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Confidential (FR) Class III FOMC

February 4, 1987

RECENT DEVELOPMENTS

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

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SELECTED DOMESTIC NONFINANCIAL DATA
(Seasonally adjusted)

	Latest Period			Percent change from		
	Period	Release date	Data	Preceding period	Three periods earlier	Year earlier
				(At annual rates)		
Civilian labor force	Dec.	01-09-87	118.6	-.9	1.1	1.9
Unemployment rate (%)[1]	Dec.	01-09-87	6.7	6.9	7.0	7.0
Nonfarm employment, payroll (mil.)	Dec.	01-09-87	101.3	3.2	3.1	2.5
Manufacturing	Dec.	01-09-87	19.2	1.9	1.8	-.5
Nonmanufacturing	Dec.	01-09-87	82.1	3.5	3.4	3.2
Private nonfarm						
Average weekly hours (Hr.)[1]	Dec.	01-09-87	34.6	34.8	34.7	34.9
Hourly earnings ($)[1]	Dec.	01-09-87	8.84	8.85	8.76	8.70
Manufacturing						
Average weekly hours (Hr.)[1]	Dec.	01-09-87	40.9	40.8	40.8	40.9
Unit labor cost (1967=100)	Dec.	02-03-87	78.5	-9.1	-7.0	-6.1
Industrial production (1977=100)	Dec.	01-16-87	126.6	5.7	5.4	.8
Consumer goods	Dec.	01-16-87	126.9	10.5	8.7	2.9
Business equipment	Dec.	01-16-87	139.3	.9	.0	-.5
Defense and space equipment	Dec.	01-16-87	186.2	11.1	9.2	4.3
Materials	Dec.	01-16-87	114.7	2.1	4.2	-.6
Consumer prices, all items (1967=100)	Dec.	01-21-87	331.5	2.9	2.7	1.1
All items, excluding food and energy	Dec.	01-21-87	332.6	3.3	4.0	3.7
Food	Dec.	01-21-87	327.2	1.8	4.1	3.8
Producers prices: (1967=100)						
Finished goods	Dec.	01-09-87	290.9	.0	2.2	-2.5
Intermediate materials, nonfood	Dec.	01-09-87	311.3	1.5	.1	-4.6
Crude foodstuffs and feedstuffs	Dec.	01-09-87	235.6	-24.0	1.5	-1.7
Personal income ($ bil.)[2]	Dec.	01-23-87	3554.8	9.6	5.3	4.0
				(Not at annual rate)		
Mfgrs. new orders dur. goods ($ bil.)	Dec.	02-03-87	109.8	.9	1.0	2.1
Capital goods industries	Dec.	02-03-87	34.6	-10.9	-6.7	-8.3
Nondefense	Dec.	02-03-87	30.1	5.9	6.7	-1.5
Defense	Dec.	02-03-87	4.5	-56.8	-49.4	-37.5
Inventories to sales ratio:[1]						
Manufacturing and trade, total	Nov.	12-15-86	1.35	1.36	1.37	1.35
Manufacturing	Dec.	02-03-87	1.35	1.40	1.41	1.42
Trade	Nov.	12-15-86	1.31	1.32	1.32	1.30
Ratio: Mfgrs.' durable goods inventories to unfilled orders[1]	Dec.	02-03-87	.519	.521	.521	.536
Retail sales, total ($ bil.)	Dec.	01-14-87	126.3	4.4	-1.6	8.1
GAF[3]	Dec.	01-14-87	26.9	1.0	.8	6.0
Auto sales, total (mil. units)[2]	Dec.	01-07-87	13.2	26.5	-15.0	16.1
Domestic models	Dec.	01-07-87	9.1	32.7	-22.7	15.9
Foreign models	Dec.	01-07-87	4.1	14.8	9.0	16.5
Housing starts, private (thous.)	Dec.	01-21-87	1802	13.7	8.3	-4.3
Leading indicators (1967=100)	Dec.	02-03-87	186.1	2.1	3.7	7.2

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

Domestic production appears to have expanded moderately in the fourth quarter--a bit more strongly than the preliminary GNP release suggested, given the recent data on the trade balance. Industrial activity, in particular, improved noticeably last quarter. Although the prices of a number of commodities, including oil, have posted appreciable increases in recent months, wage and price increases more generally have remained on a fairly steady course.

Employment and Unemployment

Growth in labor demand appears to have been well-maintained toward year-end. Preliminary data indicate that nonfarm payroll employment rose 270,000 in December, and the average monthly gain for the fourth quarter (258,000) was substantially above the average for the year (202,000). More than half of December's job growth took place in service industries, particularly business and health services, a leading source of new jobs throughout the current cyclical expansion. In contrast, employment in retail trade was essentially unchanged in December, reflecting less-than-usual holiday hiring in general merchandising stores. In manufacturing, employment advanced for a third consecutive month, with increases occurring in durable and nondurable goods industries. Initial claims for unemployment insurance, which moved down a notch last fall, remained at a reduced level through the first three weeks of January.

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

	1985	1986	1986 Q3	1986 Q4	1986 Oct.	1986 Nov.	1986 Dec.
			--Average monthly changes--				
Nonfarm payroll employment[2]	230	202	239	258	266	239	269
Manufacturing	-18	-8	-10	28	13	41	31
Durable	-16	-14	-12	9	-5	17	15
Nondurable	-2	5	2	19	18	24	16
Construction	21	18	21	-2	-9	-8	11
Trade	65	51	50	39	83	43	-8
Finance and services	122	121	107	121	80	107	177
Total government	38	27	31	59	96	27	53
Private nonfarm production workers	159	145	173	169	112	210	184
Manufacturing production workers	-18	-3	-6	35	14	48	43
Total employment[3]	162	174[e]	125	217	205	240	205
Nonagricultural	182	174[e]	132	210	185	187	259

1. Average change from final month of preceding period to final month of period indicated.
2. Survey of establishments.
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)

	1985	1986	1986 Q3	1986 Q4	1986 Oct.	1986 Nov.	1986 Dec.
Civilian, 16 years and older	7.2	7.0	6.9	6.9	6.9	6.9	6.7
Teenagers	18.6	18.3	18.1	17.8	17.7	18.2	17.3
20-24 years old	11.1	10.7	10.7	10.5	10.5	10.2	10.7
Men, 25 years and older	5.3	5.4	5.4	5.4	5.5	5.5	5.2
Women, 25 years and older	5.9	5.5	5.4	5.3	5.4	5.5	5.2
White	6.2	6.0	6.0	6.0	6.0	6.0	5.8
Black	15.1	14.5	14.5	14.1	14.3	14.2	13.7
Fulltime workers	6.8	6.6	6.5	6.5	6.6	6.6	6.3
Memo:							
Total national[1]	7.1	6.9	6.8	6.8	6.8	6.8	6.6

1. Includes resident Armed Forces as employed.

Over the year, total payroll employment grew 2.4 million, only a bit less than 1985. The services industry accounted for more than 1 million of the total, and retail trade added nearly 600,000, especially in eating and drinking establishments. The finance, insurance, and real estate industry also expanded rapidly (370,000 workers), in part an outgrowth of the demand for new and refinanced home mortgages that was fueled by lower interest rates.

In contrast, the number of jobs in the goods-producing sector was largely unchanged in 1986, as over-the-year losses in mining and manufacturing were offset by a pickup in construction jobs. Plummeting oil prices reduced employment in the oil and gas extraction industry by 25 percent last year. In manufacturing, losses in the durable goods sector were concentrated in machinery industries, while small, but widespread, gains characterized the nondurable goods sector.

As measured by the household survey, the civilian unemployment rate fell in December to 6.7 percent, from 6.9 percent in November.[1] Over the year, the unemployment rate fell 0.3 percentage point. Unemployment rate declines were most prominent for adult women in 1986, while the rate for adult males was unchanged.

Industrial Output and Capacity Utilization

After showing little net change over the first 3 quarters of the year, industrial production rose at an annual rate of about 3-1/4 percent in the final quarter.

1. The December household survey reflected annual revisions to the seasonally adjusted labor force series to incorporate the experience of 1986. As a result of these revisions, November's estimated unemployment rate was revised down 0.1 percentage point, to 6.9 percent.

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

	1986 Q3	1986 Q4	1986 Oct.	1986 Nov.	1986 Dec.
	—Annual rate—		—Monthly rate—		
Total Index	1.9	3.3	.3	.6	.5
Products	2.9	3.7	.6	.4	.6
Final products	2.1	3.6	.4	.5	.6
Consumer goods	1.5	3.3	.5	.7	.9
Durable	6.5	4.5	-.7	.6	1.7
Nondurable	-.1	2.9	.9	.7	.6
Equipment	2.7	4.0	.3	.2	.3
Business	3.4	1.1	-.1	.0	.1
Defense and space	6.3	9.0	.9	.5	.9
Oil and gas drilling	-39.3	48.7	4.6	3.9	.6
Intermediate products	5.6	3.9	1.0	.1	.5
Construction supplies	4.5	4.0	.1	.2	.3
Materials	.5	2.7	-.1	1.0	.2
Durable goods	.1	4.1	.1	1.3	-.1
Nondurable goods	10.0	3.3	-.2	.0	.8
Energy materials	-7.6	-.8	-.6	1.4	.4

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

	1978-80 High	1982 Low	1967-85 Avg.	1984 High	1986 Oct.	1986 Nov.	1986 Dec.
Total industry	86.9	69.5	81.7	81.8	79.1	79.4	79.6
Manufacturing	86.5	68.0	80.6	81.3	79.7	79.9	80.3
Durable	86.3	63.7	78.7	79.8	76.4	76.5	76.9
Nondurable	87.0	74.4	83.5	84.3	84.7	85.0	85.2
Mining	95.2	76.9	87.7	86.6	72.8	73.4	73.7
Utilities	88.5	78.0	87.9	85.8	79.4	80.3	80.0
Industrial materials	89.1	68.4	82.5	82.9	77.9	78.5	78.6
Metal materials	93.6	45.7	78.4	70.8	64.9	68.8	66.6
Paper materials	97.3	79.9	91.4	98.6	95.7	97.7	98.0
Chemical materials	87.9	63.3	80.8	78.5	82.5	81.5	82.1

PRODUCTION GROWTH IN SELECTED INDUSTRIES
(Percent change from previous period; compounded annual rate)

	Weight in IP	1986[1]	1986 Q3	1986 Q4
I. Acceleration in Output				
Iron and steel	3.49	-9.6	-1.0	13.8
Textiles	2.29	9.8	10.8	12.9
Apparel	2.79	2.6	.5	12.3
Lumber and products	2.30	8.3	5.1	15.6
Printing and publishing	4.54	6.2	4.5	9.6
Fabricated metal products	6.64	.1	-2.9	6.0
Misc. manufacturing	1.46	3.3	-6.5	9.1
II. Continued Strong Growth				
Aerospace and misc. transp.	3.87	8.4	7.0	7.1
Appliances and TV	1.19	7.0	12.1	12.3
Paper	3.15	6.9	9.3	6.0
Rubber and plastics	2.80	4.3	15.8	7.9
III. Bottoming Out				
Mining	9.83	-8.4	-12.8	-.2

1. Calculated on a year over year basis.

The pickup in production growth in the fourth quarter reflected, in part, an improved performance in several industries in which output had been sluggish earlier in the year--for example, iron and steel, textiles and apparel, and fabricated metals. These industries had been hard-hit by foreign competition in recent years, and the recent data, while not conclusive evidence of a turnabout, do point in the direction of some improvement in competitiveness.

Another factor in the fourth-quarter production rise was the continued strong showing of industries that have performed well throughout the year, such as the aerospace business, and industries that have benefited from the growth in consumer spending in the past year—appliances and television, paper, and rubber and plastics. The mining industry, which suffered earlier in the year, appears to have stabilized in the fourth quarter as a result of firming oil prices.

Two important sectors--business equipment and motor vehicles and parts--did not share in the improved production performance toward year-end. Business equipment output grew only 1 percent at an annual rate last quarter, when production of manufacturing, power, construction, mining, and farm equipment all fell sharply. Production in the motor vehicles and parts industry fluctuated during 1986, but was essentially unchanged from production a year earlier. Despite favorable domestic demand for cars, the automotive industry assembled only 7.8 million units last year, compared to 8.2 million in 1985.

Recent price developments also provide some evidence of a firming in the industrial sector. In particular, the prices of industrial commodities, which tend to be sensitive to changes in activity, were weak through most of

1986. However, according to several measures these prices turned up in the fourth quarter and increased further in January. The rise in prices late last year was concentrated in a few markets and partly reflected some special factors, but the increases early this year have been a bit more widespread.

Capacity utilization in manufacturing, mining, and utilities rose to 79.6 percent in December, from 79.4 percent in November. However, year-end capacity utilization remained below the 80.6 percent recorded in December of 1985, as the slight increase in industrial production was outpaced by an estimated 2.1 percent increase in industrial capacity.

In nondurable manufacturing, the steady increase in production over the year lifted the average operating rate to 85.2 percent in December, up from 83 5 percent a year earlier, but still 2 percentage points short of the monthly high recorded in 1978. In contrast, durable manufacturing and mining producers saw utilization rates slide again last year, resulting in layoffs and some plant closings, particularly in metal mining, oil and gas extraction, and the machinery and transportation equipment industries.

Personal Income and Consumption

The growth of nominal personal income, which had been particularly sluggish in the third quarter, perked up a little, to a 4 percent annual rate in the fourth quarter, owing to a boost from two special factors--bonus payments to auto workers in October and subsidy payments to farmers in December. Nonetheless, nominal income growth in the second

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

	1985	1986	1986 Q1	Q2	Q3	Q4
Current dollars						
Total personal income	6.1	4.4	6.0	6.0	1.8	4.0
Private wages and salaries	6.3	4.6	6.5	2.3	4.0	5.8
Manufacturing	3.9	1.8	2.6	-1.4	1.0	5.0
Farm income[2]	29.2	26.4	24.4	39.5	19.6	22.2
Disposable personal income	5.6	4.1	7.6	6.1	.2	2.9
Constant dollars						
Disposable personal income	1.9	2.4	6.5	7.1	-3.1	-.5
Personal consumption expenditures	3.5	4.0	3.6	6.2	6.7	-.5
Durables	6.2	9.9	-1.8	14.3	44.6	-10.1
Motor vehicles and parts	3.7	9.4	-8.4	18.2	91.5	-31.1
Furniture and household equip.	9.2	8.6	4.0	15.1	12.6	3.1
Other durables	6.1	13.9	2.0	4.0	19.3	33.0
Nondurables	2.0	3.4	6.5	8.0	-.9	.4
Clothing and shoes	3.2	4.8	14.0	12.9	1.5	-7.6
Gasoline and oil	1.5	15.2	2.1	40.0	7.4	14.9
Food	2.0	1.0	5.6	2.8	-5.6	1.5
Services	3.9	2.6	3.2	2.6	2.4	2.3
Memo:						
Personal saving rate (percent)	5.1	3.9	5.0	5.1	2.8	2.7

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

RETAIL SALES
(Seasonally adjusted percentage change)

	1986			1986		
	Q2	Q3	Q4	Oct.	Nov.	Dec.
Total sales	1.2	4.0	-.2	-5.2	-.6	4.4
Previous estimate[1]				-5.2	.5	
(REAL)[2]	2.4	3.1	-.9	-5.0	-.8	4.0
Previous estimate[1]				-5.3	-1.0	
Total less auto dealers nonconsumer stores, and gasoline stations	1.4	1.7	1.0	.3	.3	.9
Previous estimate[1]				.3	.9	--
GAF[3]	2.5	2.0	.0	.3	-.6	1.0
Durable	3.5	9.4	-2.0	-12.7	-2.0	10.2
Automotive group	4.2	13.5	-4.1	-19.5	-3.4	16.2
Furniture and appliances	4.2	4.3	.5	.1	.2	.6
Other durable goods	1.8	5.3	2.2	-.5	1.5	2.0
Nondurable	-.2	.7	1.0	.4	.3	.8
Apparel	3.3	1.5	.4	.5	-.4	1.0
Food	-.4	.9	2.1	.6	.8	.8
General merchandise[4]	1.5	1.1	-.5	.3	-1.0	1.3
Gasoline stations	-11.5	-4.3	.6	-.1	1.6	-.7

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

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

	1986				1986		
	Q1	Q2	Q3	Q4	Oct.	Nov.	Dec.
Total auto sales[1]	10.7	11.2	12.9	11.3	10.2	10.5	13.2
Domestic	7.8	8.2	9.4	7.7	7.0	6.9	9.1
Imported	2.8	3.0	3.5	3.7	3.3	3.6	4.1
Domestic production	8.3	7.9	7.4	7.5	7.3	7.3	7.9
Dealers' stocks	1.81	1.80	1.40	1.53	1.51	1.59	1.53
Days' supply[2]	71	68	46	61	67	71	52
Total light truck sales[3]	4.1	4.6	5.2	4.5	4.3	4.2	5.1
Domestic	3.3	3.7	4.3	3.5	3.4	3.1	4.0
Imported[4]	.8	.9	.9	1.0	.9	1.1	1.1

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.

half of the year was only half as fast as in the two previous quarters, reflecting slow growth in rental income, and declines in proprietors' income and personal interest income. With consumer prices turning up moderately after first-half declines, real disposable income fell in both the third and fourth quarters. The drop in real disposable income in the fourth quarter was matched by a slight decline in real spending, and the personal saving rate remained low, at 2.7 percent.

The weakness in consumer spending in the fourth quarter was more than accounted for by a steep drop in motor vehicle purchases often the expiration of the major incentive programs that had boosted third quarter sales. Auto sales did revive temporarily in December, mainly reflecting consumers' efforts to take advantage of sales tax deductions that were eliminated after year-end; however, sales then slumped dramatically in the first 20 days of January. Sales of imported autos gained ground throughout 1986, despite dollar-related price increases, in part due to new low-priced entrants from Korea. Indeed, imports set a quarterly selling record in the fourth quarter--3.7 million units, at an annual rate.

Excluding motor vehicles, real consumer expenditures rose 2.4 percent in the final quarter, matching the gain in the third quarter. Real spending on durables, excluding autos, rose 12.1 percent, after a 14.5 percent gain in the third quarter. In part, this strength in durable expenditures resulted from a surge in outlays for boats and pleasure aircraft, likely in anticipation of the year-end tax changes. Spending for furniture and household appliances, which had contributed importantly to consumption growth earlier this year, slowed to just over 3.0 percent annualized increase in the fourth quarter.

Real nondurable expenditures were essentially unchanged for the second consecutive quarter, as large increases for gasoline and oil offset weakness in apparel and other nondurables. Real service expenditures rose at a 2.3 percent annual rate last quarter, virtually the same pace as in the third quarter.

Business Fixed Investment

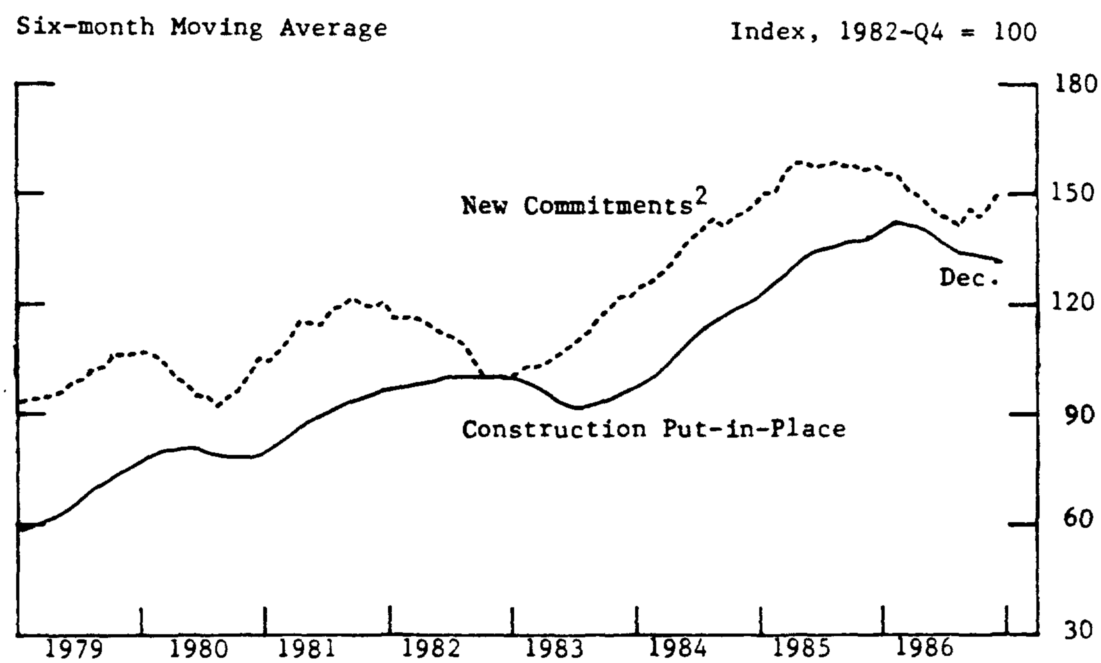
Real spending for business fixed investment is estimated to have fallen at a 3 percent annual rate in the fourth quarter. On the equipment side, outlays were pulled down by a drop in motor vehicle purchases. In contrast, investment in other equipment rose somewhat, according to preliminary BEA estimates, though less than suggested by the 3 percent increase in nondefense capital goods shipments by domestic manufacturers. The discrepancy reflects, in part, an apparent improvement in exports of capital goods, which are included in the shipments figures. At the same time, the extent to which domestic shipments were augmented by imports was somewhat less than earlier in the year.

Real outlays for nonresidential structures fell at a 3-1/2 percent annual rate last quarter, the fourth consecutive quarterly decline. December data for construction put-in-place, received after the BEA made its outlays estimate, suggest nonresidential construction was even weaker than indicated in the preliminary GNP figures. Most of the major components of nonresidential construction contributed to the fourth-quarter fall-off. In contrast, petroleum drilling activity edged up after a pronounced slump in the first half.

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

	1986 Q2	1986 Q3	1986 Q4	1986 Oct.	1986 Nov.	1986 Dec.
Producers' durable equipment						
Nondefense capital goods						
Shipments	2.5	.7	3.2	2.4	-.3	5.2
Aircraft	-.9	3.5	9.0	24.1	-13.0	18.1
Excl. aircraft	3.0	.3	2.4	-.5	1.8	3.4
Orders	-.9	4.0	4.3	-4.6	5.7	5.9
Aircraft	-12.2	.8	65.1	33.7	-12.5	55.9
Excl. aircraft	.9	4.5	-3.9	-10.5	9.8	-3.2
Sales of heavy-weight trucks (thousands of units, A.R.)	273	268	274	239	292	292
Nonresidential structures						
Nonresidential construction	-5.6	-.3	-3.3	-1.0	-1.9	-2.2
Commercial building	-7.8	.9	-7.2	-3.0	-2.9	-3.7
Office	-6.6	-4.3	-7.5	-3.3	-3.1	-3.1
Other commercial	-9.1	6.3	-6.9	-2.7	-2.7	-4.3
Industrial building	-9.4	-6.4	1.1	-1.8	3.5	-5.6
Public utilities, institutional, and other	-2.2	-.1	-.4	1.1	-2.1	-.1
Rotary drilling rigs in use	-40.2	-12.6	9.4	4.2	3.5	.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, that is, industrial, commercial, institutional, and hotels and motels.

Tax changes that took effect on January 1 probably had some infl15nce on the pattern of investment late last year. In particular, the fourth-quarter surge in purchases in some equipment categories suggests a year-end bunching of purchases, even though the changes in tax provisions for equipment were relatively minor. In contrast, there appears to have been little acceleration of nonresidential construction outlays, partly because many projects were exempted by transition rules from the requirement that construction be finished by year-end to retain front-loaded depreciation writeoffs. Moreover, developers of projects failing to qualify for these transition rules—even if able to—may have been unwilling to meet the December deadline, owing to the substantial costs incurred in rushing projects to completion.

Over the four quarters of 1986, real investment outlays fell about 5-1/2 percent, an unusually weak performance for a year of overall economic expansion. About one-half of last year's decline in outlays resulted from the collapse in petroleum drilling activity. Much of the remainder stemmed from the apparent shift of spending from early 1986 into late 1985, owing largely to attempts to beat the expected repeal of the investment tax credit. Still, even after accounting for these special factors, investment spending was lethargic last year, restrained by the slowing of output growth and the presence of excess capacity in many industries.

Leading indicators of investment spending suggest that overall outlays will remain sluggish in coming quarters. Once the aircraft group is excluded (to remove bookings that are filled with extremely long lag; and often show up as exports rather than domestic investment), new orders for nondefense capital goods fell almost 4 percent in the fourth quarter. In contrast, new commitments for nonresidential construction have firmed in the last six months, suggesting that construction outlays could level off temporarily in the near term. Nonetheless, with office vacancy rates above 20 percent in major metropolitan areas, and excess capacity in other sectors as well, the longer-term outlook for nonresidential construction is not encouraging. Moreover, survey readings for the year as a whole suggest that total investment outlays will be roughly flat. In particular, the Commerce Department survey, released just after the December FOMC meeting, indicates that firms expect nominal spending to rise only 0.9 percent this year.

Inventories

Except for auto dealers' stocks, inventory investment in manufacturing and trade remained moderate in late fall, with stocks generally in line with sales. The inventory-sales ratio for all nonauto establishments in manufacturing and trade was at the low end of the range seen over the past year.

Manufacturing stocks declined through much of 1986 and remained lean at year-end, consistent with the generally cautious inventory behavior that producers have been following for some time. In some industries (such as electrical machinery and consumer goods), the recent pickup in orders and production may provide the potential for restocking in the coming months. However, producers of basic metals and some types of business equipment are still faced with sluggish orders and may continue to be reluctant to restock.

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

	1986 Q2	1986 Q3	1986 Q4	1986 Oct.	1986 Nov.[r]	1986 Dec.[p]
Book Value Basis:						
Total	2.9	-3.4	--	41.8	-13.5	--
Manufacturing	-4.6	-7.3	-2.9	-6.8	4.9	-6.8
Wholesale	6.9	4.3	--	-8.0	-4.5	--
Retail	.6	-.4	--	56.7	-13.9	--
Automotive	-1.4	-12.7	--	39.1	-10.1	--
Ex. auto	2.0	12.3	--	17.5	-3.8	--
Constant Dollar Basis:						
Total	1.6	-11.2	--	15.7	-1.3	--
Manufacturing	1.0	-6.5	--	-9.3	6.0	--
Wholesale	4.6	8.3	--	-12.6	3.9	--
Retail	-4.0	-13.1	--	37.6	-11.3	--
Automotive	-1.8	-22.0	--	19.4	-8.1	--
Ex. auto	-2.3	8.9	--	18.2	-3.2	--

INVENTORIES RELATIVE TO SALES[1]

	Range in Preceding 12 months:[2] low	Range in Preceding 12 months:[2] high	1986 Q2	1986 Q3	1986 Q4	1986 Oct.	1986 Nov.[r]	1986 Dec.[p]
Book Value Basis:								
Total	1.33	1.40	1.39	1.36	--	1.36	1.35	--
Manufacturing	1.40	1.46	1.43	1.42	1.39	1.41	1.40	1.35
Wholesale	1.16	1.25	1.23	1.21	--	1.18	1.18	--
Retail	1.34	1.47	1.45	1.39	--	1.45	1.45	--
Automotive	1.20	1.84	1.70	1.39	--	1.61	1.63	--
Ex. auto	1.36	1.40	1.38	1.39	--	1.40	1.39	--
Constant Dollar Basis:								
Total	1.47	1.56	1.54	1.50	--	1.51	1.50	--
Manufacturing	1.68	1.74	1.70	1.69	--	1.68	1.66	--
Wholesale	1.25	1.34	1.32	1.29	--	1.27	1.27	--
Retail	1.35	1.51	1.48	1.40	--	1.47	1.47	--
Automotive	1.12	1.89	1.74	1.33	--	1.57	1.58	--
Ex. auto	1.40	1.45	1.41	1.43	--	1.45	1.44	--

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

In the trade sector, the accumulation of nonauto retail stocks in early fall appears to have subsided i· November, owing in part to a steady growth in nonauto retail sales. In particular, retail stocks of nondurable goods other than food were little changed in November after a sizable buildup in the preceding two months. Judging by the advance reports on orders and sales, the inventory situation at nonauto retail establishments probably improved further in December. In the automotive sector, dealer stocks continue to fluctuate with swings in sales. Stocks appeared to be at reasonable levels at year-end relative to historical experience, but probably accumulated considerably again in January, given the recent drop in sales.

Housing Markets

After edging down for several months, housing starts rebounded in December to a 1.80 million unit pace. Single-family starts were up 11 percent from November, spurred in part by declines in mortgage interest rates to the lowest levels recorded in eight years. Even so, for the quarter as a whole, single-family housing starts were little changed from the third quarter.

Multifamily housing starts showed a surprising uptick in December, but nevertheless contracted 10 percent in the fourth quarter as a whole to a level one-fifth below a year earlier. The downward trend in the pace of multifamily construction during 1986 in part reflects tax code changes that lowered rates of return on rental property investments,[1]

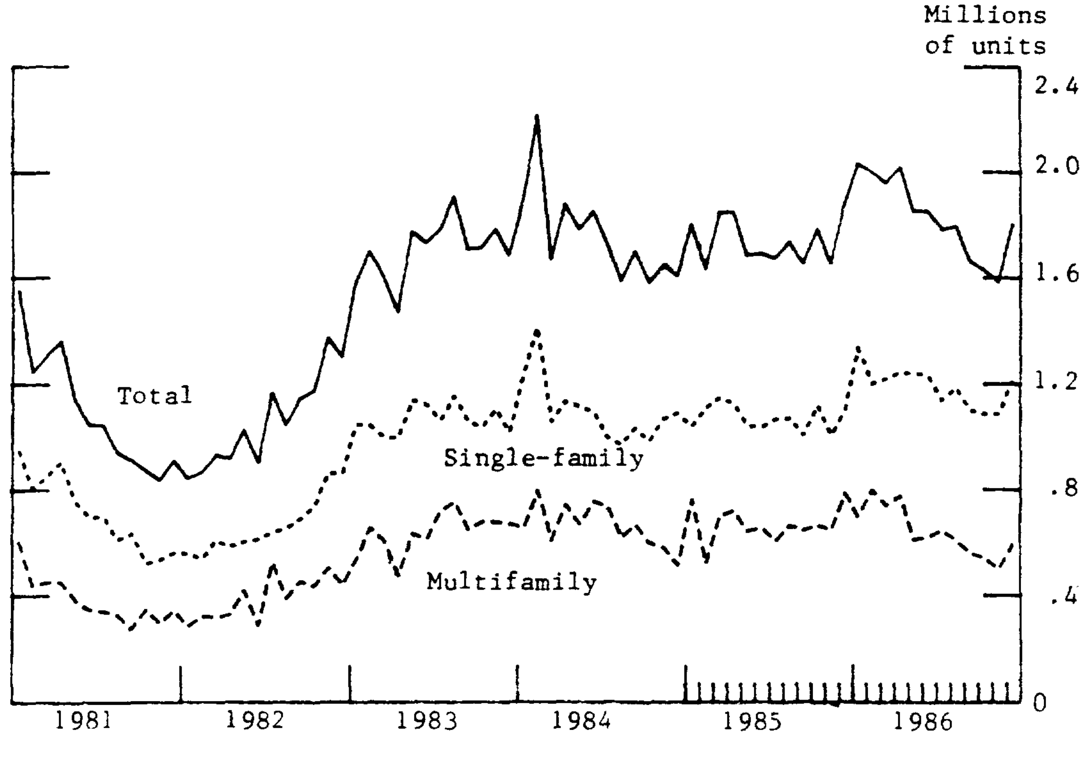
1. Rental apartments recently have accounted for 70 to 80 percent of total multifamily construction.

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

	1986	1986				1986		
	Annual	Q1	Q2	Q3	Q4	Oct.	Nov.	Dec.[1]
All units								
Permits	1.75	1.83	1.82	1.68	1.69	1.57	1.61	1.89
Starts	1.81	2.00	1.91	1.75	1.67	1.63	1.59	1.80
Single-family units								
Permits	1.07	1.05	1.12	1.06	1.05	1.01	.99	1.14
Starts	1.18	1.25	1.24	1.14	1.13	1.09	1.09	1.21
Sales								
New homes	n.a.	.80	.80	.68	n.a.	.68	.66	n.a.
Existing homes	3.58	3.26	3.47	3.62	3.96	3.81	3.91	4.17
Multifamily units								
Permits	.68	.79	.70	.62	.64	.56	.62	.75
Starts	.63	.75	.67	.61	.55	.54	.50	.59
Mobile home shipments	n.a.	.26	.24	.24	n.a.	.24	.24	n.a.

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

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



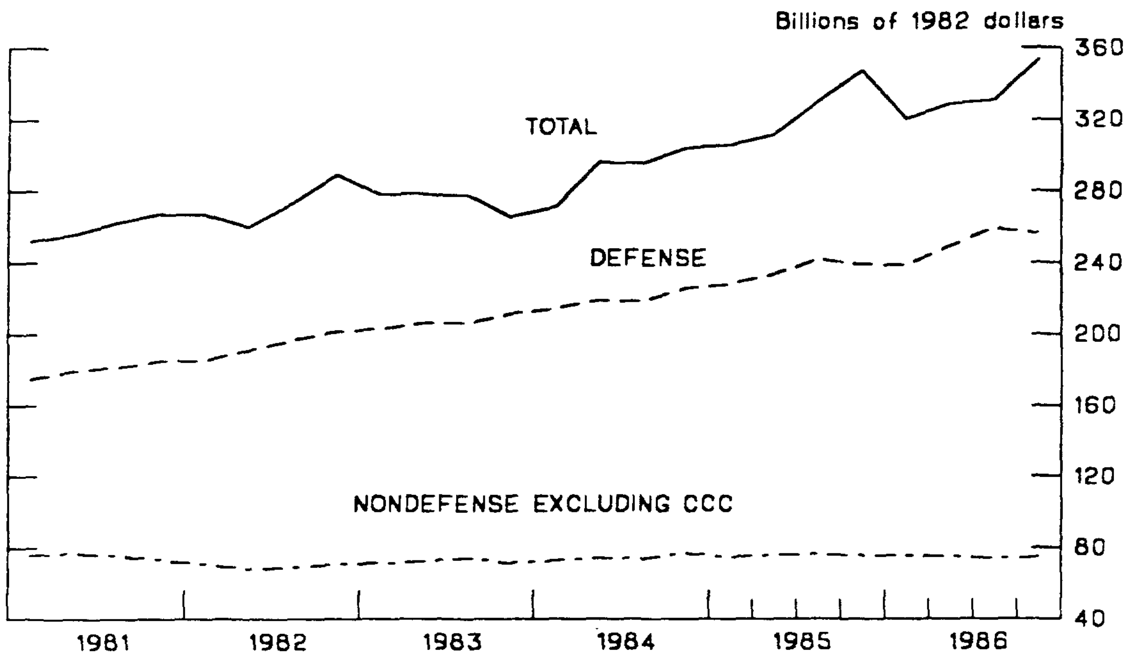
and sharply curtailed issuance of state and local government multifamily mortgage revenue bonds. Further, rental vacancy rates in the multifamily segment of the market reached 9.7 percent in the fourth quarter, the highest level recorded in the 18-year history of the series. These factors likely will continue to depress apartment construction in the months to come.

Fourth-quarter data indicate no year-to-year rise in the constant-quality new home price index. In contrast, the median sales price for new homes--an indicator that does not adjust for either changes in size and amenities of new homes or the regional mix of sales--was up 8.7 percent over the same period. Existing homes posted a lower, 6.8 percent median price gain during the year ending in December.

Southern states experienced a 6 percent contraction in the pace of housing construction in 1986, owing largely to weak demand in oil-producing states and a continuing surplus of multifamily units. While the South continues to account for more housing construction than any other region, its share of the national total has declined during the recent housing expansion--from over 50 percent in 1983 to about 40 percent in 1986. In the Northeast, by contrast, housing demand has been robust. Total housing starts rose 17 percent in that region last year, reflecting a 24 percent increase in single-family construction. During the 1983-86 period, housing starts in the Northeast surged 75 percent, increasing that region's share of national activity from 10 to 16 percent. Strong income growth, favorable demographics, and rates of housing price appreciation substantially above the national average are

REAL FEDERAL PURCHASES

(Seasonally adjusted annual rates)



among the factors underlying the impressive pace of housing construction in the Northeast.

Federal Government

Real federal purchases rose sharply in the fourth quarter of 1986, but the increase was due almost entirely to a surge in agricultural loans made by the Commodity Credit Corporation. (BEA estimates that these CCC transactions were offset by a decline in farm stocks, so that GNP was unaffected.) Military spending, which had increased at nearly a 20 percent annual rate in the second and third quarters, was down 4 percent in the fourth quarter. For the year as a whole, real defense spending continued to trend up despite reductions in appropriations. The latest calendar-year gain was more than 7 percent, somewhat larger than in other recent years as the value of equipment deliveries and R&D spending rose sharply. In contrast, nondefense purchases excluding CCC, which were up slightly in the fourth quarter, declined 2 percent over the year, reflecting budget cuts.

With the submission of the President's proposals at the beginning of 1987, Congress began to formulate the FY1988 federal budget resolution, scheduled to be passed by April 15. The resolution sets limits and targets for subsequent appropriations and other spending and revenue legislation. Under the Gramm-Rudman-Hollings legislation, the deficit target is $108 billion, compared with an actual deficit of $221 billion in FY1986 and roughly $175 billion now projected by the Administration and the Congressional Budget Office for FY1987.

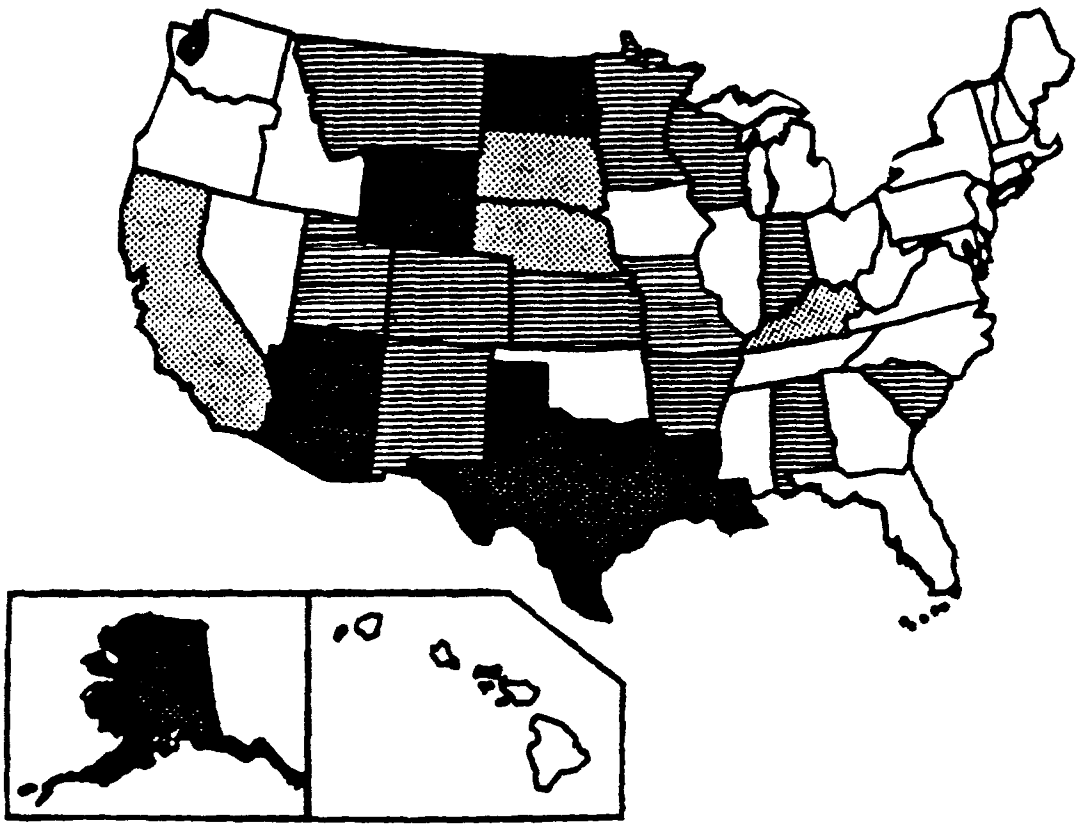
To meet the FY1988 target, the President proposed deficit-reducing actions that included selected small revenue increases, further sales of financial and physical assets, and additional cuts in domestic programs. However, in a preliminary analysis prepared for the Senate Budget Committee, CBO has suggested that the Administration's proposals, if enacted, would fall short of the amount needed to meet the Gramm-Rudman-Hollings target, and the FY1988 deficit would be in the $135 to $140 billion range. Relative to the Administration's estimates, CBO's analysis used less optimistic economic and technical estimating assumptions. In recent years, CBO's assumptions have underlaid figures in the budget resolution. Tables that detail the President's budget, CBO's baseline estimates, and other related data are provided in a statistical appendix to the Greenbook Supplement.

In addition to the FY1988 budget, Congress is expected to consider in the current session a number of proposals to reform the budget process. The President has again requested that changes be made to allow for a line-item veto of major spending bills. Moreover, he has asked that the President's signature be required for the Congressional Budget Resolution. Other proposals pending would change a number of major appropriations from an annual to a multiyear basis; a bill submitted by Senators Domenici and Roth would put the entire federal budget on a biennial cycle.

State and Local Government Sector

Real purchases of goods and services by state and local governments rose 4.6 percent in 1986, the largest annual increase since 1970. Most of the strength last year was attributable to investment in infrastructure--primarily of educational, correctional, and water facilities—stemming from a need for new building as well as modernization of existing structures.

States Cutting Their General Fund Budgets in Fiscal 1987



Cut as a percent of budget:

- –under 2 percent
- –2 to 5 percent
- –over 5 percent

The budget position of state and local governments weakened considerably last year. Excluding special one-time inflows--such as previously escrowed oil lease payments--the combined surplus of the operating and capital accounts (excluding social insurance funds) fell to near zero in 1986. Moreover, recent surveys tend to substantiate a picture of still eroding budget positions. By the middle of fiscal 1987, 22 states, primarily in the farm belt and oil patch, had cut or planned to cut their current general funds budgets to avoid a deficit, and several other states are expected to follow suit soon. (All but four states end their fiscal year on June 30.) In addition, more than a third of all cities expect to raise taxes, and more than half plan to raise fees in calendar 1987. These actions come on the heels of similar adjustments in 1986 necessitated by weakened fiscal positions.

Prices

Recent price reports indicate that the rate of inflation remained relatively moderate at year-end. The November and December increases in the CPI were in the 0.2 to 0.3 percent range, and the PPI for finished goods was unchanged in December, after rising 0.2 percent in November. Energy prices picked up somewhat in December, but food prices eased and price increases for other goods and services were similar to their average pace earlier in the year. For 1986 as a whole, the steep declines in energy prices during the year held the CPI advance to only 1.1 percent and were responsible for a 2-1/2 percent drop in the PPI for finished goods. The fixed-weighted price index for GNP--a broad measure of price change for national output--rose 2.4 percent from 1985-Q4 to 1986-Q4, compared with 3.6 percent during the preceding year.

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

	Relative Importance Dec. 1985	1985	1986	1986 Q3	1986 Q4	1986 Nov.	1986 Dec.
				-Annual rate-		-Monthly rate-	
All items[2]	100.0	3.8	1.1	2.2	2.7	.3	.2
Food	18.5	2.7	3.8	9.4	4.1	.5	.2
Energy	11.3	1.8	-19.7	-19.5	-9.7	-.7	.3
All items less food and energy	70.2	4.4	3.8	3.7	4.1	.3	.3
Commodities	25.9	2.1	1.4	3.1	2.4	.2	.2
Services	44.4	5.7	5.2	4.1	5.0	.4	.3
Memorandum:							
CPI-W[3]	100.0	3.6	.7	2.0	2.5	.2	.2

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	1986 Q3	1986 Q4	1986 Nov.	1986 Dec.
				-Annual rate-		-Monthly rate-	
Finished goods	100.0	1.8	-2.5	.7	2.2	.2	.0
Consumer foods	24.5	.5	2.9	13.0	1.8	-.1	-.4
Consumer energy	12.5	-.3	-39.1	-36.9	-15.7	.0	.2
Other consumer goods	40.3	2.7	2.9	2.2	5.4	.3	.2
Capital equipment	22.7	2.7	2.1	2.2	3.2	.3	.0
Intermediate materials[2]	95.3	-.1	-4.5	-.8	.1	.2	.1
Exc. energy	79.6	-.1	.1	2.0	.8	.2	-.1
Crude food materials	52.5	-6.4	-1.7	20.1	1.5	-.2	-2.0
Crude energy	31.6	-4.9	-29.4	-13.3	-16.9	-.7	-3.0
Other crude materials	15.9	-4.3	1.6	-18.1	20.1	1.6	1.4

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

In December, retail prices of gasoline and fuel oil rose about 1 percent, apparently in lagged response to the upturn in world crude oil prices. Despite these increases, prices of both products remained more than 30 percent below their December 1985 levels. Crude oil prices rose sharply around the turn of the year, reflecting the December OPEC agreement and severe winter weather in Europe, and these increases are likely to show up at the retail level in coming months.

In contrast to energy, the rise in consumer food prices slowed to 0.2 percent in December, after rapid increases earlier in the year that were partly weather-related. At the farm level, crude food prices were down over the last two months of the year, and in spot commodity markets, most agricultural prices continued to weaken into early 1987, before turning up in the latter part of January.

Excluding food and energy items, the CPI rose 0.3 percent in both November and December, about the average pace for the year as a whole but less than in 1984 and 1985. A deceleration in the index for the commodities component, to around 1-1/2 percent for the year, mainly reflected a decline in used car prices of about 5 percent. Prices of nonenergy services also rose less than in 1985, with the slowdown widespread.

Prices of non-oil merchandise imports at the dockside—as measured by the BEA fixed-weighted price series—picked up markedly in 1986, responding with some lag to the lower exchange value of the dollar. Over the four quarters of 1986, the increase was 6-3/4 percent, compared with a decline of about 1 percent in 1985. The 1986 increases were dominated by autos and other consumer durables, as well as capital goods. Despite the increases in point-of-entry prices, there is little evidence as of yet of a significant effect on domestic retail prices, apart from autos and a few other categories.

In recent months, commodity prices have risen notably, although from depressed levels. This pickup is evident not only in the petroleum sector, but also for a number of industrial materials, as indicated for example, in summary measures such as those maintained by the Commodity Research Bureau and the Journal of Commerce.

Wages and Labor Costs

Most available measures of labor costs continued to show moderate rates of wage increase in the final quarter of 1986. The hourly earnings index (HEI), which covers production and nonsupervisory workers, rose at a 3.1 percent annual rate in the fourth quarter, and only 2.2 percent last year, after increasing 3 percent in 1985.

A more comprehensive measure of labor costs, the Employment Cost Index (ECI), indicated that wages and salaries rose 3 percent last year, down from 4 percent in the preceding two years. The deceleration probably reflects, at least in part, a downward adjustment in inflation and probably in inflation expectations. Increases in fringe benefits, which slowed significantly in 1985, remained moderate last year and, as a result, hourly compensation in the ECI continued to rise at about the same pace as wages and salaries.

The continued deceleration of compensation this past year has come mainly from such service-producing industries as finance, insurance and real estate, transportation and public utilities, and wholesale and

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

	1984	1985	1986	1986 Q1	1986 Q2	1986 Q3	1986 Q4
Hourly earnings index, wages of production workers[1]							
Total private nonfarm	2.9	3.0	2.2	2.7	1.8	1.2	3.1
Manufacturing	3.4	3.3	1.7	2.3	2.4	1.2	1.1
Nonmanufacturing	2.7	2.9	2.4	2.8	1.6	1.1	4.0
Employment cost index, compensation of all persons[2]							
Total	4.9	3.9	3.2	4.5	3.1	2.8	2.5
By occupation:							
White collar	5.1	4.8	3.5	4.7	3.7	3.1	2.4
Blue collar	4.2	3.2	2.7	4.2	1.9	2.9	1.9
Service workers	6.6	3.0	3.1	4.4	.6	3.7	3.7
By bargaining status:							
Union	4.3	2.6	2.1	4.2	.9	2.2	1.2
Nonunion	5.2	4.6	3.6	4.8	3.8	3.1	2.8
Employment cost index, wage and salaries of all persons							
Total	4.1	4.1	3.1	3.9	3.5	2.8	2.1
Major collective bargaining agreements[3]							
First-year wage adjustments	2.4	2.3	1.2	--	--	--	--
Total effective wage change	3.7	3.3	2.3	--	--	--	--
Labor costs and productivity, all persons[1]							
Compensation per hour	4.3	3.9	2.7	3.1	2.3	2.3	3.1
Output per hour	1.0	.2	.7	4.3	.5	-.3	-1.7
Unit labor costs	3.2	3.7	2.0	-1.2	1.8	2.6	4.9

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

retail trade, which granted the largest wage increases in 1985. As a result, hourly compensation in the service-producing sector rose last year at about the same pace as in the goods-producing industries; this contrasts with the generally higher rates of wage inflation in the service-producing sector during the preceding four years. By occupation, wage increases for white-collar workers continued to exceed those for blue-collar workers in 1986, although the disparity in growth rates was considerably less in 1985.

The unionized sector continues to experience relatively small wage increases. Negotiated wage adjustments for the 2.5 million private industry workers reaching major new settlements over the period averaged just 1.2 percent in the first year of the contract and 1.8 percent annually over the life of the contract, exclusive of lump-sum payments and COLAs. Indeed, more than 20 percent of the workers covered by new settlements in 1986 accepted initial wage cuts or freezes. However, more than 40 percent of these workers received lump-sum payments, augmenting the modest wage gains.

Low rates of consumer price increase virtually eliminated COLA payments last year. As a result, compensation for unionized workers, which includes lump sums, increased only 2 percent over 1986 as measured by the ECI, well below the 3-1/2 percent increase for nonunionized workers.

Looking ahead to this year, deferred increases and lump-sum payments will account for most of the increase in union compensation. Deferred changes are scheduled to contribute about 1-1/2 percentage points to overall union wage change for workers under major private industry agreements. About a third of the employees covered by major collective bargaining agreements in private industry and state and local governments are scheduled to bargain. In the private sector, contract talks in automobile manufacturing cover about 575,000 workers, the largest number of workers in a private industry affected by 1987 negotiations. Settlements here are expected to be moderate as negotiations focus on job security and labor cost containment. Elsewhere in the private sector, negotiations in trade and construction will also be important this year. Almost 40 percent of workers slated for 1987 contract negotiations are covered by state and local government agreements where contracts reached during 1986 provided an average wage adjustment of nearly 6 percent.

APPENDIX

ADMINISTRATION AND CONGRESSIONAL BUDGET OFFICE BUDGET UPDATES

The tables that follow summarize the recent federal budget estimates of the Administration and Congressional Budget Office.

- Table 1 details the Administration's current services budget. The current services budget is an estimate of receipts and outlays as they would evolve under the Administration's economic assumptions in the absence of changes in federal laws or policies. Cost estimates are typically raised through time to maintain program levels in real terms. In addition, for entitlement programs, increases in the number of eligible participants are taken into account. However, the administration has set "current services" defense outlays at levels that would provide the three percent real growth that is now the Administration's policy. Interest outlays are allowed to rise or fall to meet the change in costs of servicing the public debt.

- Table 2 lists the Administration's proposals for deficit reduction. According to these estimates, the FY1988 deficit would decline from the $150 billion under current services to $108 billion--the target mandated by the Gramm-Rudman-Hollings Act. Similarly, deficit reduction measures proposed for subsequent years are estimated to be sufficient to lower the deficit further and to meet nearly the requirement of balance by 1991.

- Table 3 shows the Administration and CBO economic assumptions that underlie their respective budget estimates.

- Table 4 details the CBO baseline budget. The baseline concept is similar to the current services concept. The figures in this table differ from the Administration's current services estimates mainly because CBO: (1) uses different economic assumptions, (2) assumes zero real growth in defense authorizations, and (3) uses different technical assumptions related to program spend-out rates.

Table 1

ADMINISTRATION CURRENT SERVICES BUDGET ESTIMATES
(Fiscal years, billions of dollars)

	1986a	1987	1988	1989	1990	1991	1992
Receipts							
Individual income taxes	349	364	392	416	450	488	522
Corporate income taxes	63	105	116	127	138	148	159
Social insurance taxes	284	301	331	354	381	406	428
Other[1]	73	72	72	71	72	73	74
Total	769	842	910	968	1,040	1,114	1,182
Outlays							
National defense	273	282	298	312	330	350	371
Social security	199	208	220	233	247	261	275
Agriculture	31	31	27	27	26	23	22
Net interest	136	137	139	143	143	142	134
Other[2]	351	359	377	400	419	440	459
Total	990	1,017	1,061	1,115	1,165	1,216	1,261
Surplus/Deficit(-)	-221	-175	-150	-147	-126	-101	-78

a--actual.

Source: OMB, The Budget of the United States Government, Fiscal Year 1988, January 1987.

1. Includes excise taxes, estate and gift taxes, customs duties, and other miscellaneous receipts.

2. Includes, among other items, spending for international affairs, medicare and medicaid, income security, transportation, general science, space and technology, and veterans' benefits and services.

Table 2

ADMINISTRATION'S FY1988 PROPOSALS FOR DEFICIT REDUCTION
(Fiscal years, billions of dollars)

	1988	1989	1990	1991	1992
Outlay reductions:					
Mandatory spending programs:[1]					
Major medical:					
Medicare benefits	4.6	4.0	5.1	5.6	6.3
Medicare premiums[2]	.6	1.8	3.1	4.4	5.8
Other medical	2.1	3.7	4.9	6.2	7.6
Other mandatory	3.4	8.2	11.4	13.1	13.9
Subtotal, mandatory spending	10.7	17.7	24.5	29.3	33.6
Nondefense discretionary:[1]					
Expenditures on:					
Economic subsidies and development	4.6	10.7	11.9	15.0	16.2
Social programs	4.5	7.5	10.0	11.3	12.5
General government	-.5	-3.2	-2.5	-2.1	-1.5
Offsets to outlays from:					
Credit reform	1.3	.6	-.9	-2.2	-3.6
Other loan asset sales	4.2	1.7	.8	.3	
Privitization	5.4	3.7	3.8	6.5	5.3
User fees	3.2	3.5	3.6	3.7	3.8
Other offsetting receipts	1.6	.8	.5	-.1	.9
Subtotal, discretionary spending	24.3	25.3	27.2	32.4	33.6
Net interest	1.3	3.2	6.0	9.3	14.3
Subtotal, outlay changes	36.3	46.2	57.7	71.0	81.5
Receipts increases	6.1	8.0	8.6	8.8	8.9
Total deficit reduction	42.4	54.2	66.2	79.9	90.6

Note: Details may not sum to totals because of rounding.

Source: OMB, The Budget of the United States Government, Fiscal Year 1988, January 5, 1987.

1. "Mandatory spending" includes entitlements and other nearly automatic spending, such as farm price supports; discretionary spending is controlled through the annual appropriations process.

2. Scored as an offset to outlays in the budget accounts.

Table 3

ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS
(Percent)

	Near-term projections		Long-run assumptions			
	1987	1988	1989	1990	1991	1992
Real GNP growth (year over year):						
Administration	3.1	3.5	3.6	3.6	3.5	3.4
CBO	2.8	3.0	3.0	3.1	2.7	2.5
GNP deflator increase (year over year):						
Administration	3.3	3.5	3.5	3.2	2.8	2.3
CBO	3.2	3.8	4.1	4.2	4.2	4.2
Consumer price index increase (year over year):						
Administration	3.0	3.6	3.6	3.2	2.8	2.2
CBO	3.5	4.3	4.3	4.3	4.3	4.3
Civilian unemployment rate (annual average):						
Administration	6.8	6.4	6.1	5.9	5.7	5.6
CBO	6.7	6.5	6.3	6.1	6.0	6.0
Treasury bill rate (annual average):						
Administration	5.4	5.6	5.3	4.7	4.2	3.6
CBO	5.6	5.7	5.6	5.5	5.3	5.2
Treasury 10-year note rate (annual average):						
Administration	6.7	6.6	6.1	5.5	5.0	4.5
CBO	7.2	7.2	6.6	6.2	5.9	5.6

Sources: OMB, The Budget of the United States Government, January 1987, and CBO, The Economic and Budget Outlook: Fiscal Years 1988-1992, January 1987.

Table 4

CBO BASELINE BUDGET ESTIMATES
(Fiscal years, billions of dollars)

	1986a	1987	1988	1989	1990	1991	1992
Receipts							
Individual income taxes	349	361	381	412	458	502	546
Corporate income taxes*	63	101	119	126	138	151	162
Social insurance taxes	284	301	329	353	383	411	436
Other[1]	73	71	71	70	71	74	76
Total	769	834	900	962	1,050	1,138	1,220
Outlays							
National defense	273	280	290	303	317	332	346
Social security	199	208	221	236	252	270	288
Agriculture	31	30	30	29	26	23	22
Net interest	136	135	141	147	152	155	154
Other[2]	351	355	387	409	437	467	495
Total	990	1,008	1,069	1,124	1,184	1,247	1,305
Surplus/Deficit(-)	-221	-174	-169	-162	-134	-109	-85

a--actual.

Source: CBO, The Economic and Budget Outlook: Fiscal Years 1988-1992, January 1987.

1. Includes excise taxes, estate and gift taxes, customs duties, and other miscellaneous receipts.

2. Includes, among other items, spending for international affairs, medicare and medicaid, income security, transportation, general science, space and technology, and veterans' benefits and services.

SELECTED FINANCIAL MARKET QUOTATIONS[1]
(Percent)

	1984	1985	1986	1986	1987	Change from:	
	Highs	March highs	June highs	FOMC Dec. 16	Feb. 3	June highs	FOMC Dec. 16
Short-term rates							
Federal funds[2]	11.63	8.58	6.90	6.14	6.26	-.64	.12
Treasury bills[3]							
3-month	10.67	8.80	6.52	5.58	5.59	-.93	.01
6-month	10.77	9.13	6.57	5.58	5.59	-.98	.01
1-year	11.13	9.25	6.62	5.56	5.59	-1.03	.03
Commercial paper							
1-month	11.42	8.94	6.87	6.36	6.05	-.82	-.31
3-month	11.35	9.12	6.81	6.08	5.95	-.86	-.13
Large negotiable CDs[3]							
1-month	11.52	8.89	6.88	6.28	6.00	-.88	-.28
3-month	11.79	9.29	6.91	6.02	5.98	-.93	-.04
6-month	12.30	9.92	6.97	5.96	5.98	-.99	.02
Eurodollar deposits[4]							
1-month	11.89	8.89	7.01	6.36	6.09	-.92	-.27
3-month	12.20	9.58	7.01	6.16	6.10	-.91	-.06
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	6.44	6.53	-1.33	.09
10-year	13.99	12.02	8.39	7.12	7.25	-1.14	.13
30-year	13.94	11.97	7.93	7.39	7.53	-.40	.14
Municipal revenue[5] (Bond Buyer index)	11.44	10.25	8.57	7.31	6.98	-1.59	-.33
Corporate--A utility Recently offered	15.30	13.23	9.70	9.03e	8.85e	-.85	-.18
Home mortgage rates[6]							
S&L fixed-rate	14.68	13.29	10.76	9.30	9.12	-1.64	-.18
S&L ARM, 1-yr.	12.31	11.14	8.65	7.63	7.58	-1.07	-.05

	1984	1985	1986	1986	1987	Percent change from:	
	Lows	March lows	Highs	FOMC Dec. 16	Feb. 3	1986 highs	FOMC Dec. 16
Stock prices							
Dow-Jones Industrial	1086.57	1247.35	1955.57	1936.16	2168.45	10.89	12.00
NYSE Composite	85.13	102.46	145.75	142.87	157.28	7.91	10.09
AMEX Composite	187.16	222.28	285.19	263.77	305.56	7.14	15.84
NASDAQ (OTC)	225.30	276.18	411.16	353.77	399.38	-2.87	12.89

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 February 11, 1987.
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

Most short-term interest rates are about unchanged, on balance, since the last FOMC meeting, while changes in longer-term rates are mixed--Treasury yields are up somewhat but private capital market rates are down. Short-term rates rose sharply in late December against a backdrop of hectic churning in financial markets related to year-end "window dressing" and efforts to beat the deadline for favorable tax treatment on certain transactions. The federal funds rate soared to double-digit levels in the final days of 1986, and other short-term private market rates also jumped. After the turn of the year, the pressures abated and money market rates more than reversed the earlier increases; however, a more recent firming in the reserve market and uncertainties about the consequences of the sharp decline in the dollar have pushed most short-term rates back up to their mid-December levels.

Fluctuations in longer-term rates have been comparatively moderate. Treasury bond yields have risen, on net, since mid-December, but corporate and municipal rates have fallen somewhat, owing in part to a drop-off in securities issuance. Stock prices have rallied dramatically this year.

Growth in the monetary aggregates picked up markedly in December, undoubtedly influenced by the increased volume of financial transactions near the end of the year. Under the impetus of a surge in demand deposits, M1 spurted ahead at a 28-1/2 percent annual rate, pushing growth for the year to 15-1/4 percent. The broader aggregates also experienced faster growth in December, and finished the year in the vicinity of the upper ends of their target ranges. Available data indicate that M1 growth slowed appreciably in January, with demand deposits running off after the year-end

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

	1985:Q4 to 1986:Q4	1986 H1	1986 H2	1986 Nov.	1986 Dec.	1987 Jan.pe	Growth from Q4 1986 to Jan. 1987pe
	------ Percentage change at annual rates ------						
1. M1	15.3	11.9	17.6	21.0	28.4	10	18-1/4
2. M2	9.1	7.5	10.3	7.0	10.0	8	8-1/2
3. M3	8.9	8.4	9.0	5.9	9.3	9	8-3/4
Selected components							Levels in billions of dollars Dec. 1986
4. Currency	7.4	7.0	7.6	6.6	8.6	18	183.5
5. Demand deposits	11.7	9.2	13.6	21.3	38.2	-16	307.9
6. Other checkable deposits	28.5	20.9	32.7	32.7	33.4	39	232.7
7. M2 minus M1[2]	7.1	6.1	7.9	2.3	3.5	7	2074.0
8. Overnight RPs and Eurodollars, NSA	13.2	2.1	24.1	-20.2	0.0	90	75.8
9. General purpose and broker/dealer money market mutual fund shares, NSA	17.1	19.5	13.4	0.6	1.2	8	207.2
10. Commercial banks	6.5	6.5	6.2	5.7	8.2	12	895.5
11. Savings deposits, SA, plus MMDAs, NSA[3]	15.9	11.1	19.6	18.6	16.4	19	532.7
12. Small time deposits	-4.7	1.1	-10.4	-12.4	-3.6	1	362.8
13. Thrift institutions	5.1	5.9	4.2	3.5	2.8	6	898.9
14. Savings deposits, SA, plus MMDAs, NSA[3]	13.0	7.6	17.7	17.4	10.1	17	409.3
15. Small time deposits	-0.6	4.7	-5.7	-7.5	-3.2	-3	489.6
16. M3 minus M2[4]	8.0	12.1	3.7	1.2	6.4	15	683.6
17. Large time deposits	2.4	6.8	-2.1	-0.3	3.8	17	444.2
18. At commercial banks, net[5]	1.6	4.6	-1.3	9.0	10.2	30	283.4
19. At thrift institutions	3.6	10.6	-3.2	-16.1	-7.4	-5	160.8
20. Institution-only money market mutual fund shares, NSA	31.5	34.3	24.5	-1.4	-4.3	-3	84.1
21. Term RPs, NSA	27.3	34.0	17.6	61.7	-10.3	-19	81.1
22. Term Eurodollars, NSA	3.9	6.9	0.7	18.2	46.4	20	83.3
	-- Average monthly change in billions of dollars --						
MEMORANDA:							
23. Managed liabilities at commercial banks (24+25)	1.8	1.1	2.5	3.8	3.1	11	487.3
24. Large time deposits, gross	0.5	0.4	0.7	1.1	2.9	8	344.1
25. Nondeposit funds	1.3	0.7	1.8	2.7	0.2	3	143.2
26. Net due to related foreign institutions, NSA	0.5	0.2	0.8	5.5	2.8	0	-19.7
27. Other[6]	0.7	0.5	1.0	-2.8	-2.5	3	163.0
28. U.S. government deposits at commercial banks[7]	0.5	0.2	0.8	13.3	-3.3	-2	23.2

1. Semi-annual growth rates are computed on a quarterly average basis. Dollar amounts shown under memoranda 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 December 1986 and January 1987 at rates of 33.5 percent and 40 percent, respectively. At thrift institutions, savings deposits excluding MMDAs increased during December 1986 and January 1987 at rates of 22.0 percent and 29 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

surge. The deceleration in the M1 component slowed M2 growth in January, while enlarged issuance by banks of large time deposits helped to keep M3 growing at about its December rate.

Total debt of domestic nonfinancial sectors expanded rapidly in December, when tax-related transactions bloated demands for funds, but the increase appears to have slowed in January. Nonfinancial firms, in a spate of merger and restructuring activities, borrowed heavily from banks in December; bank borrowing also may have been boosted by the spike in rates on commercial paper at year-end that prompted a runoff in outstanding paper of nonfinancial businesses. In January, bank loan growth slowed but remained strong, while outstanding paper dropped further. Residential mortgage debt continued to expand briskly late in the year, while consumer installment credit was almost unchanged in December, perhaps in part reflecting increasing use of home equity lines of credit in place of consumer borrowing. Fragmentary data suggest that this pattern may have continued in January. Federal and state and local borrowing was strong in December, but slackened in January.

Monetary Aggregates and Bank Credit

Note on the monetary data: Annual benchmark and seasonal factor revisions are currently in process. The data reported here are on an unrevised basis. A discussion of revisions to the monetary aggregates will be included in the Bluebook.

Demand deposit growth surged in December to a 38 percent annual rate, as the impending change in tax laws triggered an unusually heavy volume of financial transactions. Most of this bulge was temporary: demand deposits appear to have run off at a double-digit rate in January. As a result, M1 growth is estimated to have slowed considerably in January--to about a 10 percent rate. Growth of other checkable deposits in January is

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

		1986					1987	Levels in bil. of dollars
		Q2	Q3	Q4	Nov.	Dec.	Jan.p	December
		Commercial Bank Credit						
1.	Total loans and securities at banks	3.9	13.5	9.6	8.9	17.6	21	2079.0
2.	Securities	4.9	31.9	6.3	7.9	7.7	-1	502.8
3.	U.S. government securities	7.9	28.4	20.5	20.8	18.1	14	309.4
4.	Other securities	0.7	37.3	-14.5	-11.6	-8.6	-26	193.4
5.	Total loans	3.6	7.8	10.6	9.2	20.7	28	1576.2
6.	Business loans	2.0	2.8	19.4	14.5	38.5	34	537.0
7.	Security loans	-62.7	17.9	-64.0	18.2	-83.8	6	37.3
8.	Real estate loans	13.3	13.6	17.0	14.8	24.4	33	486.3
9.	Consumer loans	6.7	5.6	5.6	5.0	7.7	8	313.1
10.	Other loans	-1.6	9.2	-2.0	-12.4	6.5	36	202.5
		Short- and Intermediate-Term Business Credit						
11.	Business loans net of bankers acceptances	1.0	2.7	19.9	14.9	39.6	34	532.1
12.	Loans at foreign branches[2]	-21.5	9.1	-28.9	0.0	-61.4	-86	16.7
13.	Sum of lines 11 & 12	0.2	2.9	18.2	14.4	36.3	31	548.8
14.	Commercial paper issued by nonfinancial firms[3]	-10.3	10.6	-7.0	-4.1	-40.0	-43	84.0
15.	Sums of lines 13 & 14	-1.3	4.0	14.7	11.7	25.6	21	632.8
16.	Bankers acceptances: U.S. trade related[4,5]	16.3	3.6	-27.7	-36.1	-37.3	n.a.	31.2
17.	Line 15 plus bankers acceptances: U.S. trade related	-0.3	3.9	12.5	9.3	22.5	n.a.	664.0 (Nov)
18.	Finance company loans to business[4]	3.8	-2.5	n.a.	24.4	n.a.	n.a.	160.7 (Nov)
19.	Total short- and intermediate-term business credit (sum of lines 17 & 18)	0.5	2.6	n.a.	12.2	n.a.	n.a.	812.5 (Nov)

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.

estimated to have approached 40 percent, however, as opportunity costs of holding assets in th s form remained historically low.

Period	Opportunity cost of NOW accounts[1]
	- -basis points- -
Annual averages:	
1984	276
1985	163
1986	78
Monthly:	
1986-December	82
1987-January	67[e]

e—estimated using weekly data in the Bank Rate Monitor.
1. Opportunity cost is defined as the difference between the 3-month Treasury bill rate and the NOW account rate at commercial banks. NOW account rates through 1985 are super NOW rates adjusted for comparability with reported rates on all NOW accounts after removal in January 1986 of ceilings on rate; for regular NOW accounts.

The recent pattern of M2 growth has been dominated by the swing in M1 and, despite some strengthening in the nontransactions component, M2 growth slowed to about an 8 percent annual rate in January. The shift toward more liquid retail deposits continued in recent months, although the runoff in small time deposits is estimated to have slowed to about a 2 percent pace in January. M3 growth increased to over 9 percent in December: both its M2 and non-M2 components grew more rapidly. M3 growth in January is estimated at near December's pace, with commercial banks increasing sharply their issuance of large CDs.

Bank credit increased markedly in December and January. Much of the acceleration was attributable to business lending, which surged to nearly a 40 percent annual rate in December and 34 percent in January at U.S. banking offices. Most of the business loan growth in both months was concentrated

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

	1985	1986	1986		1986		1987
	Year	Year[p]	Q3	Q4[p]	Nov.[p]	Dec.[p]	Jan.[e]
Corporate securities - total[1]	16.09	28.35	23.85	31.02	32.90	28.05	25.40
Public offerings in U.S.	12.93	24.65	20.48	28.03	29.83	25.75	24.25
Stocks--total[2]	2.96	5.06	4.45	5.61	6.23	5.50	3.20
Nonfinancial	1.61	2.56	2.05	3.15	3.14	3.50	.90
Utility	.37	.59	.48	.63	.30	.60	.30
Industrial	1.24	1.97	1.57	2.52	2.84	2.90	.60
Financial	1.35	2.50	2.40	2.46	3.09	2.00	2.30
Bonds--total[1]	9.97	19.59	16.03	22.42	23.60	20.25	21.25
Nonfinancial	5.21	9.63	8.23	8.03	8.31	8.65	6.30
Utility	1.51	3.60	3.14	3.67	3.75	3.30	1.45
Industrial	3.70	6.03	5.09	4.36	4.56	5.35	4.85
Financial	4.76	9.96	7.80	14.39	15.29	11.60	14.95
By quality[3]							
Aaa and Aa	2.35	5.70	3.82	7.19	6.97	5.96	5.55
A and Baa	4.58	6.03	5.15	5.16	4.54	5.95	7.25
Less than Baa	1.42	3.41	3.29	2.93	3.88	2.88	1.05
No rating (or unknown)	.34	.34	.19	.52	.73	.61	.55
Memo items:							
Equity-based bonds[4]	.70	.86	.70	.30	.20	.21	.60
Mortgage-backed bonds	1.28	4.11	3.58	6.62	7.48	4.85	6.85
Variable-rate notes	.88	1.29	.72	3.48	4.77	3.83	2.68
Bonds sold abroad - total	3.15	3.55	3.28	2.72	2.80	2.02	.90
Nonfinancial	1.26	1.50	.93	.95	.92	.71	.55
Financial	1.89	2.05	2.35	1.77	1.88	1.31	.35
Stocks sold abroad - total	.01	.15	.09	.27	.27	.28	.05
Nonfinancial	.01	.09	.07	.22	.27	.25	.05
Financial	.00	.06	.02	.05	.00	.03	.00

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

at large banks and at U.S. branches and agencies of foreign banks, although small banks also increased their lending to businesses. Business borrowing at foreign branches of U.S. banks declined in December, partly because of the shifting of loans from foreign to domestic offices of U.S. banks, as businesses found prime-based credit options (which tend to be booked domestically) to be preferable when LIBOR jumped near year-end. Prime-based loans also looked attractive, temporarily, given the runup in commercial paper rates, and nonfinancial commercial paper outstanding declined.

Real estate lending also increased rapidly in December and January, perhaps owing to stepped-up real estate closings towards year-end and to increased use of home equity lines of credit that serve as a substitute for consumer loans. Results of the January Senior Loan Officer Survey suggest strong growth of home equity lending late last year, and no districts reported any weakening in growth so far this year. Paying down consumer debt was cited as an important use of recent home equity loans, although the majority of this type of debt outstanding has been taken on to finance purchases or improvements in real estate or purchases of other big ticket items. Banks again added to their holdings of U.S. government securities in both December and January, albeit at a slower pace than in the previous two months, and they continued to reduce their holdings of other securities.

Corporate Finance

Debt of nonfinancial businesses increased at a strong pace in December, with the bulk of the rise in shorter-term liabilities. Combined bank loans and commercial paper outstanding grew at a 26 percent clip in the final month of 1986. In January, short-term borrowing by nonfinancial businesses appears to have moderated, the arithmetic of monthly averaging obscuring to

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

	86 Q4	87 Q1^e	1986 Dec.	1987 Jan.^e	1987 Feb.^e
Treasury financing					
Combined surplus/deficit(-)	-64.4	-53.2	-12.1	2.1	-26.9
Means of financing deficit:					
Net cash borrowing from the public	69.2	31.2	22.8	4.4	13.2
Marketable borrowings/ repayments(-)	54.5	28.2	17.1	3.8	12.0
Bills	15.9	-8.3	2.9	-3.5	-4.1
Coupons	38.6	36.5	14.2	7.3	16.1
Nonmarketable	14.7	3.0	5.7	.6	1.2
Decrease in the cash balance	.5	19.2	-13.9	-10.4	16.9
Memo: Cash balance at end of period	30.9	11.7	30.9	41.3	24.4
Other[2]	-5.3	2.8	3.2	3.9	-3.2
Federally sponsored credit agencies, net cash borrowing[3]	4.7	1.2	2.4	-.3	.6
FHLBs	1.7	2.7	1.9	1.5	.6
FNMA	1.9	-1.0	.1	-.3	-.4
Farm Credit Banks	-1.2	-2.5	-.4	-1.9	-.3
FHLMC	.7	.5	.1	.1	.2
SLMA	1.6	1.5	.7	.3	.5

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

some extent the weakening in bank lending and exaggerating the decline in commercial paper outstanding. Longer-term financing by nonfinancial corporations increased a bit in December: gross issuance of bonds was slightly above its fourth-quarter pace. In January, bond financing slackened, with a dearth of new low-rated issues accounting for the drop-off.

Some of the fourth-quarter momentum behind business borrowing was attributable to a pickup in share retirements, as the timing of mergers and other corporate restructurings was geared to beat the impending effective date for changes in the tax law. At a more fundamental level, capital outlays of nonfinancial corporations may have grown faster than internally generated funds in the fourth quarter, producing a small financing gap.

The volume of new issues of corporate equities was heavy in December and for the fourth quarter as a whole. Offerings tapered off in the past month, however, even though share prices skyrocketed. The market value of common stocks has risen more than $300 billion so far this year--exceeding the market appreciation for all of 1986. The Dow Jones Industrial Average has surpassed its 1986 high by 11 percent, and most other market indexes also have posted record highs. Mutual fund managers report that the market rally has attracted strong inflows into equity funds, but most also note that they have detected little switching out of bond funds.

Treasury and Sponsored Agency Financing

The combined deficit of the federal government is expected to total $53 billion in the first quarter of calendar 1987; this estimate is subject to unusual uncertainty, however, owing to changes in receipts arising from the Tax Reform Act. Retroactive repeal of the investment tax credit is expected to boost this quarter's tax receipts by $8 to $13 billion, in the final installment of corporate taxes for 1986 to be paid on March 15. Tax receipts were augmented also in January by heavy final quarterly estimated personal tax payments, which were due by January 15; the pickup in payments probably reflected estimated taxes on increased long-term capital gains realizations prior to the December 31 deadline for preferential treatment.

The Treasury is expected to cover the bulk of this quarter's deficit by borrowing $31 billion, net, from the public and running down its high cash balance. In marked contrast to the last two quarters when bill auctions raised a substantial portion of the new cash, marketable coupon issues will more than account for the funds raised in the current period. The Treasury is expected to pay down, on net, about $8 billion of bills.

Issuance of nonmarketable debt also is likely to shrink dramatically this quarter--perhaps bringing in only $3 billion of new cash, compared with nearly $15 billion in the fourth quarter. This falloff in issuance can be attributed to lessened demand for Treasury savings bonds, now that the guaranteed minimum rate paid has been reduced from 7-1/2 to 6 percent, and to a moderating in the Treasury's issuance of special state and local government issues.

Borrowing by the federally sponsored credit agencies is expected to total a bit more than $1 billion in the first quarter, well below the volume in preceding quarters. The Federal Home Loan Banks borrowed heavily in December, as the demand of thrift institutions for advances was unusually strong around the end of the year when market yields soared. So far in 1987, however, thrifts have started to repay advances and credit needs of the FHLBs likely will shrink in the current quarter. Borrowing by Fannie

Mae also picked up in the fourth quarter, when funding requirements were enlarged by a slowing in both mortgage prepayments and sales of loans from its portfolio. Fannie Mae probably will pay down debt in the first quarter, because its purchases of mortgages are expected to diminish, as competing CMO sales grow, and because some part of this year's funding needs appear to have been met in advance through borrowing late last year. The Farm Credit Banks paid down a large volume of outstanding debt in January, reflecting weak demand on the banks for longer-term funds. Further paydowns also are expected this quarter.[1]

Tax-Exempt Securities Market

Gross offerings of tax-exempt bonds trended up after passage of tax reform early in the fourth quarter, with a sizable volume of private-purpose bonds for housing and industrial development being brought to market. Earlier, the tax status of private-purpose debt under the various tax reform proposals had been uncertain. When these uncertainties were removed, issuers sought to market bonds prior to year-end so they could be included under 1986 volume caps. In January, private-purpose issuance dropped appreciably; overall tax-exempt volume was buoyed to an extent, however, by a continued large issuance of refunding bonds attracted by some of the lowest rates on municipal bonds since 1979.

Taxable municipal bond issuance has remained very light this year. The market in these bonds has yet to shake off the questions raised last fall about aggressive arbitrage transactions and the key role of one major insurance company that was able to offer issuers high-yield guaranteed investment contracts because it invested heavily in low-grade corporate bonds.

1. A discussion of developments in agricultural finance is included in the appendix.

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

Period	Total	GNMAs	FHLMCs	FNMAs	Memo: FNMA and FHLMC swap issues
1985-Q3	10.4	4.1	3.8	2.5	4.7
Q4	11.8	5.2	3.9	2.7	4.9
1986-Q1	12.6	5.1	4.4	3.1	5.3
Q2	19.2	7.0	7.5	4.7	8.5
Q3	27.3	9.7	10.4	6.8	10.9
Q4 p	29.5	10.7	13.2	5.5	10.5
1986-July	24.4	10.2	8.1	6.1	9.8
Aug.	24.0	6.8	10.1	7.1	10.5
Sept.	33.3	12.9	13.1	7.4	12.3
Oct.	27.2	10.2	11.4	5.5	10.9
Nov.	29.6	9.6	14.3	5.6	8.7
Dec. p	31.6	12.1	14.0	5.5	12.0

p--preliminary.

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

	Mortgage transactions		Net change in mortgage assets[1]		
	Originations (1)	Sales (2)	Total (3)	Mortgage loans (4)	Mortgage-backed securities (5)
1985-Nov.	18.6	13.1	3.4	3.1	.2
Dec.	20.2	8.3	5.5	4.4	1.1
1986-Jan.	18.4	11.1	5.1	3.2	1.9
Feb.	17.7	10.9	2.8	2.3	.5
Mar.	16.4	12.6	4.2	3.3	.9
Apr. r	19.3	13.2	6.1	1.0	5.1
May r	20.2	14.0	8.2	1.3	6.9
June r	21.9	12.0	4.6	-.7	5.3
July r	23.7	16.0	2.7	1.4	1.3
Aug. r	23.0	17.4	2.0	1.8	.2
Sept. r	23.6	21.5	5.2	-2.2	7.5
Oct. r	26.2	17.7	7.8	2.8	5.0
Nov. r	23.3	17.8	4.9	1.1	3.8
Dec. p	30.0	10.9	4.2	1.8	2.4

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

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

	1985	1986p	1986		1986			1987
	Year	Year	Q3	Q4e	Oct.	Nov.	Dec.e	Jan.e
Total tax-exempt	19.82	12.77	18.94	11.35	9.37	11.00	13.67	9.00
Short-term[1]	1.97	1.64	2.16	.68	.55	.92	.58	.50
Long-term	17.85	11.13	16.78	10.67	8.82	10.09	13.09	8.50
Refundings[2]	4.85	4.55	5.60	5.18	5.04	6.00	4.50	n.a.
New capital	13.00	6.58	11.18	5.49	3.71	4.09	8.59	n.a.
Total housing	2.11	.57	.44	1.39	.52	1.14	2.51	n.a.
Total taxable	.03	.32	.57	.35	.86	.07	.09	n.a.

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

Rates on revenue and general obligation bonds have fallen more than 30 basis points since the December FOMC meeting, compared with small increases in yields on Treasury bonds. Demand for tax-exempt bonds by property and casualty insurance companies, bond funds, and bank trust departments reportedly has been strong, and rates began to move down early in 1987 as new supplies shrank.

Mortgage Markets

Interest rates in primary and secondary home mortgage markets have declined further since the last FOMC meeting. For conventional fixed-rate loans, the contract interest rate on new commitments offered by S&Ls has recently averaged 9.12 percent, down 18 basis points from its level in mid-December and almost 2 percentage points below its level of a year ago. Similarly, rates on FNMA commitments to purchase fixed-rate conventional mortgages have declined nearly 30 basis points over the intermeeting period. The declines prompted the Veterans Administration to cut its maximum rate on VA-guaranteed loans from 9 percent to 8-1/2 percent, as of January 19.

DECEMBER ESTIMATES CONFIDENTIAL UNTIL
RELEASED ON FEBRUARY 6

CONSUMER INSTALLMENT CREDIT
(Seasonally adjusted)

	Percent change (at annual rate)						Net change (billions of dollars)		Memo: Outstandings (billions of dollars)
			1986		1986		1986		1986
	1985	1986p	Q3	Q4p	Nov.r	Dec.p	Nov.r	Dec.p	Dec.p
Total[1]	18.0	11.2	11.8	7.4	6.7	.7	3.28	.35	595.2
Selected types									
Auto	19.3	17.2	24.6	9.7	2.7	4.5	.55	.90	242.0
Revolving	20.1	8.1	4.1	6.0	15.0	-1.8	1.58	-.19	127.9
All other	15.6	7.1	3.4	5.8	6.2	-1.9	1.16	-.36	225.3
Selected holders									
Commercial banks	15.1	7.1	5.7	7.2	13.5	-3.6	2.87	-.78	257.9
Finance companies	24.9	21.0	28.5	2.3	-5.3	-6.9	-.64	-.84	145.4
Credit unions	12.9	11.8	11.5	11.1	8.8	12.9	.60	.89	84.0
Savings institutions[2]	37.8	14.6	6.5	15.1	8.0	15.5	.42	.81	63.6

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				
	1985	1986	Aug.	Sept.	Oct.	Nov.	Dec.
At commercial banks[1]							
New cars (48 mo.)	12.91	11.33	11.00	...	...	10.58	...
Personal (24 mo.)	15.94	14.83	14.70	...	...	14.19	...
Credit cards	18.69	18.26	18.16	...	...	18.09	...
At auto finance cos.[2]							
New cars	11.98	9.44	9.29	5.40	6.12	11.83	11.71
Used cars	17.59	15.95	15.56	15.23	15.17	15.20	15.12

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.

Reflecting the reduced cost of home mortgage credit and the incentive under tax reform to sell appreciated real estate before the end of 1986, the pace of mortgage lending was brisk late last year. Preliminary data for the fourth quarter indicate that growth of outstanding residential mortgage debt jumped to about a 16 percent annual rate. Mortgage originations at FSLIC-insured thrifts totaled $30 billion in December, easily eclipsing October's record. Despite the heavy volume, thrift holdings of mortgage assets rose only $4 billion in December--somewhat less than the average monthly increase in 1986--as FSLIC-insured thrift institutions disposed of many of these fixed-rate originations through sales in the secondary market. Mortgage-backed securities continued to be the dominant channel for housing finance. Offerings of federally related pass-throughs totaled nearly $32 billion during December, bringing the fourth-quarter volume to a record $88-1/2 billion.

Consumer Installment Credit

Consumer installment credit expanded in December at less than a 1 percent annual rate, down from 6-3/4 percent in November and substantially below the pace in the preceding two months. (Figures confidential until released February 6.) The earlier strength reflected effects of auto sales incentive programs, which ballooned auto credit extensions. Growth of nonauto credit, although jumping in November, generally trended down in 1986--especially the growth in revolving credit (primarily credit card debt). Revolving credit contracted at about a 2 percent rate in December, compared with annualized growth rates of 20 percent in 1985. It seems likely that increasing utilization of home equity credit lines has cut into the growth of credit card debt, which typically carries much higher interest charges that no longer are fully tax-deductible. Many institutions are offering home equity lines with initial interest rates of 5 to 7 percent, which generally revert after a few months to variable rates indexed 1 to 2 percentage points above prime. Other lenders are waiving or sharply reducing closing costs that might otherwise amount to $500 or more.

While few data are available on the amount of borrowing under home equity lines or the uses to which the funds are put, industry observers place the total volume of such credit outstanding at about $40 billion, as much as $20 billion (net) of which may have been added during 1986. Lenders indicate a diversity of uses for home equity credit lines. In the January Senior Loan Officer Opinion Survey, respondents estimated that about 36 percent of the outstanding borrowing under home equity lines had gone to finance purchases or improvements of real estate and 28 percent had been used to retire other debts. The survey also indicated that 9 out of 10 banks plan to step up promotional efforts this year.

APPENDIX*

RECENT DEVELOPMENTS IN AGRICULTURAL FINANCE

The Farm Credit System

On January 15, the Farm Credit System (FCS) issued a press release indicating that its independent auditor likely will give a qualified opinion of the combined financial accounts of the FCS for 1986. Price Waterhouse's concern is that, in light of recent losses and the absence of clear evidence of a return to profitability in the near future, the system may not be able to continue obtaining adequate financing in the markets unless stronger assurance of federal assistance is forthcoming. The press release also updated previous public statements by FCS on litigation involving system institutions and their regulator, the Farm Credit Administration (FCA).

The system's 1986 financial report will be issued this month and probably will show a loss for the full year in excess of $2 billion, if FCA projections of last fall prove to be correct. Over the first three quarters of the year, the system lost $1.5 billion, the bulk of which represented provisions for loan losses. There appears to be little chance for substantial improvement in 1987, as the system faces a growing volume of nonperforming loans and a flight of high quality borrowers at a time when its average cost of funds remains well above market. Non-accrual loans reached almost 13 percent of total loans at the end of the third quarter, and other high risk loans accounted for another 7 percent. Total capital of the FCS has declined. At the end of the third quarter, $1.9 billion in accumulated surplus remained; it, along with $3.6 billion of loan loss reserves, is available to offset losses--and must be used before the system can seek federal assistance under the provisions of the 1985 amendments to the Farm Credit Act.

The remaining capital surplus is very unevenly distributed among system units. In the past, weaker institutions have been shored up by transfers of capital from stronger units, but resistance to further transfers is growing. During the third quarter, six Federal Land Banks needed capital assistance totalling $415 million to prevent capital impairment--that is, net worth dropping below the book value of capital shares that borrowers own. At the urging of stronger units, a system agreement to provide this assistance requires that the assistance be reversed or cancelled when regulatory accounting practices (RAP) are implemented under authority granted in the 1986 amendments to the Farm Credit Act. However, exercising its regulatory authority, the FCA has ruled that the assistance cannot be reversed.

*The section on the Farm Credit System was prepared by Gary Gillum, Economist, Banking Section, Division of Research and Statistics. The section on the new farm bankruptcy chapter was prepared by Emil Melichar, Senior Economist, Economic Activity Section, Division of Research and Statistics.

Regulations that temporarily govern the use of RAP are now in place. Institutions will be permitted to utilize RAP in reporting financial results for the fourth quarter of 1986, if using generally accepted accounting principles would result in capital impairment. By capitalizing unusually large loan losses and certain excess interest costs and amortizing them over a period of up to 20 years, all units of the FCS apparently will be able to avoid capital impairment on a regulatory basis at the end of 1986. However, the use of RAP will not obviate the need by weaker units of the system for further financial assistance in 1987 if they are to maintain adequate collateral behind their debt, as required by the Farm Credit Act, and to remain viable institutions.

Despite the need for further financial assistance for the weaker units of the system, stronger units have undertaken a number of legal legal challenges to both the constitutionality of capital transfers and the regulations established by the FCA for carrying out these transfers. Most of these challenges have been unsuccessful, but one permanent and two temporary injunctions have been issued barring capital transfers from certain FCS units. The permanent injunction is being appealed, and FCA has taken the position that the injunctions apply only to the specific transfers being challenged. However, the process of providing capital assistance effectively has been stymied.

Market reaction to the press release has been muted, with spreads between the interest rates on outstanding FCS debt and comparable Treasuries widening by a few basis points but only for a day or two. Since then, new three- and six-month debt was issued on February 2. Although the interest rates received gave no evidence of lessened market acceptance, the system's dealers did indicate that a stronger than usual sales effort was required, despite a substantial paydown of maturing debt. On balance, it appears that the system's market access has been little affected by the recent FCS statement, presumably reflecting market assumptions that federal assistance will be forthcoming on a timely basis.

New farm bankruptcy chapter and farm lending experience at commercial banks

Late last year, Congress provided a new reorganization option for financially distressed family farms. Chapter 12 of the bankruptcy code became effective November 26, 1986, and expires on October 1, 1993. Attorneys have described the new Chapter 12 as combining elements of the streamlined procedures of Chapter 13 and the more complex reorganization procedures of Chapter 11, while recognizing some unique aspects of farming. In general, a family farmer who owes less than $1.5 million can file for Chapter 12 bankruptcy, and then must submit a reorganization plan within 90 days. Under the plan, secured debt may be written down to the current market value of the collateral, while creditors may receive all of the debtor's projected disposable income over the next three years (or for up to five years if approved by the court "for cause"). Unsecured creditors cannot block the plan, but must receive at least as much as they would have received in a Chapter 7 liquidation.

The new chapter and the mandatory arbitration law recently passed in Minnesota are legislative responses to widespread public perception of and concern about "unfair" treatment of financially-distressed farmers, in the following sense: A lender forecloses on a farmer whose debt far exceeds the value of the property, and then sells the property at its current market value, recovering only that proportion of the debt. The foreclosed farmer then states that if the lender had reduced his debt to the same level, he could have handled the payments and the loss of the family farm and home would have been avoided. Adverse reactions were heightened when, as is customary in lender sales of foreclosed nonfarm properties, favorable financing was offered to the new buyers. Many lenders have shared these concerns and have been negotiating debt restructuring with distressed farm borrowers. The new legislation formalizes one model of this process and permits borrowers to force some reluctant lenders into it.

Debtors filing Chapter 12 bankruptcy will incur substantial costs in the form of legal fees and the trustee's fee--in addition to reasonable expenses, the trustee may receive up to 10 percent of the first $450,000 of payments made under the plan, and up to 3 percent of the remainder. Management flexibility is reduced during the plan period, and some debtors may experience unfavorable income tax consequences. Thus it is thought that debtors will use the threat of Chapter 12 to encourage lenders to negotiate restructuring of debt, while both sides try to avoid an actual filing.

Lenders generally believe that Chapter 12 outcomes will be disadvantageous; however, if the property and income are fairly valued, the required write-off is a loss that has already occurred as collateral values and the net worth of the borrower have declined. But compared with foreclosure or liquidation, the disadvantage to the lender is that he emerges with a borrower with 100 percent financing while farm asset values are still trending downward. And, compared with private negotiation, the amount of debt cancelled may be greater; for example, one debt restructuring plan that has received favorable comment from farm organizations calls for debt service to be reduced to a manageable level but for all debt to be repaid eventually.

While the Chapter 12 provisions limit the flexibility lenders may have, it may be questioned whether the consequences for farm loan availability will be as adverse as some have suggested. Chapter 12 changes somewhat the cost, relative amount, and timing of recovery of bad loans. But this is not likely to be the major factor considered by most lenders contemplating entry into or exit from farm lending, farm loans to new or financially secure customers, or additional advances to borrowers already in distress.

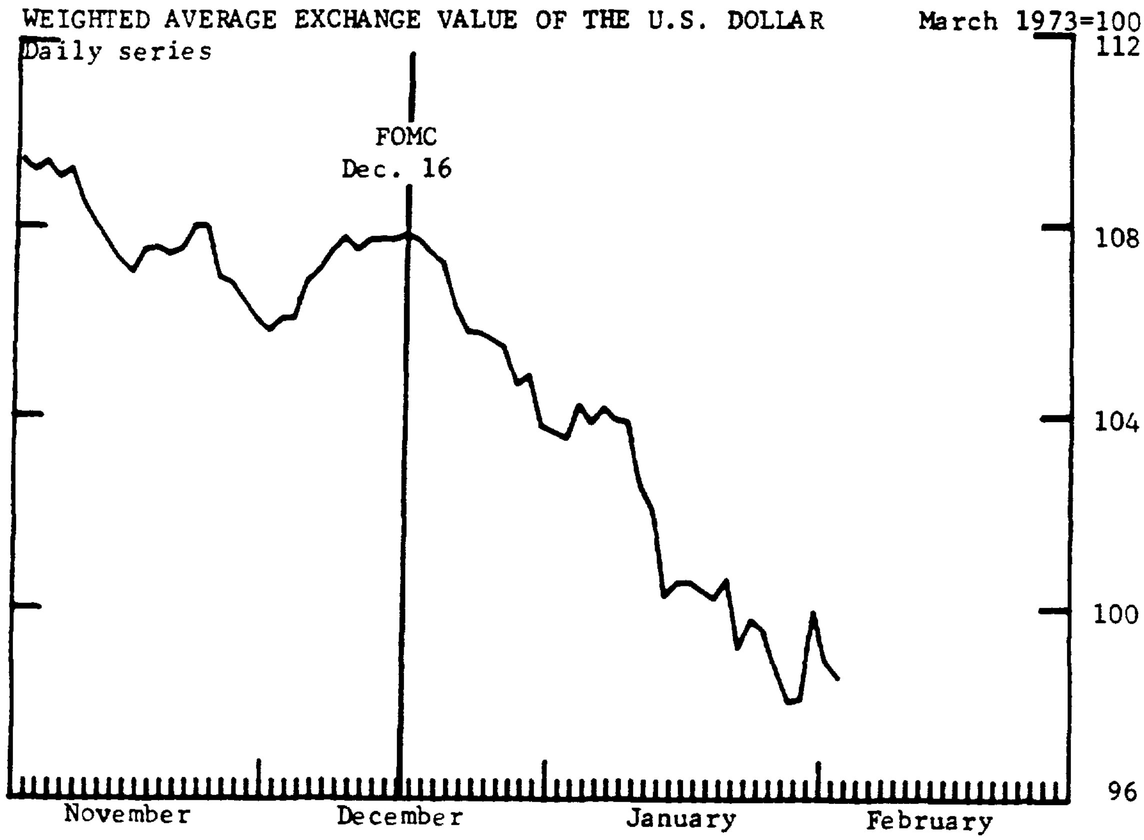
Similarly, Chapter 12 seems unlikely to be a major influence on bank experience with farm loans or on the fortunes of agricultural banks. In this connection, it is relevant that total farm debt already has been reduced by about $30 billion since its recent peak, of which about $7 billion occurred at commercial banks. Much of this reduction consisted of troubled debt. Recent banking data indicate that the amount of delinquent farm loans at banks may have peaked in 1986; for instance, all farm production loans that were nonperforming or past due 30 days or more on September 30, 1986, totaled $3.1 billion, down from $3.5 billion a year earlier. At agricultural banks, the proportion of total loans that were in nonaccrual status, which had risen in nearly every quarter from 0.8 percent in December 1982 to 3.3 percent in March 1986, fell to 3.0 percent by September. Consequently, the number of vulnerable agricultural banks (banks at which nonperforming loans exceeded total capital) has increased little over the past year, and the relative importance of farm loans among total loans at the nation's vulnerable banks has declined to 6 percent, compared with 15 percent a year earlier and a peak ratio of 19 percent in March 1985.

Foreign Exchange Markets

The weighted-average foreign exchange value of the dollar has declined about 8 percent, on balance, against the currencies of the other G-10 countries, since the December FOMC meeting. The dollar first fell sharply as a much larger-than-expected preliminary estimate of the November trade deficit and subsequent statements by U.S. officials prompted concern in the market that the dollar would have to go lower to produce the necessary adjustment in U.S. external accounts.

. Although the decline in the dollar's value in late December was associated in part with a firming of German interest rates, the dollar apparently has derived little benefit as those rates have moved back down with the reduction in the German discount rate on January 23. The dollar firmed strongly toward the end of the intermeeting period following the release of substantially better-than-expected preliminary figures on U.S. merchandise trade for December and a downward revised estimate of the November deficit, but subsequently those gains were partially eroded. Since the last FOMC meeting, the dollar has declined by 10 percent against the mark, 7 percent against the yen, and 3-3/4 percent against the Canadian dollar.

Chart 1



3-MONTH INTEREST RATES IN SELECTED COUNTRIES

Week ended:	U.S. CD's	Japan	Germany	France	Nether-lands	Canada
1986						
Dec. 17	5.99	4.39	4.82	7.91	6.00	8.33
Dec. 24	6.24	4.40	4.76	7.98	6.25	8.37
Dec. 31	6.27	4.40	4.95	8.31	6.17	8.38
1987						
Jan. 7	5.95	4.37	4.75	8.77	5.95	8.31
Jan. 14	5.85	4.33	4.64	8.49	5.70	8.16
Jan. 21	5.83	4.31	4.40	8.33	5.46	7.97
Jan. 28	5.85	4.07	4.25	8.43	5.36	7.62
Feb. 4	5.94	4.00	3.98	8.50	5.30	7.44

. The Desk intervened for the U.S. account on one occasion, purchasing $50 million against yen at about 150.50 yen/dollar, split 50/50 between the Federal Reserve and Treasury.

;

the Canadian dollar has benefited from an improved fiscal outlook and the recent firming in the dollar price of some commodities.

The dollar's sharp decline against the mark and the rise in German interest rates at year-end led to strains within the European Monetary System.

. A realignment of parities within the European monetary grid was announced on January 11; the German mark and Dutch guilder were revalued by 3 percent and the Belgian franc was revalued by 2 percent against all other currencies in the EMS. At the same time, suggestions were made concerning future reductions in German interest rates. Reflows into the weaker EMS currencies, which typically have followed a realignment, have been light, apparently reflecting some doubts by market participants that these adjustments will prove to be adequate.

The Bundesbank lowered its discount and Lombard rates 1/2 percentage point each to 3 and 5 percent, respectively, effective January 23; these measures were part of a package in which it also raised reserve requirements by 10 percent and reduced discount quotas by DM 8 billion, effective February 2. The latter measures evidently were intended to sterilize some of the capital inflows of marks not reversed after the EMS realignment. However, Bundesbank President Poehl indicated that these moves provided German authorities more latitude to support the dollar. All in all, it appears that the Bundesbank intends to guide market rates lower; the latest repurchase agreement was offered at a fixed rate of 3.8 percent, well below the 4.6 percent average rate for funds allocated in the last tender.

Interest rate developments for individual countries during the intermeeting period are summarized in the table in the lower panel. Short-term interest rates in Germany moved down about 80 basis points after a run-up at year-end, while comparable rates in Japan declined about 40 basis points. Short-term rates in most EMS countries firmed prior to the realignment on January 11; since then, interest rates in many of these countries have eased somewhat. In Canada, short-term interest rates fell 90 basis points. In contrast, rates on 90-day U.S. CDs were about unchanged, on balance.

Bank lending to foreigners in the third quarter of 1986. U.S.-chartered banks' claims on foreigners were virtually unchanged in the third quarter of last year. However, after adjustment for a rise of 5 percent in the weighted average dollar during the quarter, claims appear to have increased about $7 billion (1.7 percent). This was the first quarterly increase on an exchange-rate-adjusted basis since 1984-QII. In the interim, adjusted claims declined an estimated $13 billion in the first half of 1986 and $29 billion in 1985.

Changes in claims on country groups in the third quarter, on an unadjusted basis, showed small declines in every case except for an increase in claims on offshore banking centers. However, claims on G-10 countries can be assumed to have risen on an adjusted basis, because this group includes most of the banks' foreign-currency-denominated claims, and thus is the location for most of the upward adjustment for exchange rate changes. Claims on the non-OPEC developing countries presumably declined almost the same amount on an adjusted basis as is shown by the unadjusted figures, since such lending is almost wholly dollar-denominated. As in the two preceding quarters of 1986, there was a small drop in claims on Latin America and a larger decrease in claims on Asia and Africa; these brought the declines for the nine months to $1.1 billion vis-a-vis Latin America and $4.3 billion vis-a-vis Asia and Africa. Of the latter amount, $2.1 billion was a fall in claims on Korea, where a large improvement in the current account has led to net repayments of foreign bank credits.

Third-quarter data for all banks in the BIS quarterly reporting system show a very large rise in total claims on foreigners of

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

	Change (no sign = increase)					Outstanding 9/30/86
	1984	1985	1986			
	Year	Year	Q1	Q2	Q3	
Total, all countries	-28.2	-13.8	2.6	-3.4	0.5	391.4
Non-OPEC developing countries of which:	1.0	-6.8	-1.5	-2.1	-1.8	99.6
(Latin America)	2.1	-3.2	-0.5	-0.4	-0.2	72.3
(Asia and Africa)	-1.1	-3.6	-1.0	-1.7	-1.6	27.3
OPEC countries	-3.5	-3.3	-0.9	-0.1	-0.6	20.0
Eastern Europe	-0.9	-0.2	-0.2	0	-0.7	3.3
Smaller developed countries	-2.4	-3.2	1.2	-1.0	-1.2	29.4
G-10 countries	-19.7	0.4	7.9	3.4	-1.2	158.6
Offshore banking centers	-3.3	-0.2	-3.9	-4.3	5.4	62.6
Miscellaneous	0.5	-0.4	-0.2	0.5	0.6	17.8
Memorandum: Total adjusted for exchange rate changes (staff estimates)	-16	-29	-3	-10	7	391.4

$167 billion on an exchange-rate-adjusted basis. This was almost entirely concentrated in claims on developed countries and offshore banking centers, and mainly consisted of a surge in interbank placements, particularly involving Japanese banks. Factors contributing to the rise in interbank activity included heavy bank purchases of FRNs and other international bonds financed by interbank borrowing, as well as window

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

	Change (no sign = increase)[1]					Outstanding 9/30/86
	1984	1985	1986			
	Year	Year	Q1	Q2	Q3	
Total, all countries	127.7	232.2	27.4	72.4	167.3	3,000
Non-OPEC developing countries of which:	10.4	10.8	-4.7	*/	0.1	360
(Latin America)	5.7	1.6	-2.2	-0.1	-0.8	220
(Asia and Africa)	4.7	9.2	-2.5	*/	1.0	140
OPEC countries	-1.8	0.1	-3.4	0.6	1.7	115
Eastern Europe[2]	0.2	5.8	-1.1	2.7	0.4	81
Developed countries and offshore banking centers	118.8	211.7	35.0	67.3	164.9	2,380
Miscellaneous	0.1	3.8	1.6	1.8	0.2	64

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

dressing by Japanese banks. The BIS banks' claims on non-OPEC developing countries were virtually unchanged in the third quarter, as a small rise in claims on Asian and African countries in this group was approximately offset by a further decrease in claims on Latin American countries, principally Mexico, Chile, Colombia, and Peru. This brought the decline in claims on the Latin American countries in the first three quarters of the year to more than $3 billion; the largest declines have been vis-a-vis Mexico ($1.3 billion), Chile and Colombia ($0.6 billion each), and Peru ($0.5 billion).

U.S. International Financial Transactions

Capital inflows resulting from the growth of official reserve assets in the United States tapered off in October and November of 1986. (See line 4 the Summary Table on U.S. International Transactions.) After rates of accumulation averaging more than $4 billion per month in the second and third quarters of last year, the reserve holdings of the G-10 countries increased only $1.7 billion in October and fell slightly in November. In addition, the reported reserve holdings of OPEC members resumed their decrease in these two months. Partly offsetting these reductions in official capital inflows was the continued reserve accumulation of Taiwan: during October and November, Taiwan is reported to have increased its reserve assets in the United States by almost $1.3 billion, bringing its reserve accumulation in the United States for the first eleven months of 1986 to more than $9.6 billion. For the year through November, total reported reserve accumulation by all foreign countries was over $33 billion. Partial information from the Federal Reserve Bank of New York indicates that December's changes in the official reserve holdings of the G-10 countries, OPEC, and Taiwan continued to follow the patterns set in the first two months of the fourth quarter. Intervention in January, however, should generate some official capital inflows in early 1987.

Net purchases of U.S. Treasury obligations by foreigners other than official reserve holders (line 3) fell in October and November. November's net outflow arose largely from the net sales of $2 billion by nonmonetary international organizations. Reported holdings of Japanese residents were essentially unchanged. For the year through November,

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

	1984 Year	1985 Year	1985 Q4	1986 Q1	1986 Q2	1986 Q3	1986 Sept.	1986 Oct.
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	24.2	1.2	3.4
Securities								
2. Private securities transactions, net	7.7	43.0	21.1	12.9	21.4	17.5	4.3	6.3
a) foreign net purchases (+) of U.S. corporate bonds	13.7	46.0	18.4	12.8	16.0	12.7	4.7	4.2
b) foreign net purchases (+) of U.S. corporate stocks	-0.9	4.8	4.0	6.2	7.0	4.5	1.2	-1.3
c) U.S. net purchases (-) of foreign securities	-5.0	-7.9	-1.4	-6.1	-1.6	0.4	-1.6	3.4
3. Foreign net purchases (+) of U.S. Treasury obligations 1/	23.1	20.4	5.0	7.0	3.8	0.6	3.7	.1
Official Capital								
4. Changes in foreign official reserve assets in U.S. (+ = increase)	2.4	-2.0	-1.5	2.2	14.0	15.0	6.2	1.4
a) By area								
G-10 countries (incl. Switz.)	3.1	-0.4	-3.3	3.9	11.0	14.6	3.9	1.7
OPEC	-5.6	-7.0	-1.0	1.2	-1.9	-2.8	*	-1.2
All other countries	4.9	5.3	2.9	-3.0	5.0	3.1	2.3	.9
b) By type								
U.S. Treasury securities	4.7	-0.9	-2.0	3.3	14.5	12.2	2.2	3.9
Other 2/	-2.3	-1.1	0.5	-1.1	-0.5	2.8	4.0	-2.4
5. Changes in U.S. official reserve assets (+ = decrease)	-3.1	-3.9	-3.1	-0.1	-0.0	0.3	0.2	-0.1
Other transactions (Quarterly data)								
6. U.S. direct investment (-) abroad	-3.9	-18.8	-10.1	-9.9	-8.1	-7.7	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	25.4	17.9	2.4	1.4	4.1	3.4	n.a.	n.a.
8. Other capital flows (+ = inflow) 3/ 4/	6.8	4.5	7.1	0.7	-10.3	-13.2	n.a.	n.a.
9. U.S. current account balance 4/	-106.5	-117.7	-33.7	-34.0	-34.4	-36.3	n.a.	n.a.
10. Statistical discrepancy 4/	27.3	23.0	5.1	10.3	12.4	-3.8	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	-35.7	-37.7	-12.1	-12.8

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

private foreigners generated $9 billion in net capital inflows through transactions in U.S. Treasury obligations.

After record high net purchases of U.S. corporate stocks (line 2b) in the first three quarters of 1986, recorded net inflows attributable to these transactions stopped in the fourth quarter, October showing net sales by foreigners of $1.3 billion and November showing negligible net purchases. Foreign net purchases of U.S. corporate bonds (line 2a) continued in October and November but at a slower pace. Offsetting these reductions in capital inflows in October was a surge in net sales of foreign securities by U.S. residents (line 2c). Included in this $3.4 billion of net inflow was a reported $3 billion in net U.S. sales of foreign securities to residents of Japan. This inflow was not sustained in November, however, as Japanese purchases of foreign securities in the United States dropped to $0.7 billion and U.S. residents returned to being net purchasers of foreign securities in November. For December preliminary data on gross offerings indicate that U.S. corporations' Eurobond offerings were down from the levels of October and November and foreign bond issues in the United States rose to almost $2 billion, suggesting a continuing drop off in the net capital inflows associated with private securities transactions.

Banks reported substantial net inflows in October and November. (See line 1 of the Summary Table of U.S. International Transactions.) The bulk of these inflows seem to have arisen through transactions with banks' own offices in foreign countries. In December banks reported additional capital inflows from their own foreign offices and IBFs. (See line 1 of

International Banking Data Table.) These inflows were concentrated at fo eign-chartered banks at the end of the year and associated with high end-of-year net federal funds lending by foreign-based banks, as well as substantial increases in C&I loans.

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1982	1983	1984	1985	1986				
	Dec.	Dec.	Dec.	Dec.	Mar.	June	Sept.	Nov.	Dec.
1. Net Claims of U.S. Banking Offices (excluding IBFs) on Own Foreign Offices and IBFs 1/	49.1	44.5	33.2	29.0	22.0	26.8	27.4	24.9	22.2
(a) U.S.-chartered banks	40.0	40.5	32.1	32.4	27.1	31.1	29.9	29.5	31.8
(b) Foreign-chartered banks	9.1	4.0	1.1	-3.4	-5.1	-4.3	-2.5	-4.6	-9.5
2. 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	18.1	16.8
3. Eurodollar Holdings of U.S. Nonbank Residents 2/	112.6	124.3	117.6	112.1	118.5	119.4	119.5	120.7	124.2

1. Net claims of U.S. banking offices on their own international banking facilities (IBFs) correspond to net claims of IBFs on all foreign residents, including all banks whether related or not, and all nonbanks.
2. Includes term and overnight Eurodollars held by money market mutual funds.
*/ Less than 50 million (±).
Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactions accounts. Line 1 is an average of daily data reported to the Federal Reserve by U.S. banking offices. Line 2 is an average of daily data. Line 3 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

On January 30, the Commerce Department released preliminary trade figures for December suggesting a deficit of $10 billion ($128 billion at an annual rate). This was only half the size of the deficit initially reported for the month of November. Revised estimates for November indicated a substantially smaller deficit, as shown in the table below.

COMMERCE DEPARTMENT DATA, CIF, VALUE, NSA, BIL $, AR

	Unrevised			Revised		
	Exports	Imports (CIF)	Balance (CIF)	Exports	Imports (CIF)	Balance (CIF)
	(1)	(2)	(3)	(4)	(5)	(6)
Oct.	232	377	-145	235	411	-176
Nov.	223	454	-231	221	406	-185
Dec.	221	349	-128	n.a.	n.a.	n.a.

With the caveat that the December data are still subject to large revisions, the staff estimates that when all the data are revised, are seasonally adjusted, and are put on a balance-of-payments basis, the trade deficit in the fourth quarter will be about $157 billion (column 7 in the table on the next page), slightly larger than in the third quarter.

Exports are estimated to have increased by about 4 percent in the fourth quarter. About one-third of the rise was in agricultural products, primarily soybeans to Japan (Brazil, an important source for Japan, has a drought-induced shortage). The remaining increase was fairly widespread -- in machinery (particularly computers), industrial

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
1986*	221	27	195	371	34	337	-150	-170
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	221	25	196	363	31	332	-143	-162
3	221	26	195	372	32	340	-151	-176
4*	230	29	201	387	33	354	-157	-168

*/ BOP data for 1986-Q4 are FR staff estimates based on preliminary figures that are subject to large revisions.

supplies, automotive products, and consumer goods. During 1986, the volume of nonagricultural exports is estimated to have risen 13 percent (Q4/Q4); this compares with a less than one percent rise in volume during the previous year. Increasing price competitiveness of U.S. products arising from the decline in the dollar likely contributed to this rise in export volume.

Nonoil imports increased by an estimated 4 percent in the fourth quarter, with about one-third of the rise attributable to higher prices. The increase in volume appears to have occurred almost entirely in consumer goods and gold. The strength of U.S. consumption during the past several quarters supported part of the rise in volume. The acceleration of imports in the fourth quarter may also have been caused by increased trade tensions between the United States and several large trading partners, which could result in the imposition of various trade restrictions. Anticipation of other measures, such as the Customs Service users' fee, may have also have resulted in a temporary surge in imports.

The value of oil imports in the fourth quarter averaged about the same as in the third quarter. A 10 percent decline in volume was offset by an increase in price. From September to December the average price of imported oil rose by an estimated $2 per barrel. Oil prices in spot markets rose sharply following the announcement of the OPEC production agreement, and remained firm through January as OPEC producers limited the amount of their contract sales. The volume of oil imported in the fourth quarter, while averaging less than in the third quarter, appears to include further increases in stocks held in U.S. territories in the Caribbean.

Oil Imports*	Year 1985	Year 1986e	1985 Q4	1986 Q1	1986 Q2	1986 Q3	1986 Q4e
Value (Bil. $, SAAR)	50.53	34.00	56.48	40.06	31.32	31.97	32.70
Price ($/BBL)	26.40	14.80	26.30	21.56	13.17	11.42	13.03
Volume (mbd, SA)	5.24	6.54	5.88	5.09	6.52	7.67	6.90

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

Developments in Foreign Industrial Countries

Industrial production in the major foreign industrial countries was sluggish toward the end of last year. In Japan, despite a strong increase in IP in December, the fourth-quarter average was 1 percent below the third quarter and 1 percent below a year earlier. In Germany, fourth-quarter production was also below the third quarter and only 1 percent above a year earlier. In most other foreign industrial countries, production in October-November either stagnated or advanced only moderately.

Inflation abroad has generally remained at low levels and 1986 fourth-quarter-to-fourth-quarter rates were significantly lower than in the preceding year. Consumer prices fell in Germany and were virtually unchanged in Japan over the year. The other West European countries roughly halved their inflation rates in 1986.

Both Japan's and Germany's current account surpluses measured in U.S. dollars have continued at record rates.

Individual Country Notes. In Japan, industrial production rebounded to grow 2.9 percent (s.a.) in December after declining 1.7 percent (s.a.) in November. Retail sales figures, which have tended to suggest continued moderate strength in the consumer sector, rose 2.2 percent (s.a.) in November, but then declined 4.5 percent (s.a.) in December. From 1985 Q4 to 1986 Q4, retail sales grew 5.4 percent. New housing starts increased 3 percent (s.a.) in November to a level almost 18 percent higher than a year ago. The unemployment rate in December, 2.9 percent (s.a.), was slightly higher than its level in October and November.

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

	Q4/Q4 1985	Q4/Q4 1986	1986 Q1	1986 Q2	1986 Q3	1986 Q4	1986 Aug.	1986 Sept.	1986 Oct.	1986 Nov.	1986 Dec.	Latest 3 months from year ago 2/
Canada												
GDP	3.9	n.a.	.6	.8	.3	n.a.	*	*	*	*	*	3.5
IP	5.2	n.a.	-.2	-.5	-1.2	n.a.	-1.5	-.5	1.4	-.9	n.a.	-1.5
France												
GNP	2.3	n.a.	-.2	1.2	n.a.	n.a.	*	*	*	*	*	2.7
IP	1.8	n.a.	-1.7	1.8	2.2	n.a.	.0	-.7	-.7	.7	n.a.	1.0
Germany												
GNP	2.2	n.a.	-1.1	3.4	.7	n.a.	*	*	*	*	*	2.3
IP	3.3	.9	-.9	1.3	.7	-.3	-1.0	-.8	1.0	-.3	-.8	.9
Italy												
GNP	2.0	n.a.	-.4	2.7	.4	n.a.	*	*	*	*	*	3.0
IP	1.0	n.a.	2.8	1.5	-3.5	n.a.	-4.5	4.7	n.a.	n.a.	n.a.	.9
Japan												
GNP	4.2	n.a.	-.4	.9	.6	n.a.	*	*	*	*	*	2.3
IP	.9	-1.0	.2	.2	-.5	-.9	-2.7	3.4	-1.9	-1.7	2.9	-1.0
United Kingdom												
GNP	2.4	n.a.	1.4	.4	.3	n.a.	*	*	*	*	*	2.0
IP	4.5	n.a.	.9	-.4	1.4	n.a.	.6	.3	-1.0	.2	n.a.	1.0
United States												
GNP	2.9	2.2	.9	.2	.7	.4	*	*	*	*	*	2.2
IP	1.8	1.0	.3	-.5	.5	.8	.2	-.2	.3	.6	.5	1.0

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 1985	Q4/Q4 1986	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 Q3	1986 Q4	1986 Oct.	1986 Nov.	1986 Dec.	1987 Jan.	Latest 3 months from year ago
Canada													
CPI	4.2	4.3	.9	.9	1.2	.8	1.2	1.0	.5	.5	.1	n.a.	4.3
WPI	2.5	n.a.	.0	.8	.9	-1.5	.2	n.a.	.5	.0	n.a.	n.a.	.5
France													
CPI	4.8	2.1	.9	.6	.1	.7	.6	.7	.2	.1	.1	n.a.	2.1
WPI	1.9	n.a.	.1	-1.4	-.7	-1.4	-.6	n.a.	*	*	*	*	-4.0
Germany													
CPI	1.8	-1.0	-.2	.3	.0	-.3	-.5	-.2	-.3	.0	.2	.4	-.9
WPI	-1.1	-9.0	-2.1	-.9	-2.1	-2.6	-2.9	-1.6	-1.3	-.6	-.8	n.a.	-9.0
Italy													
CPI	8.5	4.7	1.1	2.3	1.8	1.1	.6	1.2	.6	.4	.3	.6	4.5
WPI	5.9	n.a.	-.1	.9	-.5	-1.8	-.8	n.a.	.2	.2	n.a.	n.a.	-2.4
Japan													
CPI	2.0	.1	.3	.3	.3	.3	-.5	.0	.1	-.4	-.1	-.2	-.1
WPI	-3.7	-10.5	-1.0	-2.4	-2.4	-4.2	-2.8	-1.5	-.8	.3	.0	n.a.	-10.5
United Kingdom													
CPI	5.5	3.4	.3	.5	.7	1.3	.1	1.3	.2	.8	.3	n.a.	3.4
WPI	5.2	4.2	.5	.9	1.4	1.6	.4	.7	.2	.3	.3	n.a.	4.2
United States													
CPI (SA)	3.5	1.3	.6	1.1	.4	-.4	.6	.7	.2	.3	.2	n.a.	1.3
WPI (SA)	1.6	-1.9	-.2	1.1	-1.5	-1.3	.0	.9	.3	.2	.0	n.a.	-1.9

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)

	1985	1986	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 Q3	1986 Q4	1986 Sept.	1986 Oct.	1986 Nov.	1986 Dec.
Canada												
Trade	12.8	n.a.	2.6	2.9	1.8	1.7	1.2	n.a.	1.0	.7	.6	n.a.
Current account	-.4	n.a.	-.8	-.7	-2.0	-1.4	-1.6	n.a.	*	*	*	*
France												
Trade	-2.6	-.3	-.8	-.4	.1	-1.1	.3	.5	-.4	-.0	-.1	.6
Current account	.3	n.a.	-.0	.6	1.1	.3	1.3	n.a.	*	*	*	*
Germany												
Trade (NSA)	25.4	52.3	6.1	9.1	9.5	12.5	14.1	16.2	5.1	5.3	5.0	5.8
Current account (NSA)	13.9	36.4	2.1	7.0	6.9	8.3	8.1	13.2	3.4	4.1	4.8	4.3
Italy												
Trade	-11.9	n.a.	-1.3	-3.1	-2.8	-.1	.7	n.a.	-.5	-.5	.3	n.a.
Current account (NSA)	-4.0	n.a.	1.9	-.9	-3.4	1.2	n.a.	n.a.	*	*	*	*
Japan												
Trade	46.1	82.5	12.0	14.8	15.5	20.3	24.0	22.6	8.2	7.4	8.0	7.2
Current account 2/	49.3	85.5	12.1	15.6	15.5	21.8	23.2	24.9	8.5	8.1	8.7	8.0
United Kingdom												
Trade	-2.5	-12.6	-.6	-.3	-2.0	-2.3	-4.4	-3.8	-1.3	-1.2	-1.5	-1.1
Current account	5.2	-.3	2.0	1.1	.8	.4	-1.2	-.3	-.2	-.0	-.3	.1
United States												
Trade 2/	-124.4	n.a.	-31.7	-37.4	-36.5	-35.7	-37.7	n.a.	*	*	*	*
Current account	-117.7	n.a.	-28.5	-33.7	-34.0	-34.4	-36.3	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.

Inflation remains very low in Japan. Tokyo consumer prices in the fourth quarter were 0.1 percent above the fourth-quarter level in 1985. In January, prices fell slightly to 0.6 percent below the January 1986 level. Wholesale prices were unchanged in December from their November level. For the fourth quarter on average, wholesale prices were 10.5 percent below their year-earlier level.

December customs based trade figures recorded a surplus of $7.2 billion. This brought the total for 1986 to $82.5 billion. The December current account surplus of $8 billion brought the 1986 total to $85.5 billion, substantially above the 1985 total of $49.3 billion.

The Japanese cabinet has adopted a budget for FY 1987 that maintains the generally austere fiscal stance that has characterized recent years. In the General Account budget, total nominal expenditures are essentially unchanged from those in the budget for FY 1986. In the budget for the Fiscal Investment and Loan Program--the socalled "second" official budget in which purely financial transactions are deleted--spending on economic program is to increase 7.1 percent. The tax and revenue portion of the budget contains the specific plans for the tax reform package recently formulated. Personal income tax rates will be lowered over two years, starting January 1, 1987, with interim marginal tax rates for 1987 that are only slightly changed from previous levels. The rates for central government corporate taxes will be lowered over three years. Tax breaks for small savers will be ended October 1, 1987, and a 5 percent value added tax will be levied as of January 1, 1988. Overall the tax reform program is expected to be revenue neutral for FY 1987 as a whole, which starts on April 1, 1987. The budget will be presented to the parliament in February.

German real GNP growth in 1986 was 2.5 percent, year-over-year, according to provisional data published by the Federal Statistics Office. The components of 1986 GNP growth consisted of relatively strong domestic demand with private consumption and investment in equipment growing over 4 percent and construction recovering from a very poor 1985 performance. The external sector represented a drag on growth as exports of goods and services declined by 0.6 percent while imports rose by 3.1 percent. The early release of GNP data was based on partial information about the fourth quarter. Industrial production fell 0.8 percent in December, so that the fourth quarter was only 0.9 percent above the fourth quarter of 1985. The volume of new orders declined by 1 percent in November to a level 4.7 percent below a year ago. It is noteworthy that not only foreign orders, which were 6.5 percent below a year ago in November, but also domestic orders have been very weak recently. The November level of domestic orders was 5.6 percent below the third-quarter average and 3 percent below a year ago. The latest surveys on the business climate indicate a decline in confidence. The rate of unemployment was 8.8 percent in January, four-tenths of one percentage point below a year ago.

Consumer prices rose 0.4 percent in January to a level 0.8 percent below a year ago. Import prices continued to fall in December and were 19.6 percent below a year ago. Wholesale and producers prices continued to fall toward the end of last year.

The current account surplus in December was $4.3 billion. The cumulative surplus for 1986 was $36.4 billion compared with $13.9 billion in 1985.

Central Bank Money growth in December was 9.4 percent (s.a.a.r.). This put the fourth-quarter average 7.9 percent above the fourth quarter of 1985, compared with the Bundesbank's target of 3.5 to 5.5 percent. M3, which had grown by about 7 percent (s.a.a.r.) in earlier months, fell slightly in December.

Economic expansion in Canada continues to be moderate. Growth in real domestic product was only 2-1/4 percent (s.a.a.r.) over the first three quarters of 1986 compared to growth of nearly 4 percent over the four quarters of 1985. More recently, industrial production declined 0.9 percent in November after increasing 1.4 percent in October and still remains well below the average monthly pace set earlier in the year. By the end of the year, unemployment was 9.4 percent. Consumer prices increased 4.3 percent over the four quarters of 1986, about unchanged from the previous year's inflation. On December 18, 1986, the government proposed changes to the structure and regulation of banks and other federally regulated institutions. The main policy proposals included:

(1) provision for common ownership of banks, trust and loan companies, life insurance firms, and investment dealers and a broadening of powers with greater potential for "one-stop shopping;"

(2) arresting the growth of linkages between commercial interests and non-bank financial institutions where commercial links exist;

(3) a regulatory framework that will strictly control self-dealing in all federally regulated financial institutions and create new safeguards against the abuse of conflict of interest; and

(4) consolidation of the present divided responsibility for supervising federal bank and non-bank financial institutions, and measures to strengthen the effectiveness of federal supervision.

These federal government proposals followed deregulation of the securities industry in Ontario announced on December 4, 1986, allowing banks, insurance companies and foreign financial institutions to become active players in Ontario's securities market. As a result of these policy actions Schedule B banks in Canada (foreign owned) and other non-resident federally regulated institutions will be able to fully own securities dealers in Canada by June 1988, and will be able to have a 50 percent share as of June 1987.

Noteworthy recent economic developments in other foreign industrial countries include an early official estimate of French real GNP growth in 1986 (year-over-year) at 2 percent, slightly higher than the growth figure in 1985.

In Italy, the federal deficit in 1986 achieved the government's target of 14.7 percent of estimated 1986 GDP. For 1987, the Italian parliament has enacted a budget with a projected deficit of less than 13 percent of GDP.

In contrast to the pattern of generally weak economic activity abroad, manufacturing output in the United Kingdom rose at over a 6 percent annual rate in the three months to November, and retail sales volume also grew strongly.

On January 30, the Swedish government imposed a price freeze effective until further notice. Consumer prices in December were 3.3 percent above December 1985. But the government's target and the basis for a two-year wage agreement had been 3.2 percent. Average hourly earnings for industrial workers in November were 8.3 percent above their year-earlier level.

Economic Situation in Major Developing Countries

Efforts are continuing to obtain commitments to the $7.7 billion financing package for Mexico from banks that have been reluctant to participate. The government of Brazil reached agreement with its Paris Club creditors in January to reschedule $4.1 billion in 1985-86 arrears and obligations due in the first half of 1987. Argentina has reached agreement with the IMF management for a 15-month stand-by arrangement for SDR 1.1 billion and is requesting an SDR 389 million drawing from the Compensatory Financing Facility. In late December, Venezuela received a 90-day rollover on maturities due during the first quarter of 1987 under its 1986 rescheduling agreement with its commercial bank creditors; the rollover will allow discussions to continue on a revision of the agreement covering $21.2 billion in restructured public sector debt. The Philippines' Paris Club creditors agreed on January 23 to reschedule $860 million in external debt over a ten-year period. Ecuador is seeking to modify rescheduling agreements with commercial banks and official creditors; its commercial bank steering committee has agreed, in principle, to reduce interest rate spreads, defer principal maturities, and change the interest payment schedule. Nigeria has received final approval by the IMF Executive Board of its stand-by arrangement with the Fund.

Individual Country Notes. Efforts are continuing to obtain additional commitments to the $7.7 billion financing package for Mexico from banks that have shown reluctance to participate. In December, the IMF management determined that Mexico was in compliance with the stand-by arrangement's quantitative performance criteria as of

September 30, and the first conditional tranche of SDR 225 million was disbursed before year-end. Mexico has virtually met the requirements with respect to World Bank loans needed to release $4 billion of the commercial bank financing package, once the loan agreement is signed.

Mexico's 1986 current account deficit is estimated at about $1 billion, substantially less than the $3.5 billion deficit that was projected in July. There was some recovery in oil exports in the fourth quarter of 1986, but the main factor behind the improvement was an aggressive exchange rate policy. As a result, agricultural and manufactured exports rose by $2-1/2 billion while imports contracted by $2 billion. A decline in Mexican economic activity also aided current account improvement. The strengthening of the trade position has enabled the Bank of Mexico to add modestly to its international reserves in recent months, even though the anticipated disbursements from the commercial bank financing package have not yet occurred.

Real GDP is estimated to have fallen by about 4 percent in 1986, and industrial production in the first 11 months of the year was 5.2 percent lower than in the same period of 1985. In December, consumer prices rose by 7.9 percent and were about 106 percent above a year earlier. Sharp increases in rates for electricity, water, and telephone service were instituted in early January. The minimum wage was raised by 23 percent on January 1, and further raises are expected to occur every quarter.

In Brazil, the government is apparently now permitting price adjustments of 15-25 percent for certain categories of goods whose prices have been frozen since March 1, 1986, on condition that prices not be raised further over the next four months. The policy measures adopted in late November (public sector price adjustments, new excise taxes, a policy of exchange rate mini-devaluations, and tighter monetary conditions) do not appear to have performed as the authorities had hoped. The Brazilian government now appears to be groping for an appropriate package of policy measures to attempt to reverse the deteriorating economic situation.

The overnight interest rate for federal securities is in excess of 16 percent per month at present, signalling tight monetary conditions and rising inflationary expectations. Inflation was 7.3 percent for the month of December bringing inflation for 1986 (December over December) to 59 percent. The trade surplus continued to be very low in November and December, averaging only $140 million. The trade surplus for 1986 was $9.5 billion, compared with $12.5 billion in 1985. Real GDP grew by an estimated 7.7 percent in 1986, a slight deceleration from the 8.3 percent figure posted in 1985.

Some adjustment of wages will probably be forthcoming since inflation after the introduction of the Cruzado plan on March 1, 1986 has cumulated to about 22 percent. (Crossing the 20 percent threshhold is supposed to lead to a catch-up adjustment in wages.)

The Paris Club agreed in January to reschedule $4.1 billion in obligations due official creditors, comprising 1985 and 1986 interest and principal arrears, penalty interest, and principal coming due in the first half of 1987. Brazil is expected to start negotiations on reschedulings with banks in the near future, and is likely to request new money and the rescheduling of outstanding debt at reduced spreads.

Argentina has reached agreement with the IMF management for a 15-month stand-by arrangement for SDR 1.113 billion; the stand-by has not yet been approved by the IMF Executive Board. Argentina is also requesting an SDR 389 million drawing from the Compensatory Financing Facility due to low world prices for Argentina's commodity exports. The World Bank has announced that gross new commitments for IBRD lending in 1987-88 could reach $2 billion. Negotiations with commercial banks for a new money package have not yet formally begun.

Real GDP grew 5-1/2 percent in 1986, following a decline of 4.4 percent in 1985. Inflation declined from its 1986 peak monthly rate of 8.8 percent in August to about a 5 percent monthly rate toward year-end. Lower world grain prices and the lack of a compensating real depreciation of the official exchange rate have led to weak incentives for planting and production of Argentina's principal exports. The current account deficit widened from $1 billion in 1985 to $2.6 billion in 1986.

In late December, Venezuela received a 90-day rollover on maturities due during the first quarter of 1987 under its 1986 rescheduling agreement with its commercial bank creditors. The rollover will allow discussions to continue on a revision of the agreement covering $21.2 billion in restructured public sector debt. Venezuela is seeking to defer all but a small amount of amortizations due during 1987-88 under the agreement and a reduction in the spread of 1-1/8 percent over LIBOR, and has also raised the need for new money. In November and December, Venezuela paid $666 million of the $750 million downpayment mandated under the rescheduling agreement, and has announced that it will pay the remainder in early 1987.

In 1986, Venezuela registered 3 percent real GDP growth despite a fall in oil export and public sector revenues of 10 percent of GDP. The current account moved into deficit by $2.2 billion, following a surplus of $3.1 billion in 1985. Total reserves excluding gold declined by about $4 billion to $6.4 billion. The fiscal deficit was 7.2 percent of GDP in 1986, compared with a surplus of 4.6 percent of GDP in 1985.

The Philippines' Paris Club creditors agreed on January 23 to reschedule $860 million in external debt over a ten-year period including five years of grace. The agreement applies to all principal and 70 percent of the interest falling due between January 1987 and June 1988. On January 27-28, at the Consultative Group meeting in Paris, the Philippines requested approximately $2 billion in development aid from its 13 official donors plus the World Bank, up from $1.4 billion in 1986.

Negotiations with commercial banks to restructure $3.6 billion in external debt falling due in 1987-91 are expected to start later this month. The banks agreed in mid-December to a three-month suspension of principal payments due during the first 90 days of 1987 and extended the $3 billion trade facility for six months from January 1, 1987.

Ecuador is seeking to modify rescheduling agreements with commercial banks and official creditors. The commercial bank steering committee has agreed, in principle, to reduce interest rate spreads, defer principal maturities, and change the interest payment schedule from quarterly to semi-annual payments. However, recent interest arrears to banks may jeopardize completion of the package. Ecuador will seek additional relief from the Paris Club in 1987, assuming that it reaches agreement with the IMF on reactivating its stand-by arrangement. Ecuador has been out of compliance since end-September 1986.

On January 30, the IMF Board approved a SDR 650 million 14-month stand-by arrangement, the first such program for Nigeria, upon a Board finding of satisfactory commercial bank participation in a debt restructuring package which includes $320 million in new money. The Nigerian government has indicated that it does not intend to draw from the IMF, having promised its people last year that it would not accept an "IMF loan." Nigeria will also restructure $1.7 billion in medium-term maturities and $2.5 billion in letters of credit in arrears with commercial banks. A rescheduling of external payment arrears and 1987 debt service due official creditors was negotiated at a Paris Club meeting in December 1986.