Prefatory Note

The attached document represents the most complete and accurate version available based on original copies culled from the files of the FOMC Secretariat at the Board of Governors of the Federal Reserve System. This electronic document was created through a comprehensive digitization process which included identifying the best-preserved paper copies, scanning those copies,[1] and then making the scanned versions text-searchable.[2] Though a stringent quality assurance process was employed, some imperfections may remain.

Please note that this document may contain occasional gaps in the text. These gaps are the result of a redaction process that removed information obtained on a confidential basis. All redacted passages are exempt from disclosure under applicable provisions of the Freedom of Information Act.

---

[1] In some cases, original copies needed to be photocopied before being scanned into electronic format. All scanned images were deskewed (to remove the effects of printer- and scanner-introduced tilting) and lightly cleaned (to remove dark spots caused by staple holes, hole punches, and other blemishes caused after initial printing).

[2] A two-step process was used. An advanced optimal character recognition computer program (OCR) first created electronic text from the document image. Where the OCR results were inconclusive, staff checked and corrected the text as necessary. Please note that the numbers and text in charts and tables were not reliably recognized by the OCR process and were not checked or corrected by staff.

Confidential (FR) Class III FOMC

December 10, 1986

RECENT DEVELOPMENTS

Prepared for the Federal Open Market Committee
By the staff of the Board of Governors of the Federal Reserve System

TABLE OF CONTENTS

DOMESTIC FINANCIAL DEVELOPMENTS--continued

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	Nov.	12-05-86	118.7	1.7	1.6	2.2
Unemployment rate (%)[1]	Nov.	12-05-86	7.0	7.0	6.8	7.0
Nonfarm employment, payroll (mil.)	Nov.	12-05-86	101.1	3.0	3.1	2.4
Manufacturing	Nov.	12-05-86	19.2	2.2	.8	-.5
Nonmanufacturing	Nov.	12-05-86	81.9	3.1	3.7	3.1
Private nonfarm:						
Average weekly hours (hr.)[1]	Nov.	12-05-86	34.9	34.7	34.8	34.8
Hourly earnings ($)[1]	Nov.	12-05-86	8.84	8.80	8.77	8.65
Manufacturing:						
Average weekly hours (hr.)[1]	Nov.	12-05-86	40.9	40.7	40.8	40.7
Unit labor cost (1967=100)	Oct.	12-02-86	80.6	10.5	1.0	-5.0
Industrial production (1977=100)	Oct.	11-14-86	125.2	.0	1.0	1.3
Consumer goods	Oct.	11-14-86	124.6	-4.8	-1.9	3.4
Business equipment	Oct.	11-14-86	139.6	-.9	4.9	.9
Defense and space equipment	Oct.	11-14-86	183.6	7.9	9.1	5.0
Materials	Oct.	11-14-86	113.5	.0	-.4	.1
Consumer prices, all items (1967=100)	Oct.	11-25-86	329.8	1.8	2.7	1.5
All items, excluding food and energy	Oct.	11-25-86	330.7	5.1	3.9	4.0
Food	Oct.	11-25-86	325.0	4.1	6.9	4.5
Producers prices: (1967=100)						
Finished goods	Oct.	11-14-86	290.3	4.1	4.2	-1.4
Intermediate materials, nonfood	Oct.	11-14-86	310.4	-3.1	.5	-4.2
Crude foodstuffs & feedstuffs	Oct.	11-14-86	240.8	31.2	17.3	4.2
Personal income ($ bil.)[2]	Oct.	11-20-86	3524.3	4.3	3.6	4.9
				(Not at annual rates)		
Mfgrs. new orders dur. goods ($ bil.)	Oct.	12-04-86	103.2	-5.1	-2.8	-1.2
Capital goods industries	Oct.	12-04-86	32.0	-13.6	-14.8	-3.8
Nondefense	Oct.	12-04-86	26.9	-4.8	-1.9	-.8
Defense	Oct.	12-04-86	5.1	-42.0	-49.5	-17.1
Inventories to sales ratio:[1]						
Manufacturing and trade, total	Sept.	11-17-86	1.33	1.37	1.38	1.36
Manufacturing	Oct.	12-04-86	1.41	1.41	1.44	1.43
Trade	Sept.	11-17-86	1.27	1.32	1.34	1.27
Ratio: Mfgrs.' durable goods inventories to unfilled orders[1]	Oct.	12-04-86	.524	.521	.526	.537
Retail sales, total ($ bil.)	Oct.	11-14-86	121.6	-5.0	1.5	5.8
GAF[3]	Oct.	11-14-86	26.8	.3	.7	6.8
Auto sales, total (mil. units)[2]	Nov.	12-03-86	10.5	2.2	-14.5	7.5
Domestic models	Nov.	12-03-86	6.9	-1.4	-22.9	7.7
Foreign models	Nov.	12-03-86	3.6	10.0	8.3	7.0
Housing starts, private (thous.)[2]	Oct.	11-19-86	1,648	-.2	-7.5	-7.6
Leading indicators (1967=100)	Oct.	12-02-86	180.5	.6	.6	5.2

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

DOMESTIC NONFINANCIAL DEVELOPMENTS

Recent indicators suggest that domestic production is continuing to expand at a moderate rate while domestic spending seems to be slowing. Labor demand picked up in November when another sizable increase in payroll employment was coupled with a lengthened workweek. Apart from autos, real consumer spending apparently rose in October, but this followed a sizable drop in September. Indicators of business fixed investment remain sluggish, and October housing starts were below their third-quarter pace. Wage and price increases--although still moderate--have been somewhat higher than earlier in the year.

Employment and Unemployment

Labor demand has continued to expand in the fourth quarter, with some improvement now evident in the industrial sector of the economy. Nonfarm payroll employment increased 250,000 in November, about the same pace as in October, but appreciably above the average monthly gain during the first three quarters of this year. Job growth has continued to be concentrated among service-producing establishments, although the November increase in trade employment was small, as a consequence of less seasonal hiring at general merchandising stores. Employment in manufacturing has risen in each of the last two months, bringing the number of factory jobs back to about its mid-year level. Much of the recent rise has occurred in nondurable goods industries, notably textiles, printing and publishing, and rubber and plastics. Among durables, both trade restrictions on imports of Canadian lumber and the earlier strong pace of housing starts apparently have boosted employment in the U.S. lumber industry in recent months. Sizable

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

		1986			1986		
	1985	Q1	Q2	Q3	Sept.	Oct.	Nov.
		—Average monthly changes—					
Nonfarm payroll employment[2]	230	191	120	239	277	260	249
Strike adjusted	229	184	174	194	248	264	245
Manufacturing	-18	-11	-40	-10	-18	23	35
Durable	-16	-14	-37	-12	-31	5	13
Nondurable	-2	3	-3	2	13	18	22
Construction	21	17	36	21	-2	-13	11
Trade	65	79	35	50	31	79	19
Finance and services	122	98	159	107	69	80	149
Total government	38	23	-6	31	146	85	13
Private nonfarm production workers	159	135	102	182	136	111	201
Manufacturing production workers	-18	-13	-27	-6	-11	26	47
Total employment[3]	163	79[e]	295	73	-264	349	131
Nonagricultural	183	149	335	87	-337	321	55

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 Board staff 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	Sept.	Oct.	Nov.
Civilian, 16 years and older	7.2	7.1	7.2	6.9	7.0	7.0	7.0
Teenagers	18.6	18.5	19.2	18.0	18.7	17.6	18.4
20-24 years old	11.0	10.6	11.1	10.7	11.2	10.4	10.1
Men, 25 years and older	5.3	5.3	5.4	5.4	5.3	5.6	5.5
Women, 25 years and older	5.9	5.7	5.7	5.4	5.5	5.4	5.5
White	6.2	6.1	6.2	6.0	6.0	6.0	6.1
Black	15.1	14.6	14.9	14.5	14.8	14.4	14.3
Fulltime workers	6.9	6.7	6.8	6.6	6.7	6.6	6.6
Memo:							
Total national[1]	7.1	7.0	7.1	6.8	6.9	6.9	6.9

1. Includes resident Armed Forces as employed.

purchases of aircraft have fueled employment growth in transportation equipment, while gains in the electrical equipment industry have been associated with a high level of production of home appliances. In contrast, a number of other durable goods industries remain quite weak. Employment in metals, on balance, has continued to fall in recent months, and hiring in nonelectrical machinery remains sluggish, probably owing both to foreign competition and to the weak demand for computers. Elsewhere, hiring in construction has leveled off while employment in oil and gas extraction continued its downward slide, although at a slower pace than earlier in the year.

When averaged over the past two months, the employment gains reported in the household survey were similar to the reported payroll gains. Nevertheless, the civilian unemployment rate remained at 7.0 percent in November for the third consecutive month, with the distribution of joblessness little changed by demographic group.

Industrial Output and Capacity Utilization

The labor market reports and available physical product data suggest an improvement in industrial production in November, and although output was flat in October, the sector appears positioned to record a second quarterly gain following the weakness in the first half of the year. The October index was held down by sharp declines in the output of autos and trucks. In November, motor vehicle output was about unchanged, while gains apparently were registered in most other industries.

Capacity utilization in manufacturing, mining, and utilities in November probably recovered the ground lost in October when it fell 0.2 percent. Nonetheless, the October utilization rate remains around 2 percentage points below its most recent peak in the summer of 1984. Capacity growth has slowed from an annual rate of 2-3/4 percent in the second half of 1984 to about 2 percent this year.

The Automobile Sector

General Motors recently announced plans to close 11 plants before the end of 1988. According to GM, these closings are part of a major program of modernization. The targeted plants employ 29,000 workers, or more than 5 percent of GM's work force, and have a capacity of 800,000 autos as well as truck and bus assembly lines and stampings facilities. On the other side of the ledger, GM will have opened six new plants between 1981 and the end of 1987 and refurbished 12 others. On balance, GM's capacity to assemble autos, which was about 6-1/4 million units in 1979 and is a little higher currently, probably will be reduced to about 5-3/4 million units by the end of 1988. GM's plans to cut costs involve relatively larger reductions in employment than in capacity.

Despite the planned reductions at GM, auto assembly capacity in the United States may not change much in coming years. Japanese manufacturers have announced plans to open or expand plants in the United States in 1987 and 1988 that will be able to produce more than 800,000 additional cars,[1] placing auto assembly capacity in the United States owned by foreign manufacturers (excluding AMC/Renault and NUMMI (GM/Toyota)) at about 1-1/2 million units. On balance, total assembly capacity in the U.S. (both

1. Mazda, Toyota, and Mitsubishi expect to complete plants in this period. Fuji, Subaru, and Isuzu have plans for a joint-venture plant to open in 1989, which will initially produce about 120,000 vehicles--autos and light trucks.

U.S. CAPACITY TO PRODUCE AUTOMOBILES[1]
(Millions of units per year)

	1979	1982	1986	1988[2]
TOTAL	11.095	10.241	10.844	10.986
Domestic[3]	10.881	9.903	10.255	9.557
General Motors	6.267	6.044	6.398	5.700
Ford	2.815	2.195	1.837	1.837
Chrysler	1.345	1.160	1.516	1.516
AMC/Renault	.454	.504	.504[4]	.504
Foreign-owned[3]	.214	.337	.589	1.429
Volkswagen	.214	.239	.239	.239
Honda	—	.098	.230	.360
Nissan	—	—	.120	.150
Toyota	—	—	—	.200
Mitsubishi	—	—	—	.240
Mazda	—	—	—	.240
Fuji-Isuzu[5]	—	—	—	—

1. The capacity estimates represent capability to assemble automobiles; they do not take account of shortages of key components, but do assume reasonable work patterns. The annual rate of assembly capacity is based on the historic maximum hourly rate of output for each assembly plant as reported in Ward's Automotive Yearbooks. The hourly rate for each plant is multiplied by a fixed number of 3,910 hours worked per year to obtain the annual capacity rate of output. Although this method is plausible, it leads to estimates that may never be reached in the aggregate because of shortages of parts or labor or because demand for some model cars remains low even in periods of booming automobile sales.
2. Planned.
3. Some of the capacity in both the domestic and foreign-owned categories represents joint ventures. The classification of capacity to domestic or foreign-owned depends upon the trademark displayed on the finished car.
4. AMC also is producing cars for Chrysler.
5. A plant is planned to be built in Lafayette, Indiana. It will probably open in 1989. The plant will initially produce about 120,000 vehicles—autos and light trucks.

foreign and domestic-owned) is expected to be 11 million units (at an annual rate) at the end of 1988, the same as in 1979.

The combined sales of domestic and imported cars were at a 10.5 million unit annual rate in November, up a bit from the 10-1/4 million unit pace in October. Most of the increase reflected stronger sales of Japanese cars, which boosted foreign car volume to a 3.6 million unit annual rate in November. For domestic models, the November pace--which was below that for the year-to-date--does represent a pickup of sales from the period immediately after the major incentive programs had expired, although some limited incentives recently have been introduced.

Personal Income and Consumption

Nominal personal consumption expenditures fell 2 percent in October, reflecting the drop in sales of cars and light trucks. However, excluding motor vehicles and parts, nominal spending increased 0.5 percent in October after registering no growth in the previous month. Nominal purchases of gasoline and fuel oil increased 2.2 percent last month; if this figure were to hold up in subsequent revisions, it would translate into a very sharp increase in real outlays, given the drop in consumer energy prices registered in the October CPI. In addition, nominal purchases of food and clothing, which fell during the third quarter, also increased last month, although some of this growth may reflect continued inreases in the prices of these goods. Spending on consumer services increased 0.3 percent in October, a bit less than in September. Outlays for gas and electric utilities and for transportation services have been weak in recent months, and spending for medical services also has slowed.

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

	1985 Q4	1986 Q1	1986 Q2	1986 Q3	1986 Sept.	1986 Oct.	1986 Nov.
Total auto sales[1]	10.2	10.7	11.2	12.9	15.6	10.2	10.5
Domestic	6.8	7.8	8.2	9.4	11.8	7.0	6.9
Imported	3.4	2.8	3.0	3.5	3.8	3.3	3.6
Domestic production	7.8	8.3	7.9	7.4	7.7	7.3	7.3
Dealers' stocks	1.67	1.81	1.80	1.40	1.40	1.51	--
Days' supply[2]	75	71	68	46	36	67	--
Total light truck sales[3]	4.4	4.1	4.6	5.2	6.0	4.3	--
Domestic	3.6	3.3	3.7	4.3	5.0	3.4	--
Imported[4]	.8	.8	.9	.9	1.0	.9	--

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 Q1	1986 Q2	1986 Q3	1986 Aug.	1986 Sept.	1986 Oct.
Total sales	1.2	1.2	3.9	1.4	5.3	-5.0
Previous estimate[1]			3.7	1.5	4.6	--
Total less auto dealers nonconsumer stores, and gasoline stations	1.3	1.4	1.6	.5	-.2	.3
Previous estimate[1]			--	.7	-.1	--
GAF[2]	1.4	2.7	1.9	1.4	-1.0	.3
Durable	1.8	3.5	9.3	3.5	13.8	-12.1
Automotive group	.9	4.2	13.3	4.9	22.3	-18.8
Furniture and appliances	1.1	4.2	4.5	.1	.7	-1.8
Other durable goods	.3	1.8	4.9	2.3	-.8	1.7
Nondurable	.8	-.2	.6	.2	-.2	.3
Apparel	1.5	3.9	1.0	2.5	-1.5	1.5
Food	1.4	-.4	.6	-.8	.7	.6
General merchandise[3]	1.4	1.5	1.1	1.5	-1.6	.8
Gasoline stations	-4.3	-11.5	-4.4	-2.5	.9	-1.3

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.
--Data are unavailable because of a future release date.

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	4.0
Manufacturing	8.3	3.9	6.0	2.6	-1.4	.9
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	-2.3
Personal consumption expenditures	3.6	3.5	1.7	3.6	6.2	6.5
Durables	8.8	6.2	-11.1	-1.8	14.3	39.7
Motor vehicles and parts	6.7	3.7	-32.8	-8.4	18.2	80.0
Other durables	10.5	8.2	12.4	3.6	11.3	13.4
Nondurables	2.2	2.0	1.6	6.5	8.0	-1.1
Clothing and shoes	4.0	3.2	2.8	14.0	12.9	1.5
Gasoline and oil	.6	1.5	3.4	2.1	40.0	7.4
Food	2.0	2.0	-.2	5.6	2.8	-6.2
Services	3.3	3.9	6.0	3.2	2.6	3.4
Memo:						
Personal saving rate (percent)	6.3	5.1	4.4	5.0	5.1	3.0

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

After strong gains in the first half of 1986, real disposable personal income declined moderately in the third quarter, reflecting a drop in farm proprietors' subsidies and a marked slowdown in the growth of real wages and salaries. In October, nominal personal income rose 4.3 percent at an annual rate, a little faster than the third-quarter pace, and income growth in November should get a healthy boost from the increases in production worker hours and the accompanying rise in hourly wage rates. With spending down sharply in October, the personal saving rate increased from its September low of 2.0 percent to 4.1 percent.

Business Fixed Investment

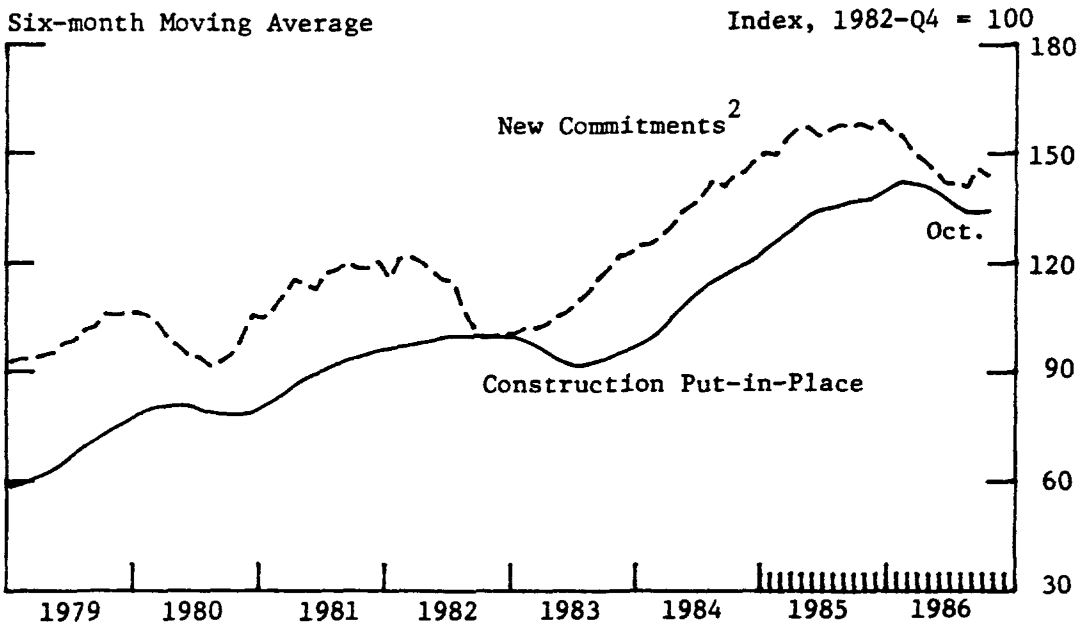
Business investment spending has been mixed in recent months. On the equipment side, purchases of autos and light trucks probably have been cut sharply, owing to the expiration of this fall's financing incentives; a similar drop occurred during the fourth quarter of 1985. In addition, sales of heavy-weight trucks--not covered by these incentives--have been weak, falling 13-1/2 percent in October. In contrast, October shipments of nondefense capital goods rose 2-1/4 percent, with the aircraft group accounting for all of this gain. Shipments could advance a bit further during the remainder of the current quarter, judging from the pattern of orders; but it would take an enormous increase in shipments to offset the effect of the likely decline in purchases of motor vehicles on overall equipment spending.

After plunging earlier this year, outlays for nonresidential structures have firmed a little in recent months. Petroleum drilling has continued to trend upward from its midyear trough, and the value of

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

	1986 Q1	1986 Q2	1986 Q3	1986 Aug.	1986 Sept.	1986 Oct.	1986 Nov.
Producers' durable equipment							
Nondefense capital goods							
Shipments	-5.8	2.5	.7	-.5	-.7	2.2	—
Aircraft	-5.9	-.9	3.5	.9	-13.3	24.1	—
Excl. aircraft	-5.8	3.0	.3	-.7	1.2	-.7	—
Orders	-4.8	-.9	4.0	-3.9	7.2	-4.8	—
Aircraft	-18.8	-12.2	.8	-18.2	36.9	33.7	—
Excl. aircraft	-2.0	.9	4.5	-1.9	3.8	-10.6	—
Sales of heavy-weight trucks (thousands of units, A.R.)	262	273	268	268	276	239	—
Nonresidential structures							
Nonresidential construction	1.0	-5.6	.0	1.8	-1.4	2.8	—
Commercial building	1.9	-7.8	1.1	3.4	-2.9	.8	—
Office	-.8	-6.6	-4.0	.6	-1.6	1.5	—
Other commercial	4.9	-9.1	6.4	6.2	-4.1	.2	—
Industrial building	-6.2	-9.4	-6.2	-2.3	5.6	1.3	—
Public utilities, institutional, and other	1.9	-2.2	.3	1.1	-1.2	5.0	—
Rotary drilling rigs in use	-18.5	-40.2	-12.6	3.6	1.9	4.2	3.5

NONRESIDENTIAL CONSTRUCTION AND NEW COMMITMENTS[1]



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

nonresidential construction put-in-place (which excludes petroleum drilling) rose 2.8 percent in October to a level 2-1/2 percent above the third-quarter average. More than one-half of the October gain in construction was in the small "institutional" grouping (hospitals, religious, and educational buildings) and may reflect a bunching of outlays in that month. In part, the recent increase in construction spending in other sectors may have been prompted by efforts to complete projects before adverse changes in depreciation provisions take effect at year end.

Based on near-term indicators, investment spending is likely to remain sluggish into early 1987. New orders for nondefense capital goods fell 4.8 percent in October; excluding the robust aircraft group, for which lead times tend to be long, the October decline was 10.6 percent. The orders series is extremely volatile on a month-to-month basis, but even so, the October decline suggests some restraint on first-quarter shipments of equipment. On the construction side, office building activity should continue to decline, as the decline in outlays to date reflects only about two-thirds of this year's drop in new commitments. In contrast, for the other categories of construction, the adjustment of outlays to earlier declines in commitments has been more rapid, suggesting that spending outside the office sector may be fairly firm in early 1987.

The first survey readings of planned 1987 capital spending were released last month. Both the McGraw-Hill and Merrill Lynch surveys indicate that firms expect nominal outlays to be roughly flat for the second year in a row. At the industry level, manufacturers generally expect capital spending to increase a bit while expenditures in other industries--particularly

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

	1986 Q1	1986 Q2	1986 Q3	1986 Aug.	1986 Sept.[r]	1986 Oct.[p]
Book Value Basis:						
Total	20.1	2.9	-3.1	-21.0	-24.0	—
Manufacturing	-9.3	-4.6	-7.3	-13.7	-10.8	-4.5
Wholesale	4.5	6.9	4.5	-.1	2.0	—
Retail	24.9	.6	-.2	-7.2	-15.2	—
Automotive	15.1	-1.4	-11.5	-14.3	-40.4	—
Ex. auto	9.8	2.0	11.3	7.0	25.2	—
Constant Dollar Basis:						
Total	29.8	1.6	-11.0	-17.3	-41.4	—
Manufacturing	-5.3	1.0	-5.2	-19.0	-6.3	—
Wholesale	6.8	4.6	8.3	10.7	-2.3	—
Retail	28.3	-4.0	-14.0	-8.9	-32.9	—
Automotive	17.2	-1.8	-21.5	-12.4	-50.3	—
Ex. auto	11.0	-2.3	7.5	3.5	17.4	—

INVENTORIES RELATIVE TO SALES[1]

	Cyclical Reference Points[2] 81 low	Cyclical Reference Points[2] 82 high	1986 Q1	1986 Q2	1986 Q3	1986 Aug.	1986 Sept.[r]	1986 Oct.[p]
Book Value Basis:								
Total	1.39	1.54	1.38	1.39	1.36	1.37	1.33	—
Manufacturing	1.60	1.77	1.43	1.43	1.42	1.44	1.41	1.41
Wholesale	1.06	1.28	1.20	1.23	1.21	1.22	1.19	—
Retail	1.37	1.46	1.47	1.45	1.39	1.42	1.34	—
Automotive	1.57	1.90	1.78	1.70	1.40	1.60	1.21	—
Ex. Auto	1.31	1.41[3]	1.38	1.38	1.39	1.37	1.39	—
Constant Dollar Basis:								
Total	1.58	1.72	1.55	1.54	1.50	1.52	1.47	—
Manufacturing	1.88	2.04	1.72	1.70	1.69	1.70	1.69	—
Wholesale	1.26	1.45	1.31	1.32	1.29	1.30	1.26	—
Retail	1.38	1.49	1.52	1.48	1.40	1.44	1.35	—
Automotive	1.54	1.90	1.83	1.74	1.33	1.56	1.13	—
Ex. auto	1.31	1.45[3]	1.44	1.41	1.42	1.41	1.43	—

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 coincident.
3. January 1985 peak value.
r--Revised estimates.
p--Preliminary estimates.

those for airlines, electric utilities, and the large "trade and services" category--are expected to weaken.

Business Inventories

Except for fluctuations in auto dealers' stocks, business inventory investment, on balance, remained moderate through early autumn. In 1982 dollars, nonauto inventories in manufacturing and trade expanded at an annual rate of $9 billion in September and $10.5 billion over the third quarter--not materially different from the pace observed during the first half of this year.

Manufacturers' inventories fell at a $5.2 billion annual rate in real terms from the end of June to the end of September; book-value data show another small decline in October. The stock-sales ratio for manufacturing has remained fairly stable.

In the trade sector, surging auto sales reduced dealers' stocks at a $50.3 billion annual rate in real terms in September; the rate of liquidation for the third quarter as a whole was $21.5 billion. The accumulation of nonauto trade inventories picked up in September, but with sales fairly robust in that month, the inventory-sales ratios for most types of nonauto retail and wholesale establishments remained within the ranges observed over the past year.

Housing Markets

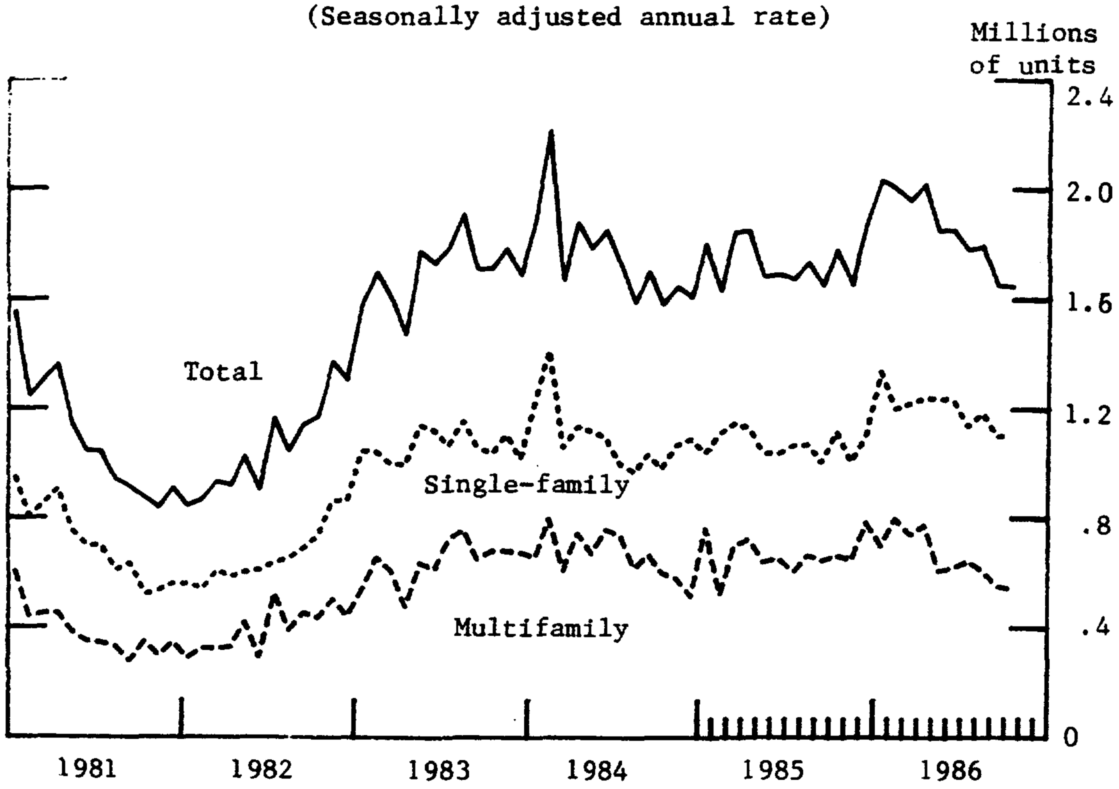
Recent data suggest further slowing of housing construction outlays. Although total private housing starts were about unchanged between September and October at 1.65 million units, that pace of construction represents a 5 percent decline from the third-quarter average and is well below the nearly 2.0 million unit rate of the first half of the year.

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

	1985	1986			1986		
	Annual	Q1	Q2	Q3	Aug.	Sept.	Oct.[1]
All units							
Permits	1.73	1.83	1.82	1.68	1.67	1.60	1.56
Starts	1.74	2.00	1.91	1.74	1.80	1.65	1.65
Single-family units							
Permits	.96	1.05	1.12	1.06	1.04	1.05	1.00
Starts	1.07	1.25	1.24	1.14	1.19	1.10	1.11
Sales							
New homes	.69	.80	.80	.68	.62	.73	.66
Existing homes	3.22	3.26	3.47	3.62	3.61	3.77	3.76
Multifamily units							
Permits	.78	.79	.70	.62	.63	.56	.55
Starts	.67	.75	.67	.60	.61	.55	.54
Mobile home shipments	.28	.26	.24	.24	.23	.24	n.a.

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

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



Multifamily housing starts declined 2 percent in October to 542,000 units, continuing the sharp cutbacks from their first-quarter peak. Several negative factors continue to contribute to the weakness in this sector: a record-high 9.4 percent vacancy rate on multifamily rental properties,[2] and recent tax code changes that will lower rates of return on investments in rental properties as well as severely constrain issuance of state and local government multifamily mortgage revenue bonds.

In recent months single-family starts also have dropped back a bit, to a 1.1 million unit pace, and new home sales have been disappointing. The apparent weakness in demand for new homes has been surprising in light of the return to single-digit conventional mortgage interest rates, the robust level of existing-home sales, and favorable consumer evaluations of the housing market.

Housing price appreciation has slowed in recent months. In the existing home market, the average twelve-month price increase has declined from double digits in the early summer to 7 percent in October. Prices of new homes sold rose about 9 percent during the 12 months ending in October, down considerably from the increases recorded during the summer. However, more than half of the rise reflected upgrades in housing quality and changes in the regional mix of sales; new home prices rose only 4 percent during the year ending in the third quarter.

Regionally, continuing problems in the energy sector have resulted in some contraction in housing demand in selected markets of the South. The

2. Rental apartments recently have accounted for 70 to 80 percent of total multifamily construction.

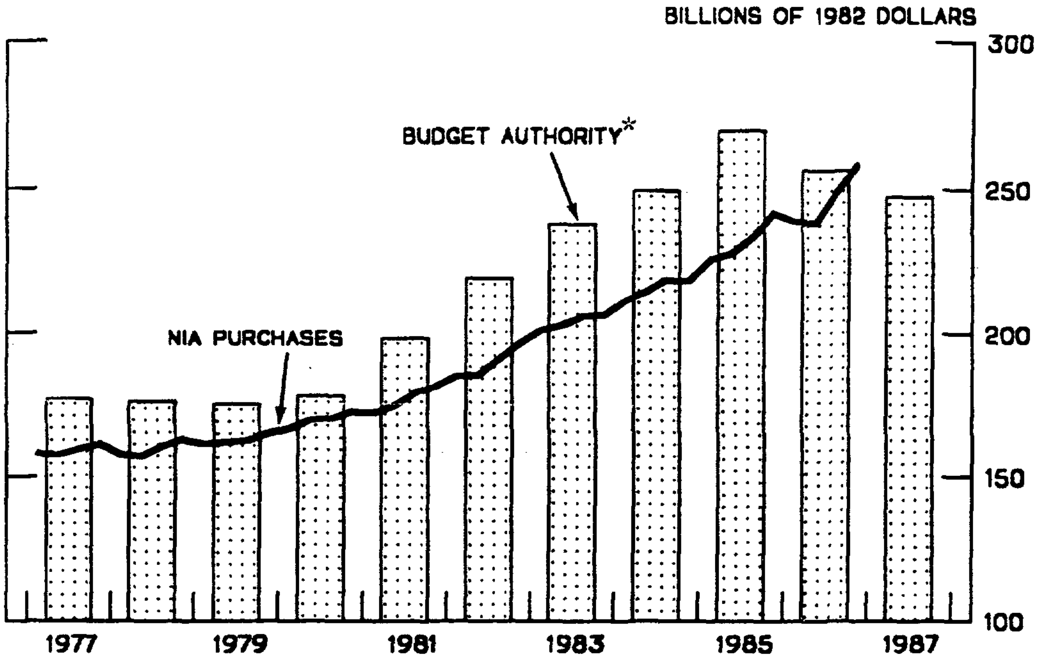
average sales price of existing homes in that region showed virtually no upward movement during the year ending in the third quarter; housing starts dropped 7 percent during the same period. In the multifamily sector, reduced demand in the oil-patch states and some other markets, coupled with previous over-building, have raised the multifamily vacancy rate in the South to above 10 percent. In the Northeast, by contrast, housing demand has remained strong; single-family starts this year have been at their highest level since 1973, and existing home prices have been increasing at rates far above the national average.

Federal Government

Revised data indicate that real federal purchases rose sharply in the third quarter, owing entirely to a further increase in defense spending. Nondefense purchases, excluding the volatile Commodity Credit Corporation component, continued to drift downward in constant dollars and were about 2-1/4 percent below the level in the third quarter of last year.

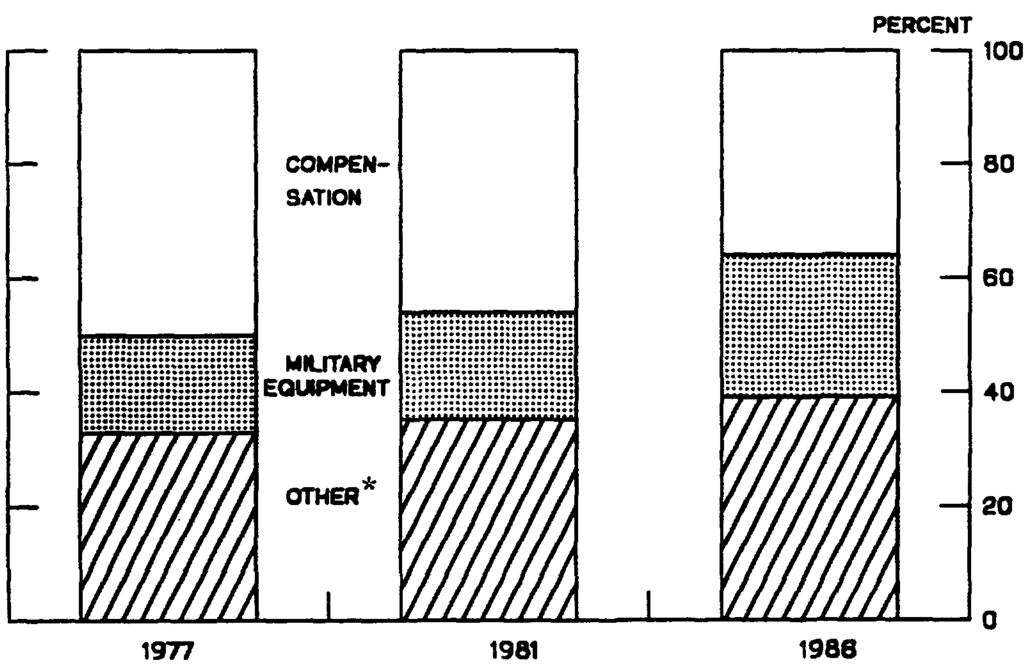
During the second and third quarters, real military outlays on an NIA basis surged at a 16 percent annual rate. This recent strength is largely a product of the defense authority enacted in recent prior years; the buildup in obligations has kept real outlays on a sharp uptrend with the rise over the past year amounting to nearly 7 percent (see chart). However, quarterly changes continue to be erratic, as a result of the uneven delivery pattern of various types of large-scale military equipment that have been in production for several years and now account for a much larger share of total purchases. For example, acquisitions of B1 bombers began slowly in 1985 but now are scheduled at 8 to 10 planes per quarter.

NATIONAL DEFENSE AUTHORITY AND SPENDING
(FISCAL YEARS)



* Estimated by FRB staff.

REAL DEFENSE PURCHASES BY CATEGORY
(FISCAL YEARS)



* Other includes R&D and other services, nondurable goods, and durable goods excluding equipment.

ADMINISTRATION'S FY1988 BUDGET ECONOMIC ASSUMPTIONS
(Calendar years)

	1986	1987	1988	1989	1990	1991	1992
	- - - - - - - Percent change, Q4 to Q4 - - - - - -						
Nominal GNP	5.4	6.9	7.3	7.2	6.8	6.3	5.3
Real GNP	2.7	3.2	3.7	3.6	3.6	3.5	3.3
GNP deflator	2.6	3.6	3.5	3.5	3.0	2.7	2.0
	- - - - - - - Percent, annual average - - - - - -						
Unemployment rate	7.0	6.8	6.4	6.1	5.9	5.7	5.6
Treasury bill rate	5.9	5.4	5.6	5.3	4.7	4.2	3.6

Source: 1988 Budget forecast, December 6, 1986.

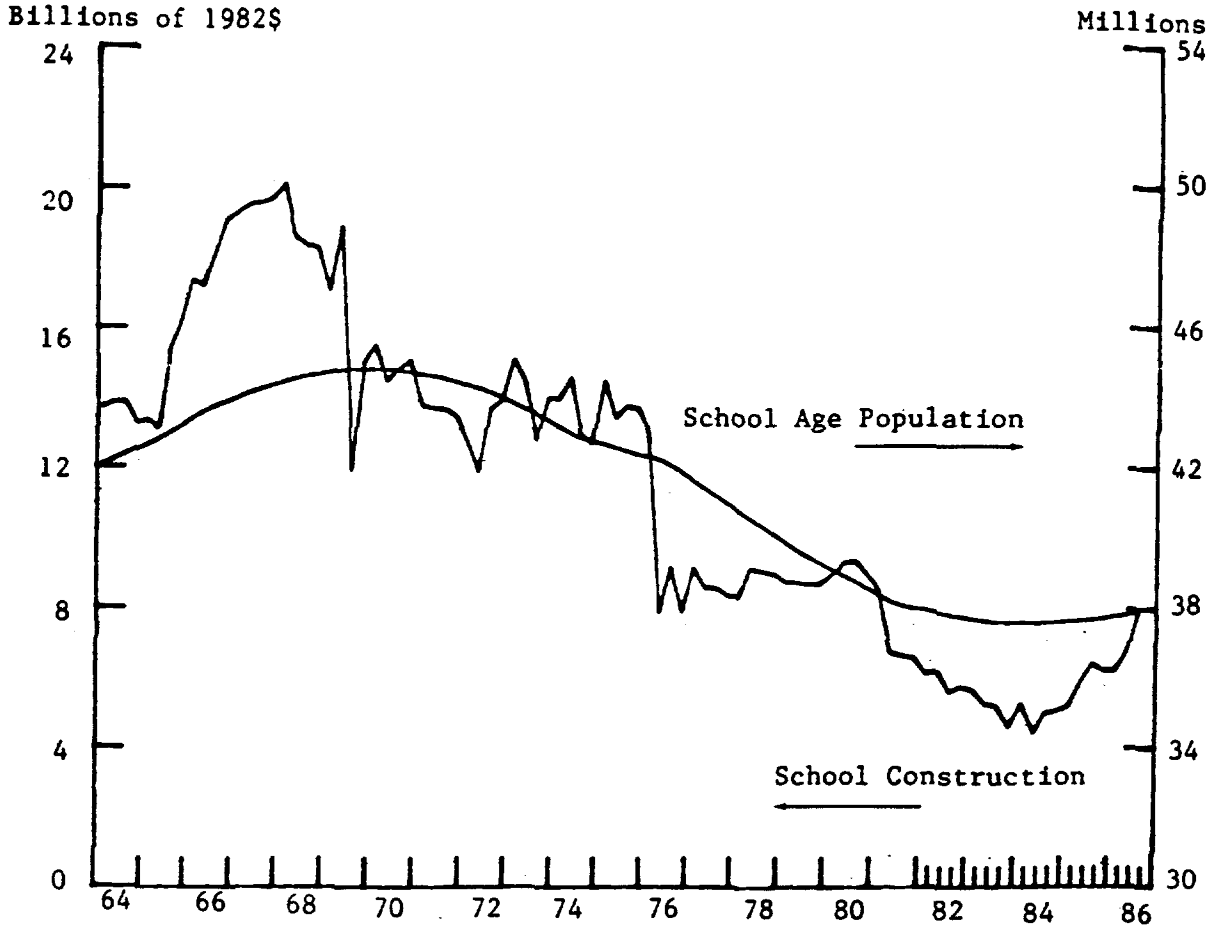
Similarly, the Pentagon has just begun receiving new C-5 cargo planes, while the MX missiles are now at or near their peak delivery rates. In addition to equipment deliveries, research and development spending has climbed in spurts, with the level of such spending in the third quarter 15 percent above that recorded a year ago.

Although defense spending probably will not continue to grow at its recent pace, the level of outlays should remain high at least into the early part of next year because the backlog of unspent appropriations remains substantial. However, Congress cut defense budget authority in fiscal 1986 and again in fiscal 1987, which suggests that real defense purchases may drift down as time progresses.

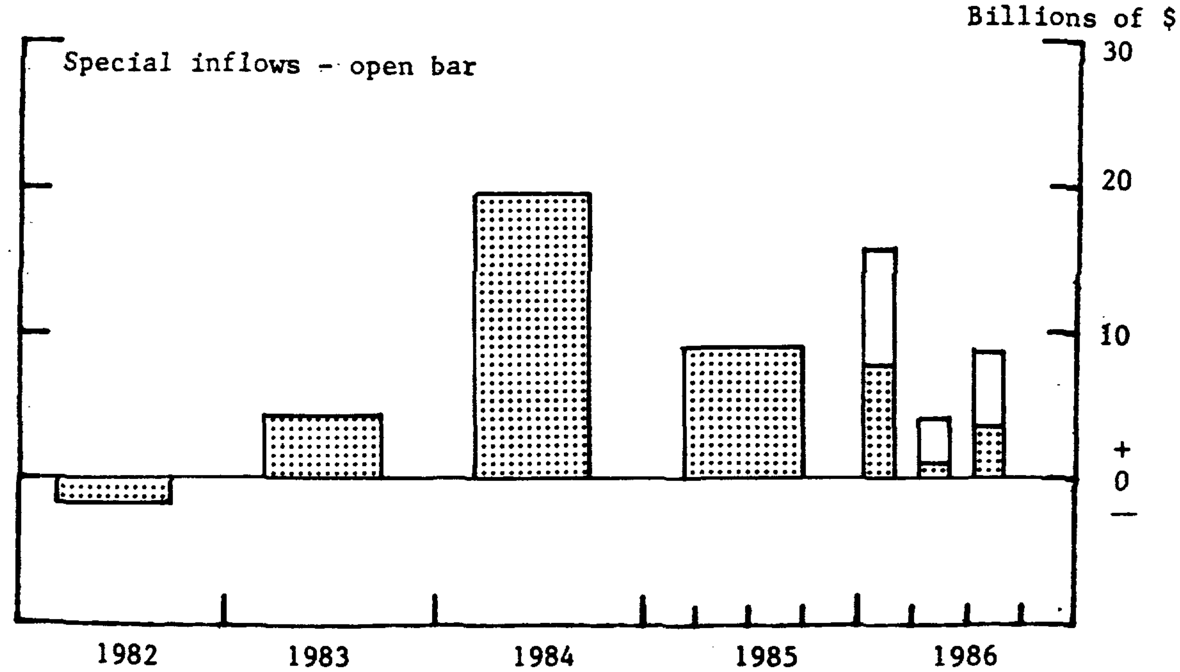
With the 1986 session of Congress adjourned and most action on the FY1987 budget completed, estimates of the 1987 deficit are being reassessed. Unofficial estimates by OMB Director Miller, which might assume some further actions to raise certain high-priority spending, have been in the $165 to $180 billion range, and were made before release of the economic assumptions earlier this week. Those assumptions show real GNP growth of 3.2 percent during 1987 and 3.7 percent in 1988, significantly less than their previous forecast. CBO's informal efforts to take account of Congressional action since August led them to project a deficit of $150 to $160 billion; these assessments do not incorporate updated economic assumptions or technical re-estimates of spending rates in light of new legislation. All of these estimates for the current fiscal year are substantially above the $108 billion target for FY1988 that must be met, according to the Gramm-Rudman-Hollings Act, in the budget expected to be submitted by the Administration early next year.

STATE AND LOCAL SECTOR

SCHOOL CONSTRUCTION



SURPLUS OF OPERATING AND CAPITAL ACCOUNT



State and Local Government

Growth in state and local government spending continued to be unusually robust during the third quarter. Real purchases of goods and services increased at an 8 percent annual rate during the past two quarters, the most rapid gain for any two-quarter period in more than 20 years.[1] Most of the strength can be attributed to a sharp jump in real outlays for construction. In addition to a surge in highway building, state and local governments have given construction of correctional institutions and educational facilities a high priority.

The increase in school building largely reflects expanding enrollments (see chart). The birth rate in the United States turned up in the late 1970s, and the grade school population, which had been declining since 1969, began to grow in 1984. That same year, real outlays by state and local governments for educational facilities began to increase. The rise in school building has been considerably more noticeable this year; real construction put-in-place for this purpose surged at a 61 percent annual rate during the second and third quarters.

Surpluses in operating and capital accounts in the state and local sector, excluding social insurance funds, averaged $9.5 billion at an annual rate over the first three quarters of 1986, about the same as in 1985. However, the 1986 surpluses partly are attributable to temporary inflows. During the first quarter, payments were transferred to the state and local sector as a result of penalties paid by Exxon for overcharges during the price control

1. Subsequent revisions to construction put-in-place data for September suggest the likelihood of some reductions in the growth rate for the third quarter.

period. In the second quarter, funds were distributed to the states as indirect business tax receipts for final settlement of the federal-state dispute over revenues of outer continental shelf rents. Moreover, in the third quarter, the surplus was boosted by payments from settlements of disputes over stripper well charges during the 1970s as well as grants that were raised due to a shifting of revenue sharing payments from the fourth quarter. Excluding these special inflows, the surplus during the first three quarters would have amounted to only $4 billion at an annual rate, the smallest surplus since a deficit was recorded in 1982. Budgetary pressure has been uneven in recent months with the greatest erosion in the oil patch and farm belt states.

Prices

Inflation remained relatively low in October: the consumer price index for all urban consumers rose 0.2 percent, and the producer price index for finished goods rose 0.3 percent.

The CPI for food rose 0.3 percent in October, less than in the preceding three months. In addition, energy prices turned down at both the retail and refinery levels, despite the firming of crude oil prices since midsummer. Excluding food and energy items, the CPI rose 0.4 percent in October, slightly faster than the average pace during the first three quarters of the year. The pick up reflected a sharp increase in new car prices, owing both to higher retail prices for the new 1987 models--which are phased into the CPI sample in proportion to sales--and to the termination of rebates on 1986 models. The CPI includes automobile financing costs among services, and the ending of the finance incentive programs was responsible for most of an October pickup in the index for

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 Sept.	1986 Oct.
			—Annual rate—			—Monthly rate—	
All items[2]	100.0	3.8	-1.9	1.5	2.2	.3	.2
Food	18.5	2.7	-1.4	3.4	9.4	.4	.3
Energy	11.3	1.8	-34.2	-12.5	-19.5	.7	-2.2
All items less food and energy	70.2	4.4	4.1	3.1	3.7	.3	.4
Commodities	25.9	2.1	.3	-.5	3.1	.2	.2
Services	44.4	5.7	6.5	5.2	4.1	.3	.5
Memorandum:							
CPI-W[3]	100.0	3.6	-2.7	1.0	2.0	.3	.1

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 Sept.	1986 Oct.
			—Annual rate—			—Monthly rate—	
Finished goods	100.0	1.8	-12.5	.4	.7	.4	.3
Consumer foods	24.5	.5	-8.1	5.9	13.0	-.2	.9
Consumer energy	12.5	-.3	-66.9	-22.3	-36.9	3.7	-4.3
Other consumer goods	40.3	2.7	2.5	2.0	2.2	.2	.8
Capital equipment	22.7	2.7	.7	2.3	2.2	.4	.5
Intermediate materials[2]	95.3	-.1	-11.8	-5.3	-.8	.5	-.3
Exc. energy	79.6	-.1	-1.0	-1.3	2.0	.3	.1
Crude food materials	52.5	-6.4	-24.7	1.6	20.1	-.8	2.6
Crude energy	31.6	-4.9	-51.3	-29.1	-13.3	3.7	-.9
Other crude materials	15.9	-4.3	-.2	7.0	-18.1	.5	1.7

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

nonenergy services. The PPI for new cars rose 4-3/4 percent in October, much more than the corresponding CPI increase. This rise, along with a jump in light truck prices, accounted for the 0.7 percent increase in the index for finished goods less food and energy. In contrast to the CPI, the PPI includes only new-model cars in its October sample and is based on manufacturers' revenues, thus reflecting the termination of incentive financing programs and other discounting by manufacturers as well as the price increases.

The dollar prices that foreign producers charge for their goods in the U.S. are beginning to respond to the lower foreign exchange value of the dollar. According to the BEA index, which measures prices of imports at their point of entry, prices of non-oil merchandise imports rose 5-1/2 percent from the third quarter of 1985 to the third quarter of 1986, compared with a 2-3/4 percent decline during the preceding four quarters. Although the acceleration has been most notable in the machinery and automobile categories, prices also have picked up considerably for some other consumer durables, such as photographic equipment.

The influence of the dollar depreciation on the prices of imported goods at the retail level appears to have been relatively small and highly variable across sectors, as some distributors or retailers apparently have been willing to narrow their profit margins. Although the CPI includes prices of foreign products, the Bureau of Labor Statistics does not construct separate <u>consumer</u> price indexes for imports and domestically produced goods. They have, however, indicated those components of the CPI that, in their view, have a higher-than-average import share. Certain of these commodities, for example new cars and audio and photographic

IMPORT AND DOMESTIC PRICES--SELECTED MEASURES
(Percent changes)

	1976	1977	1985	1986
Import Price Measures				
BEA	(Q4 to Q4)		(Q3 to Q3)	
Non-oil imports (fixed-weight)[1]	4.2	9.0	-2.8	5.5
Capital goods, exc. autos	-4.0	7.1	-4.4	7.6
Autos	5.8	10.5	1.7	11.8
Consumer goods, exc. autos	-.7	10.6	-.2	6.7
Durable	.1	11.8	-1.4	9.5
Industrial supplies and materials, exc. petroleum	11.0	6.9	-6.4	-3.8
Domestic Price Measures				
	(Dec. to Dec.)		(Oct. to Oct.)	
CPI				
Commodities less food, energy, and used cars[2]	4.5	4.7	3.0	2.4
New cars	4.8	7.2	3.1	5.0
TV and sound equipment	n.a.	n.a.	-5.3	-3.6
Photographic equipment	n.a.	n.a.	1.0	5.0
Clocks, lamps and decor items	n.a.	n.a.	2.1	-.5
Sporting goods	n.a.	n.a.	3.3	-3.2
Toys, hobbies and music equipment	n.a.	n.a.	1.4	.3

1. Fixed-weighted indexes for quarterly averages based on Census unit value data and, in recent years, on the BLS import price series; index for non-oil imports calculated by Federal Reserve from BEA series. Includes items not listed.
2. Unpublished series.

equipment, have shown some acceleration in the rate of price increase this year in comparison with the preceding year. However, little or no dollar-related effect is evident for many other goods--such as lamps, sporting goods or toys--where import proportions also are high. A somewhat similar pattern was observed after the depreciation of the dollar that began in mid-1976. Dollar prices charged by foreign producers, as represented by the BEA index for non-oil imports, accelerated during 1977, but much of the price effect at the final sales level was not seen until 1978.

Wages and Labor Costs

Recent data suggest that, on balance, wage inflation has continued at a moderate pace in the fourth quarter. The hourly earnings index for production and nonsupervisory workers was up 0.4 percent in November after a smaller increase in October. Recent increases in this measure of wage inflation are somewhat larger than those seen earlier this year, but much of the rise so far this quarter has occurred in construction, finance, and services, where the index is quite volatile. In most other industries, wages changed very little in October and November. Since the beginning of this year, the hourly earnings index has risen about 2 percent at an annual rate in the private nonfarm economy, and 1-1/2 percent in manufacturing.

Revised data on productivity and labor costs showed little change from the preliminary third-quarter figures. Compensation per hour was up 2-1/2 percent at an annual rate in the third quarter, about the same as the second quarter's increase. However, productivity growth has remained quite sluggish in the past two quarters, causing most of the increase in

HOURLY EARNINGS INDEX[1]
(Percentage change; based on seasonally adjusted data)[2]

	1985	1986 Q1	1986 Q2	1986 Q3	1986 Sept.	1986 Oct.	1986 Nov.
		—Annual rate—			—Monthly rate—		
Total private nonfarm	3.0	2.7	1.8	1.2	.1	.2	.4
Manufacturing	3.3	2.3	2.4	1.2	-.1	.2	.0
Durable	3.4	2.3	2.4	.5	-.1	.1	.1
Nondurable	3.1	2.2	2.4	2.5	.0	.3	.0
Contract construction	1.4	-2.8	4.1	.1	-.1	1.0	.9
Transportation and public utilities	3.0	2.8	1.4	.9	.4	.1	.2
Finance, insurance, and real estate	4.2	8.0	3.7	.5	.4	.1	1.1
Total trade	2.0	1.8	.2	2.0	.5	.0	.2
Services	4.1	5.0	1.6	1.0	.0	.5	.9

1. Excludes the effect of interindustry shifts in employment and fluctuations in overtime hours in manufacturing.
2. Changes over periods longer than one quarter are measured from final quarter of preceding period to final quarter of period indicated. Quarterly changes are compounded annual rates.

LABOR PRODUCTIVITY AND COSTS
Nonfarm Business Sector
(Percent change from preceding period at compound annual rates; based on seasonally adjusted data)

	1984[1]	1985[1]	1986 Q1	1986 Q2	1986 Q3	1985-Q3 to 1986-Q3
Output per hour	1.0	.2	4.3	.5	.2	.3
Compensation per hour	4.3	3.9	3.1	2.3	2.3	2.9
Unit labor costs	3.2	3.7	-1.2	1.8	2.2	2.5

1. Changes are from final quarter of preceding period to final quarter of period indicated.

compensation rates to be passed through into unit labor costs. As a result, unit labor costs rose 2 percent in the third quarter, about the same rate of growth as in the previous quarter.

DOMESTIC FINANCIAL DEVELOPMENTS

III-T-1

SELECTED FINANCIAL MARKET QUOTATIONS[1]

(Percent)

	1984 Highs	1985 March highs	1986 June highs	1986 FOMC Nov. 5	1986 Dec. 9	Change from: June highs	Change from: FOMC Nov. 5
Short-term rates							
Federal funds[2]	11.63	8.58	6.90	5.94	5.99	-0.91	0.05
Treasury bills[3]							
3-month	10.67	8.80	6.52	5.26	5.48	-1.04	0.22
6-month	10.77	9.13	6.57	5.36	5.49	-1.08	0.13
1-year	11.13	9.25	6.62	5.43	5.50	-1.12	0.07
Commercial paper							
1-month	11.42	8.94	6.87	5.78	6.04	-0.83	0.26
3-month	11.35	9.12	6.81	5.69	5.90	-0.91	0.21
Large negotiable CDs[3]							
1-month	11.52	8.89	6.88	5.68	6.05	-0.83	0.37
3-month	11.79	9.29	6.91	5.67	5.85	-1.06	0.18
6-month	12.30	9.92	6.97	5.67	5.82	-1.15	0.15
Eurodollar deposits[4]							
1-month	11.89	8.89	7.01	5.85	6.29	-0.72	0.44
3-month	12.20	9.58	7.01	5.84	6.04	-0.97	0.20
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	7.86	6.45	6.36	-1.50	-0.09
10-year	13.99	12.02	8.39	7.24	7.07	-1.32	-0.17
30-year	13.94	11.97	7.93	7.58	7.33	-0.60	-0.25
Municipal revenue[5] (Bond Buyer index)	11.44	10.25	8.57	7.30	7.15	-1.42	-0.15
Corporate--A utility Recently offered	15.30	13.23	9.70	9.27e	9.05e	-.65	-.22
Home mortgage rates[6]							
S&L fixed-rate	14.68	13.29	10.76	9.89	9.30	-1.46	-0.59
S&L ARM, 1-yr.	12.31	11.14	8.65	7.98	7.77	-0.88	-0.21

	1984 Lows	1985 March lows	1986 Record highs	1986 FOMC Nov. 5	1986 Dec. 9	Percent change from: Record highs	Percent change from: FOMC Nov. 5
Stock prices							
Dow-Jones Industrial	1086.57	1247.35	1955.57	1899.04	1916.90	-1.98	0.94
NYSE Composite	85.13	102.46	145.75	141.91	142.57	-2.18	0.47
AMEX Composite	187.16	222.28	285.19	267.21	265.36	-6.95	-0.69
NASDAQ (OTC)	225.30	276.18	411.16	362.08	359.03	-12.68	-0.84

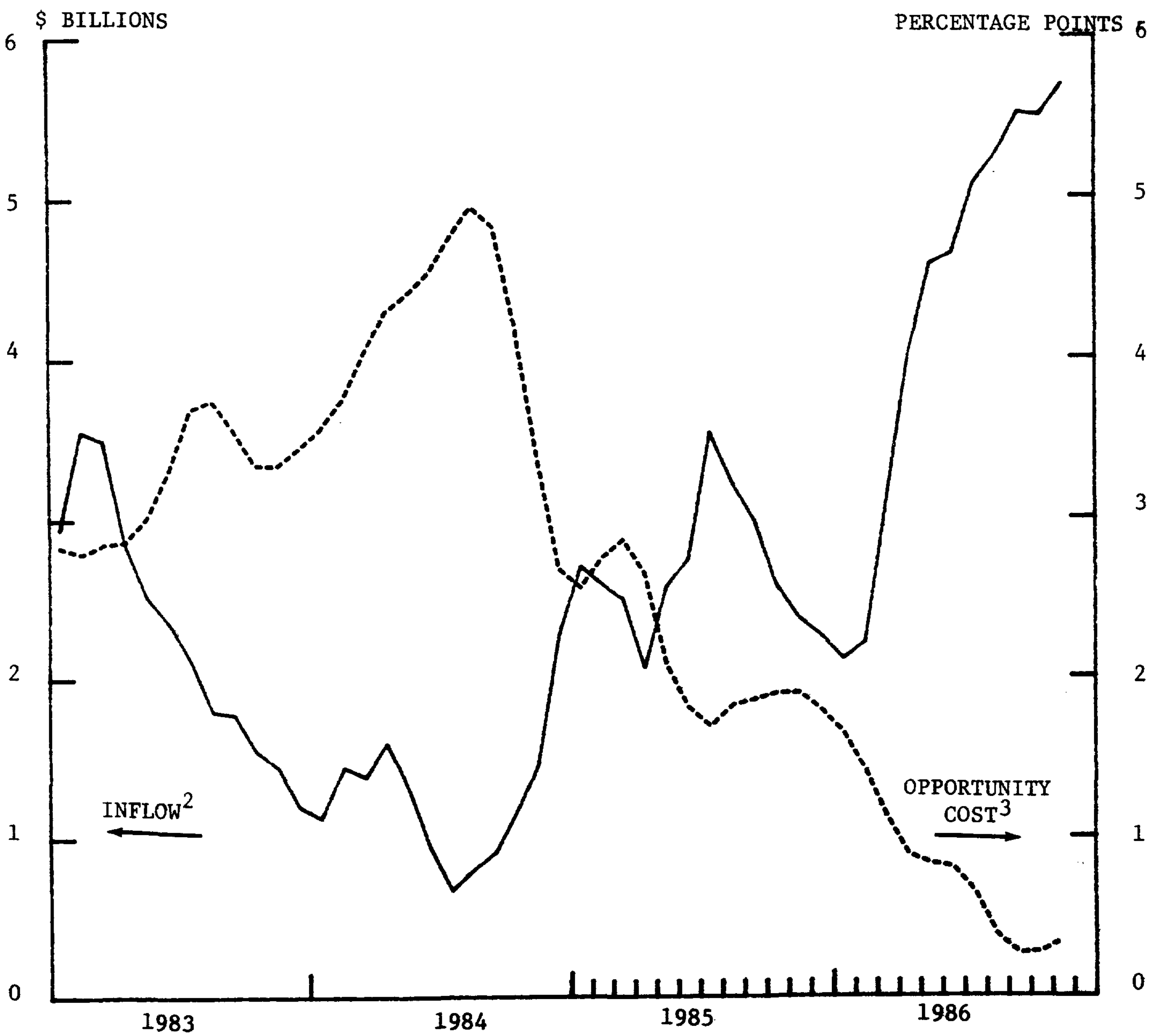
1. One-day quotes except as noted.
2. Averages for two-week reserve maintenance period closest to date shown. Last observation is the average to date for the maintenance period ending December 17, 1986.
3. Secondary market.
4. Averages for statement week closest to date shown.
5. One-day quotes for preceding Thursday.
6. One-day quotes for preceding Friday.
e--estimate

Interest rates have recorded mixed changes over the intermeeting period, with short-term rates generally up on balance and long-term rates down somewhat. Money market rates rose early in the period in response to stronger than expected economic indicators and release of the asymmetric September FOMC directive; the higher short-term rates persisted, however, owing in some part to the tendency for federal funds to trade at, or slightly above, the marginally higher level of 6 percent. Long-term rates also edged up at first, but subsequently turned downward--apparently reflecting optimism on inflation trends and the perception that dissatisfaction with world economic growth might lead to coordinated easing action by monetary authorities. The rally in the bond markets helped the equity markets to overcome the Boesky and Iran-Nicaragua shocks; some major stock price averages hit new highs in early December.

M1 accelerated to around a 20 percent annual rate of growth in November, but M2 slowed and M3 growth remained moderate; both M2 and M3 are just inside the upper bounds of their 1986 target ranges. The increase in M1 growth last month primarily reflected a sharp rebound in demand deposit growth, while other checkable deposits continued to expand sharply. The nontransactions component of M2 slowed in November with the deceleration likely being exaggerated by the transitory influence of a late-October surge in savings bond sales. Within the nontransactions component, the story continued to be one of strength in liquid retail deposits and declining time deposits.

Debt of domestic nonfinancial sectors appears to have risen strongly in November after growth slowed in October. Credit use by nonfinancial

OCD INFLOWS AND OPPORTUNITY COSTS[1]



1. Data plotted for November 1986 represent averages of October and (estimated) November only.
2. 3-month moving average of monthly inflows.
3. 3-month moving average of the 3-month Treasury bill rate minus the weighted average rate on NOWs and Super NOWs. All rates are on an annual effective yield basis.

businesses rebounded last month largely on the strength of merger activity. Residential mortgage growth evidently remained brisk, and the decline in loan rates to the lowest levels in more than eight years probably has sustained commitment activity; consumer borrowing likely slowed in November in the absence of major auto finance incentives. Federal borrowing surged in November as the Treasury caught up with its huge quarterly deficit financing needs. In the tax-exempt market, private-purpose borrowing permitted by the Tax Reform Act picked up, and refinancings were undertaken to take advantage of lower municipal bond rates.

Monetary Aggregates and Bank Credit

In November, demand deposit growth jumped to a 21 percent annual rate and other checkable deposits (OCDs) rose at about the 31 percent October pace. Over the past year, OCDs have accounted for more than half the overall increase in M1 even though they represent less than one-third of the aggregate. As may be seen in the chart, the runup in OCDs has occurred against a backdrop of sharply reduced opportunity costs. NOW account rates have continued to adjust downward only slowly, though not so slowly as the very sticky passbook savings rate. M1 growth has remained far in excess of GNP growth, and the velocity decline in the fourth quarter may be close to the record fall of the second quarter; for the year as a whole, M1 velocity is expected to be down close to 9 percent--the biggest drop in recent decades.

M2 grew at only a 7 percent annual rate in November. A shifting of funds into savings bonds at the end of October--just before the floor rate was cut from 7-1/2 to 6 percent--probably depressed the average level of M2 in November by a small amount. Retail nontransactions deposits grew at

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

		1984:Q4 to 1985:Q4	1986 Q2	1986 Q3	1986 Sept.	1986 Oct.	1986 Nov.pe	Growth from Q4 1985 to Nov. 1986pe
		------ Percentage change at annual rates ------						
1.	M1	11.9	15.8	17.3	9.6	14.0	20	15
2.	M2	8.7	10.5	11.1	7.1	10.5	7	9
3.	M3	7.7	9.0	10.1	8.7	6.6	6	8-3/4
	Selected components							Levels in billions of dollars Oct. 1986
4.	Currency	7.5	6.2	7.1	4.7	10.0	6	181.2
5.	Demand deposits	8.6	15.2	14.4	1.6	4.1	21	293.2
6.	Other checkable deposits	22.3	25.6	30.8	25.1	31.3	32	220.4
7.	M2 minus M1[2]	7.7	8.7	9.0	6.2	9.4	2	2062.7
8.	Overnight RPs and Eurodollars, NSA	20.0	-2.3	27.1	-35.7	70.2	-24	76.0
9.	General purpose and broker/dealer money market mutual fund shares, NSA	9.3	27.3	14.0	10.2	26.7	-1	206.7
10.	Commercial banks	9.1	5.7	6.3	7.1	4.9	6	885.2
11.	Savings deposits, SA, plus MMDAs, NSA[3]	19.0	13.2	18.6	20.6	20.0	18	517.5
12.	Small time deposits	-0.6	-3.1	-9.0	-10.9	-15.8	-11	367.7
13.	Thrift institutions	5.1	7.3	5.8	1.2	2.3	3	894.1
14.	Savings deposits, SA, plus MMDAs, NSA[3]	13.7	13.8	18.8	10.5	19.5	17	400.1
15.	Small time deposits	-0.4	2.6	-3.8	-6.0	-11.3	-8	494.0
16.	M3 minus M2[4]	3.8	3.4	6.5	14.9	-8.9	2	680.0
.	Large time deposits	5.7	-1.8	-0.8	-2.1	-10.7	1	443.2
	At commercial banks, net[5]	5.1	-8.8	-2.5	-2.6	-9.4	10	279.2
	At thrift institutions	6.8	11.0	2.7	-2.2	-13.0	-15	164.0
.	Institution-only money market mutual fund shares, NSA	11.1	39.2	30.9	53.5	1.4	-1	84.5
21.	Term RPs, NSA	-4.0	19.3	15.2	41.2	1.5	66	78.5
22.	Term Eurodollars, NSA	-4.9	6.1	-5.0	49.0	-44.1	18	78.6
		-- Average monthly change in billions of dollars --						
	MEMORANDA:							
23.	Managed liabilities at commercial banks (24+25)	2.5	-5.5	4.1	4.2	-4.9	3	479.9
24.	Large time deposits, gross	1.0	-2.6	0.9	-0.4	-2.4	1	340.1
25.	Nondeposit funds	1.5	-2.9	3.2	4.6	-2.5	2	139.8
26.	Net due to related foreign institutions, NSA	0.4	-1.7	-0.2	5.3	-2.8	5	-27.8
27.	Other[6]	1.1	-1.2	3.4	-0.7	0.3	-3	167.6
28.	U.S. government deposits at commercial banks[7]	0.2	0.9	-0.8	2.9	-2.8	13	13.2

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 October and November 1986 at rates of 41.7 percent and 37 percent, respectively. At thrift institutions, savings deposits excluding MMDAs increased during October and November 1986 at rates of 26.5 percent and 27 percent, respectively.
4. The non-M2 component of M3 is seasonally adjusted as a whole.
5. Net of large-denomination time deposits held by money market mutual funds and thrift institutions.
6. Consists of borrowings from other than commercial banks in the form of federal funds purchased, securities sold under agreements to repurchase, and other liabilities for borrowed money (including borrowings from the Federal Reserve and unaffiliated foreign banks, loan RPs and other minor items). Data are partially estimated.
7. Consists of Treasury demand deposits and note balances at commercial banks.

pe--preliminary estimate

about the same slow pace as in October, but general purpose and broker/dealer money fund shares were flat in November after strong gains in each of the two preceding months. Overnight RPs and Eurodollars weakened in November as their term counterparts, included in M3, increased strongly--a continuation of the sawtooth pattern of recent months. Preliminary data for November indicate that offering rates on small time deposits were little changed and that NOW and savings deposit rates fell a few basis points further.

Growth of M3 remained in the neighborhood of 6 percent for a second month. Although bank asset growth was fairly rapid, non-M3 liabilities--especially an inflow of Treasury deposits--covered a good part of funding needs. At savings and loans, large time deposits continued to run off; until very recently, thrifts had been relying heavily on RPs and Federal Home Loan Bank advances to support their asset growth.

Bank credit expanded at a 10 percent annual rate in November, after rising only 2-1/4 percent in October. A rebound in security loans and strengthening business loan growth, largely reflecting merger financing, paced the acceleration; both real estate and consumer lending picked up some. Purchases of U.S. government securities again ran at over a 20 percent pace. Many of the governments acquired were long term and likely were federally related mortgage-backed securities; preliminary call report data show that, in the year ended September 30, more than 80 percent of the growth in bank holdings of U.S. governments was of this higher-yielding category. Holdings of other securities continued to decline, probably reflecting the gradual decumulation of tax-exempt securities obtained before passage of the Tax Reform Act; the Senior Loan Officer Opinion survey conducted last month indicated that this runoff can be expected to

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

	1986 Q1	1986 Q2	1986 Q3	1986 Sept.	1986 Oct.	1986 Nov.p	Levels in bil. of dollars Novemberp
	Commercial Bank Credit						
1. Total loans and securities at banks	9.3	3.9	13.5	13.0	2.2	9.9	2050.8
2. Securities	2.0	4.9	31.9	29.3	3.1	9.8	500.4
3. U.S. government securities	-5.3	7.9	28.4	14.0	21.6	22.4	305.2
4. Other securities	12.8	0.7	37.3	52.4	-23.9	-9.2	195.2
5. Total loans	11.6	3.6	7.8	7.9	1.8	10.0	1550.5
6. Business loans	5.3	2.0	2.8	3.8	4.7	14.0	520.1
7. Security loans	102.7	-62.7	17.9	5.4	-129.7	21.2	40.3
8. Real estate loans	13.1	13.3	13.6	11.4	11.1	14.5	476.5
9. Consumer loans	11.0	6.7	5.6	7.4	3.9	6.2	311.4
10. Other loans	7.3	-1.6	9.2	11.3	-0.5	-7.0	202.2
	Short- and Intermediate-Term Business Credit						
11. Business loans net of bankers acceptances	5.2	1.0	2.7	3.1	4.5	14.4	514.9
12. Loans at foreign branches[2]	0.0	-21.5	9.1	13.5	-26.7	0.0	17.6
13. Sum of lines 11 & 12	5.1	0.2	2.9	3.4	3.4	14.1	532.6
14. Commercial paper issued by nonfinancial firms[3]	-14.4	-10.3	10.6	-5.6	23.9	-4.1	86.9
15. Sums of lines 13 & 14	2.1	-1.3	4.0	2.2	6.3	11.5	619.5
16. Bankers acceptances: U.S. trade related[4,5]	-6.2	16.3	3.6	3.6	-10.7	n.a.	33.2
17. Line 15 plus bankers acceptances: U.S. trade related	1.7	-0.3	3.9	2.4	5.4	n.a.	646.8 (Oct)
18. Finance company loans to business[4]	16.4	3.8	-2.5	-15.0	0.0	n.a.	157.5 (Oct)
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	4.6	0.5	2.6	-1.2	4.5	n.a.	804.3 (Oct)

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.

go on for a long period of time after the tax deductibility of carrying costs is sharply curtailed at year-end.

Corporate Finance

Borrowing by nonfinancial businesses appears to have increased in November. Gross offerings of new bonds were somewhat above those of the preceding two months and loans at commercial banks rose sharply; commercial paper outstanding declined a bit, however. A major contributing factor in debt growth was the accelerating pace of mergers, LBOs and share repurchases in advance of year-end changes in the tax laws.

Corporate securities markets were affected last month by the announcement of the SEC settlement with Ivan Boesky and the continuation of the SEC investigation into insider trading. Although the financing for some transactions was put in doubt, announcements of new deals were numerous, ensuring a large volume of share retirements in December. Secondary market trading in "junk bonds" was markedly affected by news of the subpoenas issued to Drexel Burnham Lambert executives. Bid-asked spreads on low-grade and unrated debt widened sharply, to roughly double their recent size for large, well-known firms in healthy industries; yields on low-grade bonds rose 50 to 100 basis points relative to Treasuries and higher-rated corporates; issues of smaller firms reportedly fared even worse. Investment grade bonds, however, were not much affected and yields dropped to near the spring lows—about in line with declines in long-term Treasury yields.

Stock prices—particularly those of takeover targets, securities dealers, and financial institutions with heavy investments in low-grade bonds—initially fell sharply after the SEC investigation became public. Markets rallied, however, as news of further revelations tapered off;

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

	1985	1986			1986		
	Year	Q1	Q2	Q3P	Sept.P	Oct.P	Nov.P
Corporate securities - total[1]	16.09	27.91	30.58	23.76	19.51	31.39	32.67
Public offerings in U.S.	12.93	23.82	26.27	20.46	16.04	28.30	29.60
Stocks--total[2]	2.96	4.46	5.71	4.44	3.23	4.90	6.20
Nonfinancial	1.61	2.20	2.84	2.04	1.43	2.40	3.30
Utility	.37	.65	.61	.48	.20	.50	.20
Industrial	1.24	1.55	2.23	1.56	1.23	1.90	3.10
Financial	1.35	2.26	2.87	2.40	1.80	2.50	2.90
Bonds--total[1]	9.97	19.36	20.56	16.02	12.81	23.40	23.40
Nonfinancial	5.21	9.99	12.27	8.23	6.46	7.15	8.00
Utility	1.51	3.30	4.30	3.14	2.71	3.95	3.75
Industrial	3.70	6.69	7.97	5.09	3.75	3.20	4.25
Financial	4.76	9.37	8.29	7.79	6.35	16.25	15.40
By quality[3]							
Aaa and Aa	2.35	5.45	6.32	3.81	1.95	8.58	6.80
A and Baa	4.58	7.72	6.10	5.15	3.59	4.92	4.40
Less than Baa	1.42	2.75	4.67	3.21	3.08	2.04	3.95
No rating (or unknown)	.34	.30	.36	.27	.23	.31	.75
Memo items:							
Equity-based bonds[4]	.70	1.16	1.26	.70	.27	.51	.18
Mortgage-backed bonds	1.28	3.14	3.11	3.58	3.96	7.55	7.50
Variable-rate notes	.87	.33	.60	.72	.88	1.84	4.31
Bonds sold abroad - total	3.15	4.02	4.14	3.21	3.39	2.84	2.80
Nonfinancial	1.26	2.04	2.09	.93	.85	.99	.90
Financial	1.89	1.98	2.05	2.28	2.54	1.85	1.90
Stocks sold abroad - total	.01	.07	.17	.09	.08	.25	.27
Nonfinancial	.01	.04	.03	.07	.07	.13	.27
Financial	.00	.03	.14	.02	.01	.12	.00

p--preliminary.
1. Securities issued in the private placement market are not included. Total reflects gross proceeds rather than par value of original discount bonds.
2. Includes equity issues associated with debt/equity swaps.
3. Bonds categorized according to Moody's bond ratings. Excludes mortgage-backed bonds.
4. Includes bonds convertible into equity and bonds with warrants that entitle the holder to purchase equity in the future.

some broad stock indexes are currently above their levels at the time of the last FOMC meeting. Trading volume has risen in the past few weeks, but it is impossible to tell how much may be associated with realizations of long-term capital gains in advance of the tax law changes. New issue volume for equity was quite high in November, and included the largest initial public offering ever by a nonfinancial corporation--a $1.2 billion issue for the newly formed Coca Cola Enterprises, comprising the bulk of all Coca Cola bottling operations. Part of this issue was sold abroad as a "Euroequity." Issuance in the Euroequity market by financial and nonfinancial corporations has grown to about $1.5 billion so far this year as foreign investors evince increasing interest in U.S. equity securities.

Treasury and Sponsored Agency Financing

The combined deficit of the federal government is expected to total $66-1/2 billion in the current quarter. This deficit, although still quite sizable, has been held down by restraint in the FY1987 appropriations bills and to a slight extent by a concentration of tax receipts early in this fiscal year associated with the Tax Reform Act.[1] The distribution of additional corporate and personal tax payments between the current quarter and early in calendar year 1987 is quite uncertain, however.

The Treasury is expected to finance this quarter's deficit by borrowing $67 billion, net, from the public. Factors other than the deficit will

1. Although the Tax Reform Act was designed to be revenue neutral over a five-year period, a revenue gain is expected to be realized in FY1987 as reductions in individual taxes are smaller than the increase in corporate taxes. A large share of this tax gain will occur in the first half of the fiscal year as firms meet their added liabilities associated with the retroactive repeal of the investment tax credit. Individual tax payments also could be large in late 1986 and early 1987 if the tax reform provisions induce investors to realize capital gains by year-end 1986 before the tax rate on this source of income increases.

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

	1986				
	Q3	Q4[e]	Oct.	Nov.[p]	Dec.[e]
Treasury financing					
Combined surplus/deficit(-)	-53.8	-66.5	-25.3	-32.2	-9.1
Means of financing deficit:					
Net cash borrowing from the public	57.6	67.2	6.0	40.5	20.7
Marketable borrowings/ repayments(-)	51.2	53.8	2.9	34.5	16.4
Bills	14.1	15.9	1.4	11.6	2.9
Coupons	37.1	37.9	1.5	22.9	13.5
Nonmarketable	6.4	13.4	3.1	6.0	4.3
Decrease in the cash balance	-6.8	1.6	17.8	-3.4	-12.7
Memo: Cash balance at end of period	31.4	29.7	13.6	17.0	29.7
Other[2]	3.0	-2.3	1.5	-4.9	1.1
Federally sponsored credit agencies, net cash borrowing[3]	5.4	.2	1.5	-1.6	.3
FHLBs	5.6	.1	*	-.4	.5
FNMA	-.9	.1	1.6	-1.5	*
Farm Credit Banks	-.1	-1.1	-.4	-.2	-.5
FHLMC	.6	.4	.1	.2	.1
SLMA	.2	.7	.2	.3	.2

p--preliminary. e--staff estimate. *--less than $50 million.
1. Data reported on a not seasonally adjusted, payment basis.
2. Includes checks issued less checks paid, accrued items and other transactions.
3. Excludes mortgage pass-through securities issued by FNMA and FHLMC.

absorb funds during the quarter, and the Treasury will reduce its cash balance slightly. It will raise $16 billion, one-fourth of total borrowing, through the issuance of bills. This is the second consecutive quarter of unusually heavy borrowing in the bill market, representing, in part, a catchup from previous reduced offerings in the wake of debt ceiling constraints as well as reduced funding needs because of inflows from nonmarketable debt. Issuance of nonmarketable debt likely will be strong again in the fourth quarter; net SLG volume jumped to $3-1/4 billion in November, when state and local government advance refundings were again large, and it should remain heavy in December.

There was a rush to buy savings bonds before November 1 but, because of lags in remitting the funds to the Treasury, most of the proceeds will be recorded in data for November, or even December. Under the circumstances, the actual volume sold in October cannot be precisely determined, but it appears that the extra sales might have been around $2 billion to $3 billion.

Net borrowing by the federally sponsored credit agencies is expected to slow sharply in the current quarter. Throughout the first three quarters of the year, it was boosted by Federal Home Loan Bank borrowing as the demand of thrift institutions for advances was strong. Recently, the demand for advances has moderated, and net borrowing by the FHLBs should be negligible in the fourth quarter. Borrowing by Fannie Mae, which increased in October, fell back in November; the demand for funds by Fannie Mae has been restrained throughout the year by mortgage prepayments and loan sales. The Farm Credit Banks should again pay down a relatively large amount of debt in the fourth quarter; in the third quarter there was only a small net repayment as the FCS issued large amounts of short-term securities to build their cash position.

State and Local Government Securities Market

The volume of tax-exempt bond offerings rose appreciably in November after the passage of the Tax Reform Act. Evidently, many states have now allocated bond authority to potential issuers under the new state-by-state volume restrictions for private-purpose bonds; a number of housing and industrial development bonds have been sold. Refunding volume matched the strong October pace as tax-exempt bond yields fell to 7-1/2 year lows. In the short-term area, issuance rose considerably in November as Texas came to the market for the first time ever, with a $600 million offering to help the state manage a cash shortfall associated with a nearly $1 billion budget deficit this year.

The expansion of the taxable municipal market was interrupted in November. Through October, around $3-1/2 billion in taxable municipal securities were sold, mostly for the support of private activities--primarily housing, agriculture, and development--that is restricted under tax reform. Proceeds from about half the bonds have been invested in guaranteed investment contracts (GICs) with Executive Life Insurance Company until the money is lent to qualified borrowers for commercial, industrial, and agricultural projects; Executive has been able to offer high yields on the GICs by investing in low-rated corporate bonds. These arrangements have come under heavy criticism from other market participants in recent months because of the apparent intent of earning arbitrage profits for the issuers and because of the large fees for the underwriters and lawyers. Most taxable municipal bonds backed by GICs initially have traded at around 130 to 150 basis points over 10-year Treasury rates. However, in the wake of the Boesky-Drexel news, yields rose in the secondary market to as much as 190 basis points above Treasuries, and several proposed deals were postponed until market uncertainties dissipate.

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

	1985	1986			1986		
	Year	Q1	Q2	Q3	Sept.	Oct.	Nov.[e]
Total tax-exempt	19.82	4.92	15.89	18.94	4.76	9.37	11.76
Short-term[1]	1.97	.63	3.09	2.16	.23	.55	.99
Long-term	17.85	4.29	12.80	16.78	4.53	8.82	10.77
Refundings[2]	4.85	2.06	5.38	5.60	1.97	5.04	5.07
New capital	13.00	2.23	7.42	11.18	2.56	3.78	5.70
Total housing	2.11	.04	.40	.44	.05	.52	.78
Total taxable	.03	.05	.30	.57	.71	.86	.05

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

Mortgage Markets

Interest rates on home mortgage commitments have eased significantly since the last FOMC meeting. The average contract rate for new commitments on conventional fixed-rate mortgages at a sample of S&Ls had fallen nearly 60 basis points by the week ending December 5 to 9.30 percent, the lowest level in 8-1/2 years. The drop in market rates prompted the Veterans Administration to lower its maximum contract rate by 50 basis points to 9 percent, effective November 24. The pace of mortgage refinancings has not yet slowed; in October, 37 percent of FHA-insured commitments made on existing homes were for refinancing purposes, while nearly half of all VA mortgage closings were refinancings. Even so, the markets appear to be

NET CHANGE IN MORTGAGE DEBT OUTSTANDING
(Seasonally adjusted annual rate)

	1982	1983	1984	1985	1986 Q1	1986 Q2	1986 Q3p
By property type (percent)							
Total	5.5	11.2	12.0	11.6	9.9	11.0	12.2
Residential	4.8	10.7	11.4	11.9	9.6	12.4	13.4
Commercial	9.1	16.5	18.3	15.1	14.2	10.2	11.6
Farm	4.0	2.6	-.7	-5.7	-4.7	-9.3	-5.4
By holder ($ billions)							
Total	86	183	218	235	225	254	289
Thrifts	-20	49	85	54	16	21	23
Commercial banks	16	29	45	50	53	57	59
Federally related agencies	12	10	10	8	-5	-14	-6
Mortgage pools[1]	54	68	47	83	114	134	170
Others[2]	24	27	31	40	47	56	43

1. Pools or trusts backing pass-through securities guaranteed by the Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Farmers Home Administration.
2. Includes mortgage companies, real estate investment trusts, state and local government retirement funds, non-insured pension funds, life insurance companies, credit unions, finance companies, and individuals.
p--preliminary.

MORTGAGE ACTIVITY AT FSLIC-INSURED THRIFTS
(Seasonally adjusted monthly averages, $ billions)

	Mortgage transactions		Net change in mortgage assets[1]		
	Originations	Sales	Total	Mortgage loans	Mortgage-backed securities
1982	4.4	4.3	.7	-1.8	2.5
1983	11.4	4.6	6.0	3.7	2.3
1984	14.5	5.2	7.8	6.5	1.4
1985	16.4	8.2	4.0	4.2	-.2
1986-Q1	17.5	11.5	4.0	2.9	1.1
Q2	20.3	13.0	6.0	.5	5.5
Q3	23.5	15.6	3.7	.4	3.3
Oct. p	26.2	17.3	6.2	2.1	4.1

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

dealing with prepayment risk more realistically, and rate premiums on mortgages and mortgage-backed securities have narrowed a bit since late summer.

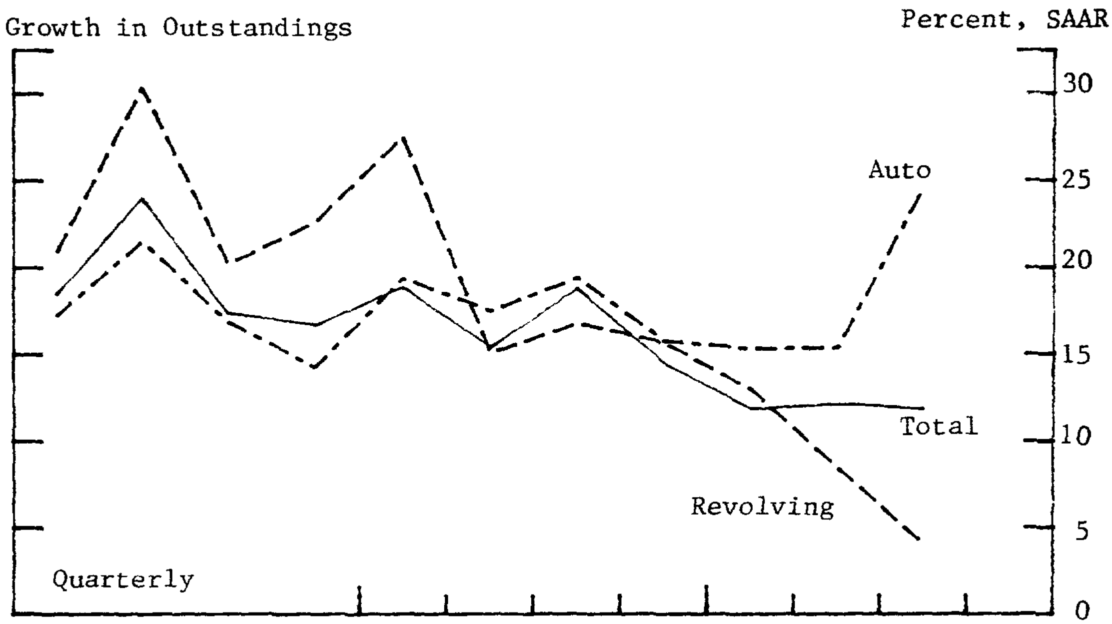
Growth in residential mortgage debt surged in the third quarter to the most robust pace in seven years. This pickup reflected a continued increase in sales of existing homes during the summer, which more than offset moderating sales of new homes. An easing of mortgage processing bottlenecks also may have helped fuel the growth. In contrast, lending on nonresidential properties remained noticeably below the recent peak rate, consistent with the slowing in office construction and the depressed agricultural economy. The funding trends observed earlier in the year continued in the third quarter: mortgage pools were the vehicle for the bulk of overall, and especially home, mortgage debt formation; federal and related agencies as a group were net sellers of mortgages; and thrift institutions shied away from investment in mortgages. Including holdings of mortgage-backed securities, however, thrifts accounted for about one-fifth of net funding.

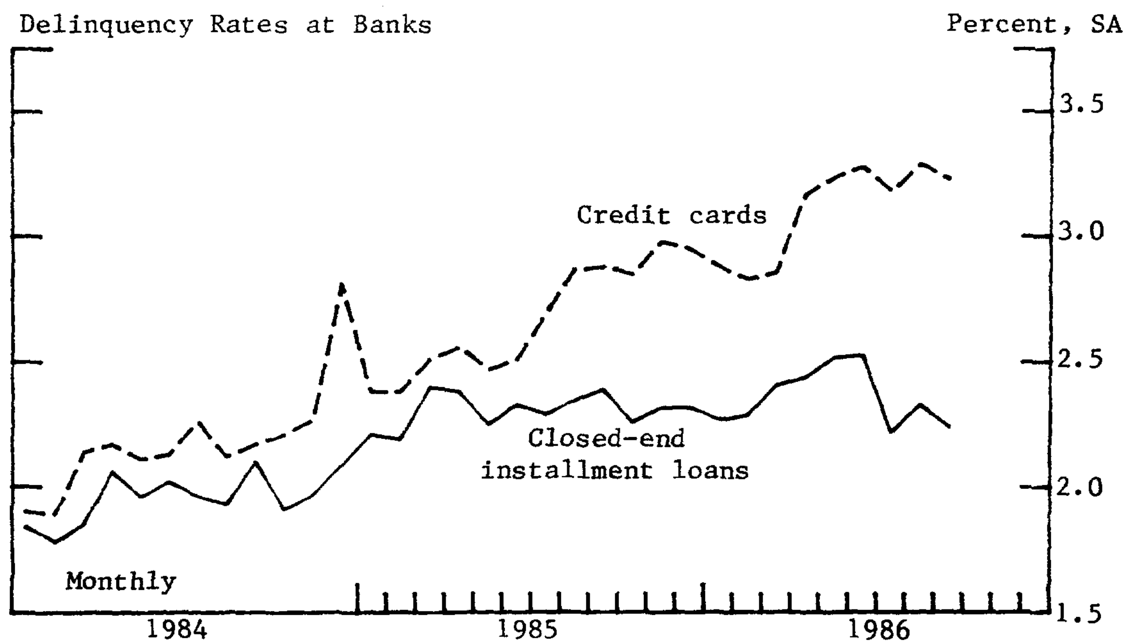
This hesitancy by thrifts to add loans to their portfolios has not detracted from their participation in the mortgage lending boom. To the contrary, FSLIC-insured institutions originated $26.2 billion in net loans during October, up 10 percent from the previously unparalleled third-quarter clip.

Consumer Installment Credit

Consumer installment credit expanded at a 14 percent annual rate in October, down from September but still above the third-quarter pace. The relative strength in September-October mainly reflected a surge in auto

CONSUMER INSTALLMENT CREDIT





credit in response to the auto incentive programs. The nonauto components accelerated in October, however, breaking the trend that has been evident for most of this year.

The general slowdown in nonauto credit growth has been particularly striking for the revolving credit component. Revolving credit growth may be responding in part to the stubbornly high interest rates on credit card receivables, which remained at an average of over 18 percent at banks in early November, and to heavy promotion of credit lines secured by home equity--a lower-cost alternative. Although no comprehensive data exist on the volume of lending under such arrangements, reports of their promotion—often at sharply reduced introductory rates--have been widespread; in some areas lenders also are waiving part, or all, of the closing costs, thus removing a formidable barrier to the substitution of a home equity line for comparatively small credit card accounts. Further, lenders themselves may have begun to curtail growth in revolving credit directly by closing or otherwise restricting the use of delinquent credit card accounts, which have climbed sharply over the past two years to reach record levels. In contrast, delinquencies on a mixture of closed-end loans at banks are little changed, on balance, from two years ago. Delinquencies on home mortgages have edged lower but remain high.

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	Q2	Q3	Sept.[r]	Oct.[p]	Sept.[r]	Oct.[p]	Oct.[p]
Total[1]	20.6	18.0	12.2	11.8	16.1	13.9	7.72	6.78	591.1
Selected types									
Auto	18.7	19.3	15.4	24.6	39.2	20.6	7.47	4.05	240.3
Revolving	25.7	20.1	8.5	4.1	.9	5.7	.10	.60	126.6
All other	19.7	15.6	11.0	3.4	.9	11.6	.16	2.14	224.2
Selected holders									
Commercial banks	23.5	15.1	7.5	5.7	6.8	11.5	1.42	2.44	255.8
Finance companies	11.6	24.9	23.6	28.5	48.5	19.1	5.62	2.30	146.9
Credit unions	25.3	12.9	11.1	11.5	11.2	15.8	.75	1.08	82.4
avings institutions[2]	37.7	37.8	19.3	6.5	-1.8	14.6	-.09	.75	62.1

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

CONSUMER INTEREST RATES
(Annual percentage rate)

			1986				
	1984	1985	May	Aug.	Sept.	Oct.	Nov.
At commercial banks[1]							
New cars (48 mo.)	13.71	12.91	11.44	11.00	...	...	10.58
Personal (24 mo.)	16.47	15.94	14.90	14.70	...	...	14.19
Credit cards	18.77	18.69	18.33	18.16	...	...	18.09
At auto finance cos.[2]							
New cars	14.62	11.98	9.49	9.29	5.40	6.12	...
Used cars	17.84	17.59	16.56	15.56	15.23	15.17	...

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.

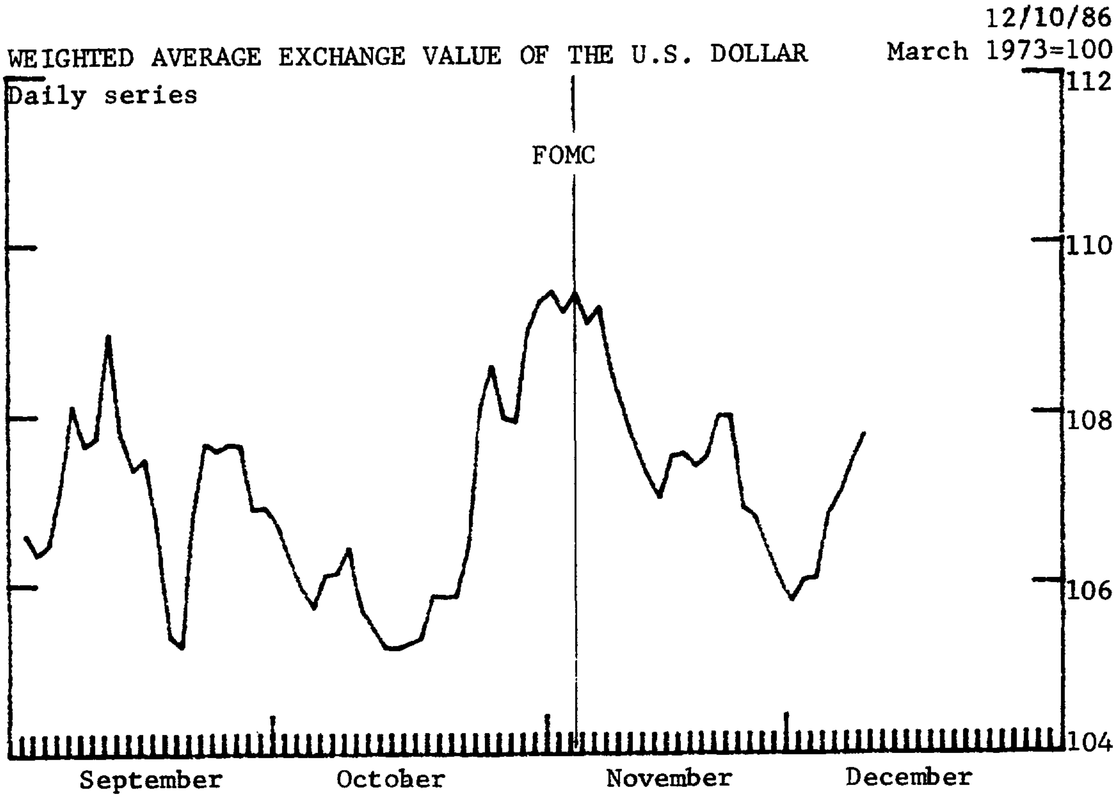
INTERNATIONAL DEVELOPMENTS

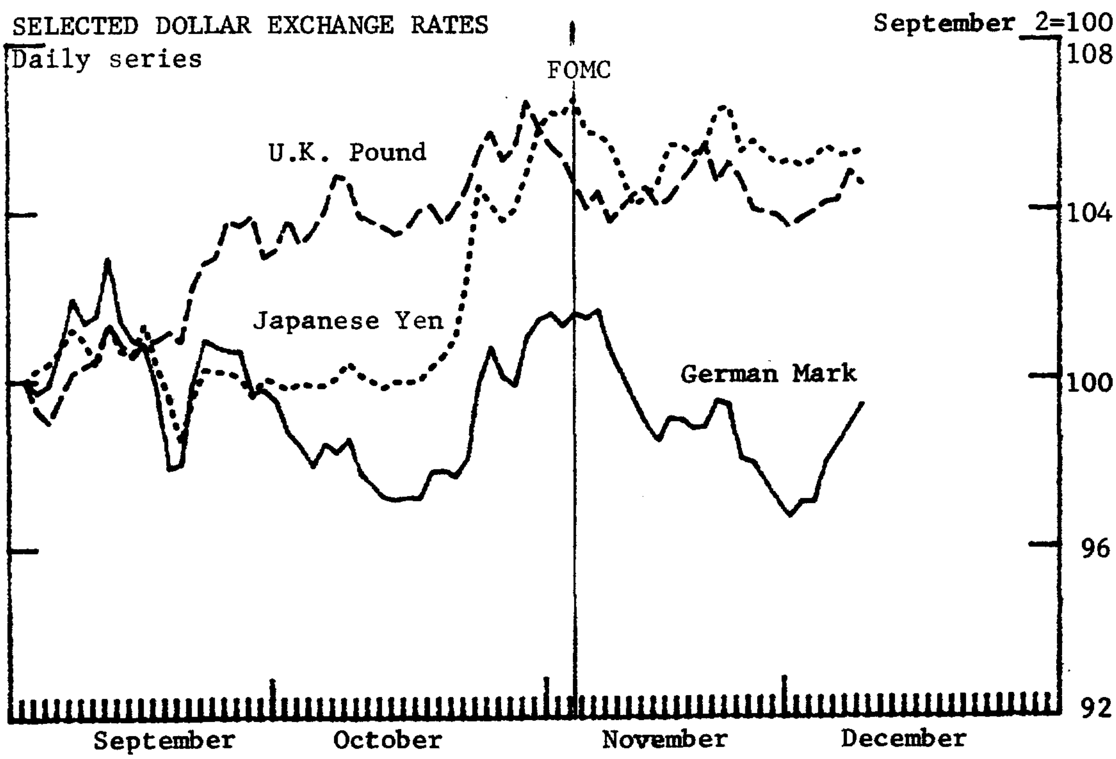
Foreign Exchange Markets

The foreign-exchange value of the dollar, measured against a weighted average of foreign G-10 currencies, has declined on balance about 1-1/2 percent since the November 5 FOMC meeting. (See Chart 1.) When valued against individual currencies, the dollar's movements have been uneven. Among the major currencies, the dollar has fallen against the mark about 2 percent and against the yen about 3/4 percent. The dollar has gained about 1/4 percent against the pound.

The erratic but generally downward trend of the dollar during the intermeeting period -- particularly against the mark -- seemed to arise primarily from market reaction to new data that suggested weaker prospects for the U.S. economy and from anticipation that credit policies in Germany might be tightened in view of recent rapid German money growth. The dollar also seemed to be weakened occasionally by developments in the controversy over shipment of U.S. arms to Iran. The dollar's downward movement reversed temporarily in mid-November following statements by U.S. and foreign officals that, against the background of the Baker-Miyazawa agreement at the end of October, suggested that authorities were satisfied with the present configuration of exchange rates, but the dollar resumed its earlier decline in the second half of November. In the first week of December, the dollar retraced some of its previously lost ground -- primarily against the mark -- following release of new German data, including third-quarter GNP figures, that suggested somewhat softer growth in Germany than had been expected.

Chart 1


12/10/86
WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR
March 1973=100
Daily series
FOMC
112
110
108
106
104
September
October
November
December


SELECTED DOLLAR EXCHANGE RATES
September 2=100
Daily series
FOMC
U.K. Pound
Japanese Yen
German Mark
108
104
100
96
92
September
October
November
December

Norwegian authorities raised overnight interest rates in early December by 2 percentage points to support the krone, which came under strong selling pressure owing to deterioration in the external outlook for Norway and budget problems.

. In late November and early December, downward pressure on the French franc against the mark was exacerbated by political protests in France,

.

The average differential between short-term dollar and foreign interest rates remained about unchanged during the intermeeting period, as both U.S. rates and foreign rates on average rose slightly. Interest rate increases in some foreign countries, including the Netherlands, France, and Italy, were greater, however, as their currencies experienced intermittent pressure within the EMS. In early November, Dutch authorities raised the interest rate on 7-day advances by about 10 basis points following smaller increases in German short-term rates that gave rise to selling pressure on the guilder. On December 8, French authorities raised their 7-day repurchase rate by 100 basis points to 8-1/2 percent in response to increases in German interest rates. Most long-term interest differentials moved against the dollar during the intermeeting period, as U.S. long-term interest rates fell by roughly 25 basis points, while foreign long-term interest rates presented a mixed picture of smaller movements.

U.S. International Financial Transactions

The growth of official reserve assets in the United States continued in September, bringing the increase in the first three quarters of the year to almost $32 billion. (See line 4 of the Summary Table on U.S. International Transactions.) Contributing to the recorded increase in September was the investment by the United Kingdom of part of the proceeds of its $4 billion Eurobond issue and probably the accumulation of interest earnings on the dollar reserve holdings of certain G-10 countries and Switzerland. The official reserve holdings of Taiwan and other newly industrializing countries also continued to increase in September. Partial information from the Federal Reserve Bank of New York indicates that official reserve holdings of the G-10 countries rose further in October. A large portion of this increase, however, includes a swap operation, undertaken by the Bundesbank to provide liquidity to West Germany's domestic markets, that was reversed in early November.

As a result of large official purchases, foreign holdings of U.S. Treasury securities have increased dramatically this year. In contrast to 1985, when net acquisitions of Treasuries by both official and non-official foreign investors were less than $20 billion, in the first three quarters of 1986 alone, net purchases were $40 billion, three-quarters by foreign official institutions. Foreign private net purchases of U.S. Treasury securities (line 3) increased sharply in September. Reported holdings of Japanese residents rose by $4 billion, in contrast to net purchases of only $1 billion in the first eight months of the year. About one-third of the September net purchases by Japanese residents was made through the U.S. offices of Japanese-based securities firms; most of the transactions of Japanese residents in the U.S. Treasury

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

	1984 Year	1985 Year	1985 Q4	1986 Q1	1986 Q2	1986 Q3	1986 July	1986 Aug.	1986 Sept.
Private Capital									
Banks									
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	20.6	33.6	7.7	9.5	-2.9	22.4	9.6	13.4	-0.6
Securities									
2. Private securities transactions, net	7.7	43.0	21.1	12.9	21.4	17.4	6.7	6.5	4.1
a) foreign net purchases (+) of U.S. corporate bonds	13.7	46.0	18.4	12.8	16.0	12.7	4.1	4.0	4.7
b) foreign net purchases (+) of U.S. corporate stocks	-0.9	4.8	4.0	6.2	7.0	4.5	1.8	1.4	1.2
c) U.S. net purchases (-) of foreign securities	-5.0	-7.9	-1.4	-6.1	-1.6	0.2	.8	1.1	-1.7
3. Foreign net purchases (+) of U.S. Treasury obligations 1/	23.1	20.4	5.0	7.0	3.8	0.6	-2.5	-0.6	3.7
Official Capital									
4. Changes in foreign official reserve assets in U.S. (+ = increase)	2.4	-2.0	-1.5	2.2	14.0	15.4	4.7	4.6	6.1
a) By area									
G-10 countries (incl. Switz.)	3.1	-0.4	-3.3	3.9	11.0	14.6	6.9	4.3	3.4
OPEC	-5.6	-7.0	-1.0	1.2	-1.9	-2.8	-1.4	-1.4	*
All other countries	4.9	5.3	2.9	-3.0	5.0	3.6	-0.7	1.6	2.7
b) By type									
U.S. Treasury securities	4.7	-0.9	-2.0	3.3	14.5	12.8	6.4	4.1	2.3
Other 2/	-2.3	-1.1	0.5	-1.1	-0.5	2.6	-1.7	0.5	3.8
5. Changes in U.S. official reserve assets (+ = decrease)	-3.1	-3.9	-3.1	-0.1	-0.0	0.3	0.5	-0.4	0.2
Other transactions (Quarterly data)									
6. U.S. direct investment (-) abroad	-3.9	-18.8	-10.1	-9.9	-5.3	n.a.	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	25.4	17.9	2.4	1.4	3.8	n.a.	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) 3/ 4/	6.8	4.5	7.1	0.7	-6.1	n.a.	n.a.	n.a.	n.a.
9. U.S. current account balance 4/	-106.5	-117.7	-33.7	-34.0	-34.7	n.a.	n.a.	n.a.	n.a.
10. Statistical discrepancy 4/	27.3	23.0	5.1	10.3	6.0	n.a.	n.a.	n.a.	n.a.
MEMO:									
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-112.5	-124.4	-37.4	-36.5	-36.0	n.a.	-13.3	-11.8	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.

securities market in 1986 (as in previous years) have been with U.S.-based dealers. In light of these facts, caution should be used in interpreting the reported activity of Japanese-based securities dealers in U.S. Treasury auctions as indicative of shifts in Japanese residents' preferences for dollar securities in general or Treasury securities in particular.

Private foreign net purchases of U.S. corporate bonds and stocks (lines 2a and 2b) continued to generate large capital inflows, totaling over $17 billion for the third quarter and almost $6 billion in September. Partly offsetting September's inflow was an increase in U.S. net purchases of foreign securities (line 2c), although for the quarter as a whole net transactions in foreign securities were negligible. Preliminary data show some drop off in the capital inflows associated with private securities transactions in the fourth quarter. U.S. corporations' Eurobond offerings in October and November fell below September's level. In addition, foreign bond offerings in the United States rose in October, largely due to two World Bank issues. November's foreign bond offerings seem to have dropped somewhat from October's, but partial data on the first week of December show nearly $2 billion in foreign bond offerings in the United States. The issues include a $0.5 billion junk bond of an Australian firm, underwritten by Drexel Burnham Lambert Inc., and a number of smaller bonds and notes of the World Bank and several governments (New Zealand, Finland, and Denmark).

Banks reported a small net outflow in September. (See line 1 of the Summary Table.) For the third quarter as a whole almost two-thirds of the reported inflow reflects a reporting change (discussed in previous greenbooks), and not actual inflows during this time period. The rest of the reported inflow was spread over a variety of categories: increased liabilities to private foreign nonbanks, including the World Bank, reduced claims on nonbank foreigners, particularly in the form of bankers' acceptances, as well as some net increase in liabilities to unaffiliated foreign banks. Partial information for November, shown on line 3 of the International Banking Data Table, indicates substantial inflows into banks from their own foreign offices and IBFs; these inflows occurred during a period when U.S. bank credit growth accelerated sharply.

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1982 Dec.	1983 Dec.	1984 Dec.	1985 Dec.	1986 Mar.	1986 June	1986 Sept.	1986 Oct.	1986 Nov. 3/
1. Net Claims of U.S. Banking Offices (excluding IBFs) on Own Foreign Offices	32.9	39.3	25.4	18.9	21.0	18.7	19.6	24.4	n.a.
2. Net Claims of U.S. Banking Offices on Own IBFs 1/	16.2	5.2	7.8	10.1	1.0	8.1	7.8	5.8	n.a.
3. Sum of lines 1 and 2 of which:	49.1	44.5	33.2	29.0	22.0	26.8	27.4	30.2	25.5
(a) U.S.-chartered banks	40.0	40.5	32.1	32.4	27.1	31.1	29.9	32.5	29.9
(b) Foreign-chartered banks	9.1	4.0	1.1	-3.4	-5.1	-4.3	-2.5	-2.3	-4.4
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	17.7	18.1	17.8	18.2
5. Eurodollar Holdings of U.S. Nonbank Residents 2/	112.6	124.3	117.6	112.1	118.5	119.4	119.5	118.5	120.0

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.
3/ Through November 24, 1986.
*/ Less than 50 million (+).
Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactions accounts. Line 1 is an estimate constructed as the residual of line 3 minus line 2. Line 2 is data for the last Wednesday of the month for the sample of monthly IBF reporters. Line 3 is an average of daily data reported to the Federal Reserve by U.S. banking offices. Line 4 is an average of daily data. Line 5 is the month-end value for data through September 1983. For dates after September 1983, the overnight portion is an average of daily data and the term portion is an average of Wednesday data.

U.S. Merchandise Trade

In October, the U.S. merchandise trade deficit was the smallest in recent months. These preliminary data are subject to possibly large revisions. On a seasonally-adjusted basis, exports are estimated to have risen moderately in October. Most of the rise appears to be increased shipments of soybeans, largely to Japan; the level of nonagricultural exports in October was about the same as in the preceding six months on average. Imports are estimated to have declined in October. The volume of oil imports dropped from roughly 8

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

	Balance-of-payments basis, seasonally adjusted							Census Balance Unrevised, NSA
	Exports			Imports				
	Total	Ag.	Nonag.	Total	Oil	Nonoil	Balance	CIF Value
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Years								
1984	220	38	182	332	57	275	-112	-123
1985	215	30	185	339	51	288	-124	-149
Quarters								
1984-4	224	37	187	341	57	283	-117	-108
1985-1	221	33	188	322	42	280	-100	-125
2	216	30	186	337	55	282	-121	-152
3	210	28	183	337	50	287	-127	-153
4	211	29	182	360	57	304	-149	-164
1986-1	215	28	186	361	40	321	-146	-174
2	219	25	195	363	31	332	-144	-162
3e	220	25	195	370	32	338	-150	-176
July-e	220	25	195	380	33	347	-160	-216
Aug.-e	215	25	190	355	30	325	-140	-160
Sept.-e	220	25	195	375	35	340	-155	-151
Oct. **	225	30	195	350	30	320	-125	-144

e/ BOP data are FR staff estimates. Months may not add to quarters because of rounding.
**/ Estimates of BOP data are based on preliminary data which are subject to large revisions.

million barrels per day in September to about 6-1/2 million barrels per day in October; this drop in volume was only partly offset by a rise in price of about 70 cents per barrel. The estimated decline in nonoil imports was largely in capital goods, especially business machines, construction equipment and aircraft.

In the third quarter, the U.S. merchandise trade deficit is estimated to have been $150 billion at an annual rate on a balance-of-payments basis; this is similar to the rate of deficit recorded in the previous three quarters (column 7 in the table above). The Commerce Department will release revised third-quarter data on December 10; these data will be included in the Greenbook supplement.

While the value of exports in the third quarter is estimated to be about the same as in the second quarter, it appears that the volume exported turned up moderately (by 2 percent). Over the past four quarters, the volume of exports rose by about 9-1/2 percent on a balance-of-payments basis and by 5-1/2 percent on a GNP basis. (Gold exports are not included in GNP; substantial gold shipments to Japan during the past two quarters account for much of the difference in export growth rates.) Agricultural commodities account for only a small part of the increase in exports over the past year. The increase in nonagricultural exports has been fairly slow in recent quarters; nontheless, the level reached in 1986-Q3 was the highest in five years.

Export prices (fixed-weight) declined in the third quarter at a 5-1/2 percent annual rate, with most of the decline in the prices of agricultural commodities and industrial supplies.

Both the value and volume of nonoil imports in 1986-Q3 are estimated to have increased moderately from the second-quarter level. Increases in some categories, such as foreign cars, business machines, apparel, footwear and paper were nearly offset by declines in other areas. The rate of nonoil import expansion appears to be slowing; of the 13 percent rise in volume during the past year (BOP basis), only 3 percent occurred in the last two quarters.

Prices of nonoil imports (fixed-weight) rose at a 4-1/2 percent rate in the third quarter, somewhat less than the 6-1/2 percent rate recorded in the first two quarters. Declines in prices of food imports offset some of the price rises recorded by various manufactured goods imports. The price of imported nonoil industrial supplies edged up in the third quarter after having declined for the preceding 8 quarters. (See the discussion of import prices in Section II of the Greenbook.)

The value of oil imports was about the same in the third quarter as in the second quarter. A strong rise in volume was offset by a sharp decline in price. Much of the increase in volume appears to have gone into inventories. While OPEC agreed to continue production restraints through December, the desire of Saudi Arabian authorities to raise both their oil production rate and the price of oil has heightened uncertainty in world oil markets.

Oil Imports*	Year 1985	1985 Q2	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 Q3-e
Value (Bil. $, SAAR)	50.53	54.53	49.49	56.48	40.06	31.32	32.00
Price ($/BBL)	26.40	26.92	25.74	26.30	21.56	13.17	11.25
Volume (mbd, SA)	5.24	5.55	5.27	5.88	5.09	6.52	7.80

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

Developments in Foreign Industrial Countries

Recent data on real GNP/GDP growth provide mixed evidence on the strength of economic activity in the major foreign industrial economies. Real GNP increased by 2.6 percent (s.a.a.r.) in Japan and rose by 2.9 percent in Germany. Real GDP was up by an estimated 4 percent (s.a.a.r.) in the United Kingdom, but increased at only a 1.2 percent rate in Canada, and fell at a 3.2 percent rate in Italy.

Inflation rates for consumer prices have shown little change over recent months, remaining at generally low levels. Wholesale prices declined further in Japan and Germany, as they have in nearly every month over the past year, and in Italy and France wholesale prices continued to be below year-earlier levels.

The Japanese trade surplus has narrowed slightly in recent months, but this year's cumulative trade and current account surpluses have continued at record high levels in Japan, as in Germany.

Individual Country Notes. Real GNP in Japan grew 2.6 percent (s.a.a.r.) in the third quarter, slowing from 3.8 percent in the previous quarter. Private consumption and residential investment continued to make strong contributions to growth, while plant and equipment investment remained sluggish. Net exports were the principal source of weakness. Calculations of changes in domestic demand and net exports were influenced by the unusual gold purchases in the second quarter. Total domestic demand excluding gold grew faster in the third quarter than in the previous quarter--8.7 percent versus 3.6 percent. Net exports excluding gold made a substantial negative contribution to

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 June	1986 July	1986 Aug.	1986 Sept.	1986 Oct.	Latest 3 months from year ago 2/
Canada												
GDP	5.4	3.9	1.8	.6	.8	.3	*	*	*	*	*	3.5
IP	4.4	5.2	1.4	-.2	-.5	-1.2	-1.0	1.3	-1.5	-.5	n.a.	-.5
France												
GNP	1.5	2.3	.7	-.2	1.2	n.a.	*	*	*	*	*	2.7
IP	1.8	1.5	.2	-1.5	1.8	2.2	4.6	1.5	.0	-.7	n.a.	2.7
Germany												
GNP	3.0	2.3	-.2	-1.1	3.4	.7	*	*	*	*	*	2.9
IP	3.5	3.4	.4	-1.0	1.3	.7	2.9	.9	-1.0	-.8	-.1	.9
Italy												
GNP	2.7	2.3	.9	-.1	2.2	-.8	*	*	*	*	*	2.2
IP	2.1	1.0	.2	2.8	1.5	-3.4	4.8	-2.8	-4.5	4.8	n.a.	1.0
Japan												
GNP	5.6	4.2	1.2	-.4	.9	.6	*	*	*	*	*	2.3
IP	10.6	.9	-.9	.2	.2	-.5	.3	-.2	-2.7	3.4	-1.9	-.8
United Kingdom												
GNP	2.7	2.8	.2	1.1	.2	n.a.	*	*	*	*	*	1.4
IP	-.3	4.5	-.0	.8	-.3	1.5	-.9	2.2	.5	.7	n.a.	2.0
United States												
GNP	4.6	2.9	.5	.9	.2	.7	*	*	*	*	*	2.3
IP	6.6	1.8	.5	.3	-.5	.6	.0	.6	.2	.1	.0	.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 Aug.	1986 Sept.	1986 Oct.	1986 Nov.	Latest 3 months from year ago
Canada													
CPI	3.7	4.2	1.1	.9	.9	1.2	.8	1.2	.3	.0	.5	n.a.	4.3
WPI	4.0	2.5	.5	.0	.8	.9	-1.5	.2	.3	.1	.5	n.a.	.6
France													
CPI	6.8	4.8	1.8	.9	.6	.1	.7	.6	.1	.4	.2	n.a.	2.2
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	-.2	.2	-.3	.0	-.8
WPI	1.3	-1.1	.3	-2.1	-.9	-2.1	-2.6	-2.9	-.2	.6	-1.3	-.6	-8.6
Italy													
CPI	8.8	8.5	2.2	1.1	2.3	1.8	1.1	.6	.2	.3	.6	.4	5.2
WPI	8.9	5.9	2.2	-.1	.9	-.5	-1.8	-.8	.1	.4	n.a.	n.a.	-2.2
Japan													
CPI	2.4	2.0	.8	.3	.3	.3	.3	-.5	-.3	.5	.1	-.4	.3
WPI	.5	-3.7	-.7	-1.0	-2.4	-2.4	-4.2	-2.8	-.9	-1.0	-.8	n.a.	-11.4
United Kingdom													
CPI	4.8	5.5	3.4	.3	.5	.7	1.3	.1	.3	.5	.2	n.a.	2.8
WPI	6.1	5.2	2.0	.5	.9	1.4	1.6	.4	.2	.3	.2	.2	4.3
United States													
CPI (SA)	4.1	3.5	1.0	.6	1.1	.4	-.4	.6	.2	.3	.2	n.a.	1.6
WPI (SA)	1.7	1.6	.6	-.2	1.1	-1.5	-1.3	.1	.3	.4	.3	n.a.	-1.3

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	Aug.	Sept.	Oct.	Nov.
Canada												
Trade	16.0	12.8	3.3	2.6	2.9	1.8	1.7	1.2	.4	1.0	.6	n.a.
Current account	1.9	-.4	.3	-.8	-.7	-2.0	-1.4	-1.6	*	*	*	*
France												
Trade	-2.4	-2.6	-.4	-.8	-.4	.1	-1.1	.3	.5	-.4	-.0	n.a.
Current account	-.8	.3	.5	-.0	.6	1.1	.3	1.2	*	*	*	*
Germany												
Trade (NSA)	18.7	25.4	6.0	6.1	9.1	9.5	12.5	14.1	3.9	5.1	5.3	n.a.
Current account (NSA)	5.9	13.9	3.1	2.1	7.0	6.9	8.2	8.4	2.4	3.3	4.0	n.a.
Italy												
Trade	-11.0	-11.9	-3.9	-1.4	-3.1	-2.8	-.0	.6	1.8	-.6	-.6	n.a.
Current account (NSA)	-2.8	-4.0	-2.2	1.9	-.9	-3.4	n.a.	n.a.	*	*	*	*
Japan												
Trade	33.4	46.1	10.6	12.0	14.8	15.5	20.3	24.0	8.4	8.2	7.4	8.0
Current account 2/	35.0	49.3	12.2	12.1	15.6	15.5	21.8	23.2	7.7	8.5	8.1	n.a.
United Kingdom												
Trade	-5.7	-2.5	-.2	-.6	-.3	-2.0	-2.3	-4.4	-2.2	-1.3	-1.2	n.a.
Current account	1.3	5.2	2.0	2.0	1.1	.7	.4	-1.2	-1.1	-.1	.1	n.a.
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.

real growth in the third quarter but a small positive contribution in the second quarter.

Japanese industrial production fell 1.9 percent (s.a.) in October after declining 0.5 percent in the third quarter. The Ministry of International Trade and Industry (MITI) believes that industrial production dropped 0.3 percent in November, but should rebound about 3 percent in December. If MITI's provisional estimates are realized, industrial production in 1986 will be roughly unchanged from its level last year.

Other signs of weakness in the Japanese economy include a fall in the August index of leading indicators to 41.7 percent after two months at the 50 percent "boom-bust" demarcation line, and a decline of 9.7 percent (s.a.) in domestic private sector orders for new machinery in the third quarter. The residential and consumer sectors are likely to remain the principal sources of strength in the economy in the fourth quarter. Retail sales rose 2.1 percent (s.a.) in October, after a 0.5 percent increase in the third quarter.

Japanese inflation remains low. For the three months ending in November, the Tokyo index of consumer prices was 0.3 percent above its year-earlier level, and wholesale prices in the three months ending in October were 11.4 percent below their level in the year-earlier period.

Japan's trade surplus, measured in U.S. dollars, narrowed in September and October before increasing in November. For the first 11 months of 1986 the cumulative trade surplus was a record $82 billion (s.a.a.r.), the same rate as the cumulative current account surplus through October. In October, export volume fell 1.7 percent (s.a.)

after a 0.2 percent rise in the third quarter, and import volume rose 5 percent following a 0.5 percent decline in the third quarter. Purchases of non-monetary gold for a probable minting next year of additional commemorative coins added to October imports.

The Tax Council of the Liberal Democratic Party (LDP) has approved a tax reform package that calls for a 2.65 trillion yen ($16.4 billion) reduction in individual income taxes and a 1.8 trillion yen ($11.1 billion) reduction in corporate taxes. These tax reductions would be balanced by the introduction of a value-added tax and the abolition of tax breaks for small savers. The LDP will recommend that the tax cuts exceed the tax increases in FY 1987/88 (beginning April 1), but that the package should be revenue neutral over the next two fiscal years. Officials of the Ministry of Finance are expected to resist the LDP's recommendation that tax reductions exceed tax increases in the coming fiscal year.

In Germany, preliminary third-quarter real GNP data released by the Bundesbank show a growth rate of 2.9 percent (s.a.a.r.). Due to a slowdown in inventory accumulation, total domestic demand grew at only a 0.5 percent rate. Net exports made a positive contribution to growth as imports fell sharply from their unusually high second-quarter level. Industrial production fell 0.1 percent (s.a.) in October from a September level that was revised upward by 0.8 percent. (The October figure is also expected to be revised upward.) The higher September number put third-quarter industrial production 0.7 percent above its second-quarter level. The rate of unemployment continued its gradual decline, reaching 8.6 percent (s.a.) in November.

The cost of living index remained unchanged (n.s.a.) in November and was 1 percent below its year-ago level. Wholesale prices fell 0.6 percent (n.s.a.) in November and were down 9.1 percent compared with a year earlier. Import prices, after falling 2 percent (n.s.a.) in October, showed a 21 percent decline over the previous 12 months.

The trade surplus was $5.3 billion (n.s.a.) in October, and $50 billion (a.r.) for January through October, compared with $24 billion in the same period last year. The current account surplus in October was $4 billion (n.s.a.). Cumulated through October, the current account surplus was $33 billion (a.r.), up from $11 billion in the same period last year.

The Budget Committee of the Bundestag has approved a draft federal budget for 1987. It calls for expenditure growth of 1.9 percent, less than the 2.9 percent increase proposed by the government in July. The proposed federal budget deficit for 1987 was reduced by DM 2 billion from the originally planned DM 24.3 billion. (The 1986 deficit is now estimated at DM 23.7 billion.) The Committee's proposals included an extension of the general spending limits imposed this summer into 1987, and cuts in unemployment compensation and defense spending.

In the <u>other G-7</u> foreign industrial countries, the pace of activity appears to have increased recently in the United Kingdom, while remaining sluggish in France and Canada and turning negative in Italy. In the United Kingdom, consumption appears to have been the main source of recent strength, with the volume of retail sales in October 7 percent above its year-earlier level. U.K. unemployment declined (s.a.) for the second consecutive month in October. Industrial production in France rose by 2.2 percent (s.a.) in the third quarter, while unemployment remained at a near-record high 10.6 percent. Despite slower growth in Canada, the unemployment rate declined for the third straight month to 8.4 percent (s.a.) in October, its lowest level in over four years.

Twelve-month consumer price inflation rates remained relatively stable in October in Canada, the United Kingdom, and France. Italian consumer price inflation has continued to decline, dropping to 4.7 percent in November, compared with 8 percent at the beginning of the year.

The trade deficits in both France and Italy have remained well below levels of last year through the first ten months of this year, in large part reflecting lower oil import costs. In the United Kingdom, in contrast, lower oil export earnings have contributed to a substantial widening of the cumulative trade deficit through October of this year. In Canada, the cumulative trade surplus through September was less than half that of last year.

In recent policy initiatives, the French government announced its monetary targets for 1987. The new M3 target was unchanged from this year's 3 and 5 percent. A target for M2 was also set calling for growth between 4 and 6 percent. (Through September, actual M3 growth this year has been 4.8 percent (s.a.a.r.), and M2 growth has been 5.9 percent.) In addition, the government announced that monetary policy procedures would be changed starting in January, with quantitative credit ceilings eliminated and increasing reliance being placed on an open market intervention policy. The government initiated its privatization program by selling shares in Saint Gobain, the first of 69 companies scheduled to be denationalized over the next five years. An additional easing of foreign exchange and price controls was also announced.

The government of the United Kingdom, in its Autumn Statement on fiscal policy, revealed higher spending plans--total government expenditure is now projected to increase by 2 percent in real terms between the current and next fiscal years. Despite higher planned spending, the government reconfirmed its goal of keeping the public sector deficit from rising above its current level of about 2 percent of GDP.

Economic Situation in Major Developing Countries

Commitments to the commercial bank financing package for Mexico reached 90 percent of the $7.7 billion sought on November 19, triggering the release of more than $1-1/4 billion from the IMF, the World Bank, and the participants in the bridge loans from the commercial banks and official sources. Brazil's overheated economy has created serious difficulties for the anti-inflation objectives of the Cruzado Plan and for Brazil's external accounts, prompting the government to take measures to slow the growth of domestic demand. Venezuela has devalued by 48 percent the exchange rate used for most imports in an effort to reduce the government deficit and slow the loss of exchange reserves. Real GDP growth in Argentina in the first three quarters of 1986 has been strong; the inflation rate remains well above the government's desired range. Chile has opened negotiations with its creditor banks on its 1987-88 financing needs. Peru has held preliminary discussions with its creditor banks on a scheme to repay some of its external debts in goods rather than cash. The Philippine negotiations with creditor banks to restructure external debts due in 1987-91 broke down in November, but resumption of the talks is being explored.

Individual Country Notes. Commitments to the commercial bank financing package for Mexico reached 90 percent of the $7.7 billion sought on November 19. With this, the World Bank released the first $300 million tranche of its sectoral adjustment loan to Mexico linked to trade policy reform approved last July, and the IMF Executive Board gave final approval to the SDR 1.4 billion stand-by arrangement negotiated with Mexico last summer. The IMF action allowed Mexico not only to make the first drawing of SDR 225 million on this credit but also to gain access to the $750 million balance--$250 million from official sources and $500 million from commercial banks--of the $1.6 billion bridge loan arranged last August. In addition, a $1 billion credit from the Export-Import Bank of Japan was signed in early December.

The 1987 public sector budget, submitted to the Mexican Congress in late November, calls for an overall deficit of 13.8 percent of GDP, 3 percentage points less than in 1986. Most of the decline is expected from increases in public sector prices and a tax reform, which will limit the corporate income tax deduction for interest payments to the real rather than the nominal payments, but will also reduce income tax rates and liberalize depreciation provisions. A 15 percent increase in public sector investment expenditures in real terms is planned, but other public spending is to be contained enough to achieve a small reduction in the ratio of total public sector expenditures to GDP.

The government is forecasting a real GDP growth of 2-3 percent in 1987, compared with a 4 percent decline in 1986, and a reduction in the inflation rate to the 70-80 percent range from 100-105 percent this year. The CPI rose by 5.7 percent in October and by 6.8 percent in November. The peso price of the dollar rose by 7.2 percent in October and by 7 percent in November. The spread between the free and controlled exchange rates has narrowed to about 1 percent.

In Brazil, the Cruzado Plan has run into serious difficulties mostly related to booming consumer demand. Real GDP growth may be as much as 9 percent this year. The trade surplus plunged to $840 million in September and $210 million in October from an average of $1.2 billion a month in September-October 1985 and about $1 billion a month for the first eight months of 1986, in part perhaps because of uncertainties surrounding the viability of the official exchange rate, but also because of strong internal demand. Cash foreign exchange reserves, which were about $7.3 billion in June 1986, are rumored to be $4-5 billion currently.

Less than a week after the November 15 elections, which resulted in a large victory for President Sarney's party, the government took steps to moderate the growth of domestic demand and improve the external accounts. Excise taxes on cars, fuel, electricity and other items were increased sharply, a move estimated to generate additional revenues of at least 3-1/2 percent of 1986 GDP and to slow 1987 GDP growth significantly. A more flexible exchange rate policy was introduced and mini-devaluations at about a 4 percent monthly rate have subsequently been implemented. Other measures involved changes in wage policy, further deindexation of financial assets, and public sector administrative reforms. In the wake of the announcements, interest rates have soared, the stock market has fallen, and the spread between the official and parallel exchange rates has remained roughly unchanged at about 100 percent. The measures will partly reverse the large real wage gains obtained by most workers during 1985-86. In protest, the unions have called for a general strike on December 12.

The IMF Executive Board reviewed Brazilian economic developments and prospects on December 10 in connection with the annual Article IV consultation. Brazil has been hoping that a positive assessment by the IMF will lead to a Paris Club rescheduling, even though Brazil will not have a formal IMF program, and that a positive IMF assessment and a Paris Club agreement will lead to a multi-year commercial bank rescheduling in early 1987.

Only two weeks after Venezuela's President Lusinchi said that a devaluation was not contemplated, he announced, late on December 5, a devaluation from Bs. 7.50 to Bs. 14.50 per dollar for most imports. The new rate will also apply to luxury imports and private sector exports, for which the free market rate, recently about Bs. 24 per dollar, had been used. To deal with the impact of the exchange rate change, the government announced a continuation of the freeze on prices of a selected list of consumer goods and compensatory wage adjustments, including a 25 percent increase in the minimum wage. Since proceeds from exports of oil and other products of state enterprises represent over 90 percent of total exports, government receipts from net sales of foreign exchange to private importers will rise substantially.

Venezuela has begun making the $750 million downpayment due under the terms of its public sector debt rescheduling, and is expected to complete the downpayment by year-end. Progress is also being made on private sector debt negotiations: the government has agreed to proceed with a scheme involving voluntary warrants by which debtors could lock in an exchange rate for a premium. The banks have indicated that the public sector downpayment and the private sector debt negotiations must be completed before they will respond to the Venezuelan request to soften the terms of last February's public sector rescheduling.

For the first three quarters of 1986, real GDP growth in Argentina has averaged 5 percent on an annual basis. Inflation as measured by the

CPI has been slowing from the peak monthly rate of 8.8 percent in August, but remains far above the 2.5 to 3 percent range envisioned by policymakers in late August. The CPI rose by 6.1 percent in October and by 5.3 percent in November. On November 28, President Alfonsin took steps to improve control over 13 major state enterprises, adjusted salary scales to attract and retain qualified senior managers in state enterprises, and instituted an early retirement program to reduce public sector employment. Negotiations with the IMF on a stand-by arrangement and a Compensatory Financing Facility drawing are continuing. Negotiations with banks began this week on a temporary rollover of maturities pending completion of discussions with the IMF.

Chile has opened negotiations with its creditor banks on its 1987-88 financing needs. Chile is projecting a financing gap of about $650 million for that period and has proposed (a) reducing the spread on its rescheduled bank debt, (b) switching from semi-annual to annual interest payments, and (c) obtaining a Paris Club rescheduling. However, several key banks rejected the second element of the proposal, and Chile may have to seek new money in place of it. On November 20, the World Bank approved a $250 million Structural Adjustment Loan, the second such loan to Chile in the past two years. The United States and several other countries abstained in the voting on the loan to protest Chilean abuses of human rights.

In November, Peru held preliminary discussions with foreign banks on a scheme to repay some of its external debts in goods rather than cash. The government projects a trade surplus of only $210 million this year, compared with $1.1 billion in 1985, due to lower export prices and to a rising volume of imports that reflects growth in economic activity. In the first nine months of 1986, real GDP was about 7 percent higher than in the same period of 1985. In early December, the government carried out a "de-facto" depreciation by shifting many imports from the official exchange rate to the "financial" rate, which is 25 percent higher, and enlarging exporters' access to the financial rate. Starting next month, both rates will be depreciated by 2.2 percent per month.

The Philippine negotiations with creditor banks to restructure $3.6 billion in external debt due in 1987-91 that began on October 27 broke down on November 7. The Philippines hoped to obtain a 20-year term, as Mexico recently did, and a 5/8 percent spread (less than Mexico's 13/16 percent). But, the bank advisory committee offered a 16-year term with a spread of 1-3/8 percent. Negotiations were suspended when one of the creditor banks refused to improve on these conditions. On December 11, the bank advisory committee met to explore ways to resume the talks.