.9	-9.1	.2	.4	--
Industrial building	3.4	-6.2	-9.0	-4.4	4.4	--
Rotary drilling rigs in use	-11.7	-18.5	-40.2	-10.6	-4.2	3.6

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.

construction put-in-place (which excludes petroleum drilling) fell 0.6 percent in July, the fifth decline in the past six months. Compared with the end-of-1985 peak, the July level of outlays for commercial and industrial buildings was down about 15 percent. The drop reflects the substantial surplus of industrial and commercial space, as well as the expected removal of some tax advantages for commercial structures investment. One encouraging development, however, is that the precipitous decline in petroleum drilling activity during the first half of this year appears to be abating.

In contrast to the downtrend in construction outlays, spending for equipment appears to have expanded somewhat in recent months. Nominal shipments of nondefense capital goods by domestic producers rose 0.4 percent in July to a level 1 percent above the second-quarter average, primarily reflecting gains in recent months for office and computing equipment plus aircraft and parts. Some additional firming in equipment demand is indicated by the data on new orders for nondefense capital goods, which rebounded moderately in June and July after three months of decline. Bookings for computers, in particular, have shown marked improvement from their depressed levels of earlier this year.[1]

The most recent Commerce Department survey of planned 1986 capital spending indicates that businesses expect nominal outlays during this

1. Since June, plans to order new aircraft from Boeing and McDonnell Douglas have been announced by several airlines. For the most part, however, these intended bookings have not been recorded officially on the books of either company. Only after this official recording takes place will these bookings be incorporated into the new orders series. As this occurs over coming months, we expect this series to show a rising trend of orders.

calendar year to be 1.9 percent below last year's spending level; in the spring survey, businesses anticipated a 0.2 percent rise in capital outlays. For the most part, the revision to 1986 plans occurred because actual second-quarter expenditures turned out weaker than previously expected. As in the previous survey, firms still expect spending to pick up in the second half of the year.

The recent performance of capital spending, as well as the outlook, has been affected by the likelihood of tax reform. For equipment, the retroactive repeal of the investment tax credit probably has already begun to restrain some purchases. Beginning in 1987, depreciation write-offs for equipment generally would become less accelerated, further holding down spending. However, the expected lengthening of depreciation schedules may shift some spending into 1986. For nonresidential construction, the impact of the bill also would be negative, with some variation across sectors. Commercial construction would be especially hard-hit, owing to the cutback in the tax-shelter benefits that frequently motivate these projects.

Business Inventories

Investment in nonauto business inventories remained moderate through July. For all manufacturers and nonauto trade establishments, inventories rose in July at an annual rate of $6.7 billion in book value terms--similar to the $4.7 billion pace seen in the first half of this year.

Manufacturers continued to maintain lean stocks through mid-summer. The book value of factory stocks was about unchanged from May to July, and the ratio of inventories to shipments remained low at most industries. On balance, manufacturers' stock adjustments have been relatively small

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

	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June[r]	1986 July[p]
Book Value Basis:						
Total	17.6	20.1	2.9	-22.5	26.2	29.2
Manufacturing	-8.6	-9.3	-4.6	-12.1	.7	-1.3
Wholesale	6.1	4.5	6.9	5.1	15.4	8.4
Retail	20.1	24.9	.6	-15.5	10.0	22.2
Automotive	19.9	15.1	-1.4	-9.2	10.9	22.5
Ex. auto	.2	9.8	2.0	-6.3	-.9	-.3
Constant Dollar Basis:						
Total	11.0	29.8	1.1	-38.1	16.2	—
Manufacturing	-10.5	-5.3	.2	-7.1	-2.8	—
Wholesale	3.6	6.8	4.3	-3.3	14.7	—
Retail	17.8	28.3	-3.4	-27.7	4.3	—
Automotive	15.9	17.2	-2.3	-14.3	8.0	—
Ex. auto	1.9	11.0	-1.2	-13.5	-3.7	—

INVENTORIES RELATIVE TO SALES[1]

	Cyclical Reference Points[2] 81 low	Cyclical Reference Points[2] 82 high	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June[r]	1986 July[p]
Book Value Basis:								
Total	1.39	1.53	1.36	1.38	1.39	1.39	1.38	1.38
Manufacturing	1.60	1.77	1.42	1.43	1.43	1.44	1.44	1.43
Wholesale	1.06	1.28	1.18	1.20	1.23	1.25	1.23	1.21
Retail	1.37	1.46	1.43	1.47	1.45	1.44	1.44	1.46
Automotive	1.57	1.90	1.65	1.78	1.70	1.65	1.68	1.76
Ex. Auto	1.31	1.37	1.37	1.38	1.38	1.38	1.37	1.37
Constant Dollar Basis:								
Total	1.58	1.72	1.54	1.55	1.54	1.54	1.55	—
Manufacturing	1.88	2.04	1.72	1.72	1.70	1.71	1.72	—
Wholesale	1.26	1.45	1.30	1.31	1.32	1.34	1.33	—
Retail	1.38	1.49	1.48	1.52	1.48	1.47	1.47	—
Automotive	1.54	1.90	1.66	1.83	1.74	1.67	1.74	—
Ex. auto	1.31	1.41	1.44	1.44	1.41	1.42	1.40	—

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

in recent months, suggesting that factory inventories have been roughly in line with recent market conditions. Inventories held by nonauto retailers have been little changed recently. Indeed, the inventory position of stores that carry largely discretionary consumption goods improved in early summer as brisk sales helped to reduce their inventory-sales ratios.

For autos, book-value data showed a large increase in July that appears anomalous in light of information on unit production and sales. Dealer stocks of new domestic cars declined in July and were pared significantly further in August, reflecting the cutbacks in assembly schedules and the latest round of sales incentives.

Housing Markets

Despite recent declines, the level of residential construction was fairly well-maintained through the summer. Housing starts totaled 1.8 units (annual rate) in July and August. Single-family starts turned up in August; the level rose 3 percent to a 1.2 million unit annual rate, close to the vigorous pace seen in the first half of the year. Multifamily housing starts held steady in August at a pace considerably below the level seen earlier in the year. In light of the high vacancy rates and the prospect of unfavorable tax changes, construction of multifamily units is likely to decline further in the near term.

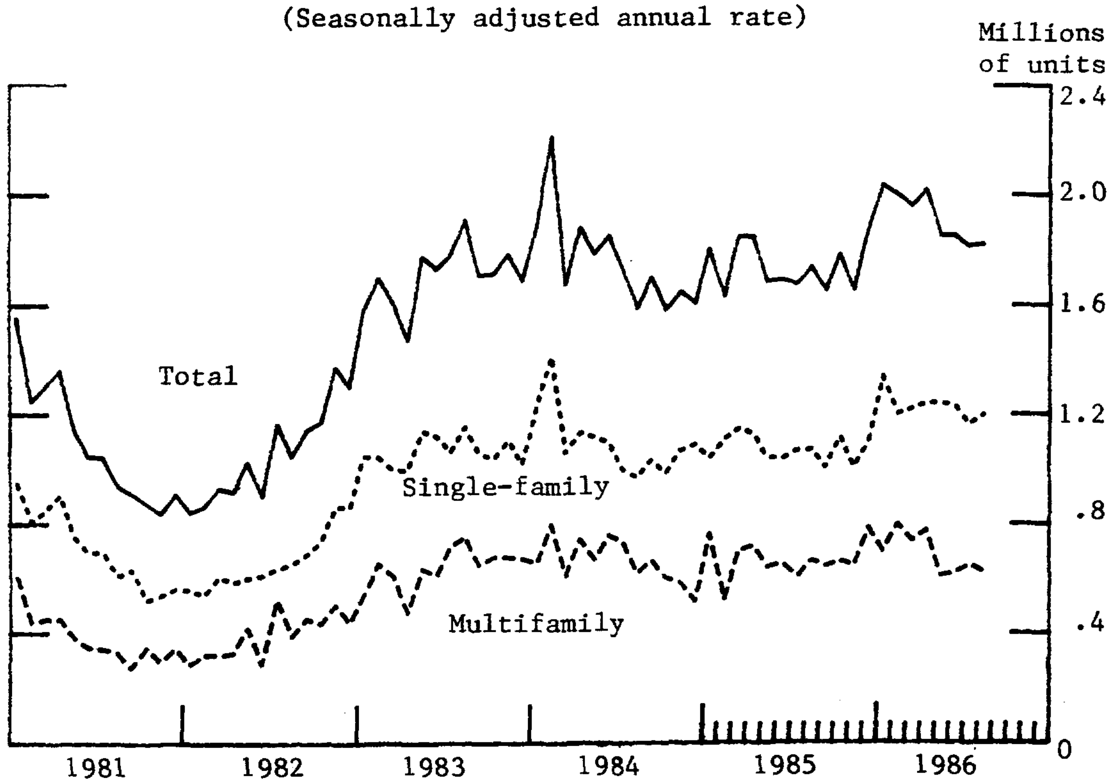
Sales of new homes have dropped below the extraordinary levels recorded earlier in the year when mortgage rates were 50 basis points or more below the July average. Sales in July fell 5.6 percent to a seasonally adjusted annual rate of 658,000 units--off 16 percent from the second-quarter average. In contrast sales of existing homes edged up 2

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

	1985 Annual	1985 Q4	1986 Q1	1986 Q2	1986 June	1986 July	1986 Aug.[1]
All units							
Permits	1.73	1.74	1.83	1.82	1.79	1.76	1.65
Starts	1.74	1.77	2.00	1.91	1.85	1.82	1.82
Single-family units							
Permits	.96	.96	1.05	1.12	1.12	1.09	1.03
Starts	1.07	1.07	1.25	1.24	1.23	1.16	1.20
Sales							
New homes	.69	.70	.80	.79	.70	.66	n.a.
Existing homes	3.22	3.50	3.26	3.47	3.39	3.45	n.a.
Multifamily units							
Permits	.78	.78	.79	.70	.67	.67	.62
Starts	.67	.70	.75	.67	.62	.65	.63
Mobile home shipments	.28	.29	.26	.24	.23	.24	n.a.

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

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



percent in July to 3.45 million units (annual rate)—in the upper part of the range that has prevailed since late last year.

House prices continued their sharp rise in July. New home prices rose 17.6 percent during the 12 months ending in July, while the average sales price of existing homes increased by 9.7 percent relative to one year earlier. Adjusted prices of new homes available for the second quarter indicate that nearly half of that price jump is attributable to changes in the quality or regional mix of sales.

The Federal Government

With fiscal 1986 about over, the federal deficit apparently will be bigger than last year's record $212 billion and will remain in the range of 5 to 5-1/2 percent of GNP. Large spending increases continued for defense and agricultural programs, but the rise in receipts slowed to only half the pace experienced in 1984 and 1985.

For FY1987, which begins October 1, the large number of spending and revenue measures still before Congress have created a substantial legislative log-jam. The tax reform conference agreement is scheduled to be taken up in both chambers this month. Congress also is still considering all 13 regular appropriations bills (the House has passed nearly all, but none has gone to House-Senate conference), a budget reconciliation bill, a long-term debt limit increase, and changes to the Gramm-Rudman-Hollings (G-R-H) legislation to restore the automatic procedure for budget cuts that was invalidated by the Supreme Court. In the past, Congress has resorted to enactment of an omnibus continuing resolution in place of appropriations for large parts of the government. In recent years, this vehicle has been used to avoid disruption of federal programs until

GRAMM-RUDMAN-HOLLINGS BASE LEVEL FEDERAL OUTLAY ESTIMATES FOR 1987[1]

	Billions of dollars	Percent of total
Total	990.5	100.0
Defense	274.6	27.6
Subject to across-the-board sequestration	169.0	17.1
Exempt	104.6	10.6
Nondefense		
Subject to sequestration	231.1	23.3
Across-the-board	96.0	9.7
Special rules	135.2	13.6
Exempt	485.8	49.0
Social security	204.3	20.6
Net interest	138.7	14.0
Income support[2] and veterans' benefits	92.9	9.3
Other[3]	49.9	5.0

1. Figures are the average of OMB and CBO estimates, which differed by $16 billion because of disagreements over interpretations of the law, differences in economic assumptions, and technical estimating differences.
2. Includes, among other things, spending for child nutrition, food stamps, medicaid, and state unemployment benefits.
3. Outlays from prior-year appropriations, certain prior legal obligations, and small exempt programs.

Source: OMB and CBO, Initial Sequestration Report for Fiscal 1987, August 20, 1986.

Note: Outlay estimates were based on FY1986 appropriation levels and other laws and regulations in effect August 15, 1986.

regular appropriations were passed and to finance some part of the government for the entire fiscal year. There has been speculation that such an omnibus bill might be a convenient way this year to deal with G-R-H spending and deficit limitations under tight time deadlines.

With regard to the G-R-H requirements, OMB and CBO jointly issued the initial sequestration report for FY1987 on August 20. Based on laws and regulations in effect August 15 (including FY1986 appropriations since none were enacted for FY1987), the report found that the deficit would be $163 billion--$9 billion above the sequestration trigger and $19 billion over the $144 billion deficit target mandated by the law. To meet the target, the backup procedures require Congress to enact legislation immediately, with half the spending cuts in defense and the other half in nondefense. As shown on the table, however, 60 percent of the budget is exempt from sequestration (11 percent in defense spending and 49 percent in nondefense spending). In addition, 14 percent of outlays are subject to special rules that limit allowable reductions. As a result, the defense portion of budget not exempted by the act would be cut 5.6 percent and the nondefense portion would be subject to 7.6 percent in across-the-board reductions. Under the law, a special joint House-Senate committee must report a resolution specifying such cuts. That resolution, which is in a form requiring presidential signature to become law, would be the basis for the final sequester order. Alternatively, Congress could meet the current G-R-H requirements through appropriations and other budget cutbacks or revenue measures that bring the deficit under the $154 billion FY1987 trigger level when re-estimated early in October.

Current deliberations on the reconciliation bill suggest this latter alternative is more likely than the across-the-board sequester.

State and Local Government

Economic conditions in the state and local government sector remain uneven across geographic regions. Exceptionally good state fiscal conditions in New England and the mid-Atlantic region contrast sharply with eroding budget positions in energy-related states and in those dependent on agriculture and timber.

Indicators of growth in the sector continued to be mixed. Total real construction spending rose again in July, but outlays for highways and streets, which had been rising rapidly, fell to a level below their second-quarter average. Despite a small gain last month, August employment in the state and local sector was nearly 40,000 below the second-quarter level.

Prices

Energy price movements have dominated inflation measures so far this year. In July, prices of crude oil and refined products plunged at all levels, causing the PPI to drop 0.4 percent and holding the CPI unchanged from June. In August, energy prices as measured in the PPI were down again, as the August 12th pricing date apparently captured only part of the rebound in energy prices that had occurred in spot commodity markets. Among finished energy products, heating oil prices rose substantially in August, but the index for gasoline prices fell 1.5 percent. Nonetheless, private survey data on pump prices for gasoline suggest some increase in the August CPI.

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 July	1986 Aug.
			—Annual rate—			—Monthly rate—	
Finished goods	100.0	1.8	9.2	-12.5	.0	-.4	.3
Consumer foods	24.5	.5	16.0	-8.1	6.0	1.9	1.3
Consumer energy	12.5	-.3	20.7	-66.9	-25.1	-11.9	-1.5
Other consumer goods	40.3	2.7	4.4	2.5	1.7	.3	.1
Capital equipment	22.7	2.7	5.6	.7	1.9	.2	.1
Intermediate materials[2]	95.3	-.1	2.9	-11.8	-4.8	-.7	-.2
Exc. energy	79.6	-.1	.0	-1.0	-1.3	.2	.0
Crude food materials	52.5	-6.4	47.0	-24.7	-.2	3.4	2.5
Crude energy	31.6	-4.9	-4.0	-51.3	-33.8	-2.8	-2.6
Other crude materials	15.9	-4.3	1.5	-.2	6.6	.1	-5.3

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

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 June	1986 July
			—Annual rate—			—Monthly rate—	
All items[2]	100.0	3.8	5.3	-1.9	1.5	.5	.0
Food	18.5	2.7	5.9	-1.4	3.4	.1	.9
Energy	11.3	1.8	3.3	-34.2	-12.5	2.3	-4.1
All items less food and energy	70.2	4.4	5.4	4.1	3.1	.3	.4
Commodities	25.9	2.1	3.6	.3	-.5	.1	.2
Services	44.4	5.7	6.5	6.5	5.2	.4	.4
Memorandum:							
CPI-W[3]	100.0	3.6	5.2	-2.7	1.0	.5	.0

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.

Led by steep increases in meat prices, food prices moved up sharply during the summer. The CPI for food advanced 0.9 percent in July, and measures of food prices in the PPI rose in both July and August. Meat prices were boosted by tighter pork supplies and weather-related disruptions in the poultry industry. Since mid-August, however, upward pressures on meat prices have eased somewhat at the farm level. Crop prices generally have remained weak, reflecting this year's sharp downward adjustments in price support levels and, for some crops, a further buildup of stocks.

For commodities other than food and energy, the CPI rose 0.2 percent in July after showing little net change over the first half of the year. The cost of nonenergy services was up 0.4 percent--somewhat below the average pace in the first half. At the producer level, prices of capital equipment and of consumer goods less food and energy continued to rise more slowly than during 1985; both were up only 0.1 percent in August after increases of 0.2 and 0.3 percent, respectively, in July. At earlier stages of processing, prices of intermediate materials less food and energy were flat, on average, in August; the index for crude nonfood materials less energy dropped more than 5 percent, in large part reflecting a plunge in cotton prices associated with the ending of price supports.

Spot prices for precious metals rose markedly during August. In addition to concerns about supply disruptions in South Africa--the major world producer of platinum and gold--market reports have attributed the recent increases to renewed inflationary expectations associated with oil price developments, the lower exchange value of the dollar, and a strong industrial demand for platinum. Spot prices of lumber also have picked up notably since early August and were 40 percent above their year-earlier level in mid-September.

Wages and Labor Costs

Wage rates have continued to rise slowly in recent months. The hourly earnings index, which covers wages of production and nonsupervisory workers, rose 0.2 percent in August after a small decline in July. During the past eight months, this measure of wage change has risen less than 2 percent at an annual rate, after increasing 3 percent in 1985. In addition, compensation trends have shown no signs of acceleration: hourly compensation in the nonfarm business sector rose about 2-1/2 percent over the first half of this year, after a 3.9 percent increase in 1985.

Productivity growth has been modest over the past year. The second quarter estimate of output per hour, revised down sharply from the preliminary estimate, stands only 0.6 percent above its year-earlier level. Unit labor costs were up 2-1/2 percent between 1985-Q2 and 1986-Q2, after rising 4 percent during the previous four-quarter period.

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

	1984	1985	1985 Q4	1986 Q1	1986 Q2	1986 Year to date
Hourly earnings index, wages of production workers[1]						First eight months
Total private nonfarm	2.9	3.0	3.2	2.7	1.8	1.3
Manufacturing	3.4	3.3	2.4	2.3	2.4	1.6
Nonmanufacturing	2.7	2.9	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	2.2	4.5	3.1	3.8
By occupation:						
White collar	5.1	4.8	3.1	4.7	3.7	4.2
Blue collar	4.2	3.2	1.3	4.2	1.9	2.9
Service workers	6.6	3.0	2.2	4.4	.6	3.4
By bargaining status:						
Union	4.3	2.6	1.9	4.2	.9	2.5
Nonunion	5.2	4.6	2.2	4.8	3.8	4.2
Employment cost index, wage and salaries of all persons[2]						
Total	4.1	4.1	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	3.7	3.1	2.2	3.1
Output per hour	1.0	.2	-3.5	4.3	-.5	.6
Unit labor costs	3.2	3.7	7.4	-1.2	2.8	2.5

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*

THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 was agreed to by House and Senate conferees on August 16 and is widely expected to be enacted in this form. The House is expected to begin debate on the bill around September 19; the Senate has not scheduled action yet, but consideration in the Senate is expected before the end of September. Definitive information about the bill is not available yet; the conference report, which will contain the legislative language, official explanations and revenue estimates, is just being completed by the Joint Committee on Taxation (JCT) staff and is not expected to be publicly available before September 22. This appendix is based on a JCT summary of the conference agreement and prelimiminary JCT revenue estimates.

The Tax Reform Act of 1986 will restructure the federal individual and corporate income tax code by dramatically cutting marginal tax rates and eliminating many tax preferences. These changes constitute a fairly pure "reform"; the act is designed neither to cut nor to increase tax receipts in the aggregate over the five year horizon of the official revenue estimates. There will, however, be significant shifts in tax burdens for sectors, industries, firms, and individuals. This appendix describes the general characteristics of this tax bill--changes in the tax rate structure and broadening of the tax base, and preliminary revenue estimates. A more detailed comparison of the provisions of the proposed tax code with current law, along with effective dates of major provisions, is included as table 2.

Changes in the individual and corporate income tax rate structure

A key element of the proposal is a dramatic lowering of marginal tax rates. The top legislated rate for individuals will be cut from 50 percent to 28 percent when the new rates are fully effective in 1988, and tax brackets will be substantially broadened and reduced in number from 14 to two (plus some surtax "brackets" that phase out the benefits of several provisions available to lower income taxpayers). As indicated in table 1, many upper income individuals will face a 33 percent marginal tax rate because the tax benefits of the 15 percent bracket and personal exemptions are phased out at higher income levels, adding five percentage points to the 28 percent top rate beginning with taxable incomes of $71,900. And the phase-out at higher income levels of the benefits of certain real estate tax-shelter write-offs (not shown in table 1) could raise marginal tax rates for some taxpayers to 49.5 percent. A transitional rate schedule for 1987, also shown in table 1, represents around two-thirds of the rate cut for 1988.

Higher tax rates will apply to other selected income items. The top rate for realized capital gains income will increase from 20 percent

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

to 28 percent (or possibly 33 percent and higher if one or more of the various phase-outs are in effect) owing to the repeal of the capital gains exclusion. Many individuals will face even larger increases in capital gains rates because they currently pay less than the top rate but will pay the top rate under the new law. The expansion of the alternative minimum tax to include more preferences and the increase in the tax rate from 20 percent to 21 percent also will raise marginal tax rates on some sources of income.

Corporations, too, will face sharply lower nominal tax rates, with a reduction of the top rate from 46 percent in 1986 to a 40 percent transitional top rate in 1987 and a new 34 percent top rate in 1988. The effect of the corporate rate cuts on capital spending decisions, however, will be modified by changes in capital cost recovery allowances. Specifically, the investment tax credit (ITC) is repealed and the rate at which investment can be written off against taxable income is slowed for many items. Indeed, effective tax rates[1] on new investment will rise for producers' durable equipment and rental housing. Effective tax rates for industrial structures will be little changed because lower nominal tax rates will about offset the slower depreciation write-offs; but will rise for many commercial structures because new restrictions on tax-sheltered partnerships will increase financing costs.

Base broadening provisions

Base broadening provisions, in addition to making up the revenue loss from the rate reductions, are intended both to improve the efficiency of the tax system by reducing its intrusion into economic choices and to enhance its equity. The individual tax base is broadened by including in taxable income a number of items that are now excluded from the tax base by law, and by limiting itemized deductions. Major exclusions are repealed or limited; affected provisions of current law include the two-earner deduction (marriage penalty relief), deductions for IRA contributions for many taxpayers (deferral of tax on IRA income remains), deferred compensation plans, unemployment compensation payments, the $100 dividend exclusion, and losses from passive tax shelters (of particular relevance for commercial and multi-family residential structures). The revenue loss from exclusion of tax-exempt bond interest income is reduced by the imposition of tighter restrictions on the issuance of tax-exempt private-purpose state and local bonds. Also repealed or scaled back are itemized deductions for state and local sales taxes, consumer interest, miscellaneous deductions, and most medical expenses.

Major new sources of corporate income tax revenues include the restructuring of capital consumption allowances and the repeal of the investment tax credit that were discussed above. Many of the other base

1. The effective tax rate on investment is the difference between the real before-tax rate of return and the real after-tax rate of return, divided by the before-tax rate of return.

broadeners that affect business tend to be industry specific. For example, completed contract accounting provisions will increase the tax payments of firms such as defense contractors that produce products under long-term contracts; financial institutions face new restrictions on deductions of interest to carry tax-exempt securities and on loan loss reserve deductions; various special deductions specific to the insurance industry are repealed rehabilitation credits for old buildings are reduced; and new restrictions are placed on private-purpose tax-exempt bond issuance.

The tax reform also raises some revenues from sources that are not strictly rate or base changes--stricter IRS enforcement and an acceleration of estimated tax payments, for example.

Revenue estimates

As shown below, tax reform will, if not offset by other fiscal actions, contribute to deficit reduction and be a restraining economic influence in 1987, will add to the unified deficit in 1988 and 1989, and will again become a restraining influence in 1990 and 1991. In the context of deficit reduction, tax reform will ease the job of hitting the Gramm-Rudman targets in 1987, but will significantly complicate the task in the following two years.

Revenue Effects of the Conference Agreement
on the Tax Reform Act of 1986
(Fiscal years, billions of dollars)

	1987	1988	1989	1990	1991	Total 1987 to 1991
Total revenue	11	-17	-15	9	12	0

Source: Preliminary Joint Committee on Taxation estimates.

Table 1

INDIVIDUAL INCOME TAX RATES IN THE TAX REFORM ACT OF 1986
(For filers of joint returns with 2 dependents)

Transitional Tax Rate Structure for 1987

Taxable Income Class	Proposed Tax Rate	Present Law Tax Rates
0 - $3,000	11%	11% - 12%
3,000 - 28,000	15%	12% - 25%
28,000 - 45,000	28%	25% - 33%
45,000 - 90,000	35%	33% - 42%
Above 90,000	38.5%	42% - 50%

Permanent Tax Rate Structure Beginning in 1988[1]

Taxable Income Class	Proposed Tax Rate	Present Law Tax Rates
0 - $29,750[2]	15%	11% - 25%
29,750 - 71,900[2]	28%	25% - 42%
71,900 - 192,930[3]	33%	42% - 50%
Above 192,930	28%	50%

1. Brackets are indexed for inflation starting in 1989.
2. Most individuals would not pay higher taxes under the proposed rate schedules because increases in the standard deduction and personal exemption will reduce taxable income under the proposed law relative to what it would be under present law.
3. The phase-out of the 15 percent bracket for joint filers occurs over the $71,900 to $149,250 taxable income range. Personal exemptions are phased out beginning at $149,250 at the rate of $10,920 per exemption in 1988.

Table 2

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986[1]

	Current law	Conference Agreement	
Individual Taxes[2]			
Individual tax rate schedule	14 rate brackets: 11% to 50%; during 1986 50% bracket applies to incomes above $175,250 (on joint returns). Brackets indexed.	1987: 5 rate brackets: Rate — Taxable income bracket 11% — 0 - $3,000 15% — 3,000 - 28,000 28% — 28,000 - 45,000 35% — 45,000 - 90,000 38.5% — above 90,000	1988 and beyond: 2 rate brackets: Rate — Taxable income bracket 15% — 0 - $29,750 28% — above 29,750 The phase-out of the benefit of the 15% bracket for taxpayers with taxable income between $71,900 and $149,250 and the phase-out of personal exemptions at incomes above $149,250 would raise marginal rates to 33% over this income range (5% is added to the 28% top rate during both phase-outs; each personal exemption claimed would extend the range to which the 33% rate applies by $10,920 in 1988). Brackets indexed.
Personal exemption	$1,080 in 1986, indexed.	$1,900 in 1987, $1,950 in 1988, $2,000 in 1989. Indexed after 1989. Benefits of exemption phased out at at incomes above $149,250. Extra exemption for the elderly and blind replaced by larger standard deduction.	

1. Most provisions are effective in the tax year starting after December 31, 1986. This is denoted as "beginning in 1987" in the table. A summary of major effective dates appears at the end of this table.
2. Unless noted, the tax rates, allowances and limits shown in this table are for taxpayers filing a joint return. Different rates and limits may apply to single taxpayers, heads of households, and married taxpayers filing separate returns.

Table 2--con

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Income averaging	Yes	Repealed beginning in 1987.
Earned income credit	Refundable credit of 11% on first $5,000 of earned income. Credit is phased out over the $6,500 to $11,000 income range.	Refundable credit is increased to 14% of first $5,714 of earned income beginning in 1987. Credit is phased out over a higher income range ($9,000 to $17,000) beginning in 1988. Indexed.
Adjustments and exclusions:		
Two earner deduction	$3,000 maximum.	Repealed beginning in 1987.
Unemployment compensation	Taxed if adjusted gross income (AGI) is above $18,000 ($12,000 on single returns).	Included in income subject to tax beginning in 1987.
Business meals and entertainment expense	Deductible	Deduction limited to 80% of expenses. Other criteria for deductiblity become more stringent. Changes effective beginning in 1987.
Employee business expenses	Reduce adjusted gross income.	Added to miscellaneous itemized deductions; miscellaneous itemized deductions limited (with some exceptions) to the amount above 2% of adjusted gross income (AGI) beginning in 1987.
Retirement plans:		
IRA limit	$2,000	$2,000 deduction. Full deduction is limited to employees without qualified pension plan or having an AGI of less than $40,000; the deduction for workers with a pension plan is phased out between $40,000 and $50,000 in AGI. Workers who do not qualify to make deductible contributions can still make nondeductible contributions and have earnings accumulate on a tax deferred basis. Changes effective beginning in 1987.
Spousal IRA	$250	$250 deduction; same limits as above; beginning in 1987.

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Deferred compensation plans (401(k)).	$30,000 limit	$7,000 per year limit beginning in 1987. Indexed.
Standard deduction	1986 zero bracket amount is $3,670 ($2,480 for singles) Indexed.	$3,800 for joint returns ($2,570 single) in 1987; $5,000 for joint returns ($3,000 single) in 1988. Elderly and blind get additional $600 deduction ($1,200 if both elderly and blind). Indexed beginning in 1989.
Itemized deductions:		
State and local income, property and sales taxes	Deductible	State and local sales tax deduction is repealed; property, real estate and income taxes remain deductible.
Charitable contributions	Deductible for itemizers and nonitemizers in 1986.	Only for taxpayers who itemize deductions. The deduction for nonitemizers expires at the end of 1986 under present and proposed law.
Mortgage interest	Deductible	Deductible for principal residence and a second home. (Limited to interest on portion of principal that is below the purchase price of the home plus improvements.)
Other interest expense	Limited to $10,000 plus amount of investment income.	No consumer interest deduction (phased out over 4 years--35% of interest deduction is disallowed in 1987, 60% in 1988, 80% in 1989, 90% in 1990 and 100% in 1991). Use of mortgage debt to finance other purchases limited to tuition, medical expenses, and home improvements. Investment interest deduction limited to amount of investment income.
Medical expenses	Amount above 5% of AGI deductible.	Deduction limited to amount above 7.5% of AGI beginning in 1987.

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Miscellaneous deductions	Union dues, other expenses related to earning income deductible if itemized.	Combined with employee business expenses. Deduction limited to amount above 2% of AGI beginning in 1987.
Political contributions credit	Credit equal to half of contribution up to limit of $100 on joint returns.	Repealed beginning in 1987.
Passive losses	Losses from shelters that taxpayer does not materially participate in managing may offset portfolio and earned income.	Passive losses are deductible only against passive income, with some exceptions for oil and gas and certain rental housing. The benefits of the exceptions are phased out at higher income levels. The restrictions are phased in over a five year period beginning in 1987 (in 1987 35% of losses are disallowed, 60% in 1988, 80% in 1989, 90% in 1990 and 100% in 1991). In the case of rental real estate in which an individual actively participates, up to $25,000 of losses can be taken against nonpassive income; this amount is phased out between $100,000 and $150,000 of AGI. Rehabilitation and low-income housing credits (from passive investments) may offset up to $25,000 of nonpassive income, subject to a phase-out between $200,000 and $250,000 of AGI.
At-risk limits on deductions	Losses which can be deducted on most activities are limited to the amount a taxpayer has invested (including loans for which the taxpayer is personally liable). Holdings of real estate are excepted.	At risk limits are extended to real estate beginning in 1987.
Trusts, estates, and minor children		Unearned income of a minor child above $1,000 would be taxed at the parent's marginal tax rate. Clifford trusts are repealed. The "generation skipping" tax on transfers to grandchildren becomes less stringent.

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Capital gains of individuals:		
Capital gains exclusion	60% exclusion.	Capital gains exclusion is repealed effective January 1, 1987. Top rate limited to 28% in 1987 (despite higher transitional marginal tax rates).
Maximum capital gains tax rate:		
Short-term gains	50%	28%
Long-term gains	20%	28% (Rate will be higher over income ranges in which various phase-outs are in effect.)
Capital gains on sale of principal residence.	Can be rolled over into new residence, one-time exclusion of $125,000 by taxpayers age 55 or older.	Retained
Individual minimum tax	Alternative minimum tax with 20% rate.	Expands the list of preferences that are included in the minimum tax base; 21% tax rate. The following preferences are included in the tax base: accelerated depreciation on real estate, accelerated depreciation on personal property, intangible drilling costs, 60 month amortization on certified pollution control facilities, expensing of certain mining costs, percentage depletion, incentive stock options, tax-exempt nonessential function bonds, completed contract accounting, installment method of accounting, passive business losses, passive farm losses and charitable contributions of appreciated property. Effective beginning in 1987.
Corporate and Business Taxes		
Corporate tax rates	Graduated up to $100,000, 46% top rate.	Blended top rate of 40% in 1987. Fully phased-in top rate of 34% beginning in 1988. Reduced rate of 15% for profits below $50,000 and 25% between $50,000 and

Table 2--con

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Corporate tax rates (cont.)		$75,000. Benefits of reduced rate phased out over the $100,000 to $335,000 profit range by adding 5% to the top rate.
Dividend exclusion for individuals	$200 exclusion ($100 on single returns).	Exclusion is repealed beginning in 1987.
Corporate deduction for dividends received	85% deduction.	Deduction is reduced to 80% beginning in 1987.
Capital gains of corporations	28% maximum rate.	Preferential rate is repealed; 34% maximum rate (1987 rate is capped at 34% despite higher transitional corporate income tax rates).
Investment tax credit	6% credit for equipment in 3 year ACRS class. 10% credit for other equipment.	Investment tax credit is repealed retroactively to January 1, 1986. Beginning in 1988, carryovers are subject to a 35% reduction (17.5% in 1987).
Depreciation	Accelerated Cost Recovery System (ACRS): 3-year class: (autos, light trucks and some R.&D. equipment, for example) 150% declining balance schedule. 5-year class: (all personal property not included in other classes--majority of equipment is in this class) 150% declining balance schedule. 10-year class: (Public utility property with 18.5 to 25 year ADR life, mobile	Writeoffs for capital assets are generally slower than under present law. Equipment is classified into 6 classes with class boundaries keyed to the pre-ACRS, Asset Depreciation Range (ADR) system. There are 2 additional classes for real estate. 3-year class: All assets with an ADR midpoint life of 4 years and less, with the exception of automobiles and light trucks (special tools and some R.&D. equipment, for example). 200% declining balance schedule. 5-year class: Assets with an ADR midpoint life of more than 4 and less than 10 years, plus automobiles and light trucks and assorted "hi tech" equipment. 200% declining balance schedule. 7-year class: Assets with an ADR midpoint life 10 and more and less than 16 years and single purpose

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Depreciation (cont.)	homes, for example) 150% declining balance schedule. 15-year public utility class: (utility property with ADR life above 25 years) 150% declining balance schedule. 15-year real property class: (Low income housing) 200% declining balance schedule. 19-year real property class: (Buildings and structures) 175% declining balance schedule.	agricultural structures. Property with no ADR midpoint is not classified elsewhere. 200% declining balance schedule. 10-year class: Assets with an ADR midpoint life of 16 and more and less than 16 and 20 years. 200% declining balance schedule. 15-year class: Assets with an ADR midpoint life of 20 and more and less than 25 years and sewage plants and telephone distribution plants. 150% declining balance schedule. 20-year class: Assets with an ADR midpoint life of 25 years or more, other than real property with an ADR life of 27.5 years or more. 150% declining balance schedule. 27.5 year class: Residential rental real estate. Straight-line schedule. 31.5 year class: Nonresidential real property with an ADR life greater than 27.5 years. Straight-line schedule. In general the new depreciation rules will apply to investments made after December 31, 1986, but the taxpayer may elect to depreciate property that is placed in service after July 31, 1986 and not subject to special transition rules under the new schedules (which are more favorable than the old rules in certain cases).
Finance leasing	The fact that a lessee has a fixed price option on a property is not taken into account in determining whether a transaction is a lease.	Repealed beginning in 1987

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Corporate minimum tax	Add-on tax. 15% tax rate on certain preferences with exemption of $10,000 or regular tax paid.	Replaced by a new alternative minimum tax that applies to an expanded list of preferences. 20% rate. The following list of preferences is included in the minimum tax base: accelerated depreciation on real property, 60 month amortization of certified pollution control facilities, bad debt reserve deductions for financial institutions, percentage depletion, accelerated depreciation on personal property, certain mining expenses, intangible drilling expenses, expensing of certain research expenses, tax-exempt interest, excluded Foreign Sales Corporation income, completed contract and other methods of accounting for long term contracts, contributions of appreciated property, installment method of accounting and untaxed reported profits. In general, provisions apply beginning in 1987; treatment of private activity tax-exempt bond interest as preference applies to bond issued after August 7, 1986.
Employer funded pension and fringe benefit plans	In general, a qualified plan must cover all employees. This requirement is implemented through various nondiscrimination rules which limit the degree to which highly compensated employees, officers and owners may be favored.	Minimum standards for qualified plans are modified by tightening coverage requirements, minimum participation requirements and other nondiscrimination rules. Most provisions effective beginning in 1989.
Accounting provisions:		
Deferral of income from installment sales	Yes	The installment method is limited if receivables are pledged beginning in 1987 (with some transition rules).
Cash method of accounting	Permitted for firms without inventories.	The cash method is disallowed for most corporations; it is still permitted for qualified personal services corporations, farming businesses and entities with less than

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Cash method (cont.)		$5 million in gross receipts. Effective beginning in 1987.
Long-term contracts	Income can be deferred until contract is completed.	Benefits of the completed contract method of accounting are curtailed; in part by making firms that use this method capitalize some costs; other details to be worked out by JCT staff.
Capitalization rules for inventories, construction and development costs	Costs of producing "inventory" goods generally are not deductible until goods are sold. Interest cost are generally deductible as they are incurred; some construction period interest must be capitalized.	New capitalization rules would require additional inventory costs, some interest expenses, and costs of self-constructed property to be capitalized. Effective beginning in 1987.
Bad debt reserves	The reserve method allows a current deduction for a portion of the debts that are expected to become uncollectible.	Bad debt reserves are disallowed for all but financial institutions. Bad debts can be deducted only as they occur. Effective beginning in 1987.
Mergers and acquisitions:		
General Utilities doctrine	Under the General Utilities rule (named after a Supreme Court case) a corporation does not recognize any gains or losses for tax purposes if it is sold or distributes its assets.	General Utilities is repealed, i.e. a gain or loss, based on the fair market value of the company, is realized by a corporation when it liquidates its assets in a sale or through distribution to shareholders. There are liberal transition rules.
Net operating loss carryovers	Loss carryovers are reduced to different degrees depending on whether purchase	New rules limit the use of net operating loss carryovers by a new owner. Applicable to changes of ownership beginning in 1987.

Table 2--cont

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Net loss carryovers (cont.)	takes form of taxable exchange or a tax-free re-organization.	
Industry specific provisions:		
Agriculture	Certain soil improvement and develpment costs can be expensed; liberal accounting rules apply to preproduction period expenses.	Soil improvement and development can be expensed only if a part of an approved Department of Agriculture plan; stricter accounting and capitalization rules apply. Generally effective in 1987.
Oil and energy industry:		
Percentage depletion	Available to small independent producers.	Retained.
Intangible drilling costs	May be expensed.	Integrated oil and gas companies must amortize 30% of intangible drilling costs beginning in 1987.
Energy credits	Solar energy credits of up to 15% and a motor fuels tax exemption for alcohol fuels.	Credits are extended at reduced rates for the next two years.
Timber	Special capital gains treatment and other special rules.	Top capital gains tax rate on timber conforms to top capital gains rate for other assets; other special rules are retained.
Financial institutions:		
Bad debt reserves	Special deduction	Special deduction is eliminated for banks with more than $500 million of assets. There is an exception for for troubled banks. Effective beginning in 1987.

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Deduction for interest to carry tax-exempts	Yes	Sharply restricted for banks, an exception is provided for holdings of small issuers. Effective beginning in 1987 with respect to securities acquired after August 7, 1986.
Insurance companies:		
Special life insurance deductions	Life insurance companies are allowed a special deduction equal to 20% of their life insurance income.	Special deduction is repealed beginning in 1987.
Property and casualty reserve deductions	Property and casualty companies may deduct expected losses from income as they occur, rather than when actually paid.	Payments to reserves for incurred, but unpaid, losses have to be discounted. Effective for taxable years beginning after 1986.
Blue Cross and Blue Shield	Exempt from corporate tax.	Exemption repealed beginning in 1987.
Real Estate:		
Rehabilitation tax credits	Rehabilitation credit of 25% available for certified historical buildings, 20% for buildings older than 40 years and 15% for older than 30 years.	Credit for rehabilitation of historical buildings is is reduced to 20%. Other credits replaced by 10% credit for rehabilitation of structures built before 1936. Effective beginning in 1987.
Low-income rental housing	Incentives for low-income housing include preferential depreciation schedules for new construction and rehabilitation and special treatment of construction period taxes and interest.	Replaced by new credits for reconstruction and rehabilitation. Credit effective for property placed in service after December 31, 1986 and before January 1, 1990.

Table 2--cont

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1986

	Current law	Conference Agreement
Other real estate provisions		As noted above, writeoff periods for real estate have lengthened, at-risk rules are extended to real estate, and new restrictions have been placed on interest deductions and passive losses.
State and local bonds	Tax-exempt; volume limits on private purpose bonds; excess arbitrage profits on private purpose bonds must be refunded to the Treasury.	Direct limit on tax exemption for banks; limit on exemption for others because some tax exempt bond interest is included in the base of the corporate and individual minimum tax. State volume limits for private purpose bonds are sharply curtailed over 2 years. New arbitrage limits are set for public and private purpose bonds. Provisions generally apply to bonds issued after August 15, 1986, except for provisions and bonds covered by the Joint Statement on Effective Dates of March 14, 1986 which will be effective on September 1, 1986.
<u>Foreign provisions</u>		Numerous special provisions having comparatively small revenue losses.
<u>Compliance</u>		
Estimated tax payments (individual)	Lesser of 100% previous year's liability or 80% of current year's liability.	Lesser of 100% of previous year's liability or 90% of current year's liability beginning in 1987.
IRS enforcement		Many fees and penalties are increased. Information reporting requirements are expanded.
<u>Effective dates</u>		Generally January 1, 1987. Personal rates reduced in 2 stages--on January 1, 1987 and January 1, 1988. Other provisions increasing tax liabilities are phased in; often over a 5 year period. Depreciation changes are effective January 1, 1987. The repeal of the investment tax credit is retroactive to January 1, 1986. Various tax-exempt bond provisions apply to bonds issued after August 15, 1986. Some transition rules are still being worked out by JCT staff.

DOMESTIC FINANCIAL DEVELOPMENTS

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

	1984	1985	1986			Change from:	
	Highs	March highs	April Lows	FOMC Aug. 19	Sept. 16	April Lows	FOMC Aug. 19
Short-term rates							
Federal funds[2]	11.63	8.58	6.95	6.33	5.83	-1.12	-.50
Treasury bills[3]							
3-month	10.67	8.80	5.77	5.56	5.13	-.64	-.43
6-month	10.77	9.13	5.81	5.57	5.33	-.48	-.24
1-year	11.13	9.25	5.79	5.56	5.44	-.35	-.12
Commercial paper							
1-month	11.42	8.94	6.42	6.11	5.80	-.62	-.31
3-month	11.35	9.12	6.30	5.96	5.74	-.56	-.22
Large negotiable CDs[3]							
1-month	11.52	8.89	6.51	6.03	5.75	-.76	-.28
3-month	11.79	9.29	6.39	5.93	5.74	-.65	-.19
6-month	12.30	9.92	6.35	5.92	5.75	-.60	-.17
Eurodollar deposits[4]							
1-month	11.89	8.89	6.59	6.33	5.90	-.69	-.43
3-month	12.20	9.58	6.55	6.26	5.79	-.76	-.47
Bank prime rate	13.00	10.50	8.50	8.00	7.50	-1.00	-.50
Intermediate- and long-term rates							
U.S. Treasury (constant maturity)							
3-year	13.49	11.22	6.49	6.38	6.66	.17	.28
10-year	13.99	12.02	6.98	7.02	7.53	.55	.51
30-year	13.94	11.97	7.14	7.19	7.67	.53	.48
Municipal revenue[5] (Bond Buyer index)	11.44	10.25	7.55	7.43	7.63	.08	.20
Corporate--A utility							
Recently offered	15.30	13.23	9.15	9.42e	9.57e	.42	.15
Home mortgage rates[6]							
S&L fixed-rate	14.68	13.29	9.86	10.23	9.96	.10	-.27
S&L ARM, 1-yr.	12.31	11.14	8.41	8.42	8.18	-.23	-.24

	1984	1985	1986	1986		Percent change from:	
	Lows	March Lows	Record Highs	FOMC Aug. 19	Sept. 16	Record Highs	FOMC Aug. 19
Stock prices							
Dow-Jones Industrial	1086.57	1247.35	1919.71	1862.91	1778.54	-7.35	-4.53
NYSE Composite	85.13	102.46	145.75	141.91	133.21	-8.60	-6.13
AMEX Composite	187.16	222.28	285.19	270.59	255.72	-10.33	-5.50
NASDAQ (OTC)	225.30	276.18	411.16	378.82	343.67	-16.41	-9.28

1. One-day quotes except as noted.
2. Averages for two-week reserve maintenance period closest to date shown. Last observation is the average for the maintenance period ending September 10, 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

Money market yields generally declined after the announcement on August 20 of another half-point cut in the discount rate. Although the size of the drop in short-term rates suggests that the System's action was not fully anticipated by the market, the easing step provided little if any boost to longer-term securities prices. Indeed, bond yields have increased noticeably in recent weeks, as traders have evidenced concerns about potential inflationary pressures, reportedly mirrored as well in commodity markets, and have viewed incoming data on economic activity here and abroad as suggesting a reduced likelihood of further easing actions by monetary authorities. The weakness in the bond markets has in turn contributed to a substantial decline in equity prices, in very volatile trading. Meanwhile, administered rates—notably the prime rate and primary mortgage rates—have declined on net, in response to earlier movements in market yields.

Growth in M2 and M3 was somewhat less rapid in August, but both measures remained around the upper bounds of their target ranges. Runoffs in small time deposits became more pronounced as investors moved to more liquid deposits on which offering rates have been comparatively sticky. M1 continued to expand extremely rapidly; all components grew briskly, but increases in NOW accounts were especially large.

The aggregrate debt of domestic nonfinancial sectors appears to have accelerated thus far in the third quarter. Net borrowing by nonfinancial firms probably picked up somewhat in August: bank loans and commercial paper strengthened; bond issuance remained substantial in August though slackening a bit in September; and mergers and other restructurings continued to extinguish large amounts of outstanding equity shares. Municipal bond offerings

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

	1984:Q4 to 1985:Q4	1986 Q1	1986 Q2	1986 June	1986 July	1986 Aug^p	Growth from Q4 1985 to Aug. 1986^p
	------ Percentage change at annual rates ------						
1. M1	11.9	7.7	15.8	14.8	16.7	20.2	14.4
2. M2	8.7	4.3	10.5	9.4	12.9	10.4	8.9
3. M3	7.7	7.6	9.0	8.6	13.0	8.3	9.0
							Levels in billions of dollars Aug. 1986^p
Selected components							
4. Currency	7.5	7.5	6.2	6.1	5.4	10.1	179.0
5. Demand deposits	8.6	3.0	15.2	14.1	14.3	13.7	291.6
6. Other checkable deposits	22.3	15.0	25.8	24.0	29.5	38.3	210.4
7. M2 minus M1[2]	7.7	3.3	8.7	7.7	11.6	7.2	2035.1
8. Overnight RPs and Eurodollars, NSA	20.0	5.9	-1.8	-48.6	99.5	38.4	74.1
9. General purpose and broker/dealer money market mutual fund shares, NSA	9.3	10.9	27.1	24.8	13.4	4.8	200.2
10. Commercial banks	9.1	7.2	5.8	7.5	6.1	4.7	875.7
11. Savings deposits, SA, plus MMDAs, NSA[3]	19.0	8.7	13.2	21.4	15.3	19.3	500.2
12. Small time deposits	-0.6	5.3	-3.1	-9.7	-5.7	-14.2	375.8
13. Thrift institutions	5.1	4.3	7.3	7.2	7.3	3.5	891.3
14. Savings deposits, SA, plus MMDAs, NSA[3]	13.7	1.3	13.8	24.9	17.7	16.2	390.2
15. Small time deposits	-0.4	6.6	2.6	-5.7	-0.5	-6.2	501.1
16. M3 minus M2[4]	3.8	20.7	3.4	5.2	13.6	-0.4	676.1
17. Large time deposits	5.7	15.6	-1.9	-3.2	0.8	4.6	447.1
18. At commercial banks, net[5]	5.1	18.5	-8.8	-4.3	-3.4	6.0	281.1
19. At thrift institutions	6.8	10.0	11.0	-2.2	8.0	2.2	166.0
20. Institution-only money market mutual fund shares, NSA	11.1	26.8	39.2	-17.3	40.0	51.1	80.8
21. Term RPs, NSA	-4.0	46.3	19.3	21.0	-9.5	9.6	75.5
22. Term Eurodollars, NSA	-4.9	8.7	6.0	9.0	-14.9	0	79.5
	--- Average monthly change in billions of dollars ---						
MEMORANDA:							
23. Managed liabilities at commercial banks (24+25)	2.5	7.7	-5.4	-3.7	1.9	4.7	479.1
24. Large time deposits, gross	1.0	3.4	-2.6	-0.6	-1.4	4.2	342.6
25. Nondeposit funds	1.5	4.3	-2.8	-3.1	3.3	0.5	136.5
26. Net due to related foreign institutions, NSA	0.4	2.2	-1.7	-2.3	-5.8	-1.3	-31.5
27. Other[6]	1.1	2.2	-1.2	-0.8	9.1	1.8	168.0
28. U.S. government deposits at commercial banks[7]	0.2	-0.6	0.9	-2.8	-3.8	-1.6	13.1

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 July and August 1986 at rates of 22.9 percent and 30.6 percent, respectively. At thrift institutions, savings deposits excluding MMDAs increased during July and August 1986 at rates of 22.3 percent and 17.0 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.
p--preliminary

were exceptionally heavy in July and August, but the volume has dropped off sharply since then in light of proposed tax reform restrictions. Federal borrowing has remained strong in the third quarter. Overall, household debt growth shows little sign of abating and may have strengthened some this quarter; available evidence suggests net mortgage lending is continuing at a brisk pace, and incentive programs for automobile loans likely will boost consumer installment debt appreciably in September.

Monetary Aggregates and Bank Credit

M1 accelerated to a 20 percent annual rate of increase in August, which pushed it further beyond its 1986 target range. Demand deposits and currency rose at double-digit rates, but the expansion was paced by continued strong inflows to other checkable deposits (OCDs). Yield spreads between OCDs and less liquid alternatives were already relatively small, and additional narrowing to the 1/4 to 1/2 percentage point range helped propel OCD growth to almost a 40 percent annual rate.[1]

RECENT BEHAVIOR OF THE OPPORTUNITY COST OF NOW ACCOUNTS
(Last Wednesday of month)

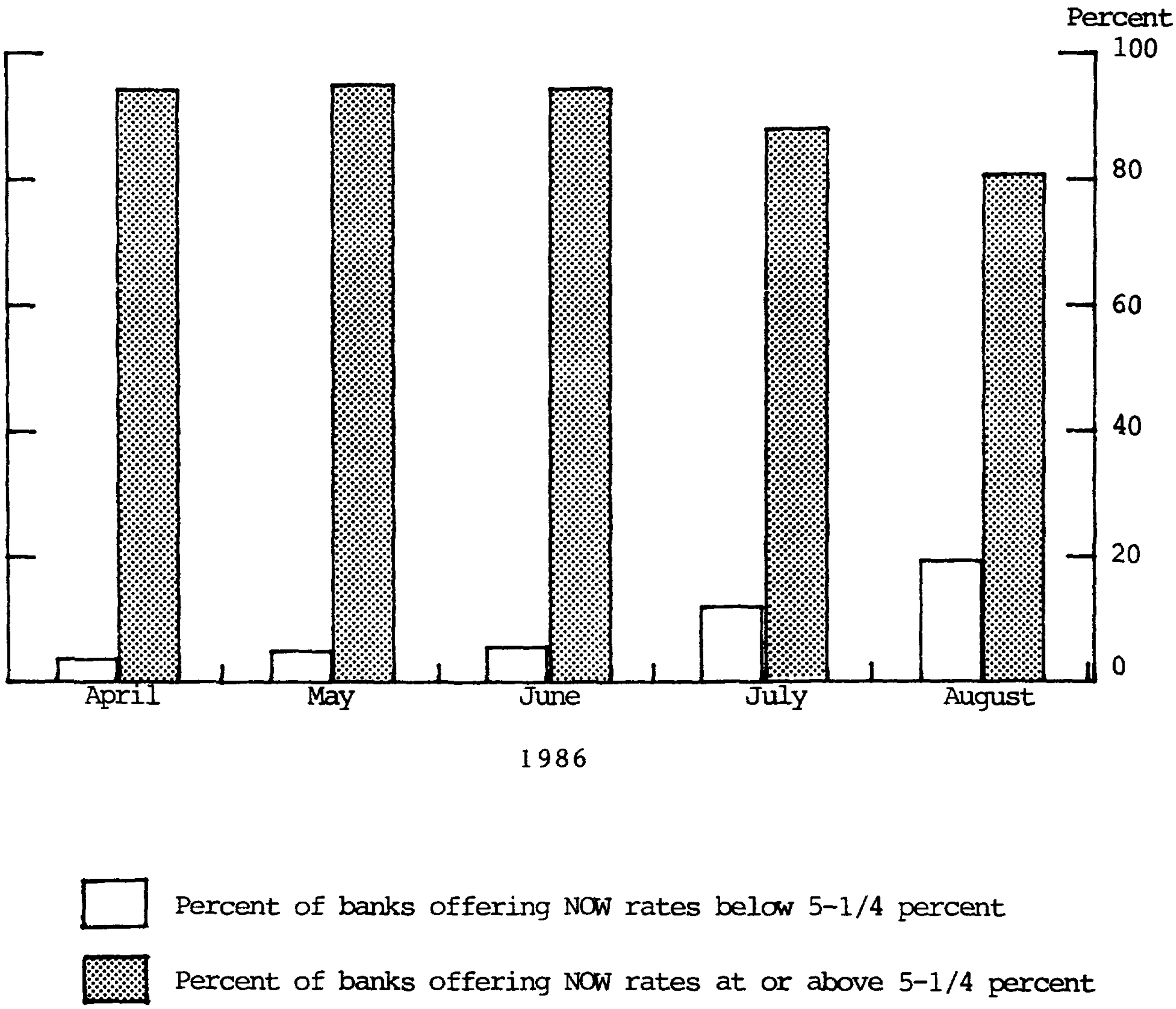
	Opportunity cost, in basis points, relative to:			Memo:
	6-month Treasury bill	Commercial bank 6-month small time	MMDA	OCD growth rate[1]
1986-Q2	97	98	61	26
July	78	78	38	30
August	30	47	24	38

1. Percent growth over previous period at an annual rate.
Source: Federal Reserve survey of a sample of commercial banks.

Between January of this year (when NOW rates were deregulated) and August, the average rate paid by commercial banks on NOW accounts fell only 1/2

1. For some depositors, these spreads are negative. For example, at several large banks in California, New York City, and Chicago, NOW account rates equal or exceed the rates offered on MMDAs. At banks with this pricing strategy, NOW balances have grown faster than the national average.

DISTRIBUTION OF NOW ACCOUNT OFFERING RATES
AT COMMERCIAL BANKS



percentage point while short-term market interest rates dropped roughly 2 percentage points. The proportion of banks paying rates below the discontinued 5-1/4 percent ceiling had risen substantially as of August, but it still was only 19 percent.

A deceleration in its nontransactions component produced a slight reduction in the overall growth of M2 to an annual rate of 10-1/2 percent in August. Growth of overnight RPs, Eurodollars, and money market mutual funds slowed, and runoffs of small time deposits picked up. Expansion of MMDAs and savings deposits remained strong, however, reflecting preferences for relatively liquid monetary assets within M2 as a whole. Like NOW accounts, these more liquid deposits have been available at only a small sacrifice in yield relative to small time deposits. For example, at commercial banks in August, the spread between average offering rates on MMDAs and on 6-month small time deposits was less than 1/4 percentage point. In the case of passbook accounts, the tendency for spreads to narrow has been reinforced by a reluctance to cut rates below former ceilings for fear of sensitizing long-time depositors to the availability of competitive instruments.[1]

M3 growth moderated in August to an 8-1/4 percent annual rate. Large CDs decelerated at thrifts, but they advanced somewhat at banks after several months of declines. M3 money funds recorded strong growth; these funds, which are held by institutions that tend to be quite sensitive to

1. Experience suggests that savings rates may not be lowered quickly even if they exceed market rates. Rates on Treasury bills fell as much as 60 basis points below the then 5-percent passbook ceiling for eight consecutive months from 1976 into 1977, but very few banks lowered their offering rates below 5 percent.

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

		1985	1986					Levels in bil. of dollars
		Q4	Q1	Q2	June	July	Aug.p	Augustp
		Commercial Bank Credit						
1.	Total loans and securities at banks	11.5	9.3	3.9	3.8	13.0	13.7	2007.6
2.	Securities	19.9	2.0	4.9	6.3	34.3	29.8	483.2
3.	U.S. government securities	-3.5	-5.3	7.9	3.1	46.3	23.5	291.0
4.	Other securities	62.5	12.8	0.7	11.2	16.3	39.3	192.2
5.	Total loans	8.9	11.6	3.6	3.0	6.5	8.7	1524.4
6.	Business loans	6.0	5.3	2.1	4.7	0.0	3.5	510.2
7.	Security loans	4.0	101.7	-62.0	-100.9	64.9	-18.8	44.1
8.	Real estate loans	12.6	13.0	13.4	11.6	13.8	13.7	461.1
9.	Consumer loans	8.5	11.0	6.7	5.0	4.3	5.1	306.9
10.	Other loans	10.2	7.3	-1.6	-0.6	-3.0	22.4	202.1
		Short- and Intermediate-Term Business Credit						
11.	Business loans net of bankers acceptances	6.1	5.2	1.0	3.6	0.7	3.3	505.2
	Loans at foreign branches[2]	-16.5	0.0	-21.5	-26.7	34.1	-19.9	17.8
13.	Sum of lines 11 & 12	5.2	5.1	0.2	2.5	1.6	2.5	523.0
14.	Commercial paper issued by nonfinancial firms[3]	55.5	-14.4	-10.3	13.1	-21.6	60.1	85.9
15.	Sums of lines 13 & 14	11.9	2.1	-1.2	4.0	-1.6	10.3	608.9
16.	Bankers acceptances: U.S. trade related[4,5]	-30.8	-6.2	16.3	25.8	14.5	n.a.	33.6
17.	Line 15 plus bankers acceptances: U.S. trade related	9.5	1.8	-0.4	5.1	-0.8	n.a.	637.3 (July)
18.	Finance company loans to business[4]	19.2	16.4	3.8	-2.3	2.3	n.a.	158.8 (July)
19.	Total short- and intermediate-term business credit (sum of lines 17 & 18)	11.3	4.5	0.5	3.8	-0.5	n.a.	796.0 (July)

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.

relative rate movements, typically expand during a decline in market rates because their yields lag the fall in other rates.

The surge in bank credit that began in July continued in August, paced again by expanded securities holdings. During the month, banks acquired sizable amounts of both government and municipal securities. They continued to add munis to their portfolios even after August 7, for while they are slated to lose their existing tax deduction for the cost of carrying tax-exempt securities bought after that date, this provision of the tax reform bill will not become effective until next year. Bank loans to businesses, which had been flat in July, rose a little in August. Real estate loans continued to rise rapidly, and consumer loan growth remained restrained.

Business Finance

In addition to borrowing at banks, nonfinancial firms in August raised $4 billion through the issuance of commercial paper, reversing much of the decline in outstandings earlier this year. Only a minor portion of this paper was associated with merger programs, and increases in outstanding paper appeared to be widespread among issuers. Dealers could not pinpoint any general influences to account for the sudden jump in paper issuance.

Gross long-term debt offerings also picked up in August from July, but volume was still below the record second-quarter pace. Although rates subsequently backed up, declines in yields during August to the lowest levels since early spring induced a resurgence in refunding issues, especially by utilities. The increase in high-grade utility volume helped offset a decrease in low-grade debt offerings by industrial firms. After LTV declared bankruptcy in July, the market for other low-rated bonds

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

	1985 Year	1986 Q1	1986 Q2p	1986 June p	1986 July p	1986 Aug. p
Corporate securities - total[1]	16.09	27.86	30.59	28.93	23.90	26.37
Public offerings in U.S.	12.94	23.84	26.43	26.00	20.80	23.30
Stocks--total[2]	2.96	4.46	5.72	5.04	4.00	5.20
Nonfinancial	1.61	2.20	2.82	2.20	2.60	2.50
Utility	.37	.65	.61	.70	.60	.90
Industrial	1.24	1.55	2.21	1.50	2.00	1.60
Financial	1.35	2.26	2.90	2.84	1.40	2.70
Bonds—total[1]	9.99	19.38	20.71	20.96	16.80	18.10
Nonfinancial	5.21	9.99	12.27	10.58	8.40	9.80
Utility	1.51	3.30	4.30	3.00	2.45	4.20
Industrial	3.70	6.69	7.97	7.58	5.95	5.60
Financial	4.78	9.39	8.44	10.38	8.40	8.30
By quality[3]						
Aaa and Aa	2.35	5.45	6.32	7.18	3.40	5.98
A and Baa	4.58	7.72	6.13	4.96	4.64	7.00
Less than Baa	1.42	2.75	4.65	4.49	4.33	2.01
No rating (or unknown)	.34	.30	.38	.38	.45	.45
Memo items:						
Equity-based bonds[4]	.70	1.16	1.26	.72	1.09	.76
Mortgage-backed bonds	1.30	3.16	3.23	3.95	3.98	2.66
Variable-rate notes	.87	.33	.56	1.17	.97	.32
Bonds sold abroad - total	3.15	4.02	4.16	2.93	3.10	3.07
Nonfinancial	1.26	2.04	2.07	.77	1.15	.72
Financial	1.89	1.98	2.09	2.16	1.95	2.35

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.

deteriorated, and spreads between yields of low-grade and investment-grade bonds widened on average 1/4 to 1/2 percentage point.

The underlying financing gap of nonfinancial corporations appears to be narrowing in the third quarter because of weak investment spending, although cash flow, which had been rising sharply through last year's third quarter, has since fluctuated around lower levels. The primary spur to business borrowing continues to be the large volume of equity retirements from mergers and share repurchases. These equity retirements likely will be larger in the second half of this year than in the first, perhaps boosted by tax reform provisions that make some aspects of mergers more advantageous this year than next.[1]

Most stock indexes hit new highs during the intermeeting period before plunging about 9 percent in last week's sell-off. Issues of potential takeover targets did well during the upswing, as did those of petroleum firms. Share prices of Texas banks also rose, benefitting from firmer oil prices and from legislation facilitating takeovers by out-of-state banks. The subsequent price declines were widespread, encompassing blue chips as well as smaller capitalization issues.

Initial public offerings (IPOs) of shares were very large in August, and dollar volume for the year should surpass the 1983 record. More than one-fourth of last month's IPO volume came from thrift institutions converting from mutual to stock ownership. New regulations by the Federal

1. Higher tax rates on capital gains beginning in 1987 may spur firms that are considering share repurchases or sale of the business to complete the transaction this year. In addition, proposed tax legislation would repeal the General Utilities rule. Under this principle, the assets of an acquired company can be revalued to reflect their purchase price, and the acquiring corporation does not have to recognize the gain for tax purposes when subsequent distributions are made.

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

	Fiscal Year 1986e	Calendar Year 1986 Q3e	Aug.p	Sep.e	Oct.e
Treasury financing					
Combined surplus/deficit(-)	-224.1	-57.2	-30.7	-4.3	-26.9
Means of financing deficit:					
Net cash borrowing from the public	233.5	55.0	20.1	19.9	16.7
Marketable borrowings/ repayments(-)	188.4	50.0	17.3	20.3	15.7
Bills	26.2	13.7	2.9	6.7	6.7
Coupons	162.2	36.3	14.4	13.6	9.0
Nonmarketable	45.1	5.0	2.8	-.4	1.0
Decrease in the cash balance	-9.8	-2.3	10.4	-16.5	7.7
Memo: Cash balance at end of period	26.9	26.9	10.4	26.9	19.2
Other[2]	.4	4.5	.2	.9	2.5
Federally sponsored credit agencies, net cash borrowing[3]	13.1	5.5	2.9	1.0	1.2
FHLBs	15.2	6.0	3.2	1.3	1.0
FNMA	1.5	.7	-.4	.2	.1
Farm Credit Banks	-6.4	-1.7	*	-1.0	-.4
FHLMC	-.2	.2	.1	.1	.2
SLMA	3.0	.3	*	.4	.3

p--preliminary e--staff estimate *--less than $500 million.
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.

Home Loan Bank Board have eased the stock conversion process; these conversions and the resulting stock issuance may have been spurred by tougher capital standards recently approved by the FHLBB.

Treasury and Sponsored Agency Financing

The combined deficit of the federal government is estimated by the Board staff at $57 billion in the third quarter, bringing the deficit for fiscal year 1986 to $224 billion. The $32 billion increase in the debt ceiling passed in mid-August will provide room for normal financings through the balance of the quarter, but in early October the Treasury likely will exhaust this expanded debt authority along with the small amount of remaining borrowing authority of the Federal Financing Bank.[1] Without congressional action, the Treasury once again will have to alter its normal financing pattern or delay the issuance of nonmarketable securities to the government trust funds. Indeed, the Treasury has already postponed the auction of 7-year notes that would be expected to settle early in October.

Issuance of nonmarketable debt has been much heavier in this fiscal year than previously. With sizable refunding activity by state and local governments, the net increase in special nonmarketable securities (SLGS) is estimated to be about $40 billion in fiscal 1986, more than double the $20 billion in the previous fiscal year. Demand for SLGS is likely to be very small in fiscal 1987 as a result of new restrictions on tax-exempt bond issuance incorporated in proposed tax legislation. Issuance of savings bonds has been more than double the average pace of the past three fiscal years, although these instruments still provide only a small

1. The Treasury transferred to the Federal Financing Bank $13.7 billion of securities it had previously issued to the government trust funds. The limit on such debt issuance by the FFB is $15 billion.

fraction of the Treasury's financing needs. With a minimum rate of 7-1/2 percent on bonds held at least five years, savings bonds have become attractive relative to deposit accounts and market instruments. In fact, the potential costliness of these obligations has led the Treasury to consider lowering or eliminating the minimum rate and to take little action to overcome spot shortages of the bonds.

Borrowing by the federally sponsored credit agencies continues to be dominated by the Federal Home Loan Banks, which are estimated to have raised $6 billion this quarter. Demand for advances from FHLBs by thrift institutions has been strong as these institutions have substituted advances for other managed liabilities. Fannie Mae is purchasing a large amount of mortgages in the secondary market, but its financing needs have been small as a result of both prepayments and its liquidation of some old, lower-rate mortgages from its portfolio. The Farm Credit Banks continue to pay down debt, given the weak demand for new loans by the farm sector.

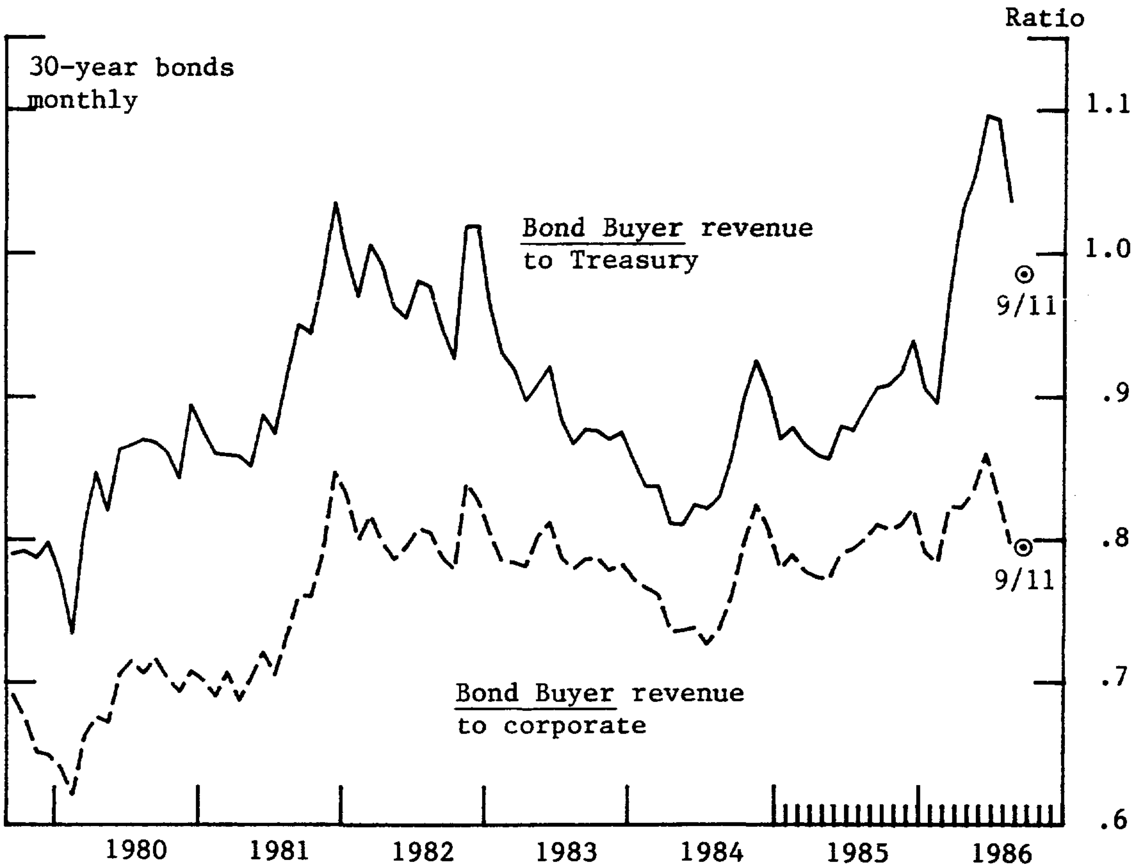
Interest rate spreads between outstanding sponsored agency securities and Treasury securities recently have narrowed somewhat. Earlier this summer, in response to heavy volume, spreads on longer-term issues of the FHLBs and Fannie Mae widened to about 75 basis points from the 30 basis point level typical in the first half of the year. As these seasoned securities have been absorbed by investors, spreads have narrowed to a range of 50 to 65 basis points, but a new 10-year issue of the FHLBs again had a spread of more than 70 points. Recent issues of the Farm Credit Banks have fared well. The latest 6-month security of the FCBs carried an interest rate spread of about 15 basis points, compared with spreads of 20 to 25 points in previous months. In general, legislation affecting the operations of the FCBs and FSLIC appears to be reassuring investors in the debt issues of sponsored agencies despite widespread awareness of credit problems in the agricultural sector and at some thrift institutions.

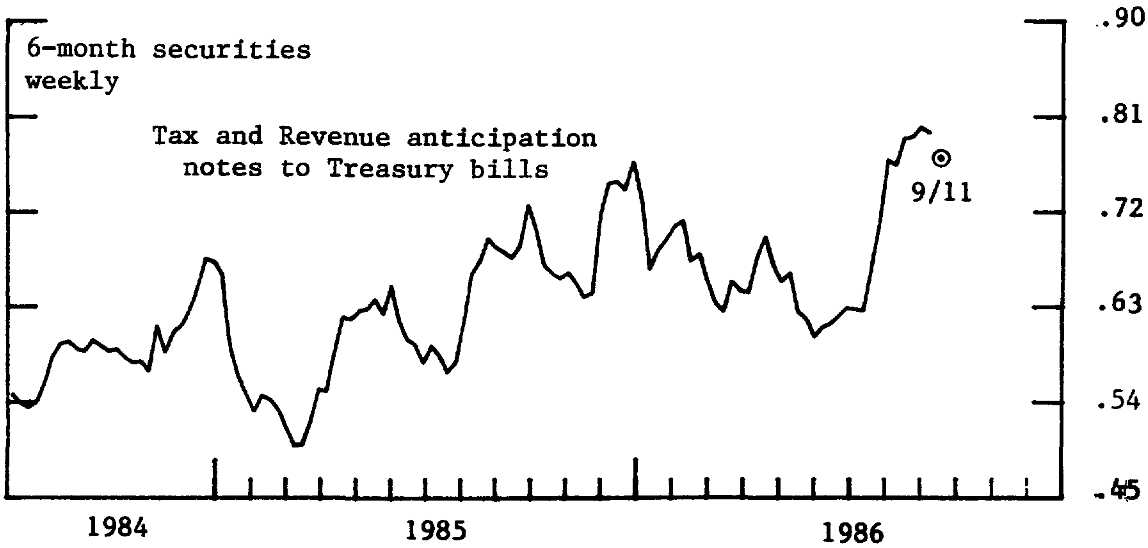
State and Local Securities Markets

After three months over which offerings of tax-exempt securities averaged more than $20 billion, volume has dropped sharply thus far in September in response to restrictions contained in proposed tax legislation. It appears that volume in September will be less than $5 billion. Earlier, issuers rushed to market to beat a variety of restrictions that would narrow the definition of public-purpose bonds, effective September 1. Other provisions of the tax reform bill would reduce existing volume caps on private-purpose bonds and further limit arbitrage and advance refunding opportunities on all tax-exempt offerings in future years, likely depressing supply. Provisions affecting demand are expected to have both negative and positive effects: incentives for commercial banks to hold tax-exempt securities would be reduced by elimination of the deductibility of interest expense incurred in carrying such investments,[1] and lower marginal tax rates should lessen the attractiveness of tax-exempt securities relative to taxables; but these factors may be offset by the elimination of many alternative tax shelters. On balance, most analysts expect demand to be strong relative to a diminished supply of tax-exempt debt, providing room for a reduction in ratios of tax-exempt to taxable yields from the high levels seen this summer.

1. Under the conference bill, banks will retain the 80 percent deduction for bonds issued by certain small governmental units and not-for-profit entities, in aggregate amounts of $10 million or less per year.

RATIOS OF TAX-EXEMPT TO TAXABLE YIELDS





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

	1985	1985	1986		1986		
	Year	Q4	Q1	Q2	June	July^p	Aug.^p
Total	19.82	37.69	4.93	15.89	17.54	25.05	22.93
Short-term[1]	1.97	.91	.64	3.09	4.93	5.22	.78
Long-term	17.85	36.78	4.29	12.80	12.61	19.83	22.15
Refundings[2]	4.84	9.40	2.06	5.38	4.43	6.67	6.97
New capital	13.00	27.38	2.23	7.42	8.18	13.16	15.18
Total housing	2.11	5.59	.05	.40	.76	.38	1.00

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

The ratio of long-term tax-exempt to taxable yields rose steadily over the first half of the year as a burgeoning supply of municipal offerings encountered investors reluctant to purchase tax-exempt securities owing to tax-reform uncertainties. Subsequently, more investors were drawn into the market as rates on some tax-exempt issues rose above those on Treasury bonds and as some investors developed expectations for capital gains after September 1 when supplies would contract. The ratios of the 30-year revenue bond index to comparable yields on Treasuries and corporate securities have fallen steadily since early July. The ratio of yields on short-term (6-month) tax-exempt notes relative to Treasury bill rates rose in August to 0.8, well above its average of 0.6 over the past year or so. The ratio is expected to fall back somewhat, and it showed signs of doing so in early September. However, it appears that some permanent upward adjustment of the ratio at the short end would be inevitable under tax reform, reflecting the reduced advantage of tax exemption with lower marginal tax rates.

Among investors, property and casualty insurance companies have again become active participants in municipal markets because of their renewed need to shelter profits. These firms returned to profitability during the first half of this year, largely the result of sizable increases in premium rates.[1]

Proposed volume and arbitrage restrictions contained in tax legislation have encouraged the issuance of a notable volume of taxable municipal securities. Taxable offerings by state and local governments, which were rarely seen before this year, totaled an estimated $2.5 billion in the first 8-1/2 months of 1986. Volume in September to date is $430 million, about the same as in all of August. The proceeds of most of this year's issues have been intended for private purposes, predominantly housing.

Mortgage Markets

During the intermeeting period, the cost of construction and land development loans at commercial banks generally fell in tandem with the 50 basis point cut in the prime rate, while interest rates on permanent mortgage financing retreated by smaller amounts. By early September, the contract interest rate on new commitments for fixed-rate home loans at S&Ls had fallen 33 basis points to 9.9 percent, near the recent low of April, before backing up a little in response to a pickup in secondary market yields. Commitment rates on adjustable-rate mortgages at S&Ls also have eased, but the share of loans closed with adjustable-rate features reportedly has remained small. At current rate levels, an initial rate advantage of ARMs

1. Property and casualty insurance company profits have been boosted this year both by substantially lower underwriting losses and by increased investment income.

relative to fixed-rate borrowing of well under 2 percentage points has not been sufficient to overcome the desire of mortgagors for stable payments.

Residential lending continued at a brisk pace throughout the summer. Large mortgage companies reported a continued, strong volume of applications during July and August, despite some slippage in refinancing requests. Mortgage originations at FSLIC-insured thrifts surged to an all-time high of $23.7 billion, seasonally adjusted, during July. Nevertheless, a high level of loan sales and a record pace of loan retirements held their net acquisition of mortgage loans to $1 billion. Total holdings of loans plus mortgage-backed securities at these institutions grew only $2.2 billion, the smallest monthly increase in more than a year.

A large volume of home mortgages has continued to be sold into the secondary market and packaged into pass-through securities. Gross issuance of mortgage pass-through securities that carry a GNMA, FHLMC, or FNMA credit enhancement totaled $22.6 billion during August, an amount exceeded only by the record volumes of June and July. The exceptional pace of pass-through issuance reflects the surge in fixed-rate lending during the spring and early summer as well as the packaging of seasoned mortgage loans into securities. Most notably, FNMA volume was boosted by $5.5 billion during the past five months from the sale of pass-throughs backed by seasoned FHA/VA loans that had been held in the corporation's portfolio. These sales are part of Fannie Mae's plan to restructure its balance sheet by selling $10 billion of low-yielding mortgages acquired before 1981.

Consumer Installment Credit

Consumer installment credit grew at about an 11-1/2 percent annual rate in July, the same pace as in June. Automobile credit, which accounted

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 r	19.2	7.0	7.5	4.7	8.5
1986-Apr.	15.3	6.9	5.6	2.8	5.8
May	17.7	5.9	7.4	4.5	8.7
June r	24.6	8.2	9.6	6.8	11.2
July r	25.3	10.2	8.9	6.1	10.0
Aug. p	22.6	6.8	9.0	6.8	11.1

r--revised. p--preliminary.

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

	Mortgage transactions		Net change in mortgage assets[1]		
	Originations (1)	Sales (2)	Total (3)	Mortgage loans (4)	Mortgage-backed securities (5)
1985-July	14.9	10.6	2.4	4.7	-2.3
Aug.	16.0	7.9	6.6	5.1	1.5
Sept.	17.0	10.0	9.5	4.0	5.5
Oct.	19.5	8.2	5.5	6.2	-.7
Nov.	18.6	13.1	3.4	3.1	.2
Dec.	20.2	8.3	5.5	4.4	1.1
1986-Jan.	18.4	11.1	5.1	3.2	1.9
Feb.	17.7	10.9	2.8	2.3	.5
Mar.	16.4	12.6	4.0	3.1	.9
Apr.	19.6	13.8	5.5	1.4	4.1
May r	20.3	18.0	8.2	1.3	6.9
June r	21.5	12.8	4.6	-.9	5.4
July p	23.7	14.6	2.2	1.0	1.2

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

for a disproportionate two-thirds of the June and July increases, rose at a 20 percent annual rate during those two months, largely the result of incentive financing programs by the auto manufacturers--programs considerably less attractive than those now in place. Growth in other forms of installment credit meanwhile has been moderate.

Various measures of debt payment problems indicate increased difficulties for consumers. Delinquency rates on both installment and mortgage debt rose in the second quarter (see table on page III-20). At commercial banks, the ratio of delinquent closed-end consumer installment loans rose to its highest level since late 1980 but still remained below the 1974-75 peaks. Credit card delinquencies soared to a record 3.23 percent. The rapid run-up in credit card delinquencies likely reflects past campaigns by many banks to increase their cardholder base and individual credit limits. Many bankers anticipated that they would experience substantial delinquencies from unseasoned credit card accounts, and they feel that the associated charge-offs are manageable given the ample rate margins. The System's survey of bank lending officials continues to show a broad enthusiasm for consumer lending.

CONSUMER INSTALLMENT CREDIT
(Seasonally adjusted)

	Percent change (at annual rate)						Net change (billions of dollars)		Memo: Outstandings (billions of dollars)
			1986		1986		1986		1986
	1984	1985	Q1	Q2	June r	July p	June r	July p	July p
Total[1]	20.6	18.0	11.8	12.2	11.5	11.4	5.39	5.38	573.0
Selected types									
Auto	18.7	19.3	15.3	15.4	20.0	19.5	3.64	3.63	226.2
Revolving	25.7	20.1	13.0	8.5	1.7	6.0	.18	.63	125.3
All other	19.7	15.6	7.8	11.0	8.6	6.1	1.57	1.12	221.5
Selected holders[1]									
Commercial banks	23.5	15.1	7.3	7.5	5.2	6.2	1.07	1.29	251.0
Finance companies	11.6	24.9	24.4	23.6	34.4	20.1	3.76	2.26	137.2
Credit unions	25.3	12.9	9.7	11.1	9.5	15.3	.62	1.00	80.1
Savings institutions[2]	37.7	37.8	14.5	19.3	2.1	13.9	.11	.70	61.0

1. Includes items not shown separately.
2. Savings and loans, mutual savings banks, and federal savings banks.
r—revised. p—preliminary.

CONSUMER DELINQUENCY RATES
(Delinquent loans as percent of total loans outstanding, seasonally adjusted)

			1985				1986	
	1983	1984	Q1	Q2	Q3	Q4	Q1	Q2
Installment loans, total	2.01	1.96	2.27	2.32	2.34	2.30	2.32	2.50
Credit card loans	2.24	2.18	2.42	2.51	2.81	2.93	2.86	3.23
Mortgages, 60+ days	1.77	1.81	1.96	1.86	1.89	1.90	1.95	2.01

Source: American Bankers Association; Mortgage Bankers Association.

INTERNATIONAL DEVELOPMENTS

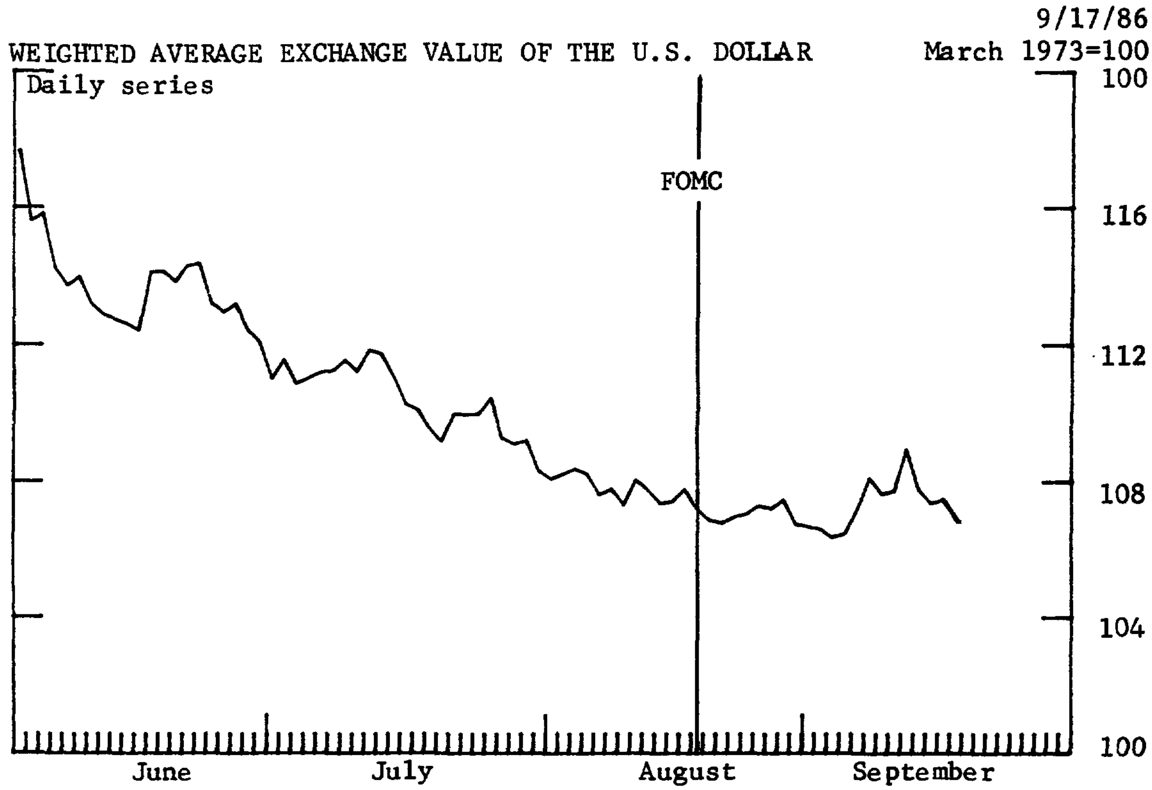
Foreign Exchange Markets

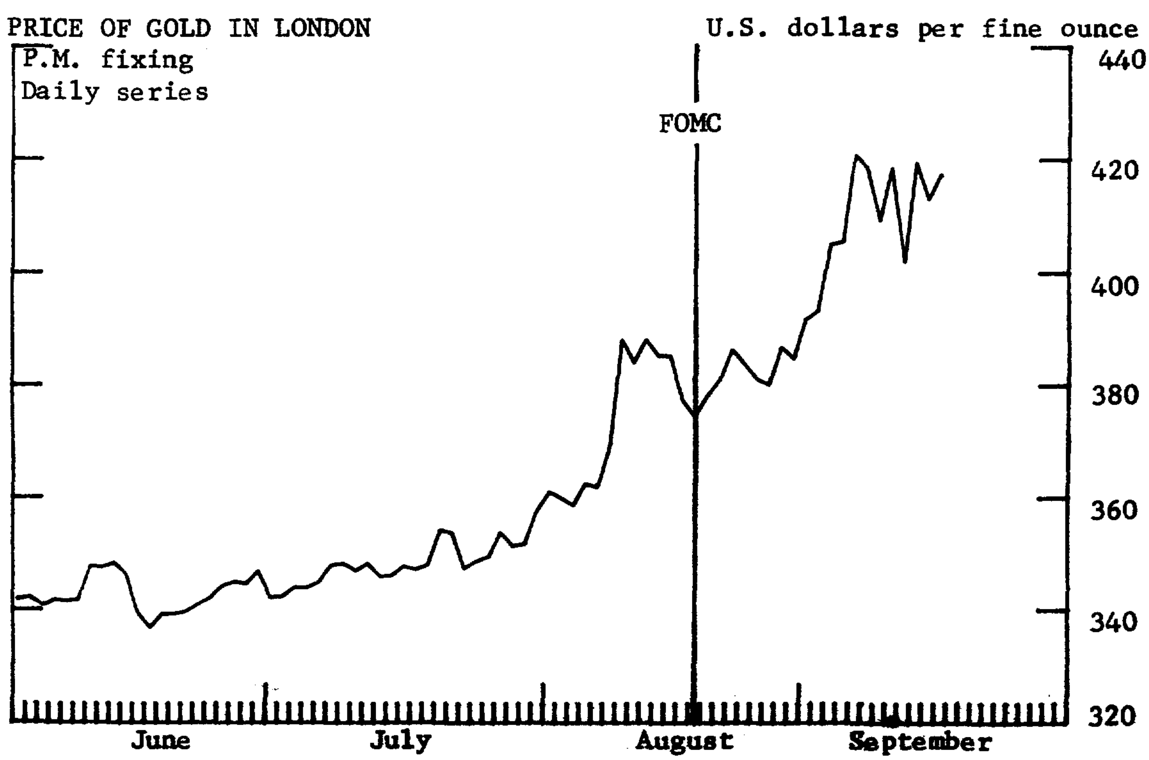
The weighted-average foreign exchange value of the dollar is about unchanged on balance since the last FOMC meeting, as shown in the upper panel of the chart. During the first two weeks of the intermeeting period the dollar generally was supported by expectations that Germany and perhaps Japan would lower interest rates, but declined sharply following the release of data showing a larger-than-expected U.S.-trade deficit in July. The dollar rebounded in response to additional U.S. economic data suggesting improved prospects for U.S. growth. Toward the end of the intermeeting period the dollar resumed its decline as the view emerged in the market that foreign authorities -- particularly in Germany -- would tolerate further dollar depreciation if the recent strength in domestic demand abroad proved insufficient to produce adjustment in the external accounts. This shift in opinion was prompted by

statements by German monetary authorities maintaining no need to add stimulus in the face of robust German economic activity. On a bilateral basis, the dollar's value rose about 1-1/2 percent against the yen and sterling but has depreciated 1-1/4 percent against the mark during the intermeeting period.

With foreign monetary authorities showing little inclination to follow the U.S. reduction in the discount rate, short-term interest rates abroad were about unchanged during the intermeeting period, while comparable U.S. interest rates declined about 20 basis points. Meanwhile, as the yield curve in the United States steepened, U.S.

Chart 1


9/17/86
WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR
March 1973=100
Daily series
FOMC
100
116
112
108
104
100
June
July
August
September


PRICE OF GOLD IN LONDON
U.S. dollars per fine ounce
P.M. fixing
Daily series
FOMC
440
420
400
380
360
340
320
June
July
August
September

long-term nominal interest rates moved up sharply relative to comparable foreign interest rates.

In other currency developments, the value of the Argentine austral in parallel exchange markets has fallen about 30 percent against the dollar since August 1. A significant deterioration in Argentina's inflation performance kindled selling pressure on the austral. The Argentine monetary authorities responded by stepping-up the pace of devaluations in the official exchange rate; since August 1, the controlled value of the austral has declined 9 percent including a 3 percent devaluation as part of a package of reforms introduced on August 29.

. The Canadian dollar's value firmed slightly in terms of the dollar, having received some support from repeated declarations by U.S. officials that an appreciation of the Canadian dollar was appropriate to resolve trade imbalances.

; episodes of selling pressure on the Australian dollar were prompted by skepticism regarding the economic assumptions in the budget and a downgrading of Australian debt issues by Moody's investment service.

•

Dollar prices of precious metals continued to move up sharply during the intermeeting period. As shown in the lower panel of the chart, since August 1, gold prices have risen 16 percent to a level of nearly $420 an ounce -- while the price of silver has climbed 13 percent. Meanwhile, platinum prices surged to a peak of $680 an ounce before retreating to a level of $570 -- registering an overall gain of 27 percent. Economic and political developments potentially affecting supply from South Africa and -- to some extent -- concern over prospects for inflation reportedly motivated the run-up in metals' prices.

U.S. International Financial Transactions

Foreign official assets in the United States increased again in July,

. The

increase in holdings was largely in the form of Treasury bills. Preliminary information available from the Federal Reserve Bank of New York indicates that official reserve accumulation by the G-10 countries and Switzerland continued strong in August. The data on official holdings in the United States for September are likely to reflect the proceeds of the $4 billion floating rate note issued by the United Kingdom in the Euromarket; the proceeds of the $2.5 billion floating rate note issued by the United Kingdom in 1985 were added to reserves in the United States.

Foreigners other than official reserve holders sold U.S. Treasury securities net in July. This result was more than accounted for by the World Bank; other private foreigners added almost $1.4 billion to their holdings. However, reported Japanese net purchases continued to be small, only $300 million in July, bringing total Japanese net purchases to $233 million for the first seven months of 1986.

Private capital inflows through other securities transactions continued to be large in July. Foreign net purchases of U.S. corporate bonds were almost $4 billion on a payments basis, and net purchases of corporate stocks were $1.8 billion. Japanese net purchases of both were unusually large for a single month: over $1 billion in bonds and $600 million in stocks. The data on Japanese purchases of U.S. corporate bonds are undoubtedly understated since purchases of Eurobonds through underwriters in Europe would be reported as sales to the country of the underwriter. Market commentary has indicated that Japanese institutional

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

	1984 Year	1985 Year	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June	1986 July
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	-1.9	4.1	0.9	2.2
Securities									
2. Private securities transactions, net	7.7	42.9	10.0	21.1	12.8	21.5	9.8	5.7	6.5
a) foreign net purchases (+) of U.S. corporate bonds	13.7	46.0	10.2	18.4	12.8	16.2	7.2	3.8	3.9
b) foreign net purchases (+) of U.S. corporate stocks	-0.9	4.8	1.4	4.0	6.1	6.9	2.7	0.5	1.8
c) U.S. net purchases (-) of foreign securities	-5.0	-7.9	-1.6	-1.4	-6.1	-1.6	-0.1	1.3	.8
3. Foreign net purchases (+) of U.S. Treasury obligations 1/	23.1	20.1	7.8	4.9	6.7	3.5	-0.9	1.6	-2.2
Official Capital									
4. Changes in foreign official reserve assets in U.S. (+ = increase)	2.4	-2.0	2.2	-1.5	2.2	13.9	1.2	4.3	4.5
a) By area									
G-10 countries (incl. Switz.)	3.1	-0.4	2.4	-3.3	3.9	11.0	1.5	2.8	6.5
OPEC	-5.6	-7.0	-2.3	-1.0	1.3	-2.4	-0.7	-1.5	-1.4
All other countries	4.9	5.3	2.1	2.9	-3.0	5.4	0.5	3.0	-0.6
b) By type									
U.S. Treasury securities	4.7	-0.9	-0.4	-2.0	3.3	14.5	3.7	3.8	6.0
Other 2/	-2.3	-1.1	2.6	0.5	-1.1	-0.6	-2.5	0.5	-1.4
5. Changes in U.S. official reserve assets (+ = decrease)	-3.1	-3.9	-0.1	-3.1	-0.1	-0.0	-0.2	0.1	0.5
Other transactions (Quarterly data)									
6. U.S. direct investment (-) abroad	-3.9	-18.8	-6.2	-10.1	-9.9	-5.3	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	25.4	17.9	6.1	2.4	1.4	3.8	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) 3/ 4/	6.8	6.6	-1.5	9.0	1.3	-6.8	n.a.	n.a.	n.a.
9. U.S. current account balance 4/	-106.5	-117.7	-28.5	-33.7	-34.0	-34.7	n.a.	n.a.	n.a.
10. Statistical discrepancy 4/	27.3	23.0	-1.3	5.1	10.3	6.0	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	-36.5	-36.0	-11.8	-11.3	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.

investors have been diversifying in response to the relatively low rate of return paid on U.S. Treasury securities.

Issuance of Eurobonds by U.S. corporations remained strong in August, although below peak rates reached in the spring. Floating rate notes enjoyed renewed popularity in July and August, with a substantial volume issued by U.S. Savings and Loan Associations and collateralized by GNMA-guaranteed mortgages.

Overall, banks reported a net inflow in July, despite substantial net outflows to affiliated banks outside the United States. As much as $9 billion of the increase in bank liabilities to foreigners in July and $5 billion in June are probably attributable to a change in the Treasury International Capital (TIC) reporting system which clarifies reporting responsibility, and not to capital inflows that occurred during those months. As of July, banks that book loans to U.S. corporations at their offshore offices must either send a written report to their corporate customers and the FRBNY (which acts as agent for the Treasury in collecting TIC data), notifying the corporations that they have reportable liabilities to foreigners, or the banks must themselves report liabilities of U.S. residents held in custody for banks outside the United States. It is these custody liabilities to banks in the Bahamas and British West Indies that have increased, mostly on the books of U.S.-based banks. Since Federal Reserve reports of credit extended to U.S. nonbank residents by foreign branches of U.S.-based banks show no increase during these months, it appears that the banks are now reporting loans that were made earlier and that previously were reflected in the positive statistical discrepancy in the accounts.

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1982 Dec.	1983 Dec.	1984 Dec.	1985 Dec.	1986 Mar.	1986 Apr.	1986 May	1986 June	1986 July	1986 Aug.
1. Net Claims of U.S. Banking Offices (excluding IBFs) on Own Foreign Offices	32.9	39.3	25.4	18.9	21.0	17.5	18.2	18.7	25.1	23.6
2. Net Claims of U.S. Banking Offices on Own IBFs 1/	16.2	5.2	7.8	10.1	1.0	11.4	6.5	8.1	7.5	9.0
3. Sum of lines 1 and 2 of which:	49.1	44.5	33.2	29.0	22.0	28.9	24.7	26.8	32.6	32.6
(a) U.S.-chartered banks	40.0	40.5	32.1	32.4	27.1	30.9	30.0	31.1	34.4	31.8
(b) Foreign-chartered banks	9.1	4.0	1.1	-3.4	-5.1	-2.0	-5.3	-4.3	-1.8	.8
4. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	15.8	18.6	20.7	18.7	17.6	18.1	18.0	17.7	17.9	17.9
5. Eurodollar Holdings of U.S. Nonbank Residents 2/	112.6	124.3	117.6	112.1	118.5	117.5	117.6	119.4	118.0	116.8

1. Corresponds to net claims of international banking facilities (IBFs) on all foreign residents, including all banks whether related or not, and all nonbanks.
2. Includes term and overnight Eurodollars held by money market mutual funds.
*/ 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.

Recently released data on U.S. international transactions for the second quarter indicate that the statistical discrepancy in the accounts continues to be large and positive. (See line 10 of the Summary of U.S. International Transactions table.) In addition, foreign direct investment in the United States (line 7) amounted to almost $4 billion in the second quarter, while U.S. direct investment abroad (line 6) fell to about $5 billion.

U.S. Merchandise Trade

Commerce Department figures on U.S. merchandise trade through July show (in column 8 of the table below) that the deficit in July was substantially larger than in previous months as imports rose sharply. The staff believes that much of the surge in imports will prove to be temporary. The rise in imports in July was spread among all major trade categories.

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)	(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	215	28	186	361	40	321	-146	-174
2	219	25	195	363	31	332	-144	-162
July	225e	24e	201e	405e	30e	375e	-180e	-216

e/ FR staff estimate.

The value of total exports in the second quarter was up 2 percent from first-quarter levels. However, a substantial increase in exports of gold masked declines in agricultural exports and many categories of nonagricultural trade particularly petroleum products, construction machinery, automotive parts to Canada, and chemicals. Part of the recent decline in agricultural exports may have resulted from an anticipation of price declines that would occur when U.S. support price levels for corn, wheat and cotton were reduced (on September 1, June 1, and August 1 respectively). Excluding gold exports, the volume of nonagricultural exports declined by 1/2 percent in the second quarter. Gold exports, nearly $13 billion at an annual rate 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. Nonagricultural exports to Western Europe, Canada, Mexico and the newly industrialized countries in the Far East were little changed from first-quarter levels.

On the import side, the value of total imports rose less than 1 percent in the second quarter. However, a sharp decline in oil imports was offset by an increase in imports of other items. The decline in the value of oil imports resulted from a nearly 40 percent drop in the price of oil that was partly offset by a nearly 30 percent increase in the volume of oil 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	1985 Q1	1985 Q2	1985 Q3	1985 Q4	1986 Q1	1986 Q2
Value (Bil. $, SAAR)	50.53	41.61	54.53	49.49	56.48	40.06	31.32
Price ($/BBL)	26.40	26.67	26.92	25.74	26.30	21.56	13.17
Volume (mbd, SA)	5.24	4.27	5.55	5.27	5.88	5.09	6.52

*/ As published in the balance-of-payments accounts.

Nonoil imports increased by 3-1/2 percent 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 6-1/2 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 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).

U.S. Current Account

In the second quarter, the U.S. current account was $138.9 billion at an annual rate, marginally larger than the deficit in the first quarter (revised). Smaller net deficits in merchandise trade, military transactions and other services were more than offset by increased net portfolio (interest) payments to foreigners, increased unilateral transfers (largely U.S. government grants to developing countries), and a reduction in income from U.S. direct investments abroad (mainly from reduced earnings of petroleum affilites).

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

	1985		1986		$ Change	
	Year	Q4	Q1[r]	Q2	Q1-Q4	Q2-Q1
1. Trade Balance	-124.4	-149.4	-145.8	-144.1	3.6	1.7
2. Exports	214.4	210.9	214.6	219.2	3.7	4.6
3. Imports	338.9	360.3	360.5	363.5	.2	3.0
4. Investment income, net	25.2	37.0	26.1	21.2	-10.9	-4.9
5. Direct investment, net	26.3	40.7	33.2	30.4	-7.5	-2.8
6. Capital gains or losses 1/	4.3	12.3	6.8	9.4	-5.5	2.6
7. Other D.I. income	22.0	28.4	26.4	21.0	-2.0	-5.4
8. Portfolio income, net	-1.1	-3.7	-7.1	-9.3	-3.4	-2.2
9. Military, net	-2.9	-5.3	-4.3	-2.8	1.0	1.5
10. Other services, net	-.6	-.1	-.1	3.0	0	3.1
11. Unilateral transfers	-15.0	-17.0	-12.1	-16.2	4.9	-4.1
12. Current Account Balance	-117.7	-134.8	-136.2	-138.9	-1.4	-2.7
13. Excluding capital gains or losses	-122.0	-147.1	-143.0	-148.3	4.1	-5.3
Memo:						
Statistical discrepancy, not AR	23.0	5.1	10.3	6.0		

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

Foreign Economic Developments. Recent data for the foreign industrial economies provide evidence of a pick-up of real growth in the second quarter of 1986 after weak or negative real growth in the first quarter. Real GNP in Japan grew 3.6 percent (s.a.a.r.) in the second quarter after a moderate decline in the first quarter. In Germany, real GNP grew by 14.3 percent (s.a.a.r.) in the second quarter following a revised 4.3 percent fall in the first quarter. Second-quarter real GDP growth was also higher than first quarter growth in France and Canada. In July, industrial production fell in Japan while it rose in Germany and the United Kingdom.

Inflation abroad continues to be very low. In August, the German cost of living index stood below its year-earlier level while consumer prices in Japan were close to year-ago levels. Inflation in France, Canada, Italy, and the United Kingdom has remained moderate in recent months, although there is some evidence that the deceleration of prices is slowing.

External surpluses in Japan and Germany have remained at record rates while France and Italy have experienced substantial declines in their trade deficits. In recent months, trade balances in the United Kingdom and Canada have deteriorated. In the United Kingdom, increased trade deficits have been largely a result of the lower value of U.K. oil exports.

Individual Country Notes. In Japan, recent data indicate that real GNP grew 3.6 percent (s.a.a.r.) in the second quarter after declining 2.1 percent in the first quarter. The increase in growth reflected stronger personal consumption, a positive contribution of the government

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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 Apr.	1986 May	1986 June	1986 July	1986 Aug.	Latest 3 months from year ago 2/
Canada												
GDP	5.4	3.9	.8	1.8	.5	.8	*	*	*	*	*	3.9
IP	4.4	5.2	2.3	1.4	-.2	n.a.	3.1	-2.0	n.a.	n.a.	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	-1.5	1.5	3.8	-5.1	2.3	n.a.	n.a.	1.5
Germany												
GNP	3.0	2.3	1.7	-.2	-1.1	3.4	*	*	*	*	*	3.8
IP	3.5	3.4	2.1	.4	-1.1	1.4	3.6	-3.3	3.5	1.4	n.a.	1.6
Italy												
GNP	2.7	2.3	.3	.6	1.2	1.0	*	*	*	*	*	3.0
IP	2.1	1.0	-1.1	.2	2.8	n.a.	1.5	-6.7	n.a.	n.a.	n.a.	3.4
Japan												
GNP	5.7	4.0	.7	1.4	-.5	.9	*	*	*	*	*	2.5
IP	10.6	.9	-.1	-.9	.2	.2	.0	.3	.3	-.2	n.a.	-1.0
United Kingdom												
GNP	2.6	2.7	-.3	.5	.7	n.a.	*	*	*	*	*	2.5
IP	-.3	4.5	-.4	-.0	.8	-.7	.7	-1.8	-1.4	3.3	n.a.	.0
United States												
GNP	4.6	2.9	1.0	.5	.9	.2	*	*	*	*	*	2.6
IP	6.6	1.8	.4	.5	.3	-.5	.9	-.4	.0	.3	.2	.6

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

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

	Q4/Q4 1984	Q4/Q4 1985	1985 Q1	1985 Q2	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June	1986 July	1986 Aug.	Latest 3 months from year ago
Canada													
CPI	3.7	4.2	1.2	1.1	.9	.9	1.2	.8	.5	.2	.8	.3	4.1
WPI	4.0	2.3	1.2	.5	-.0	.6	.9	-.9	-.7	.0	.1	n.a.	.3
France													
CPI	6.8	4.8	1.4	1.8	.9	.6	.1	.7	.2	.3	.1	.1	2.1
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	.0	.2	-.5	-.2	-.4
WPI	1.3	-1.1	1.7	.3	-2.1	-.9	-2.1	-2.6	-.9	-.9	-2.1	n.a.	-8.1
Italy													
CPI	8.8	8.5	2.6	2.2	1.1	2.3	1.8	1.1	.4	.4	.0	.2	6.0
WPI	8.9	5.9	2.7	2.2	-.1	.9	-.5	-1.8	-.7	.0	-.8	n.a.	-1.9
Japan													
CPI	2.4	2.3	.6	.5	.1	1.0	-.1	.0	.3	-.8	-.3	-.2	.4
WPI	.5	-3.7	.4	-.7	-1.0	-2.4	-2.4	-4.2	-1.0	-.7	-1.1	-.9	-10.7
United Kingdom													
CPI	4.8	5.5	1.3	3.4	.3	.5	.7	1.3	.2	-.1	-.3	.3	2.4
WPI	6.1	5.2	1.6	2.0	.5	.9	1.4	1.6	.3	.0	.1	.1	4.4
United States													
CPI (SA)	4.1	3.5	.8	1.0	.6	1.1	.4	-.4	.2	.5	.0	n.a.	1.6
WPI (SA)	1.7	1.6	.1	.6	-.2	1.1	-1.5	-1.3	.6	-.0	-.4	.3	-2.0

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

	1984	1985	1985 Q1	1985 Q2	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 May	1986 June	1986 July	1986 Aug.
Canada												
Trade	16.0	12.8	4.0	3.3	2.6	2.9	1.7	1.7	.6	.3	-.2	n.a.
Current account	1.9	-.8	.8	.2	-1.1	-.7	-2.0	-1.3	*	*	*	*
France												
Trade	-2.4	-2.6	-1.1	-.4	-.8	-.4	.1	-1.1	-.3	-.2	.2	.5
Current account	-.8	.9	-.6	.5	.0	1.0	1.1	.3	*	*	*	*
Germany												
Trade (NSA)	18.7	25.4	4.2	6.0	6.1	9.1	9.5	12.5	3.6	4.4	5.1	n.a.
Current account (NSA)	5.9	13.9	1.7	3.1	2.1	7.0	6.8	8.3	2.7	1.9	2.7	n.a.
Italy												
Trade	-11.0	-11.9	-3.6	-4.0	-1.3	-3.1	-2.9	-.1	.0	.1	-.5	n.a.
Current account (NSA)	-2.8	-4.0	-2.8	-2.2	1.9	-.9	n.a.	n.a.	*	*	*	*
Japan												
Trade	33.4	46.1	8.8	10.6	12.0	14.8	15.5	20.3	7.8	6.0	7.4	8.4
Current account 2/	35.0	49.3	9.4	12.2	12.1	15.6	15.5	21.8	7.8	6.7	7.1	n.a.
United Kingdom												
Trade	-5.5	-2.5	-1.4	-.2	-.6	-.3	-2.0	-2.3	-1.0	-.9	-.9	n.a.
Current account	1.3	5.2	.1	2.0	2.0	1.1	.9	.6	-.0	.0	.0	n.a.
United States												
Trade 2/	-112.5	-124.4	-25.0	-30.4	-31.7	-37.4	-36.5	-36.0	*	*	*	*
Current account	-106.5	-117.7	-26.1	-29.4	-28.5	-33.7	-34.0	-34.7	*	*	*	*

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.

sector, and growth in exports. Domestic demand grew by 8.2 percent (s.a.a.r.), while net exports made a negative contribution to growth. However, government purchases of gold to produce coins commemorating the 60th anniversary of Emperor Hirohito's reign were added to government inventories and subtracted as imports, and thus, affected the distribution of growth between domestic demand and net exports without affecting the overall growth rate. Excluding these extraordinary gold imports, domestic demand grew by 3.4 percent (s.a.a.r.), and net exports made a small positive contribution to growth that was attributable to strong automobile exports.

Preliminary indications on the pace of economic activity in the third quarter do not suggest continued strength in growth. Industrial production fell 0.2 percent (s.a.) in July and the Ministry of International Trade and Industry (MITI) has projected an even steeper decline in August with a rebound in September. Retail sales have been erratic in recent months, rising 0.8 percent (s.a.) in June but falling 0.6 percent in July. The unemployment rate rose to 2.9 percent in July from 2.7 percent in June. Two signs of strength in the third quarter are the July increase in new housing starts by 5.5 percent (s.a.) and a 9 percent year-over-year rise in new construction orders in July.

Japanese consumer prices have remained stable in recent months. The Tokyo consumer price index rose a modest 0.4 percent in the three months ending in August relative to the comparable period last year. Wholesale prices have continued to decline, and the overall wholesale price index stood 11.2 percent below its year-earlier level in August. This sharp fall in wholesale prices has been primarily due to the decline in oil prices and the impact of the yen's appreciation on imported goods prices.

Japan's external surplus continues at a record rate. Through August, the cumulative trade surplus was $77.5 billion (s.a.a.r.). The cumulative current account surplus through July was $76.1 billion (s.a.a.r.) compared with $44 billion through July of 1985. Adjustment in trade volumes has continued. In August, export volume was 3.7 percent below and import volume was 12.6 percent above year-earlier levels.

Money growth accelerated in August, with M2 + CDs growing a preliminary 8.9 percent relative to last August, after growing 8.4 percent in the second quarter compared with the second quarter of 1985. The Bank of Japan attributes the rise in money growth to an increase in large-denomination time deposits stemming from recently liberalized interest rates.

Prime Minister Nakasone will announce an economic stimulus package around September 19 that is expected to include a supplementary budget of at least 3 trillion yen (about $19 billion), largely for public works projects, measures to stimulate housing investment, further assistance to small business hurt by the yen's appreciation, and perhaps a reference to more flexible monetary policy. Prime Minister Nakasone's term has been extended for one year beyond its October 30, 1986, expiration date.

Real GNP in Germany grew at an annual rate of 14.3 percent in the second quarter to a level 3.8 percent above the second quarter of last year. Domestic demand increased by 18.6 percent (s.a.a.r.) in the second quarter with private consumption and construction as the leading components. The external sector's contribution to second-quarter growth was negative. Very strong import growth more than offset above average export growth. Among more recent indicators, industrial production grew 1.4 percent in July, and the June result was revised substantially upward. New orders in July also showed strength, especially in domestic sectors. Employment is gradually increasing, and the unemployment rate was below 9 percent (s.a.) in July and August for the first time in 2-1/2 years. Survey returns on the business climate, investment intentions and consumer confidence suggest support for modest growth in economic activity.

The cost of living index has continued to decline this year to a level in August that was 0.4 percent below August of last year. Wholesale, producer, and especially import prices, are substantially below their year-ago levels.

The German current account continues to benefit from large terms of trade gains. Through July, the cumulative current account surplus was $17.8 billion, compared with a $5.7 billion surplus for the same period of last year. Similarly, this year's trade surplus through July of $27 billion was larger than the $12.5 billion surplus in the same period last year. The increased external surplus is entirely due to price movements. If measured in constant DM prices, the trade surplus so far this year is below its comparable level of last year.

German Central Bank Money grew 10 percent (s.a.a.r.) in August. The growth rate between the fourth quarter of last year and August was

7.1 percent (s.a.a.r.), well above the Bundesbank's target of 3.5 to 5.5 percent growth between the fourth quarters of 1985 and 1986.

In France, industrial production increased by 2.3 percent (s.a.) in June and was 1.5 percent above its year-earlier level. The unemployment rate (s.a.) increased slightly to a record 10.7 percent in August. Real GDP grew 4.5 percent (s.a.a.r.) in the second quarter, driven by an increase in domestic demand of 12.2 percent. The increase in domestic demand was fueled by strong growth in investment and government consumption in the second quarter.

Consumer prices in August were 2 percent above their level of August 1985. The decline in energy prices is slowing while prices of personal services are increasing at a faster rate, and thus, the decline of inflation is slowing. Inflation is generally expected to be higher this fall as additional price controls are removed.

The French trade balance improved further in August. For the first eight months of 1986 the trade deficit was about $0.5 billion (s.a.a.r.), down significantly from the $2.8 billion deficit in the same period last year. The decline in the trade deficit was primarily due to savings on energy imports that offset a deterioration in the surplus on manufactures trade. For the first half of 1986 the current account was in surplus, in contrast to a year-earlier deficit.

In the United Kingdom, real activity has continued to increase at a moderate rate. The output measure of real GDP increased by an estimated 2 percent (s.a.a.r.) in the second quarter, and was about 1.5 percent above its year-earlier level. Industrial production rose more than 3 percent (s.a.) in July and was 2.4 percent above its year-ago level.

Retail sales decreased by 1.2 percent (s.a.) in July, and were up 4.3 percent on a year-over-year basis. The unemployment rate was unchanged (s.a.) in July at a record high 11.7 percent.

In August, retail prices increased by 0.3 percent (n.s.a.) and were 2.4 percent above year-earlier levels. Average earnings increased by 0.8 percent (s.a.) in June and were up 8.1 percent on a year-over-year basis as real earnings continue to rise sharply.

The current account remained in slight surplus (s.a.) in July. The cumulative trade deficit through July of this year was $9.1 billion (s.a.a.r.), compared with a deficit of $3.2 billion in the comparable period last year. This year's larger deficit is accounted for largely by a fall in the value of net oil exports. Also, the dollar value of the non-oil deficit has risen, reflecting the appreciation of the pound relative to the dollar since last year.

Economic expansion in Canada has slowed considerably in 1986 from last year's pace. Growth in real gross domestic product was 3 percent (s.a.a.r.) in the second quarter after a slower first quarter pace of 2.1 percent. This brings average 1986 growth of GDP to 2.6 percent (s.a.a.r.) since the fourth quarter of last year, compared with 3.9 percent growth over the preceding four quarters. Most of the second-quarter growth resulted from strong consumer and housing demand, which was somewhat offset by a decline in business fixed investment. The unemployment rate in Canada fell in August to 9.7 percent after increasing in July to 9.9 percent.

Although inflation has remained relatively low, it has increased slightly in 1986 thus far. In August, consumer prices were 4.3 percent above year-earlier levels, an increase from the 4 percent rate in the preceding 12-month period. Inflation of industrial product prices has continued to decline, however, standing at 0.3 percent in the 12 months ending in July of this year, compared with 2 percent in the 12 months ending in July 1985.

In July, Canada posted its first merchandise trade deficit in 10 years, bringing the cumulative trade surplus to $3.2 billion (s.a.) for the first seven months of 1986 compared with $7.7 billion in the comparable period in 1985. The current account deficit also declined in the second quarter to $1.3 billion (s.a.) bringing the cumulative deficit in the first half of 1986 to $3.4 billion, compared with a surplus of $1 billion over the same period last year.

In Italy, real GDP rose by 3.9 percent (s.a.a.r.) in the second quarter, after increasing 4.7 percent in the first quarter, bringing the year-over-year growth rate to 3 percent.

The consumer price index rose 0.2 percent (n.s.a.) in August, bringing the 12-month inflation rate to 5.9 percent compared with an 8.6 percent rate for the previous 12-month period. Wholesale prices fell 0.8 percent (n.s.a.) in July, leaving this index 2.2 percent below its year earlier level.

In July, the trade deficit was $0.5 billion (s.a.); during the first seven months of 1986, the cumulative trade deficit was $6 billion (s.a.a.r.), as compared with a deficit of almost $14 billion in the same period of 1985.

Economic Situation in Major Developing Countries. Mexico's negotiations with commercial banks for a $6 billion bank financing package are proceeding slowly in the face of Mexico's desire for substantially easier terms in the restructuring of old debt. Responding to a flare-up of inflation in July and August, Argentina implemented tighter monetary policy and stiffened wage and price controls for the remainder of 1986. Brazil raised interest rates in order to restrain the continuing rapid expansion of domestic demand and to relieve pressure on controlled prices. Responding to complaints from foreign banks that the Venezuelan government had imposed a unilateral rescheduling of private sector debt, the Venezuelan Congress repealed the offending legislation; the issue of the mechanism by which private debt to external creditors is to be repaid remains open. In early September, Nigeria's Finance Minister signed a letter of intent for an IMF stand-by program.

Individual Country Notes. On September 8, the IMF Executive Board approved in principle an 18-month, stand-by arrangement of SDR 1.4 billion for Mexico, with provision for increased credit up to SDR 0.8 billion if oil prices fall below specified levels. The initial disbursement will be contingent on a finding that satisfactory arrangements for financing the estimated balance of payments deficit during the 18-month period have been made. Such a finding must be made by September 29, 1986, although that deadline could be extended. The stumbling block is the provision of $6 billion in new money from the commercial banks. Negotiations between the banks and the Mexicans are continuing. Mexico considers it essential to obtain from the banks easier terms than those of the 1985 multi-year restructuring agreement. Total financing requirements are estimated at $12 billion. A $1.6 billion bridging loan from the monetary authorities of a number of industrial and developing countries and commercial banks was announced on August 27. An initial drawing of $850 million from official creditors took place on August 29, and will be repaid from IMF and IBRD disbursements. A commercial bank component of the bridge loan, for $500 million, will be available only when about 90 percent of the $6 billion medium-term credit from banks is committed.

In August, Mexican oil export prices averaged about $11.30 per barrel, an increase of about $3.30 from the July average. The volume of crude oil exported, which had fallen to about 1.1 million barrels per day in January-April, averaged about 1.4 million barrels per day in May-July. Following the August 4 announcement of an OPEC cut in output, Mexico announced a 10 percent cut for two months in its self-imposed export ceiling, from 1.5 to 1.35 million barrels per day.

In August, the Mexican CPI rose by 8 percent. Deposit interest rates were increased twice but lag behind Treasury bill rates. The Treasury bill rate stood at 101.5 percent at the September 10 auction. With deposit rates more than 10 percentage points lower, the banks were losing deposits. The peso price of the dollar in the controlled market continued to rise at the monthly rate of 10 percent in August and early September, as it had in July, and the spread between the free and controlled rates remained under 3 percent. In the first half of 1986, industrial production was 2.7 percent lower than in the same period of 1985.

Last month, Argentina adopted measures to slow accelerating inflation, including wage and price controls along with monetary restraint. Monthly inflation rose from 4-5 percent per month in the second quarter to 6.8 percent in July and 8.8 percent in August. Under controls announced August 29, industrial price increases are to be limited to 3 percent in September, declining thereafter each month with a maximum permissible increase of 2 percent for December. This complements actions taken earlier in August to tighten monetary policy and to accelerate the mini-devaluations of the austral to a rate that fully compensates for changes in the domestic price level. The government hopes to achieve an inflation rate target of 2.5 percent per month by year-end and in September resumed negotiations with the IMF on a new economic program.

Brazil's trade surplus in August remained about $1 billion despite accelerating non-oil imports. For the first eight months of 1986, Brazil's trade surplus was $8.2 billion, compared with $7.8 billion in the same period a year earlier.

Brazil's central bank fostered an interest rate rise over the last several weeks in an effort to stem domestic demand in the midst of a booming economy. Inflationary forces are building and the government hopes to restrain demand to relieve pressures on price controls. The overnight rate increased from 2.7 percent per month at the beginning of August to 4 percent at the beginning of September. This complements the modest fiscal measures that were taken in July. Official estimates for 1986 indicate that even with the July measures the public sector borrowing requirement will be 4.7 percent of GDP.

Consumer prices rose by 1.2 percent according to the official index in July; the official price index has increased by less than 5 percent during the first five months of the Cruzado Plan. However, increasingly price controls are being evaded and supplies are unavailable.

On September 4, Brazil's agreement with banks to reschedule $6 billion in 1985 maturities and to roll over $9 billion in 1986 maturities and $15 billion in trade and interbank lines until March 1987 became effective.

In mid-September, the Venezuelan Congress repealed legislation passed in July for the Exchange Compensation Fund (FOCOCAM) to coordinate rescheduling of some private sector external debt. Through FOCOCAM, the government would have issued 15-year, 5 percent dollar-denominated bonds against local currency deposits. Finance Minister Azpurua has not yet provided precise details as to the form of any new arrangement with respect to private sector debtors.

The Philippines has yet to take prior actions in the financial and trade sectors required for IMF approval of a new 18-month stand-by arrangement. The World Bank has found unsatisfactory the specific proposals presented by the Philippine government for the reform of various government financial institutions. Unless the government liberalizes treatment of some import items by September 30 and provides the World Bank a satisfactory plan for reform of government financial institutions, IMF Board approval of the stand-by program is unlikely to occur by late October.

In early September, Nigeria signed a letter of intent for an IMF stand-by program, but does not intend to draw IMF funds. The program will not go to the Board until the government opens the long-awaited free foreign exchange market, which is expected around October 1. A meeting between the Nigerians and commercial banks took place on September 11-12 in London. The Bank Steering Committee agreed to recommend continued deferral of principal through December 31. The Nigerians are seeking about $320 million in new money from the banks; the two sides will meet again the first week of October.

On August 15, 1986, the IMF Board declared Peru ineligible to make further use of IMF resources. Peru's arrears to the Fund have been accumulating since September 1985; they totalled $161 million on August 15. Despite continuing buildups of arrears to most creditors, Peru's reserves (less gold) had dropped to $1.6 billion by June, down from $1.9 billion in January.

Although President Garcia's commitment to hold the official exchange rate for the dollar through next July has precluded a direct devaluation, the government adjusted eligibilities under Peru's complex three-tiered exchange system to effect a de facto devaluation. Despite the adjustment, the real effective exchange rate faced by exporters is still 10 percent higher than it was in June 1985.

The IMF Board approved in August an SDR 75 million stand-by arrangement and SDR 40 million Compensatory Financing Facility (CFF) drawing for Ecuador, and commercial banks over-subscribed to the new $200 million oil trade facility. The CFF was the first for an OPEC country to compensate for a shortfall in oil receipts. As part of its economic program, Ecuador devalued the sucre by about 35 percent, removed certain interest rate ceilings and eliminated import controls on a wide range of products.