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October 29, 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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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	Sept.	10-03-86	118.2	.4	.4	2.1
Unemployment rate (%)[1]	Sept.	10-03-86	7.0	6.8	7.1	7.1
Nonfarm employment, payroll (mil.)	Sept.	10-03-86	100.4	1.3	2.1	2.3
Manufacturing	Sept.	10-03-86	19.1	-2.4	-1.1	-.6
Nonmanufacturing	Sept.	10-03-86	81.3	2.1	2.9	3.0
Private nonfarm:						
Average weekly hours (hr.)[1]	Sept.	10-03-86	34.7	34.8	34.7	34.9
Hourly earnings ($)[1]	Sept.	10-03-86	8.77	8.75	8.74	8.62
Manufacturing:						
Average weekly hours (hr.)[1]	Sept.	10-03-86	40.8	40.8	40.6	40.7
Unit labor cost (1967=100)	Aug.	09-30-86	80.4	.0	-7.8	-4.3
Industrial production (1977=100)	Sept.	10-16-86	125.3	1.9	3.5	.8
Consumer goods	Sept.	10-16-86	125.2	2.9	2.6	3.4
Business equipment	Sept.	10-16-86	139.7	4.3	9.1	-.5
Defense & space equipment	Sept.	10-16-86	181.9	2.6	7.8	4.2
Materials	Sept.	10-16-86	113.4	.0	1.1	-.4
Consumer prices all items (1967=100)	Sept.	10-23-86	329.3	4.0	2.2	1.7
All items, excluding food & energy	Sept.	10-23-86	329.3	3.3	3.7	4.1
Food	Sept.	10-23-86	323.9	5.2	9.1	4.2
Producer prices: (1967=100)						
Finished goods	Sept.	10-10-86	289.3	4.6	1.1	-.9
Intermediate materials, nonfood	Sept.	10-10-86	311.2	6.6	-1.3	-3.9
Crude foodstuffs & feedstuffs	Sept.	10-10-86	234.7	-9.1	20.6	7.8
Personal income ($ bil.)[2]	Sept.	10-23-86	3,511.5	3.8	3.4	5.3
				(Not at annual rates)		
Mfgrs. new orders dur. goods ($ bil.)	Sept.	10-23-86	109.0	4.9	6.1	2.2
Capital goods industries	Sept.	10-23-86	37.1	7.0	10.1	-.7
Nondefense	Sept.	10-23-86	28.6	8.8	8.4	-2.1
Defense	Sept.	10-23-86	8.5	1.4	16.5	4.3
Inventories to sales ratio:[1]						
Manufacturing and trade, total	Aug.	10-16-86	1.38	1.38	1.39	1.35
Manufacturing	Aug.	10-16-86	1.44	1.44	1.44	1.45
Trade	Aug.	10-16-86	1.33	1.34	1.35	1.27
Ratio: Mfgrs.' durable goods inventories to unfilled orders[1]	Aug.	10-16-86	.524	.526	.528	.543
Retail sales, total ($ bil.)	Sept.	10-15-86	127.2	4.6	6.9	7.5
GAF[3]	Sept.	10-15-86	26.8	-.5	1.5	7.0
Auto sales, total (mil. units)[2]	Sept.	10-03-86	15.6	27.4	37.6	10.0
Domestic models	Sept.	10-03-86	11.8	32.3	41.6	5.6
Foreign models	Sept.	10-03-86	3.8	14.1	26.6	26.4
Housing starts, private (thous.)[2]	Sept.	10-17-86	1,680	-7.6	-9.3	1.6
Leading indicators (1967=100)	Aug.	09-30-86	179.1	-.2	.5	5.5

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

DOMESTIC NONFINANCIAL DEVELOPMENTS

Economic activity picked up in the third quarter, with real GNP growth at a 2.4 percent annual rate according to the Commerce Department's preliminary estimate. Consumer expenditures increased rapidly through September, as incentive programs boosted the demand for new cars and led to a substantial reduction in the level of auto inventories. Although capital spending was flat during the quarter, new orders were up in September, and oil and gas well drilling appears to be leveling off. Housing starts have trended downward in the past several months, but, reflecting normal lags, residential construction expenditures rose through the summer. Wage increases continued to moderate; however, price inflation increased a bit in the third quarter in response to a spurt in food prices and somewhat smaller declines in energy prices than in the first half of the year.

Industrial Production and Capacity Utilization

Industrial production edged up 0.1 percent in both August and September, following an upward-revised 0.5 percent increase in July; on a quarterly average basis, output grew at a 2-1/4 percent annual rate in the summer months. The September advance was concentrated in consumer durables and business equipment, where higher automobile and truck assemblies offset declines in other categories. In addition, the production of construction supplies and defense and space equipment rose further. But output of business supplies was down, and materials production was flat.

Capacity utilization in manufacturing, mining, and utilities was unchanged in September at 79.2 percent. The utilization rate in mining

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

	1986		1986		
	Q2	Q3	July	Aug.	Sept.
	--Annual rate--		--Monthly rate--		
Total Index	-2.1	2.3	.5	.1	.1
Products	-.8	3.5	.6	.3	.2
Final products	-2.6	2.7	.8	.3	.3
Consumer goods	4.7	2.3	.6	-.1	.3
Durable	-1.1	4.9	1.4	-.6	1.4
Nondurable	6.7	1.4	.3	.0	-.1
Equipment	-10.3	3.2	1.0	.8	.4
Business	-6.2	4.0	1.2	.7	.3
Defense and space	2.4	6.6	.7	1.1	.2
Oil and gas drilling	-86.7	-39.3	-4.1	4.0	2.0
Intermediate products	5.7	6.2	.3	.3	-.1
Construction supplies	2.2	4.7	-.1	1.2	.4
Materials	-4.1	.5	.4	-.1	.0
Durable goods	-6.9	-.2	.7	.1	.2
Nondurable goods	4.1	7.2	.8	.3	.0
Energy materials	-6.2	-4.5	-.6	-1.0	-.4

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

	1978-80	1982	1967-85	1984	1986		
	High	Low	Avg.	High	July	Aug.	Sept.
Total industry	86.9	69.5	81.7	81.8	79.3	79.2	79.2
Manufacturing	86.5	68.0	80.6	81.3	79.8	79.7	79.8
Durable	86.3	63.7	78.7	79.8	76.3	76.3	76.4
Nondurable	87.0	74.4	83.5	84.3	85.1	84.8	84.8
Mining	95.2	76.9	87.7	86.6	73.5	73.1	72.9
Utilities	88.5	78.0	87.9	85.8	80.7	80.1	80.6
Industrial materials	89.1	68.4	82.5	82.9	78.3	78.1	78.0
Metal materials	93.6	45.7	78.4	70.8	63.8	63.4	63.9
Paper materials	97.3	79.9	91.4	98.6	96.9	97.2	n.a.
Chemical materials	87.9	63.3	80.8	78.5	80.5	80.9	n.a.

continued to decline while the rate in manufacturing edged up 0.1 percentage point, reflecting the pickup in motor vehicle production. Among individual industries, textiles, paper, and petroleum refining continued to operate at relatively high rates, while capacity use remained low in the metal and machinery-producing industries.

Employment and Unemployment

Employment growth was relatively sluggish in September, as nonfarm payroll employment increased 107,000—only 80,000, after adjusting for strike activity. The average monthly gain for the third quarter as a whole (130,000) fell short of the average increase over the first half of the year.

The September report painted a weak picture of labor demand in manufacturing. A revision to the August data erased half of an earlier-reported gain in (strike-adjusted) factory jobs, and September payrolls were down noticeably. By industry, monthly changes in employment continue to be quite small throughout the nondurable goods sector and in many durable goods industries. However, persistent cutbacks still are being reported in the machinery, electrical equipment, and primary metals industries; these three industries account for more than three-quarters of the drop in manufacturing employment this year. In other sectors, the number of construction jobs was little changed in September, while hiring in services, trade, and finance slowed somewhat from their recent rapid pace.

Employment in the household survey declined in September, after a four-month period in which gains substantially exceeded those recorded in

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

		1986			1986		
	1985	Q1	Q2	Q3	July	Aug.	Sept.
		—Average monthly changes--					
Nonfarm payroll employment[2]	230	191	120	175	262	156	107
Strike adjusted	229	184	174	130	117	196	78
Manufacturing	-18	-11	-40	-17	-14	1	-38
Durable	-16	-14	-37	-16	-13	2	-38
Nondurable	-2	3	-3	-1	-1	-1	0
Manufacturing Strike adjusted	-17	-13	-29	-18	-41	19	-31
Construction	21	17	36	22	33	32	2
Trade	65	79	35	57	68	57	45
Finance and services	122	98	159	105	143	97	74
Total government	38	23	-6	-20	-85	23	2
Private nonfarm production workers	159	135	102	153	279	104	75
Manufacturing production workers	-18	-13	-27	-12	-18	5	-24
Total employment[3]	163	79[e]	295	73	209	273	-264
Nonagricultural	183	57[e]	335	87	261	338	-337

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)

		1986			1986		
	1985	Q1	Q2	Q3	July	Aug.	Sept.
Civilian, 16 years and older	7.2	7.1	7.2	6.9	6.9	6.8	7.0
Teenagers	18.6	18.5	19.2	18.0	17.5	17.7	18.7
20-24 years old	11.0	10.6	11.1	10.7	10.8	10.2	11.2
Men, 25 years and older	5.3	5.3	5.4	5.4	5.5	5.3	5.3
Women, 25 years and older	5.9	5.7	5.7	5.4	5.4	5.4	5.5
White	6.2	6.1	6.2	6.0	6.0	5.8	6.0
Black	15.1	14.6	14.9	14.5	14.0	14.6	14.8
Fulltime workers	6.9	6.7	6.8	6.6	6.6	6.4	6.7
Memo:							
Total national[1]	7.1	7.0	7.1	6.8	6.8	6.7	6.9

1. Includes resident Armed Forces as employed.

the payroll survey. These relative movements can be attributed in large part to the behavior of married women, whose labor force participation this year evidently has not followed traditional seasonal patterns. Fewer women left the work force at the end of the school year, boosting employment from June to August; subsequently, the upswing in their employment this September was much smaller than usual. Unemployment rose somewhat last month, particularly among younger workers, and the civilian jobless rate moved back up to 7 percent.

Personal Consumption and Income

Real consumption spending continued to show considerable strength in the third quarter, increasing at a 7-1/4 percent annual pace, after growing at a 5 percent annual rate during the first half of the year. The third-quarter increase was led by a jump in expenditures on motor vehicles, as auto and truck sales soared following the expansion of sales incentive programs by domestic automakers in late August. During September, domestic cars sold at a record 11.8 million unit annual rate, up from an average 8-1/4 million unit pace in the preceding five months; U.S.-built light trucks registered a 5.0 million unit sales pace—also a monthly record. Foreign cars sold at a record 3.8 million unit rate in September, in part because General Motors also offered incentive programs on its "captive imports." Outside of motor vehicles, outlays on durable goods grew somewhat more slowly in September, although for the third quarter as a whole, real spending increased at a 13 percent annual rate, reflecting especially strong sales of home electronic equipment.

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

	1984	1985	1985 Q4	1986 Q1	1986 Q2	1986 Q3
Current dollars						
Total personal income	8.4	6.1	7.4	6.0	6.0	2.1
Private wages and salaries	8.8	6.3	7.5	6.5	2.3	4.1
Manufacturing	8.3	3.9	6.0	2.6	-1.4	1.1
Farm income[2]	31.5	29.2	29.4	24.4	39.5	21.4
Disposable personal income	8.0	5.6	7.3	7.5	6.0	.6
Constant dollars						
Disposable personal income	4.2	1.9	2.6	6.5	7.1	-2.2
Personal consumption expenditures	3.6	3.5	1.7	3.6	6.2	7.2
Durables	8.8	6.2	-11.1	-1.8	14.3	38.4
Motor vehicles and parts	6.7	3.7	-32.8	-8.4	18.2	76.4
Other durables	10.5	8.2	12.4	3.6	11.5	13.1
Nondurables	2.2	2.0	1.6	6.5	8.0	.8
Clothing and shoes	4.0	3.2	2.8	14.0	12.9	2.8
Gasoline and oil	.6	1.5	3.4	2.1	40.0	10.2
Food	2.0	2.0	-.2	5.6	2.8	-4.2
Services	3.3	3.9	6.0	3.2	2.6	3.5
Memo:						
Personal saving rate (percent)	6.3	5.1	4.4	5.0	5.1	2.9

1. Annual figures are from the fourth quarter of preceding year to fourth quarter of year indicated.
2. Level, billions of dollars.

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

	1985	1986			1986		
	Q4	Q1	Q2	Q3	July	Aug.	Sept.
Total auto sales[1]	10.2	10.7	11.2	12.9	10.9	12.2	15.6
Domestic	6.8	7.8	8.2	9.4	7.6	8.9	11.8
Imported	3.4	2.8	3.0	3.5	3.3	3.3	3.8
Domestic production	7.8	8.3	7.9	7.4	7.6	7.0	7.7
Dealers' stocks	1.67	1.81	1.80	1.40	1.76	1.65	1.40
Days' supply[2]	75	71	68	46	71	57	36
Total light truck sales[3]	4.4	4.1	4.6	5.2	4.8	4.9	6.0
Domestic	3.6	3.3	3.7	4.3	3.7	4.2	5.0
Imported[4]	.8	.8	.9	.9	1.1	.7	1.0

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.

RETAIL SALES
(Seasonally adjusted percentage change)

	1986			1986		
	Q1	Q2	Q3	July	Aug.	Sept.
Total sales	1.2	1.2	3.7	.7	1.5	4.6
Previous estimate[1]			—	.3	.8	—
Total less auto dealers nonconsumer stores, and gasoline stations	1.2	1.4	1.8	.8	.7	-.1
Previous estimate[1]			—	.6	.2	—
GAF[2]	1.4	2.7	1.9	.8	1.2	-.5
Durable	2.0	3.5	8.3	1.6	3.0	11.9
Automotive group	1.1	4.2	11.8	1.2	4.1	19.5
Furniture and appliances	1.0	4.2	4.3	2.0	-.4	1.4
Other durable goods	.1	1.8	4.1	3.4	1.5	-1.5
Nondurable	.7	-.2	.9	.2	.5	-.1
Apparel	1.6	3.9	.9	-.4	1.9	-.6
Food	1.4	-.4	1.2	.4	.0	.7
General merchandise[3]	1.4	1.5	1.3	.8	1.6	-1.3
Gasoline stations	-4.4	-11.5	-4.1	-3.0	-1.9	.4

1. Based on incomplete sample counts approximately one month ago.
2. General merchandise, apparel, furniture and appliance stores.
3. General merchandise excludes mail order nonstores; mail order sales are also excluded in the GAF grouping.

In contrast to durables, expenditures on nondurable goods decelerated to a 1 percent annual rate of increase in the third quarter from an 8 percent annual rate in the second quarter. Although spending for most categories of nondurable goods was sluggish in recent months, gasoline purchases were relatively strong again in the third quarter, possibly reflecting higher demand at the lower level of prices. Meanwhile, outlays for consumer services continued to grow moderately, increasing at a 3-1/2 percent annual rate during the third quarter.

Real disposable personal income fell at a 2-1/4 percent annual rate in the third quarter after increasing at a 7 percent pace in the previous period. The decline in real income growth reflects a drop in farm subsidies from their high second-quarter levels, a large increase in personal taxes, and higher consumption prices. As a result of the strong advance in consumption and the poor income performance, the saving rate averaged only 2.9 percent in the third quarter, down sharply from around 5 percent in the preceding two quarters.

Business Fixed Investment

Spending for business fixed investment is estimated to have been virtually flat in the third quarter. Although business purchases of motor vehicles advanced at nearly a 35 percent annual rate, spending for most other components of equipment was down, and outlays for nonresidential structures declined substantially for the third consecutive quarter.

Most of the decline in construction outlays was concentrated in petroleum drilling activity, where real spending fell 13 percent (quarterly rate). Drilling has been the weakest component of nonresidential structures

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

	1986			1986		
	Q1	Q2	Q3	July	Aug.	Sept.
Producers' durable equipment						
Nondefense capital goods						
Shipments	-5.8	2.5	.9	.6	-.5	-.2
Aircraft	-5.9	-.9	2.1	17.7	.9	-17.4
Excl. aircraft	-5.8	3.0	.7	-1.5	-.7	2.4
Orders	-4.8	-.9	4.6	3.7	-3.9	8.8
Aircraft	-18.8	-12.2	3.8	74.7	-18.2	47.6
Excl. aircraft	-2.0	.9	4.7	-1.9	-1.9	4.3
Sales of heavy-weight trucks (thousands of units, A.R.)	262	273	268	261	268	276
Nonresidential structures						
Nonresidential construction	1.0	-5.6	--	-.2	1.6	--
Commercial building	1.9	-7.8	--	.8	1.5	--
Office	-.8	-6.6	--	-2.0	1.1	--
Other commercial	4.9	-9.1	--	3.6	2.0	--
Industrial building	-6.2	-9.4	--	-1.1	2.4	--
Rotary drilling rigs in use	-18.5	-40.2	-12.6	-4.2	3.6	1.9

REAL OUTLAYS FOR PRODUCERS' DURABLE EQUIPMENT
(from 1985-Q3 to 1986-Q3)

	Percent change (annual rate)	Net change (billions of dollars)
Total producers' durable equipment	5.3	16.5
Office and computing equipment	9.5	5.4
Aircraft	24.5	3.3
Industrial equipment	3.2	2.1
Motor vehicles	3.8	2.1
All other categories	3.0	3.6

thus far this year, reducing real GNP growth by approximately 1/2 percentage point at an annual rate over the first three quarters. In contrast, BEA estimates that spending in the remaining categories of nonresidential construction was down only slightly in the third quarter, as gains in outlays for retail stores and warehouses about offset continued declines in the industrial and office sectors. With office vacancy rates at record-high levels and new commitments down sharply, a continued contraction in outlays for these buildings is expected.

On the equipment side, real outlays have been quite volatile on a quarterly basis, but, on balance, have expanded at a 5-1/4 percent annual rate over the past year. Much of the quarterly volatility reflects the bunching of outlays at the end of 1985, owing to the expectation of adverse tax changes for equipment installed during or after 1986. About one-half of the total rise in equipment outlays during the past year has been for aircraft and computing equipment, with smaller gains spread across several other categories. The uptrend in spending results, in part, from the apparent drop in real long-term interest rates during the past two years, from continuing efforts by firms to modernize production facilities, and from growth in the airline industry.

This higher real equipment spending has not translated into increased domestic production of business equipment, as U.S. firms have been directing an increasing share of their equipment demand to foreign suppliers. As a result, shipments of nondefense capital goods by domestic manufacturers have been essentially flat in nominal terms since late 1984, and domestic production of business equipment currently is 1/2 percent below its level of a year ago. The modest third-quarter advance in shipments represents no significant break from this longer-term pattern.

Looking ahead, new orders for nondefense capital goods rose nearly 9 percent in September, as bookings for aircraft surged. Outside of aircraft, gains also were widespread, which may reflect tax factors similar to those at work late last year. As part of the recently enacted tax reform package, less generous depreciation rules will apply to most types of equipment installed after year-end,[1] and firms may be ordering now to beat this deadline. Given this tax incentive, shipments may be boosted in the fourth quarter before falling off early next year.

Business Inventories

Except for the sharp liquidation by auto dealers during August and September, business inventory changes appear to have been relatively moderate in recent months. In manufacturing, a buildup in stocks of petroleum, chemicals, and processed food products in July and August was partially offset by a continued reduction in metals and machinery inventories. Overall, manufacturers' inventory position has changed little in recent months. In the trade sector, wholesale inventories have grown rapidly since May, apparently reflecting the continued high volume of imports. In retail trade, nonauto inventories edged up a bit in July and August, after stocks in this sector were drawn down substantially in late spring.

1. For aircraft, communications equipment, and most types of industrial machinery, the Tax Reform Act increases depreciation lives from five to seven years and provides an incentive to install such equipment this year. A similar incentive applies to autos and light trucks, for which depreciation periods will be lengthened from three to five years. In contrast, other assets--notably computing equipment and heavy trucks--will receive more generous depreciation allowances under the new law. However, because firms have the option of using these new rules in the second half of 1986, little shifting of expenditures into 1987 is likely for these assets.

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

	1985	1986		1986		
	Q4	Q1	Q2	June	July[r]	Aug.[p]
Book Value Basis:						
Total	17.6	20.1	2.9	26.2	35.8	-7.9
Manufacturing	-8.6	-9.3	-4.6	.7	2.4	-13.7
Wholesale	6.1	4.5	6.9	15.4	11.5	11.8
Retail	20.1	24.9	.6	10.0	21.9	-6.0
Automotive	19.9	15.1	-1.4	10.9	20.1	-9.9
Ex. auto	.2	9.8	2.0	-.9	1.8	3.9
Constant Dollar Basis:						
Total	11.0	29.8	1.6	12.1	22.8	-4.6
Manufacturing	-10.5	-5.3	1.0	-.2	10.1	-11.5
Wholesale	3.6	6.8	4.6	15.6	17.0	19.4
Retail	17.8	28.3	-4.0	-3.3	-4.3	-12.4
Automotive	15.9	17.2	-1.8	3.5	-6.0	-15.0
Ex. auto	1.9	11.0	-2.3	-6.8	1.7	2.6

INVENTORIES RELATIVE TO SALES[1]

	Cyclical Reference Points[2]		1985	1986		1986		
Book Value Basis:	81 low	82 high	Q4	Q1	Q2	June	July[r]	Aug.[p]
Total	1.39	1.53	1.36	1.38	1.39	1.38	1.38	1.38
Manufacturing	1.60	1.77	1.42	1.43	1.43	1.44	1.44	1.44
Wholesale	1.06	1.28	1.18	1.20	1.23	1.23	1.22	1.23
Retail	1.37	1.46	1.43	1.47	1.45	1.44	1.45	1.42
Automotive	1.57	1.90	1.65	1.78	1.70	1.68	1.72	1.63
Ex. Auto	1.31	1.37	1.37	1.38	1.38	1.37	1.37	1.36
Constant Dollar Basis:								
Total	1.58	1.72	1.54	1.55	1.54	1.54	1.53	1.52
Manufacturing	1.88	2.04	1.72	1.72	1.70	1.72	1.70	1.71
Wholesale	1.26	1.45	1.30	1.31	1.32	1.32	1.30	1.31
Retail	1.38	1.49	1.48	1.52	1.48	1.47	1.47	1.44
Automotive	1.54	1.90	1.66	1.83	1.74	1.73	1.73	1.56
Ex. auto	1.31	1.41	1.44	1.44	1.41	1.40	1.40	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.

The auto inventory overhang that developed in the spring now appears to have been largely corrected. Auto dealers' stocks were drawn down sharply in August and September as assembly schedules were scaled back and the new round of incentives boosted car sales to record levels. At the end of September, auto dealer stocks were estimated at 1.4 million units, in sharp contrast to 1.8 million units last spring.

Housing Markets

Total private housing starts declined 8 percent in September to a 1.68 million unit annual rate from about 1.8 million units during July and August. Single-family starts fell 7 percent in September to a 1.12 million unit annual rate, the lowest monthly reading since December 1985. Declines also have been recorded for in new home sales, which, in August, were 25 percent below their second-quarter average. In contrast, other indicators suggest some strength in the single-family segment of the market. Sales of existing homes registered their third consecutive monthly increase in September to establish a new seven-year high, while consumer attitudes toward homebuying remain very positive.

Multifamily housing starts fell 9 percent in September to a 564,000 unit annual rate, after a 4 percent decline the previous month. Further downward adjustments seem likely in light of record high vacancy rates for multifamily units,[2] diminished rates of return on rental properties in the wake of tax reform, and reduced stimulus to construction from tax-exempt mortgage revenue bonds issued at the end of last year.

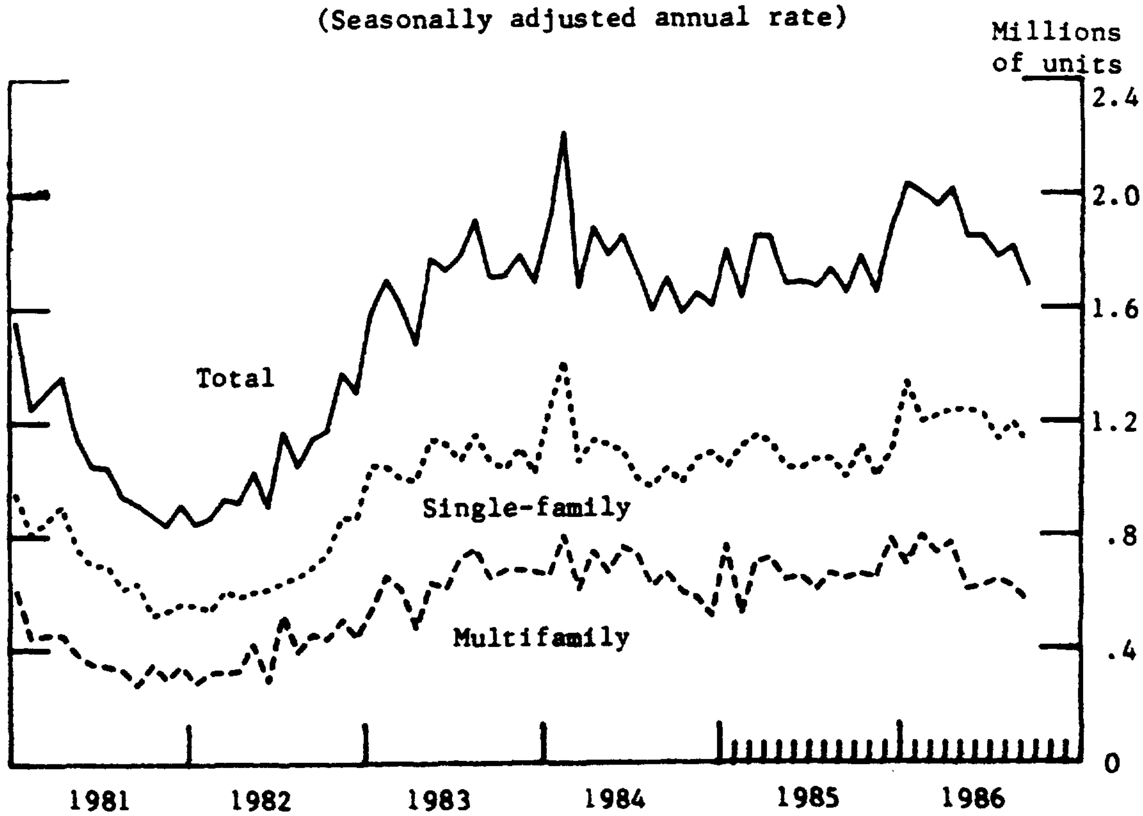
2. Rental apartments recently have accounted for 80 percent of total multifamily construction.

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

	1985	1986			1986		
	Annual	Q1	Q2	Q3	July	Aug.	Sept.[1]
All units							
Permits	1.73	1.83	1.82	1.68	1.76	1.67	1.61
Starts	1.74	2.00	1.91	1.76	1.78	1.82	1.68
Single-family units							
Permits	.96	1.05	1.12	1.06	1.09	1.04	1.05
Starts	1.07	1.25	1.24	1.15	1.14	1.20	1.12
Sales							
New homes	.69	.80	.80	n.a.	.69	.59	n.a.
Existing homes	3.22	3.26	3.47	3.62	3.47	3.61	3.77
Multifamily units							
Permits	.78	.79	.70	.62	.67	.63	.56
Starts	.67	.75	.67	.61	.65	.62	.56
Mobile home shipments	.28	.26	.24	n.a.	.24	.23	n.a.

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

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



The rate of appreciation in existing home prices has slowed recently. In August and September, existing home prices were only 7 percent higher than a year ago, down from double-digit gains in the spring. In contrast, the rate of increase in new home prices has remained high, hitting 17 percent in the 12 months ending in August; however, a considerable part of this run-up likely reflects changes in the mix of sales towards larger, better-equipped homes.

Federal Government

Real federal purchases (on an NIA basis) were about unchanged between the second and third quarters. Defense spending rose slightly, following a surge of 20 percent at an annual rate in the second quarter. This seesaw pattern of spending largely reflects the erratic delivery of equipment--such as aircraft (including the B1 bomber), missiles (MX and others), and vehicles--that was authorized for purchase in earlier years.

The federal deficit (unified basis) reached a record $221 billion in FY1986, up from $212 billion in FY1985. Revenues rose only 5 percent in FY1986, half the pace of the previous two years, as sluggish economic growth and low inflation held down the growth of the tax base and the drop in oil prices reduced excise tax receipts. Outlays were up 4-1/2 percent over the year, but this relatively slow rate of spending growth was from a FY1985 base that was elevated by a one-time payment of $14 billion for HUD-guaranteed housing loans. In FY1986, particularly large outlay increases were recorded in defense (8 percent) and agriculture (22.5 percent). In addition, social security and medicare payments continued to rise at a 5-1/2 percent rate, and the growth of federal debt pushed net interest payments up 4-3/4 percent despite the decline in interest rates.

The Congress completed action on FY1987 budget legislation prior to adjournment on October 18 with the enactment of a reconciliation bill and an unusual continuing resolution; both measures have been signed by the President. The reconciliation bill was designed to reduce the FY1987 deficit almost $12 billion through the sale of assets, increased IRS enforcement activities, changes to a number of entitlement programs (principally medicare), and several small revenue increases. The continuing resolution folded all thirteen appropriation bills into one act that provides $577 billion in FY1987 budget authority. The increases in authority for defense were quite moderate by comparison with recent years, but outlays can be expected to continue to rise on the basis of prior-year authorizations; small increases or reductions were made in authority for other budget functions. Together, the two budget measures appear to meet the requirements of the Gramm-Rudman-Hollings Act to keep the deficit at or below $154 billion, without taking into account the added revenues from the first year of tax reform. Even so, most analysts believe that the deficit will turn out to be larger than $154 billion.

State and Local Government

Real purchases of goods and services by state and local governments increased at a 6 percent annual rate in the third quarter, only somewhat below the 8-3/4 percent pace of the second quarter. Real construction spending rose at a 30 percent annual rate; when combined with the 61 percent second-quarter rise, this surge was the largest for any two quarters since 1949. Despite the first drop in employment in three years, real outlays for compensation also increased in the third quarter, apparently reflecting a rise in compensation for teachers.

The fiscal position of states and localities remains mixed. Budget positions have continued to erode in most energy and farm states, while in contrast, the fiscal situation in most New England and mid-Atlantic states remains quite healthy. Many states under budgetary pressure are hoping that tax reform will provide some improvement in their fiscal position next year. About thirty states couple their income taxes to either federal adjusted gross income or federal taxable income, both of which are expected to rise as a result of the base-broadening aspects of tax reform. Financially-distressed states are expected to retain part or all of that windfall. Others, however, are considering various means of dealing with these increased receipts and, in many states, this has become an important campaign issue.

Exports and Imports

Based on preliminary GNP estimates,[3] the volume of merchandise exports rose 6 percent in the third quarter and the volume of imports was up 5-1/2 percent (quarterly rates). Although the increase in exports was the largest quarterly advance in several years, it was concentrated mainly in the aircraft category. Based on available data (July and August), there appears to be little increase in exports of machinery or

3. BEA's third-quarter estimates are based on incomplete information for both the prices and volume of merchandise trade and are subject to revision when the actual data become available.

consumer goods from their second-quarter levels and only a small increase in exports of industrial supplies. The rise in imports in the third quarter was dominated by a large swing in oil imports; excluding oil, import volume expanded 2-1/2 percent, with the gains evenly spread among capital goods, automobiles, and industrial supplies.

BEA estimates that import prices were little changed in the third quarter, as declines in the prices of oil and food imports were offset by increases in the prices of various manufactured products. However, the prices of imported non-oil industrial supplies were up in the third quarter, after declining for the past two years.

Prices

Although the overall rate of inflation picked up a bit during the third quarter, the acceleration mainly reflected movements in food and energy prices. Excluding food and energy items, the consumer price index rose 0.3 percent in September, about the same as the average monthly pace so far this year.

Petroleum prices moved up sharply at the wellhead and refinery levels in the September PPI, reflecting the rebound in spot market prices for crude oil that followed the early-August OPEC meeting. These higher crude costs also appeared at the retail level in September, with gasoline prices rising 2-1/2 percent and heating fuel prices up 1 percent. Although OPEC recently agreed to extend its production limitations until the end of the year, stocks are high and should continue to restrain upward pressure on retail energy prices in the near term.

Food prices increased rapidly in July and August, mainly reflecting reduced supplies of pork and summer drought conditions in the Southeast.

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

	Relative Importance Dec. 1985	1985	1986 Q1	1986 Q2	1986 Q3	1986 Aug.	1986 Sept.
			--Annual rate--			--Monthly rate--	
All items[2]	100.0	3.8	-1.9	1.5	2.2	.2	.3
Food	18.5	2.7	-1.4	3.4	9.4	.9	.4
Energy	11.3	1.8	-34.2	-12.5	-19.5	-1.9	.7
All items less food and energy	70.2	4.4	4.1	3.1	3.7	.3	.3
Commodities	25.9	2.1	.3	-.5	3.1	.3	.2
Services	44.4	5.7	6.5	5.2	4.1	.3	.3
Memorandum:							
CPI-W[3]	100.0	3.6	-2.7	1.0	2.0	.2	.3

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

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

	Relative Importance Dec. 1985	1985	1986 Q1	1986 Q2	1986 Q3	1986 Aug.	1986 Sept.
			--Annual rate--			--Monthly rate--	
Finished goods	100.0	1.8	-12.5	.0	1.1	.3	.4
Consumer foods	24.5	.5	-8.1	6.0	12.8	1.3	-.2
Consumer energy	12.5	-.3	-66.9	-25.1	-34.5	-1.5	3.7
Other consumer goods	40.3	2.7	2.5	1.7	2.5	.1	.2
Capital equipment	22.7	2.7	.7	1.9	2.6	.1	.4
Intermediate materials[2]	95.3	-.1	-11.8	-4.8	-1.3	-.2	.5
Exc. energy	79.6	-.1	-1.0	-1.3	2.0	.0	.3
Crude food materials	52.5	-6.4	-24.7	-.2	22.3	2.5	-.8
Crude energy	31.6	-4.9	-51.3	-33.8	-7.1	-2.6	3.7
Other crude materials	15.9	-4.3	-.2	6.6	-17.8	-5.3	.5

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

By September, however, supply conditions had improved somewhat, and food prices rose only 0.4 percent in the CPI for that month. Beef and pork prices continued to rise, but at a less rapid pace than in earlier months, while fresh poultry prices declined from their summer highs.

Outside of the food and energy sectors, the CPI inflation rate remained moderate through September. Both new and used car prices registered small increases, while apparel prices were up almost 2 percent over the July to September period, reflecting higher prices for fall merchandise. The August and September advances for nonenergy services were somewhat lower than in previous months, mainly because of smaller rent increases in August and a large decline in auto finance charges in September.

Excluding food and energy, the PPI for finished goods rose 0.3 percent in September, owing mainly to sizable increases in auto and light truck prices, despite widespread incentive programs. The PPI often is distorted at this time of year by measurement and seasonal adjustment problems associated with end-of-model-year liquidation allowances in September and the subsequent switch to the pricing of new-model vehicles in October.

Wages and Labor Costs

Recent data on wages and compensation suggest that low rates of price inflation, combined with little improvement in unemployment rates, have exerted downward pressure on wage growth this year. According to the BLS Employment Cost Index (ECI), which is based on a separate survey of employers, wages and salary rates in private industry rose about 3-1/2

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

	1984	1985	1986 Q1	1986 Q2	1986 Q3	1986 Year to date
Hourly earnings index, wages of production workers[1]						First nine months
Total private nonfarm	2.9	3.0	2.7	1.8	1.1	1.5
Manufacturing	3.4	3.3	2.3	2.4	1.4	1.6
Nonmanufacturing	2.7	2.9	2.8	1.6	1.0	1.5
Employment cost index, compensation of all persons[2]						1985-Q4 to 1986-Q3
Total	4.9	3.9	4.5	3.1	2.8	3.5
By occupation:						
White collar	5.1	4.8	4.7	3.7	3.1	3.8
Blue collar	4.2	3.2	4.2	1.9	2.9	3.0
Service workers	6.6	3.0	4.4	.6	3.7	2.9
By bargaining status:						
Union	4.3	2.6	4.2	.9	2.2	2.4
Nonunion	5.2	4.6	4.8	3.8	3.1	3.9
Employment cost index, wage and salaries of all persons[2]						
Total	4.1	4.1	3.9	3.5	2.8	3.4
Major collective bargaining agreements[3]						First nine months
First-year wage adjustments	2.4	2.3	—	—	—	1.3
Total effective wage change	3.7	3.3	—	—	—	2.7
Labor costs and productivity, all persons[1]						1985-Q4 to 1986-Q3
Compensation per hour	4.3	3.9	3.1	2.3	2.3	2.6
Output per hour	1.0	.2	4.3	.5	.2	1.7
Unit labor costs	3.2	3.7	-1.2	1.8	2.1	.9

1. Changes are from final quarter of preceding period to final quarter of period indicated. Quarterly and year-to-date changes at compound rates. Seasonally adjusted data.
2. Changes are from final month of preceding period to final month of period indicated. Quarterly changes at compound rates; not seasonally adjusted.
3. Agreements covering 1,000 or more workers; not seasonally adjusted.

percent over the past 12 months, down from the 4 percent advance for 1985. The rise in fringe benefits also has remained moderate and, as a result, hourly compensation in the ECI also is up at a 3-1/2 percent rate so far this year. The other measure of hourly compensation in the nonfarm business sector, which is derived from the national income accounts and the BLS establishment survey, shows a slightly faster slowing in compensation growth--from 4 percent in 1985 to a 2-1/2 percent annual rate over the first three quarters of this year.

In general, the deceleration in wage inflation this year has been widespread across industries and occupations. Pay gains at service-producing establishments have slowed especially sharply in recent quarters, but pay increases in manufacturing also moderated further. By occupation, hourly compensation has slowed considerably this year for white-collar workers, but the size of increases for this group continues to outpace those for blue-collar workers.

Wage increases continue to be especially small in the unionized sector. Negotiated wage adjustments for the 1.8 million private industry workers reaching new settlements so far this year averaged just 1.3 percent in the first year of the agreement and 1.9 percent over the life of the contract, exclusive of lump-sum payments and COLAs. In many contracts, however, lump-sum payments have been negotiated in lieu of general wage increases; indeed, more than one-third of the workers covered by settlements reached so far this year--including workers in communications, steel, and aerospace--will receive lump sums. Nevertheless, when viewed as a whole, the union sector remains a source of wage restraint. Not only have new settlements been quite small, but low rates of price inflation have virtually eliminated COLA payments this year. As a result, wage increases for unionized workers, which this year have averaged about 2-1/4 percent in the ECI compensation measure (which includes lump sums), remain well below the 4 percent average for nonunion workers.

Despite the deceleration in wage growth, slow productivity growth has caused most of the increase in hourly compensation to be passed directly through into unit labor costs. Productivity was little changed in the third quarter and has risen just 0.3 percent over the past year. Unit labor costs were up 2 percent in the third quarter and 2-1/2 percent over the past year.

DOMESTIC FINANCIAL DEVELOPMENTS

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

	1984 Highs	1985 March highs	1986 April lows	1986 FOMC Sept. 23	1986 Oct. 28	Change from: April lows	Change from: FOMC Sept. 23
Short-term rates							
Federal funds[2]	11.63	8.58	6.95	5.83	5.87	-1.08	.04
Treasury bills[3]							
3-month	10.67	8.80	5.77	5.25	5.20	-.57	-.05
6-month	10.77	9.13	5.81	5.41	5.27	-.54	-.14
1-year	11.13	9.25	5.79	5.49	5.47	-.32	-.02
Commercial paper							
1-month	11.42	8.94	6.42	5.78	5.77	-.65	-.01
3-month	11.35	9.12	6.30	5.75	5.73	-.57	-.02
Large negotiable CDs[3]							
1-month	11.52	8.89	6.51	5.81	5.73	-.78	-.08
3-month	11.79	9.29	6.39	5.81	5.73	-.66	-.08
6-month	12.30	9.92	6.35	5.82	5.75	-.60	-.07
Eurodollar deposits[4]							
1-month	11.89	8.89	6.59	6.01	5.95	-.64	-.06
3-month	12.20	9.58	6.55	5.96	5.95	-.60	-.01
Bank prime rate	13.00	10.50	8.50	7.50	7.50	-1.00	--
Intermediate- and long-term rates							
U.S. Treasury (constant maturity)							
3-year	13.49	11.22	6.49	6.77	6.62	.13	-.15
10-year	13.99	12.02	6.98	7.58	7.45	.47	-.13
30-year	13.94	11.97	7.14	7.76	7.75	.61	-.01
Municipal revenue[5] (Bond Buyer index)	11.44	10.25	7.55	7.57	7.49	-.06	-.08
Corporate--A utility Recently offered	15.30	13.23	9.15	9.64[e]	9.46[e]	.31	-.18
Home mortgage rates[6]							
S&L fixed-rate	14.68	13.29	9.86	10.07	9.95	.09	-.12
S&L ARM, 1-yr.	12.31	11.14	8.41	8.19	8.03	-.38	-.16

	1984 Lows	1985 March lows	1986 Record highs	1986 FOMC Sept. 23	1986 Oct. 28	Percent change from: Record highs	Percent change from: FOMC Sept. 23
Stock prices							
Dow-Jones Industrial	1086.57	1247.35	1919.71	1797.81	1845.47	-3.87	2.65
NYSE Composite	85.13	102.46	145.75	135.60	137.89	-5.40	1.68
AMEX Composite	187.16	222.28	285.19	262.65	262.45	-7.98	-.08
NASDAQ (OTC)	225.30	276.18	411.16	353.37	357.20	-13.13	1.08

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 October 22, 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

Interest rates generally have declined marginally on balance since the last FOMC meeting. While federal funds have continued to trade mainly in the vicinity of 5-7/8 percent, other rates have fluctuated over the intermeeting period in response to incoming economic data and to any indications of official attitudes here and abroad regarding possible policy actions. Although some of the more noticeable rate declines in recent weeks have been in the intermediate and long-term sectors, the term structure of rates basically has maintained the steeper upward slope that emerged over the summer.

M1 and M2 decelerated in September, and while some reacceleration appears in train for October, their expansion has remained below the rates seen in prior months. The slower rise in M1 has reflected primarily a sharp drop in demand deposit growth; inflows to NOW accounts have remained strong, as have the liquid retail categories of the nontransactions component of M2. M2 has remained near the upper bound of its 1986 growth range, while M1 is still far above its range, registering velocity declines of a magnitude unparalleled in recent decades. M3 growth in September was closely in line with its average for the year, keeping this aggregate at the upper limit of its range, and early indications are that M3 will slow somewhat this month.

Debt of domestic nonfinancial sectors likely continued to rise rapidly in September. Household borrowing undoubtedly was boosted by the surge in auto sales stemming from cut-rate financing promotions, and mortgage credit growth appears brisk. In contrast, credit use by nonfinancial businesses in September appears to have diminished in both short- and long-term markets. Federal borrowing had been comparatively light for several weeks, reflecting

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

	1984:Q4 to 1985:Q4	1986 Q2	1986 Q3p	1986 July	1986 Aug.	1986 Sept.p	Growth from Q4 1985 to Sept. 1986p
	------ Percentage change at annual rates ------						
1. M1	11.9	15.8	17.4	16.7	20.8	9.9	14.2
2. M2	8.7	10.4	11.2	12.8	11.1	7.6	8.9
3. M3	7.7	9.0	10.1	13.0	8.9	8.9	9.1
							Levels in billions of dollars Sept. 1986p
Selected components							
4. Currency	7.5	6.2	7.3	5.4	10.1	5.4	179.8
5. Demand deposits	8.6	15.2	14.4	14.3	14.6	1.6	292.2
6. Other checkable deposits	22.3	25.8	31.2	29.5	39.4	25.6	215.1
7. M2 minus M1[2]	7.7	8.7	9.1	11.5	7.9	6.8	2047.8
8. Overnight RPs and Eurodollars, NSA	20.0	-2.3	28.3	97.7	41.8	-30.7	72.3
9. General purpose and broker/dealer money market mutual fund shares, NSA	9.3	27.3	13.8	14.6	3.6	11.4	202.2
10. Commercial banks	9.1	5.7	6.3	6.1	5.5	7.1	881.5
11. Savings deposits, SA, plus MMDAs, NSA[3]	19.0	13.2	18.5	15.3	19.5	20.6	508.9
12. Small time deposits	-0.6	-3.1	-9.0	-5.3	-12.6	-10.9	372.6
13. Thrift institutions	5.1	7.3	5.9	7.3	4.2	1.6	892.9
14. Savings deposits, SA, plus MMDAs, NSA[3]	13.7	13.8	18.9	17.7	16.8	10.8	393.8
15. Small time deposits	-0.4	2.6	-3.6	-0.5	-5.7	-5.3	499.1
16. M3 minus M2[4]	3.8	3.4	6.0	13.8	0.0	14.0	683.9
17. Large time deposits	5.7	-1.8	-1.1	1.6	5.1	-2.1	446.8
18. At commercial banks, net[5]	5.1	-8.8	-3.0	-2.1	7.3	-2.6	281.1
19. At thrift institutions	6.8	11.0	2.4	8.0	2.2	-2.2	165.7
20. Institution-only money market mutual fund shares, NSA	11.1	39.2	30.9	40.0	51.1	53.5	84.4
21. Term RPs, NSA	-4.0	19.3	15.2	-4.8	9.6	41.2	78.4
22. Term Eurodollars, NSA	-4.9	6.1	-6.5	-19.5	-9.1	36.8	80.6
	-- Average monthly change in billions of dollars --						
MEMORANDA:							
23. Managed liabilities at commercial banks (24+25)	2.5	-5.5	4.0	2.0	5.9	4.1	484.4
24. Large time deposits, gross	1.0	-2.6	0.8	-1.4	4.2	-0.5	342.1
25. Nondeposit funds	1.5	-2.9	3.2	3.4	1.7	4.6	142.3
26. Net due to related foreign institutions, NSA	0.4	-1.7	-0.2	-5.7	0.0	5.2	-25.0
27. Other[6]	1.1	-1.2	3.4	9.1	1.8	-0.7	167.3
28. U.S. government deposits at commercial banks[7]	0.2	0.9	-0.8	-3.8	-1.6	2.9	16.0

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 August and September 1986 at rates of 30.6 percent and 36.0 percent, respectively. At thrift institutions, savings deposits excluding MMDAs increased during August and September 1986 at rates of 17.0 percent and 15.6 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

debt ceiling constraints, but the recently enacted increase in the debt ceiling is enabling the Treasury to bring to market a substantial volume of securities, including the midquarter financing. The tax-exempt bond market also appears to be rebounding somewhat after a lull in issuing activity, now that various impediments have been removed by the enactment of tax reform.

Monetary Aggregates and Bank Credit

M1 growth fell in September to a 10 percent annual rate, reflecting an abrupt halt to demand deposit growth as well as some slowing of OCD growth--albeit only to a 26 percent annual rate. Partial data for October suggest only a slight pickup in demand deposit growth, while OCD growth appears to have rebounded to about its average pace of the summer.

The slowdown in M1 growth in September combined with somewhat reduced growth in nontransactions balances to produce a deceleration in M2, to a 7-1/2 percent annual rate of expansion. Overnight RPs declined markedly, reflecting a substitution of term financing, and small time deposits again ran off rather sharply. Savings deposits, however, continued to grow rapidly, increasing at a 23-1/2 percent annual rate, about the average pace of the previous four months. In October, the nontransactions component of M2 appears to have picked up despite increased outflows from small time deposits: overnight RPs have resumed growing, and the remaining nontransactions components of M2 all seem to be expanding at faster rates than in September.

Patterns of retail deposit growth continue to be influenced by relative movements in interest rates. The particular strength of passbook savings apparently reflects the fact that, although some institutions have

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

		1986 Q1	Q2	Q3p	July	Aug.	Sept.	Levels in bil. of dollars September
		Commercial Bank Credit						
1.	Total loans and securities at banks	9.3	3.9	13.0	13.2	13.8	11.5	2027.1
2.	Securities	2.0	4.9	31.6	34.3	29.0	28.2	494.6
3.	U.S. government securities	-5.3	7.9	28.1	46.3	23.1	13.2	294.1
4.	Other securities	12.8	0.7	36.8	16.3	40.0	51.2	200.5
5.	Total loans	11.6	3.6	7.3	6.6	8.9	6.2	1532.6
6.	Business loans	5.3	2.0	1.7	0.5	4.0	0.7	510.8
7.	Security loans	102.7	-62.7	14.1	64.9	-16.1	-5.4	44.0
8.	Real estate loans	13.1	13.3	13.6	14.1	14.7	11.4	465.8
9.	Consumer loans	11.0	6.7	5.6	4.7	4.7	7.4	308.8
10.	Other loans	7.3	-1.6	8.6	-3.0	19.4	9.5	203.2
		Short- and Intermediate-Term Business Credit						
11.	Business loans net of bankers acceptances	5.2	1.0	1.7	1.0	4.0	0.2	505.6
12.	Loans at foreign branches[2]	0.0	-21.5	9.1	34.1	-19.9	13.5	18.0
13.	Sum of lines 11 & 12	5.1	0.2	2.0	2.1	3.2	0.7	523.7
14.	Commercial paper issued by nonfinancial firms[3]	-14.4	-10.3	10.6	-21.6	60.1	-5.6	85.5
15.	Sums of lines 13 & 14	2.1	-1.3	3.2	-1.2	10.9	-0.2	609.2
16.	Bankers acceptances: U.S. trade related[4,5]	-6.2	16.3	2.4	14.5	-7.1	0.0	33.4
17.	Line 15 plus bankers acceptances: U.S. trade related	1.7	-0.3	3.1	-0.6	9.8	0.0	642.6
18.	Finance company loans to business[4]	16.4	3.8	n.a.	2.3	5.3	n.a.	159.5 (Aug.)
19.	Total short- and intermediate-term business credit (sum of lines 17 & 18)	4.6	0.5	n.a.	0.0	8.9	n.a.	801.9 (Aug.)

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.

lowered the rates paid on these accounts, most have been reluctant to risk disturbing a long profitable class of stable deposits. The interest rate spread of 6-month retail CDs over savings accounts has narrowed sharply since the second quarter, and the rate advantage of MMDAs has virtually disappeared. Even the slow-to-adjust rates on NOW accounts have fallen more rapidly than savings rates, placing the average rate on NOWs below that on savings accounts.

COMMERCIAL BANK INTEREST RATE SPREADS:
SELECTED ACCOUNTS LESS SAVINGS ACCOUNTS
(Basis points, except as noted)

Account	Q2 average	July	August	September
6-month small-time deposit	116	88	61	45
MMDA	61	33	14	2
NOW account	3	-3	-9	-15
Memo: savings deposit rate (percent)	5.43	5.36	5.34	5.30

Despite the slowdown in M2, M3 growth in September matched the 9 percent pace of the preceding month. The pickup in the non-M2 component of M3 was paced by increases in institution-only money funds, term RPs, and Eurodollars. Large time deposits ran off a bit in September and appear to have dropped noticeably in October. Large CDs have been declining throughout much of this year; commercial banks experiencing earnings pressures have contributed to this decline, but the weakness in CDs has been widespread.

Bank credit growth slowed somewhat in September; nonetheless, owing to a large month-average increase in securities holdings, asset expansion

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

	1985	1986			1986		
	Year	Q1	Q2	Q3p	Aug.p	Sept.p	Oct.e
Corporate securities - total[1]	16.08	27.84	30.36	23.48	27.19	19.20	25.90
Public offerings in U.S.	12.93	23.82	26.27	20.26	24.12	15.70	22.90
Stocks—total[2]	2.96	4.46	5.71	4.38	5.82	3.00	4.40
Nonfinancial	1.61	2.20	2.84	2.09	2.44	1.60	2.20
Utility	.37	.65	.61	.51	.64	.30	.40
Industrial	1.24	1.55	2.23	1.58	1.80	1.30	1.80
Financial	1.35	2.26	2.87	2.29	3.38	1.40	2.20
Bonds—total[1]	9.97	19.36	20.56	15.88	18.30	12.70	18.50
Nonfinancial	5.21	9.99	12.27	8.17	9.83	6.30	4.50
Utility	1.51	3.30	4.30	5.04	5.57	2.70	2.50
Industrial	3.70	6.69	7.97	3.13	4.26	3.60	2.00
Financial	4.76	9.37	8.29	7.71	8.47	6.40	14.00
By quality[3]							
Aaa and Aa	2.35	5.45	6.32	3.72	5.87	1.95	7.20
A and Baa	4.58	7.72	6.10	5.04	7.23	3.60	3.80
Less than Baa	1.42	2.75	4.67	3.05	2.19	2.60	1.40
No rating (or unknown)	.34	.30	.36	.52	.24	.65	.30
Memo items:							
Equity-based bonds[4]	.70	1.16	1.26	.70	.76	.27	.40
Mortgage-backed bonds	1.28	3.14	3.11	3.55	2.77	3.90	5.80
Variable-rate notes	.87	.33	.60	.72	.32	.88	.80
Bonds sold abroad - total	3.15	4.02	4.09	3.22	3.07	3.50	3.00
Nonfinancial	1.26	2.04	2.07	.91	.72	.85	1.00
Financial	1.89	1.98	2.02	2.31	2.35	2.65	2.00

p—preliminary. e—staff estimate.
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.

remained at a double-digit annual rate. The bulk of this rise reflected purchases of securities around the beginning of the month; during the remainder of September, banks sold off both U.S. government and state and local securities on balance. Loan growth moderated in September, as real estate loans expanded somewhat less rapidly and business loans grew only marginally. Foreign-related institutions accounted for the increase in business loans, in part through their continued extensive participation in merger-related loans.[1] In October, business loan growth seems to have picked up somewhat, but declines in security loans outstanding and in bank holdings of state and local securities probably have depressed the growth of total bank credit to a rate well below that of the third quarter.

Corporate Finance

Borrowing by nonfinancial businesses appears to have diminished in September as the weakness in business loans at banks was accompanied by a paydown of outstanding commercial paper and a reduction in gross offerings of corporate bonds. Incomplete data for October provide a mixed picture for credit growth this month; outstanding nonfinancial commercial paper and business loans at large banks rose in the first part of the month, but corporate bond volume has eased somewhat further.

Gross equity issuance by nonfinancial corporations declined abruptly in September in conjunction with the sharp drop in share prices around midmonth. Although activity has picked up again since the market has firmed, gross offerings have remained well below the volume of share retirements. Provisions of the Tax Reform Act that will reduce the tax

1. One factor that may be contributing to the continued rapid growth of business loans at foreign-related institutions is that these lenders are not subject to the capital guidelines imposed on U.S.-chartered banks.

advantages of some types of mergers after year-end have contributed to a hectic pace of corporate acquisitions, LBOs, and share repurchases.

The backup in corporate bond yields in early September discouraged public offerings of bonds in domestic markets by financial as well as nonfinancial firms. Mortgage-backed bonds--mainly CMOs--accounted for more than half of September issuance by financial institutions, and the volume of these bonds is expected to increase further in October. This increased issuance, as well as that of other asset-backed securities, appears to have boosted total gross offerings by financial corporations to a record level in October.

The family of asset-backed securities has expanded to include those backed by automobile loans, computer leases, and credit card receivables as well as home mortgages. Securities backed by car loans have been particularly popular, totaling some $4.4 billion during the first three quarters of this year, with an additional $4-billion offering of debt securities backed by General Motors Acceptance Corporation automobile loans in October. These GMAC-backed bonds have three tranches of differing average maturity and yield and, unlike most asset-backed bonds, will repay principal according to a fixed schedule without subjecting investors to prepayment risk (which will be borne by the investment banker). Another unusual aspect of these asset-backed securities is that investors retain substantial recourse to the originator/servicer--GMAC--in case of loan defaults.

Treasury and Sponsored Agency Financing

The combined deficit of the federal government is projected by the Board staff to total $59 billion in the fourth quarter, after deficits of

$54 billion in the third quarter and $221 billion for FY 1986. The proportion of the combined deficit to be financed by marketable Treasury debt in November and December is greater than that for October and the third quarter because of both the delayed increase in the debt ceiling and the anticipation of a continued reduction in the issuance of special nonmarketable securities to state and local units (SLGs). The debt ceiling constraint forced the Treasury to draw down its cash balance in late September and October as it postponed one note offering and scaled down weekly bill auctions. Enactment of the new debt ceiling--which should provide adequate leeway until next spring--is allowing the Treasury to catch up on its financing needs just before the regular midquarter refunding. The expected reduction in issuance of SLGs during the remainder of the year reflects a post-tax-reform decrease in state and local government offerings of advance refunding bonds, which typically have their proceeds placed into SLGs.

In addition to the traditional forms of finance available to the Treasury, the FY 1987 Budget Reconciliation Act contains provisions for selling to the public both physical assets and loans; however, the timing of these sales has not yet been determined. The most notable planned sale of assets is that of Conrail, which is expected to net some $1.7 billion. Roughly $3 billion in proceeds are expected in FY 1987 from the sale of loans, the face value of which totals about $4-1/2 billion; these sales will be without guarantee or other recourse to the federal government.

Borrowing by the federally sponsored credit agencies is expected to fall off in the fourth quarter from the $4-1/2 billion to $5 billion pace of the two preceding quarters. Debt issuance by the Federal Home Loan Banks (FHLBs) likely will moderate because the demand by thrift institu-

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

	1986				
	Q3[p]	Q4[e]	Sep.[p]	Oct.[e]	Nov.[e]
Treasury financing					
Combined surplus/deficit(-)	-53.8	-59.0	-3.7	-26.8	-25.1
Means of financing deficit:					
Net cash borrowing from the public	57.6	58.6	22.3	4.6	36.3
Marketable borrowings/ repayments(-)	51.2	54.0	21.5	2.8	34.9
Bills	14.1	17.2	7.1	1.4	11.7
Coupons	37.1	36.8	14.4	1.4	23.2
Nonmarketable	6.4	4.6	.8	1.8	1.4
Decrease in the cash balance	-6.8	3.4	-21.0	20.5	-5.0
Memo: Cash balance at end of period	31.4	28.0	31.4	10.9	15.9
Other[2]	3.0	-3.0	2.4	1.7	-6.2
Federally sponsored credit agencies, net cash borrowing[3]	5.3	3.0	1.5	0.9	1.0
FHLBs	5.8	4.5	1.6	1.5	1.5
FNMA	-0.9	-1.0	-0.7	-0.4	-0.3
Farm Credit Banks	-0.3	-1.5	0.3	-0.6	-0.4
FHLMC	0.6	0.5	0.1	0.2	0.1
SLMA	0.1	0.5	0.2	0.2	0.1

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

tions for advances appears to be slowing.[1] The external financing needs of FNMA continue to be reduced by prepayments and sales of older mortgages from its portfolio. The Farm Credit Banks (FCBs) borrowed a small amount in September; for the third quarter as a whole, they made only a modest net paydown of debt and built up liquid assets. It is expected that the farm credit agencies will resume more sizable paydowns in the fourth quarter, as the underlying weakness of agricultural loan demand shows through more fully in the FCBs' financing needs.

Legislation has recently been enacted that will allow the Farm Credit Banks to improve their reported net income through accounting gimmicks. One element is the reporting of interest expense as if older, higher-yielding debt were replaced by securities paying current, lower interest rates. The FCBs will not be required to realize the implicit capital loss on this balance sheet restructuring in the current period. Also, they will be allowed to write off loan losses over a period of 20 years, instead of having to realize them fully in the current period. These changes do not resolve, in any fundamental sense, the difficulties faced by the FCBs, and the market has reacted with skepticism: the spread between interest rates on Farm Credit securities and those on Treasury debt has widened somewhat since this plan was announced. For example, the spread at the 6-month maturity is currently 10 to 15 basis points greater than it had been throughout most of the year (although still substantially less than at the peak of the FCS financial crisis).

1. The FHLBs have taken steps to broaden the financing options of thrift institutions. For example, they have issued letters of credit to support interest rate swaps and debt instruments of member thrifts. Recently, the FHLBs have developed a plan to lower the cost of brokered deposits to troubled thrifts by marketing their CDs nationally and issuing letters of credit to the dealers who sell them.

State and Local Securities Markets

Offerings of tax-exempt securities shriveled after September 1, when various restrictions on public-purpose securities became effective under the Tax Reform Act. After massive issuance--$52 billion--in the previous two months, volume dropped off to less than $5 billion in September. A pickup in offerings appears to have gotten under way this month, but thus far it has been of moderate proportions.

GROSS OFFERINGS OF MUNICIPAL SECURITIES
(Monthly rates, not seasonally adjusted, billions of dollars)

	1985	1986			1986			
	Year	Q1	Q2	Q3	July	Aug.	Sept.	Oct.[e]
Total tax-exempt	19.82	4.93	15.89	18.98	25.05	26.99	4.89	8.50
Short-term[1]	1.97	.64	3.09	2.14	5.22	1.03	.18	.50
Long-term	17.85	4.29	12.80	16.84	19.83	25.96	4.71	8.00
Refundings[2]	4.84	2.06	5.38	5.37	6.67	8.15	1.28	n.a.
New capital	13.00	2.23	7.42	11.47	13.16	17.81	3.43	n.a.
Total housing	2.11	.05	.40	.44	.38	.81	.14	n.a.
Total taxable	.03	.05	.30	.48	.37	.62	.44	1.00

1. Does not include tax-exempt commercial paper.
2. Includes all refunding bonds, not just advance refundings.
e--staff estimate.
n.a.--not available.

The signing of the Tax Reform Act into law may cause issuance of private-purpose tax-exempt bonds to surge during the remainder of this year. While the aggregate volume of private-purpose tax-exempt issuing authority for 1986 contained in the Act is small relative to recent years, virtually none of this authority has yet been tapped.[1] Throughout most of the year, many potential issuers of these bonds were uncertain as to

1. The aggregate volume of private-purpose tax-exempt bonds authorized by the Tax Reform Act for 1986, not counting issues of certain exempt private entities, is about $21 billion. Annual issuance of all such bonds ranged between $55 billion and $75 billion in the years 1983 to 1985.

how tax reform legislation would affect the tax status of their issues. Tax reform provisions regarding arbitrage and advance refunding opportunities, which profoundly affect the attractiveness of issuing these securities, also were unclear for much of the year. Even now that the Tax Reform Act has become law, many states have not yet allocated the authority among competing issuers.[1]

Mortgage Markets

Interest rates in the primary and secondary mortgage markets have eased a little over the intermeeting period. At S&Ls, contract rates for new commitments on conventional fixed-rate home mortgage loans averaged 9.95 percent for the week ending October 24, down 12 basis points since the last FOMC meeting, and close to the low recorded during the spring. The effective interest rate on fixed-rate commitments quoted by large mortgage companies was off by 30 basis points, reflecting similar declines in the secondary market.

Over the past several months, adjustable-rate mortgages (ARMs) have become more popular relative to fixed-rate loans, according to a Federal Home Loan Bank Board survey of major institutional lenders; in early September, one in three conventional loans closed for the purchase of a single-family home carried an adjustable rate, up from one in five during June. The growing acceptability of ARMs is attributable to more attractive pricing; the spread between initial rates on fixed- and adjustable-rate loans currently exceeds 190 basis points, about half a percentage point wider than the spread six months ago. Furthermore, over this same interval,

1. Under the Act, state-by-state caps limit the annual volume of all private purpose tax-exempt bonds (except for certain exempt entities) to greater of $75 per capita or $250 million for calendar years 1986 and 1987.

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-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	19.2	7.0	7.5	4.7	8.5
Q3 p	26.2	8.7	9.6	7.9	10.8
1986-Apr.	15.3	6.9	5.6	2.8	5.8
May	17.7	5.9	7.4	4.5	8.7
June	24.6	8.2	9.6	6.8	11.2
July r	24.4	10.2	8.1	6.1	9.8
Aug. r	23.0	6.8	9.1	7.1	10.7
Sept.p	31.8	12.9	11.5	7.4	11.8

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-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. r	17.6	10.9	2.8	2.3	.5
Mar. r	16.4	12.5	4.2	3.3	.9
Apr. r	19.2	13.1	5.2	1.1	4.1
May r	20.1	14.0	8.2	1.3	6.9
June r	21.7	11.6	4.6	-.8	5.4
July r	23.8	13.6	2.2	1.0	1.3
Aug. r	22.9	14.4	2.0	1.7	.2
Sept.p	22.8	17.7	2.1	-1.3	3.5

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

lenders have, on average, lowered origination fees on ARMs while raising fees on fixed-rate loans.

Indicators of lending activity suggest that mortgage debt grew rapidly during the third quarter. Real estate loans at commercial banks rose at a 13-1/2 percent clip during the period, about the same pace as during the second quarter. At FSLIC-insured thrifts, mortgage originations reached a record level in the third quarter. However, holdings of mortgage loans at these institutions have risen comparatively little due to an extraordinary level of prepayments and to swapping of residential loans for more liquid mortgage-backed securities. Issuance of mortgage-backed securities continues to fuel the major portion of residential mortgage credit; a record $79 billion of federally related MBSs were issued during the third quarter, compared with $108 billion for all of 1985.

In October, the first REMICs--Real Estate Mortgage Investment Conduits--were priced for settlement in January. Created by the Tax Reform Act, REMICs are tax-favored entities that hold mortgage loans and issue securities backed by these assets. For issuers of multi-class mortgage-backed securities, REMICs provide several advantages over collateralized mortgage obligations (CMOs), and REMICs will eventually supplant CMOs.[1] The REMICs issued thus far have been backed by FNMA pass-through securities, representing pools of conventional, fixed-rate loans.

1. Compared with REMIC securities, CMOs must be structured with various characteristics--such as overcollateralization--in order to gain favorable tax treatment, even though these attributes serve no economic purpose. Two other advantages REMIC securities have over CMOs are that they will count as qualifying mortgage assets for purposes of determining a thrift's eligibility for the bad debt reserve deduction, and the securities will be eligible investments for REITs. The tax reform legislation prohibits issuance of CMOs after 1991.

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	July[r]	Aug.[p]	July[r]	Aug.[p]	Aug.[p]
Total[1]	20.6	18.0	11.8	12.2	11.8	7.8	5.56	3.74	577.0
Selected types									
Auto	18.7	19.3	15.3	15.4	19.6	13.3	3.63	2.51	228.7
Revolving	25.7	20.1	13.0	8.5	8.2	1.8	.86	.19	125.8
All other	19.7	15.6	7.8	11.0	6.1	5.7	1.08	1.04	222.4
Selected holders									
Commercial banks	23.5	15.1	7.3	7.5	6.9	5.3	1.45	1.11	252.3
Finance companies	11.6	24.9	24.4	23.6	20.1	15.2	2.26	1.74	138.9
Credit unions	25.3	12.9	9.7	11.1	15.7	6.4	1.04	.43	80.6
Savings institutions[2]	37.7	37.8	14.5	19.3	13.9	7.5	.70	.38	61.4

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

CONSUMER INTEREST RATES
(Annual percentage rate)

			1986				
	1984	1985	Apr.	May	June	July	Aug.
At commercial banks[1]							
New cars (48 mo.)	13.71	12.91	...	11.44	...	...	11.00
Personal (24 mo.)	16.47	15.94	...	14.90	...	...	14.70
Credit cards	18.77	18.69	...	18.33	...	...	18.16
At auto finance cos.[2]							
New cars	14.62	11.98	10.55	9.49	9.35	9.31	9.29
Used cars	17.84	17.59	16.67	16.56	16.06	15.83	15.56

1. Average of "most common" rate charged for specified type and maturity during the first week of the mid-month of each quarter.
2. Average rate for all loans of each type made during the month regardless of maturity.

Consumer Installment Credit

Growth in consumer installment credit slowed in August to a 7-3/4 percent annual rate from an 11-3/4 percent July advance. The weakness in August was widespread across most credit types and holders. Auto credit growth accounted for about two-thirds of the total gain for the third consecutive month.

Installment credit likely advanced strongly in September, reflecting the full impact of automakers' concessionary finance programs that began in late August. Although the largest share of the increase in September auto credit probably occurred at the captive finance companies, other lenders also are likely to have experienced significant gains; foreign car sales were up sharply and a significant number of buyers of domestic cars chose cash rebates instead of cut-rate financing.

Consumer installment credit growth has slowed appreciably in 1986 from the very rapid pace seen in 1984 and 1985. Installment debt rose at an annual rate of about 12 percent between December 1985 and August 1986--down sharply from about 20 percent in each of the previous two years. Excluding auto credit, the slowdown has been even more striking--to 9 percent this year from 17 percent in 1985 and 22 percent in 1984. There is no evidence--despite increasing loan losses--that lenders are less willing suppliers of credit. On the demand side, surveys continue to indicate that an unusually large proportion of consumers still regard borrowing as an acceptable means to make desired purchases, but a combination of high relative interest rates on credit cards and record debt burdens may be tempering borrowing.

INTERNATIONAL DEVELOPMENTS

Foreign Exchange Markets

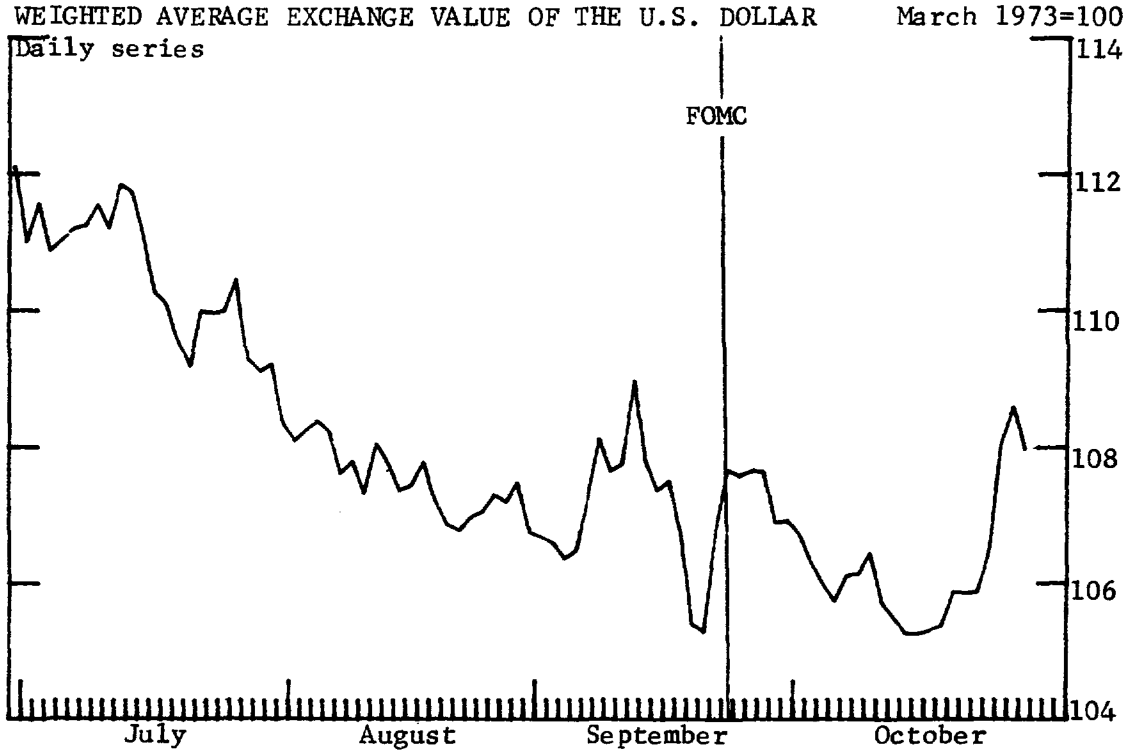
As shown in Chart 1, on a weighted-average basis the foreign-exchange value of the dollar has gained about 1/4 percent since the September 23 FOMC meeting. During the first two weeks of the inter-meeting period, the dollar moved downward, most noticeably against the mark, as it became apparent that any expectations of interest-rate reductions in Germany would not be realized. Disappointing U.S. data and the failure of G-7 authorities to agree on new initiatives in the international monetary area at the time of the annual meetings of the International Monetary Fund and World Bank in late September seemed also to contribute to the dollar's weakness.

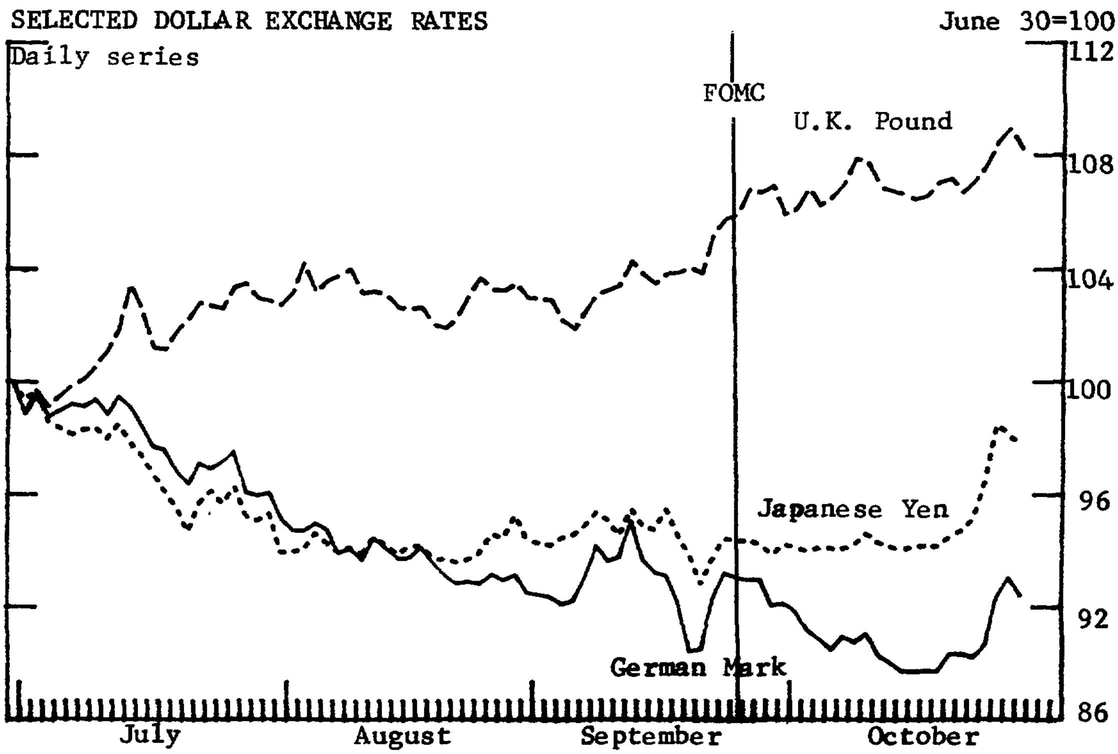
. Through mid-October the dollar's value fell by about 3-3/4 percent against the mark and 2-1/4 percent on a weighted-average basis, but remained relatively flat against the yen and gained steadily against sterling.

During the past week or so, the dollar has recovered strongly, primarily against the yen as Japanese institutional investors were reported to have shifted from yen-denominated assets and toward assets denominated in dollars. Recent gains have moved the dollar's value versus the yen to a level 3-3/4 percent above that at the start of the intermeeting period; against the mark, the dollar is down on balance about 1-1/4 percent during the same period.

Chart 1

10/29/86





Both short-term and long-term interest-rate differentials have moved somewhat against the dollar during the intermeeting period. Foreign short-term interest rates generally have moved upward while U.S. short-term interest rates have eased slightly. In the United Kingdom, short-term interest rates increased by about 150 basis points as U.K. authorities raised their discount and official dealing rates to banks by a full percentage point in mid-October to counteract strong downward pressure on the pound, which had fallen to record lows against the mark. The weakness of sterling appears to be based on concern over rising U.K. wage costs and decreasing confidence in the Thatcher government. Long-term interest-rate differentials have exhibited similar movements, as U.S. long-term rates have eased by about 10 basis points during the intermeeting period and long-term rates in several foreign countries including Japan, Germany, and the United Kingdom have moved upward by 10-20 basis points.

. In recent weeks, spreads against the mark within the EMS have narrowed.

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Bank lending to foreigners in the second quarter. U.S.-chartered banks' claims on foreigners declined $3 billion in the second quarter of 1986. However, on an exchange-rate-adjusted basis the decrease appears to have been about $10 billion, because the weighted average dollar fell 5 percent in the second quarter and thereby raised the dollar value of the banks' nondollar claims by about $7 billion. On an exchange-rate-adjusted basis, claims fell about $13 billion in the first half of 1986, following an estimated $29 billion drop in the full year 1985. The 1985 figure reflected inter alia the sale of about $2.3 billion of claims on non-OPEC developing countries by Crocker National Bank to its U.K parent, Midland Bank.

In the second quarter, changes in claims on the various country groups (on an unadjusted basis) were small or nil. Claims on non-OPEC developing countries dropped $1.8 billion, bringing the cumulative decline since the end of 1984 to $10 billion (and only slightly more at constant exchange rates, since probably 95 percent or more of these claims are dollar-denominated). Within this group, second-quarter changes in claims on Latin American countries were small, the largest being a rise of $0.3 billion in claims on Argentina, which drew the remaining balance of its 1985 bank loan. In Asia, the most notable changes were further declines in claims on Korea and Taiwan that brought the cumulative decreases in claims on these countries since end-1984 to $1.9 billion (almost 20 percent) vis-a-vis Korea and $1.5 billion (30 percent) vis-a-vis Taiwan.

Data through the first half of 1986 for all banks in the BIS quarterly reporting system show erratic quarterly changes but no clear

CLAIMS ON FOREIGNERS OF U.S.-CHARTERED BANKS
(billions of dollars)

	Change (no sign = increase)					Outstanding
	1984	1985		1986		
	Year	Year	H2	Q1	Q2	6/30/86
Total, all countries	-28.2	-13.8	-4.9	2.5	-3.3	391.1
Non-OPEC developing countries of which:	1.0	-6.8	-5.0	-1.6	-1.8	101.6
(Latin America)	2.1	-3.2	-2.4	-0.7	-0.2	72.6
(Asia and Africa)	-1.1	-3.6	-2.6	-0.9	-1.6	29.0
OPEC countries	-3.5	-3.3	-1.2	-1.0	0	20.6
Eastern Europe	-0.9	-0.2	-0.1	-0.2	0	4.0
Smaller developed countries	-2.4	-3.2	-1.9	1.1	-0.9	30.6
G-10 countries	-19.7	0.4	1.8	8.1	3.1	159.7
Offshore banking centers	-3.3	-0.2	1.5	-3.9	-4.3	57.2
Miscellaneous	0.5	-0.4	0	-0.1	0.6	17.4
Memorandum: Total adjusted for exchange rate changes (staff estimates)	-16	-29	-19	-3	-10	391.1

trend in claims on non-OPEC developing countries over the most recent six quarters. On an exchange-rate-adjusted basis, these claims increased $6 billion (2 percent) in this period of a year and one-half. They rose almost $11 billion in 1985, of which more than $7 billion was in claims on China and Korea alone. But this was followed by a decline

CLAIMS ON FOREIGNERS OF ALL BIS BANKS
(billions of dollars)

	Change (no sign = increase)[1]					Outstanding 6/30/86
	1984	1985		1986		
	Year	Year	H2	Q1	Q2	
Total, all countries	127.7	232.2	158.9	27.4	73.4	2,772
Non-OPEC developing countries of which:	10.4	10.8	8.0	-4.8	*/	356
(Latin America)	5.7	1.6	1.0	-2.3	*/	219
(Asia and Africa)	4.7	9.2	7.0	-2.5	*/	137
OPEC countries	-1.8	0.1	1.7	-3.4	0.6	112
Eastern Europe	0.2	5.8	3.3	-1.2	2.7	77
Developed countries and offshore banking centers	118.8	211.7	144.4	35.3	67.9	2,166
Miscellaneous	0.1	3.8	1.5	1.5	2.2	61

[1]Adjusted for the effects of exchange rate changes on the dollar value of the stock of claims.
*Less than $50 million.

of nearly $5 billion in the first half of 1986 (all in the first quarter) that was spread over a very wide number of countries. In the first half of 1986, claims on the Latin American countries in this group decreased $2.3 billion. Claims on Argentina rose $1.1 billion (reflecting its loan drawings), but there were substantial declines in claims on Mexico ($1.1 billion), Brazil ($0.6 billion), Chile ($0.5 billion), Colombia ($0.4 billion), and Peru ($0.3 billion).

U.S. International Financial Transactions

Foreign official assets in the United States rose by nearly $5 billion in August, bringing the increase for the first eight months of the year to $25 billion. (See line 4 of the summary table on U.S. International Transactions.) These increases were largely concentrated in holdings of the G-10 countries

. Partial information for September indicates that G-10 official assets in the United States increased by an additional $5 billion,

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. (The NT dollar appreciated 6 percent between January and August compared with a 23 percent appreciation of the Japanese yen.) Since July, Treasury officials have been meeting informally with Taiwan's trade representatives to discuss the value of the NT dollar and the nearly $10 billion U.S.-Taiwan trade imbalance. Since August, the NT dollar has appreciated 1-3/4 percent and the central bank has continued to purchase US dollars to slow its currency's appreciation.

Foreigners other than official reserve holders made net purchases of $4-3/4 billion in U.S. securities in August, bringing their year-to-August purchases to $60 billion. Of this total, private investors (excluding

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

	1984 Year	1985 Year	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 June	1986 July	1986 Aug.
rivate 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	-2.9	-0.1	9.6	13.4
Securities									
2. Private securities transactions, net	7.7	42.9	10.0	21.1	12.8	21.4	5.5	6.6	6.5
a) foreign net purchases (+) of U.S. corporate bonds	13.7	46.0	10.2	18.4	12.8	16.1	3.7	3.9	3.9
b) foreign net purchases (+) of U.S. corporate stocks	-0.9	4.8	1.4	4.0	6.1	6.9	0.5	1.8	1.4
c) U.S. net purchases (-) of foreign securities	-5.0	-7.9	-1.6	-1.4	-6.1	-1.5	1.3	.8	1.2
3. Foreign net purchases (+) of U.S. Treasury obligations 1/	23.1	20.1	7.8	4.9	6.7	3.8	1.8	-2.6	-0.6
Official Capital									
4. Changes in foreign official reserve assets in U.S. (+ = increase)	2.4	-2.0	2.2	-1.5	2.2	14.0	4.4	4.2	4.8
a) By area									
G-10 countries (incl. Switz.)	3.1	-0.4	2.4	-3.3	3.9	11.0	2.8	6.3	4.5
OPEC	-5.6	-7.0	-2.3	-1.0	1.3	-1.9	-1.0	-1.4	-1.4
All other countries	4.9	5.3	2.1	2.9	-3.0	5.0	2.6	-0.7	1.7
b) By type									
U.S. Treasury securities	4.7	-0.9	-0.4	-2.0	3.3	14.5	3.8	6.4	4.2
Other 2/	-2.3	-1.1	2.6	0.5	-1.1	-0.6	0.6	-2.3	0.7
Changes in U.S. official reserve assets (+ = decrease)	-3.1	-3.9	-0.1	-3.1	-0.1	-0.0	0.1	0.5	-0.4
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	-6.1	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	-36.6	-36.0	-11.3	n.a.	n.a.

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

non-monetary international institutions) purchased $11 billion in U.S. Treasury securities while non-monetary international institutions (principally the World Bank) sold $4 billion in Treasuries. Although the level of foreign private purchases of Treasuries remains substantial, the share of such investments as a proportion of foreign private investment inflows has declined to 12 percent this year compared with 28 percent last year and 64 percent in 1984. Along with the shift away from Treasuries toward corporate securities, foreign investors showed an increased preference for equities; of the corporate securities purchased by private foreigners in the first eight months of 1986, 30 percent was equities as compared with only 10 percent in 1985.

While foreign residents have increased their holdings of U.S. securities, U.S. residents have decreased their holdings of foreign securities, following sizable net purchases earlier in the year. The $1-1/4 billion decline in August (Summary Table, line 2.c) marks the third consecutive month of net sales, and may reflect a desire by U.S. residents to realize the dollar capital gains on foreign-currency-denominated assets resulting from the dollar's depreciation.

Banks reported another large net inflow in August (Summary Table, line 1). Unlike the July inflow, which was associated with a change in reporting instructions (discussed in the last Greenbook), the August inflow was spread over a wide variety of transactions. Deposit liabilities to foreign nonbanks (particularly the World Bank) increased and claims on foreign nonbanks (mainly in Europe) fell. Substantial inflows were also recorded in net transactions with both affiliated and unaffiliated banks outside the United States.

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.	1986 Sept.
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	25.0	n.a.
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	7.6	n.a.
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	27.1
(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	29.6
(b) Foreign-chartered banks	9.1	4.0	1.1	-3.4	-5.1	-2.0	-5.3	-4.3	-1.8	.8	-2.5
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	17.8	18.1
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	117.5	116.4	119.1

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.

U.S. Merchandise Trade

For July and August combined, the U.S. merchandise trade deficit was estimated to be $150 billion at an annual rate on a balance-of-payments basis; this was roughly the same rate of deficit as recorded in the previous three quarters (column 7 in the table below). Both exports and imports rose somewhat during the July-August period.

The value of total exports in July-August was up about 2½ percent from second-quarter levels. A sharp increase in exports of civilian aircraft accounted for most of the rise. While there were small increases in exports of business machines, chemicals and some agricultural

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

	Balance-of-payments basis, seasonally adjusted							Census Balance Unrevised, NSA
	Exports			Imports				
	Total (1)	Agr. (2)	Nonagr. (3)	Total (4)	Oil (5)	Nonoil (6)	Balance (7)	CIF Value (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
J/A-e	225	25	200	375	30	345	-150	-188

e/ Balance-of-payments basis data are FR staff estimates.

commodities (including wheat, rice, meat), there were also somewhat larger declines in exports of passenger cars and trucks to Canada, fuel oil, and soybeans. Thus the recent strength of exports continues to rest on a few high-value items -- large jet aircraft in July-August and nonmonetary gold shipments to Japan in the second quarter.

Preliminary estimates in the GNP accounts show a decline in export prices (fixed-weight) in the third quarter of about 4 percent at an annual rate; most of the decline was in exports of agricultural commodities and industrial supplies. Price increases were recorded for capital, automotive and consumer goods exports. Additional data on export and import prices will be available on October 30 when the Bureau of Labor Statistics releases data for the third quarter.

On the import side, the 3 percent rise in value in July-August from the second-quarter rate was largely in foreign passenger cars, machinery (business and industrial) and to a lesser extent in some consumer goods (particularly footwear) and some industrial supplies (for example, paper). Even so, imports of various other industrial supplies (especially nonmonetary gold), of various other consumer goods, and of coffee all declined.

The price of imports, on average, was little changed from second quarter levels on a fixed weight basis. Declines in prices of food and oil imports were offset by estimated increases in the price of various manufactured goods imports. The price of imported industrial supplies tipped up in the third quarter after declining for the past two years.

The value of oil imports was about the same in July-August as in the second quarter. However, a strong rise in volume was offset by a sharp decline in price. Last week OPEC agreed to continue production restraints through December. This decision should allow world oil prices to continue near current spot-market levels (about $15 per barrel) through the end of the year. Much of the increase in volume appears to have gone into inventories, which may, in turn, be drawn down in the fourth quarter. Uncertainties regarding world oil prices continue to result in wide swings in the quantity of oil imports from quarter to quarter.

OIL IMPORTS*

	Year 1985	1985 Q2	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 J/A[e]
Value (Bil. $, SAAR)	50.53	54.53	49.49	56.48	40.06	31.32	30.00
Price ($/BBL)	26.40	26.92	25.74	26.30	21.56	13.17	11.00
Volume (mbd, SA)	5.24	5.55	5.27	5.88	5.09	6.52	7.50

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

Foreign Economic Developments. Data available so far for the third quarter suggest further moderate expansion in Germany, France, the United Kingdom, and to a lesser extent in Japan, following the second-quarter rebound. The average level of Japanese industrial production in the third quarter was 3/4 percent below the second-quarter level, while in Germany, average industrial production in July and August was 1-3/4 percent above its second-quarter level.

Inflation rates abroad remain modest. The German consumer price index has declined relative to year-earlier levels in each of the past seven months through October. Japanese consumer prices in the third quarter were little changed from their year-ago level. In France, the United Kingdom and Italy, consumer prices rose 1/4 to 1/2 percent (n.s.a.) in September, and the year-over-year inflation rates remained well below last year's rates. In Canada, consumer prices were unchanged in September, and the 12-month inflation rate approximately equaled last year's rate. Wholesale prices (n.s.a.) have continued to decline in recent months in Japan and France, but have risen somewhat in Germany, Italy, Canada, and the United Kingdom.

External surpluses in Japan and Germany continue at record rates for the year. In Canada and the United Kingdom, the trade balance has deteriorated recently in comparison with the first half of the year.

Individual Country Notes. Recent Japanese data suggest that the pace of economic activity is sluggish. The index of industrial production rose 2.6 percent (s.a.) in September following declines in July and August. For the three months ending in September, industrial production was 0.6 percent above the year-ago level. The Ministry of

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

	Q4/Q4 1984	Q4/Q4 1985	1985 Q4	1986 Q1	1986 Q2	1986 Q3	1986 May	June	July	Aug.	Sept.	Latest 3 months from year ago 2/
Canada												
GDP	5.4	3.9	1.8	.5	.8	n.a.	*	*	*	*	*	3.9
IP	4.4	5.2	1.4	-.2	-.4	n.a.	-1.9	-.9	.8	-.9	n.a.	.2
France												
GNP	1.5	2.3	.7	-.2	1.2	n.a.	*	*	*	*	*	2.7
IP	1.8	1.5	.5	-1.5	1.8	n.a.	-5.8	4.6	.7	.0	n.a.	2.5
Germany												
GNP	3.0	2.3	-.2	-1.1	3.4	n.a.	*	*	*	*	*	3.8
IP	3.5	3.4	.4	-1.1	1.3	n.a.	-3.3	3.1	.9	-.3	n.a.	2.1
Italy												
GNP	2.5	2.0	-.2	.3	2.2	n.a.	*	*	*	*	*	2.9
IP	2.1	1.0	.2	2.8	1.7	n.a.	-6.6	5.5	n.a.	n.a.	n.a.	3.6
Japan												
GNP	5.7	4.0	1.4	-.5	.9	n.a.	*	*	*	*	*	2.5
IP	10.6	.9	-.9	.2	.2	-.8	.3	.3	-.2	-2.7	2.6	-1.3
United Kingdom												
GNP	2.7	2.8	.2	1.1	.2	n.a.	*	*	*	*	*	1.4
IP	-.3	4.5	-.0	.8	-.7	n.a.	-1.8	-1.4	2.1	.5	n.a.	.3
United States												
GNP	4.6	2.9	.5	.9	.2	.6	*	*	*	*	*	2.2
IP	6.6	1.8	.5	.3	-.5	.6	-.4	.0	.6	.2	.2	.9

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

CONSUMER AND WHOLESALE PRICES IN MAJOR INDUSTRIAL COUNTRIES
(Percentage change from previous period) 1/

	Q4/Q4 1984	Q4/Q4 1985	1985 Q2	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 Q3	1986 July	1986 Aug.	1986 Sept.	1986 Oct.	Latest 3 months from year ago
Canada													
CPI	3.7	4.2	1.1	.9	.9	1.2	.8	1.2	.8	.3	.0	n.a.	4.2
WPI	4.0	2.3	.5	-.0	.6	.9	-.9	n.a.	-.1	.3	n.a.	n.a.	.3
France													
CPI	6.8	4.8	1.8	.9	.6	.1	.7	.6	.1	.1	.4	n.a.	2.1
WPI	7.4	1.9	1.5	.1	-1.4	-.7	-1.3	n.a.	*	*	*	*	-3.2
Germany													
CPI	2.1	1.8	.6	-.2	.3	.0	-.3	-.5	-.5	-.2	.2	-.3	-.6
WPI	1.3	-1.1	.3	-2.1	-.9	-2.1	-2.6	-2.9	-2.1	-.2	.6	n.a.	-8.3
Italy													
CPI	8.8	8.5	2.2	1.1	2.3	1.8	1.1	.6	.0	.2	.3	n.a.	5.9
WPI	8.9	5.9	2.2	-.1	.9	-.5	-1.8	n.a.	-.8	.1	n.a.	n.a.	-2.0
Japan													
CPI	2.4	2.3	.5	.1	1.0	-.1	.0	-.6	-.3	-.2	1.1	n.a.	.4
WPI	.5	-3.7	-.7	-1.0	-2.4	-2.4	-4.2	-2.8	-1.1	-.9	-1.0	n.a.	-11.2
United Kingdom													
CPI	4.8	5.5	3.4	.3	.5	.7	1.3	.1	-.3	.3	.5	n.a.	2.6
WPI	6.1	5.2	2.0	.5	.9	1.4	1.6	.4	.1	.2	.3	n.a.	4.4
United States													
CPI (SA)	4.1	3.5	1.0	.6	1.1	.4	-.4	.6	.0	.2	.3	n.a.	1.6
WPI (SA)	1.7	1.6	.6	-.2	1.1	-1.5	-1.4	.1	-.4	.3	.4	n.a.	-1.7

1. Asterisk indicates that monthly data are not available.

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

	1984	1985	1985			1986			1986			
			Q2	Q3	Q4	Q1	Q2	Q3	June	July	Aug.	Sept.
Canada												
Trade	16.0	12.8	3.3	2.6	2.9	1.8	1.7	n.a.	.3	-.1	.3	n.a.
Current account	1.9	-.8	.2	-1.1	-.7	-2.0	-1.3	n.a.	*	*	*	*
France												
Trade	-2.4	-2.6	-.4	-.8	-.4	.1	-1.1	.3	-.2	.2	.5	-.4
Current account	-.8	.9	.5	.0	1.0	1.1	.3	n.a.	*	*	*	*
Germany												
Trade (NSA)	18.7	25.4	6.0	6.1	9.1	9.5	12.5	14.1	4.4	5.1	3.9	5.1
Current account (NSA)	5.9	13.9	3.1	2.1	7.0	6.9	8.2	8.1	1.9	2.7	2.0	3.3
Italy												
Trade	-11.0	-12.0	-3.9	-1.4	-3.1	-2.8	-.1	n.a.	.1	-.6	1.7	n.a.
Current account (NSA)	-2.8	-4.0	-2.2	1.9	-.9	n.a.	n.a.	n.a.	*	*	*	*
Japan												
Trade	33.4	46.1	10.6	12.0	14.8	15.5	20.3	24.0	6.0	7.4	8.4	8.1
Current account 2/	35.0	49.3	12.2	12.1	15.6	15.5	21.8	n.a.	6.7	7.1	7.7	n.a.
United Kingdom												
Trade	-5.7	-2.5	-.2	-.6	-.3	-2.0	-2.3	-4.4	-.9	-.9	-2.2	-1.3
Current account	1.3	5.2	2.0	2.0	1.1	.8	.5	-1.7	.0	.0	-1.3	-.4
United States												
Trade 2/	-112.5	-124.4	-30.4	-31.7	-37.4	-36.5	-36.0	-37.5	*	*	*	*
Current account	-106.5	-117.7	-29.4	-28.5	-33.7	-34.0	-34.7	n.a.	*	*	*	*

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

International Trade and Industry (MITI) attributed these declines to the impact on exporters of the yen's sharp appreciation. MITI issued a forecast that industrial output will fall in 1986 for the first time in 10 years. Other economic indicators have been mixed. New housing starts rose 7.7 percent (s.a.) in September after falling 6.3 percent in August. The unemployment rate was unchanged in August at a record high 2.9 percent (s.a.). Retail sales have been quite erratic in recent months, rising 1.9 percent (s.a.) in August after dropping 0.9 percent in July.

Japanese inflation remains low. Wholesale prices have continued to decline, and the overall wholesale price index in the third quarter was 11.2 percent below its year-earlier level. The fall in wholesale prices reflects lower oil product prices and the yen's appreciation. Bank of Japan officials have said declines in wholesale prices are likely to narrow starting in October reflecting current stable prices of many primary commodities in overseas markets.

Despite a slight narrowing of Japan's trade surplus in September, Japan's cumulative trade surplus for the first nine months of 1986 was a record $80 billion (s.a.a.r.); the cumulative current account surplus through August was $78 billion (s.a.a.r.). After six consecutive months of year-over-year declines, export volume in September rose 3.2 percent relative to its year-earlier level. Third-quarter export volume was 0.5 percent lower than in the third quarter of 1985. Import volume growth remains strong, with import volume increasing 18 percent in the third quarter compared with the third quarter of 1985.

A Japanese government tax council has proposed a reform of the tax system that is intended to be revenue neutral. The council recommended a substantial lowering of the maximum rates for national and local income taxes and a reduction in the number of income tax brackets. Some reduction in the rate on corporate taxes was also recommended. To offset these tax cuts, the council proposed the introduction of a value-added tax, and reviews of the tax-free savings system and of the exemption of individuals from capital gains taxation. The council said the proposed tax reforms would boost real GNP by 0.1 percentage point. The council's recommendations will be reviewed by the government and submitted to parliament by early 1987. The government hopes that tax reform can be implemented for fiscal year 1987/88 (starting April 1).

Industrial production in Germany declined by 0.3 percent (s.a.) in August to a level 3.4 percent above August of last year. Production growth in the three months ending in August was 10.3 percent (s.a.a.r.) compared with the previous three-month period. The volume of new manufactured goods orders fell 0.9 percent in August after rising 0.9 percent in July. The July/August new orders index was 2 percent lower than a year ago, with domestic orders one percent higher, but foreign orders 6-1/2 percent lower. The unemployment rate remained unchanged at 8.8 percent in September. Unemployment has declined by one-half of one percentage point over the past 12-months.

Consumer prices fell 0.3 percent in October to a level 0.9 percent below their year-earlier level. Since December 1985, the CPI has declined at an annual rate of 1.4 percent. Import prices in September were 22 percent lower than in September 1985. Wholesale and producers prices in September were 8 and 4 percent below their respective levels of a year ago. The current account surplus in September was $3.3 billion, bringing the cumulative total so far this year to $23.1 billion, compared with $6.9 billion for the first nine months of last year.

Central bank money rose 0.8 percent (s.a.) in September from August and 7.1 percent (s.a.a.r.) relative to the fourth quarter of 1985 target base period. The level reached in September was above the upper limit of the target range for CBM growth for all of 1986--3.5 to 5.5 percent growth between the fourth quarters of 1985 and 1986.

In France, real activity continued to increase at a moderate rate. Industrial production rose 0.7 percent (s.a.) in the combined months of July and August after increasing by a revised 4.6 percent (s.a.) in June. The index for July and August stood at a level that was 2.2 percent above its level a year ago. Revised figures indicate real GDP grew 4.8 percent (s.a.a.r.) in the second quarter after falling 0.7 percent (s.a.a.r.) in the first quarter of 1986. In September, the unemployment rate (s.a.) remained unchanged at its record high level of 10.7 percent.

The French trade balance was in deficit in September, bringing the cumulative trade deficit this year to about $1 billion (s.a.a.r.), compared with a $2.6 billion deficit last year. Recently the increase in strength of the mark against the dollar has put downward pressure on the French franc and a postponement of plans to announce further decontrol of exchange restrictions.

The growth of French M-3 money supply has accelerated recently. The 3-month moving average of M-3 centered on July rose 5.8 percent from the year-earlier level, compared with the government's target of holding money supply growth below 5 percent this year.

In September the government announced its 1987 budget that seeks to cut the deficit and taxes simultaneously. Across-the-board tax relief for individuals and corporations is to be accompanied by significant cutbacks in government expenditures.

Real activity in the United Kingdom has continued to increase, but at a relatively slow pace. The average measure of real GDP rose by only 0.7 percent (s.a.a.r.) in the second quarter, and was 1.4 percent above its year-earlier level. Industrial production was up by 0.5 percent (s.a.) in August and showed a year-over-year increase of 1.3 percent. The unemployment rate, after reaching a record high level of 11.7 percent (s.a.) in August, eased back by 0.1 percentage point in September. Wage increases have continued to exceed price rises by a wide margin, with average earnings 8.1 percent above their year-earlier level in August, and 3 percent year-over-year retail price inflation in September.

The trade deficit in September was $1.3 billion (s.a.), about half as large as the record high deficit of the previous month. Through the first nine months of this year, the cumulative trade deficit was $11.7 billion (s.a.a.r.), substantially exceeding the $2.5 billion deficit recorded last year. The cumulative current account deficit through September has been $200 million (s.a.a.r.), compared with a surplus of $5.2 billion last year.

On October 14, the Bank of England triggered an increase in commercial banks' base lending rates from 10 to 11 percent. Two days later, Chancellor of the Exchequer Nigel Lawson justified this base rate increase by the weakness of the pound on exchange markets and the accelerated growth in recent months of the M0 targeted monetary aggregate. The Chancellor noted that because of distortions arising from continuing financial innovation, the rapid growth of the other targeted aggregate, M3, would have relatively little impact on policy. On October 22, Bank of England Governor Leigh-Pemberton said that consideration was being given to abandoning broad money targets altogether.

The London Stock Exchange experienced a major change in operating procedures--the "Big Bang"--on October 27. In the markets for equities and government bonds (gilts), there was an elimination of fixed commissions, a merging of the previously separated roles of brokers (who acted only as agents for customers) and jobbers (who acted only as market makers), and entry into the market by British commercial and merchant banks, and foreign (including U.S.) financial institutions. In a related development, the Financial Services Bill, which contains a new framework for financial market regulation, is expected to win parliamentary approval early next month.

Growth in Canada picked up in July and levelled off in August after slowing in the first half of 1986. The monthly measure of real gross domestic product was unchanged in August after increasing 0.6 percent in July (s.a.); in August, GDP was 4 percent above its year-earlier level. Industrial production (accounting for about 26 percent of monthly GDP) rose 0.8 percent (s.a.) in July but fell 0.9 percent (s.a.) in August. Industrial production in August remained below the pace set for most of last year. More recently, the unemployment rate declined to 9.5 percent in September (matching June's three-and-a-half year low).

The merchandise trade balance (s.a.) rebounded in August to a surplus of $315 billion, up from a deficit in July of $135 million. The improvement in August was the result of slow export growth that was more than offset by a sharp decline in imports. Through August, the cumulative merchandise trade surplus stood at $5.5 billion (s.a.a.r.), down sharply from the cumulative trade surplus of $12.8 billion in 1985.

In Italy, revised data indicate that real GDP rose by 8.9 percent (s.a.a.r) in the second quarter after having risen 1.3 percent (s.a.a.r.) in the first quarter. The rate of unemployment fell to 10.7 percent (n.s.a.) in July from a rate of 11.3 percent in April.

The trade surplus in August was $1.7 billion (s.a.), reflecting a large decrease in imports. The cumulative trade deficit for the first eight months of 1986 was $2.7 billion (s.a.a.r), compared with a deficit of $12 billion in all of 1985.

In October, the Chamber of Deputies approved a withholding tax on interest income earned on Treasury bills. This is the first time in Italian financial history that an effective tax on interest income has been imposed. It is unclear whether the imposition of this tax will reduce nominal payments for the service of the outstanding stock of public debt because before-tax interest rates on Treasury bills may rise.

Economic Situation in Major Developing Countries. At the end of September, Mexico reached agreement with its bank advisory committee on a $6 billion loan package and an easing of terms for the repayment of $44 billion in public sector debt. The IMF Executive Board gave provisional approval to an 18-month stand-by arrangement on September 8. However, that approval technically expired on September 29 because the "critical mass" of subscriptions to the financing package was not in place; the IMF Managing Director has now requested the banks to assemble the critical mass by October 31. Although the rate of inflation in Argentina eased slightly in September, the adoption of a 3 percent monthly depreciation rate for the austral appears likely to lead to a further appreciation of the real effective exchange rate in the coming months. Brazil devalued the cruzado against the dollar by 1.8 percent in mid-October, presumably to prevent further deterioration of its strong trade surplus that, in fact, declined in September. Venezuela's agreement with creditor banks to reschedule $21 billion in public sector debt became effective October 4. The IMF Executive Board approved a new stand-by program for the Philippines on October 24, and Philippine officials began negotiations with creditor commercial banks on October 27 to reschedule some $3-1/2 billion in non-trade external debts falling due in 1987-1992. Since the opening of a new foreign exchange auction market on September 26, the Nigerian naira has depreciated 62 percent against the dollar.

Mexico reached agreement with its bank advisory committee at the end of September on a $6 billion loan package, $500 million of which would be guaranteed by the World Bank, with provision for: (1) an additional \$1.2 billion if specified factors threaten the financing of the public sector investment program; and, (2) an additional \$500 million in 1987, half of which would be guaranteed by the World Bank, if economic recovery fails to materialize. The committee also agreed to extend from 1998 to 2006 the repayment schedule of \$43.7 billion in Mexican public sector debts to banks and to lower the spread to 13/16 of a percentage point over LIBOR with no prime rate option. A \$1 billion portion of the commercial bank loan package will be co-financing of World Bank loans for the transportation sector.

In September the Mexican CPI increased by 6 percent, reaching a level 96 percent above a year earlier. The peso price of the dollar in the controlled market rose by 8 percent in September, reaching a level 147 percent above a year earlier, and in the first 21 days of October, it rose at a monthly rate of 7 percent. The spread between rates in the free market and in the controlled market remains under 3 percent. The effective annual yield on 28-day Treasury bills at the October 22 auction was 161 percent, compared with a peak of 167 percent in early September.

Effective October 22, the minimum wage was increased by 21 percent, bringing the minimum wage in real terms to a level 2 percent above that of a year ago. Industrial production in the first eight months of 1986 was 4.1 percent lower than in the same period of 1985.

The monthly rate of increase in consumer prices for Argentina edged downward from 8.8 percent in August--the highest figure for the year--to 7.2 percent in September. The rate of depreciation of the austral against the dollar has declined from 6.15 percent in September to an expected 3 percent figure for October. This depreciation rate will result in an appreciation of Argentina's real effective exchange rate unless inflation drops dramatically in the coming months. Recent increases in expenditures on military salaries and a seasonal fourth-quarter increase in public wage expenditures will increase the government's deficit in the fourth quarter relative to the 2.5 percent of GNP estimated for the third quarter. The rate of money growth has slowed recently and could lead to a possible recession in the next six months. Preliminary figures indicate that M1 growth slowed from an average of 8.0 percent monthly over May-July 1986 to a 1.7 percent monthly average in August-September 1986. M3 (which includes regulated-rate and free-rate time deposits) slowed from 6.6 percent monthly over May-July to 4.7 percent in August-September.

Brazil devalued the cruzado relative to the dollar by 1.8 percent in mid-October. This was the first adjustment in the rate for the cruzado since the institution of the Cruzado Plan on February 28, 1986. The exchange rate change probably reflects the fear of the authorities that the still strong trade surplus is weakening. The trade surplus through the first nine months of this year was $9.1 billion, which is the same-sized surplus that was achieved in the first nine months of 1985. However, the $840 million surplus in September was substantially below the monthly average of $1.2 billion recorded over the previous six months.

There is an increasing concern among policymakers in Brazil that domestic demand will have to be restrained. Real GDP growth is likely to be about 8 percent in 1986, similar to 1985 growth. Consumer prices rose at a somewhat faster rate of 1.7 percent in September according to the official index; since the beginning of March, prices, as measured by the official index, have increased by 8 percent. Price controls are increasingly being evaded and supplies are often unavailable at controlled prices.

On October 4, Venezuela's agreement with creditor banks to reschedule $21.2 billion in public sector debt became effective. Venezuela will now make a $750 million downpayment (originally due upon signing in February 1986) to the banks in the final quarter of the year. Venezuela is seeking to renegotiate the terms of the agreement to extend maturities and to link future principal payments to developments in oil prices and interest rates. Progress on these negotiations is likely to be hindered by uncertainties regarding the repayment of Venezuela's private sector debt.

On October 24, the IMF Executive Board approved a SDR 422 million, 18-month program for the Philippines. About SDR 224 million was disbursed immediately by the Fund under the Compensatory Financing Facility, reflecting a shortfall in Philippine exports, and the remaining SDR 198 million will be disbursed in seven tranches, with Fund reviews of the Philippine program in April and October of next year. The IMF action has cleared the way for the final disbursement of $350 million from the commercial bank creditors' "new money" loan of $925 million approved in May 1985. The Philippines began negotiations with its commercial bank creditors on October 27 with three main objectives: (1) to restructure about $3-1/2 billion in debts falling due in 1987-1992; (2) to obtain lower margins than those obtained in the 1985 rescheduling of $6 billion in debt; and, (3) to receive Mexican-type repayment terms of 20 years with 7 years of grace. The bank creditors have stated that problems could arise if the Philippines insists on a Mexican-type contingency facility that would require the banks to provide new credits if certain economic targets, such as growth, are not reached.

After maintaining an overvalued exchange rate for many years, Nigeria opened a second-tier foreign exchange market on September 26 to cover most external transactions through an auction system. External debt service will continue to be transacted at the official first-tier rate. Through October 23 the naira had depreciated by 62 percent against the dollar. In early October, Nigeria's commercial bank steering committee agreed in principle to a rescheduling package which includes $320 million in new money during 1987. The offer is contingent upon an IMF stand-by arrangement. On October 16, the World Bank Executive Board approved a $452 million loan aimed at supporting the new foreign exchange market and encouraging trade liberalization. Proceeds of this loan will be used to fund the auction market. The Bank of England has organized a $250 million multilateral bridge loan to the proposed World Bank loan. U.S. Treasury participation will be $37 million.