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Confidential (FR) Class III FOMC

March 23, 1988

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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Economic activity has continued to expand in the current quarter, but just how rapidly is not yet clear. Strong gains in employment and hours through February suggest another sizable increase in GNP. However, the fragmentary evidence on domestic final spending points to a more moderate advance, led by rebounds in auto sales and business fixed investment. After a substantial buildup during the fourth quarter, inventory accumulation appears to have slowed, owing largely to a decline in auto dealers' stocks. The unemployment rate has edged lower, and capacity utilization rates remain high in a number of materials industries; nonetheless, there is as yet no clear sign of generalized wage or price acceleration.

Labor Markets

The labor market surveys indicate continued strength in economic activity during the first two months of this year. Employment, as measured by the household survey, rose 280,000 in February, after an even larger gain a month earlier, and the civilian unemployment rate edged down to 5.7 percent.

According to the establishment survey, nonfarm payroll employment posted an average monthly gain of about 350,000 in January and February, a pace exceeding the sizable increases during the second half of last year. Surprisingly large employment gains occurred in trade, and hiring in services was brisk over the two months. However, employment in the finance industry fell 10,000 in February, the first decline since the

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

	1986	1987	1987 Q2	1987 Q3	1987 Q4	1987 Dec.	1988 Jan.	1988 Feb.
	-Average monthly changes-							
Nonfarm payroll employment[2]	159	254	163	205	393	327	174	531
Strike-adjusted	159	251	164	227	370	324	173	534
Manufacturing	-14	34	7	51	71	46	18	20
Durable	-17	19	0	31	45	36	2	8
Nondurable	4	15	7	21	26	10	16	12
Construction	13	15	-8	-6	44	47	-62	107
Trade	31	50	35	41	67	35	186	127
Finance, insurance and real estate	29	18	20	14	13	11	13	-4
Services	81	89	80	71	106	119	35	201
Total government	30	29	18	6	74	58	-18	68
Private nonfarm production workers	105	181	112	143	269	281	89	275
Manufacturing production workers	-7	28	11	38	56	44	11	24
Total employment[3]	174[e]	257	282	191	291	240	385	280
Nonagricultural	174[e]	252	297	193	280	197	307	346

1. Average change from final month of preceding period to final month of period indicated.
2. Survey of establishments. Strike-adjusted data noted.
3. Survey of households.
e--Adjusted by Board staff to eliminate distortions caused by the introduction of revised population estimates.

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

	1986	1987	1987 Q2	1987 Q3	1987 Q4	1987 Dec.	1988 Jan.	1988 Feb.
Civilian, 16 years and older	7.0	6.2	6.3	6.0	5.9	5.8	5.8	5.7
Teenagers	18.3	16.9	17.0	16.1	16.6	16.1	16.0	15.4
20-24 years old	10.7	9.7	10.0	9.5	8.8	8.5	9.1	8.7
Men, 25 years and older	5.4	4.8	4.9	4.6	4.4	4.4	4.4	4.3
Women, 25 years and older	5.5	4.8	4.7	4.7	4.7	4.7	4.6	4.7
White	6.0	5.3	5.4	5.1	5.0	4.9	5.0	4.8
Black	14.5	13.0	13.2	12.5	12.2	12.2	12.2	12.6
Fulltime workers	6.6	5.8	5.9	5.6	5.5	5.4	5.4	5.3
Memo:								
Total national[1]	6.9	6.1	6.2	5.9	5.8	5.7	5.7	5.6

1. Includes resident armed forces as employed.

stock market crash. Construction employment moved erratically over the two months, but the February level was up substantially from December. Factory employment posted comparatively small increases in January and February.

For all production and nonsupervisory workers on private nonagricultural payrolls, the index of aggregate hours worked rose 1 percent in February to a level 1.2 percent above the fourth-quarter average. In manufacturing, the small employment gains were offset by a decline in the average workweek, and aggregate hours of production workers in February were little changed from the fourth-quarter average. Although still high by historical standards, the factory workweek has declined, on balance, since peaking in October at 41.3 hours.

Industrial Production and Capacity Utilization

After rising at an annual rate of 8 percent during the second half of last year, industrial production has decelerated in recent months. Total industrial production is estimated to have risen 0.3 percent in January and 0.2 percent in February. The level of production last month was up about 3-1/2 percent, at an annual rate, from the fourth quarter of 1987.

Output of business equipment posted solid gains during the first two months of this year, bringing the February reading to 8 percent, at an annual rate, above the fourth-quarter average. Growth in this sector apparently stems from a combination of robust foreign and domestic demand. In recent months, production gains have been particularly strong for construction and mining equipment, special industrial

INDUSTRIAL PRODUCTION
(Percentage change from preceding period)[1]

	1986	1987	1987 Q3	1987 Q4	1987 Dec.	1988 Jan.	1988 Feb.
	-------Annual rate			------	--Monthly rate--		
Total Index	1.0	5.8	8.8	7.0	.5	.3	.2
Products	1.8	4.9	8.3	4.1	.0	.6	.4
Final products	.8	4.6	7.9	4.1	.3	.6	.3
Consumer goods	3.3	3.1	6.4	2.0	.0	.7	.2
Durable goods	4.2	4.2	6.9	9.5	-2.9	.9	-.2
Nondurable goods	3.1	2.7	6.3	-0.4	1.1	.6	.3
Equipment	-2.1	6.3	9.7	6.5	.5	.6	.5
Business equipment	-1.1	6.9	9.3	8.7	.9	.7	.7
Defense & space eq.	5.0	1.9	.4	.1	.1	.6	-.1
Oil & gas well drill.	-50.1	37.1	159.6	13.7	-5.1	-1.1	-1.2
Intermediate products	5.4	5.8	9.6	4.2	-.7	.4	.5
Construction supplies	5.0	4.7	9.7	3.4	-.4	.1	.8
Materials	-.2	7.2	9.6	11.6	1.1	-.2	-.2
Durable goods mat.	-.5	8.1	9.2	15.9	1.6	-.3	-.3
Nondurable goods mat.	5.7	8.0	14.1	5.6	1.9	-.7	.1
Energy materials	-5.2	4.6	5.7	9.1	-.8	.6	-.3

1. Annual changes are from fourth quarter to fourth quarter.

CAPACITY UTILIZATION IN INDUSTRY
(Percent of capacit ; seasonally adjusted)

	1978-80 High	1982 Low	1967-87 Avg.	1984 High	1987 Dec.	1988 Jan.	1988 Feb.
Total industry	86.9	69.5	81.5	81.8	82.4	82.4	82.4
Manufacturing	86.5	68.0	80.6	81.3	82.5	82.5	82.5
Durable	86.3	63.7	78.7	79.9	80.2	80.1	80.1
Nondurable	87.0	74.2	83.5	84.2	86.0	86.1	85.9
Mining	95.2	76.9	86.7	86.6	81.5	81.1	80.6
Utilities	88.5	78.0	86.9	84.8	80.4	81.7	82.2
Industrial materials	89.1	68.5	82.2	82.8	83.7	83.4	83.1
Metal materials	93.6	45.7	77.7	70.8	87.6	81.9	81.3
Paper materials	97.3	79.9	91.7	97.5	101.6	100.0	n.a.
Chemical materials	87.9	63.5	81.0	78.3	90.8	89.8	n.a.

machinery (which includes capital goods for the food, textiles, and paper industries), boiler shop products, and medical instruments. Output of computers, which had surged during the fourth quarter, decelerated in January and February, but the February level of output still was substantially higher than the fourth-quarter average.

In the motor vehicles components of both consumer goods and business equipment, a slight increase in auto assemblies last month was more than offset by a decline in trucks. Current schedules indicate that both auto and truck assemblies will show gains in March, which can be expected to add about 0.2 percentage point to the growth of total industrial production.

After surging last fall, output of consumer home goods, particularly appliances, has dropped considerably since November. Moreover, production of clothing, which declined at an annual rate of 2-1/2 percent in the fourth quarter, remained weak in January and February. These cutbacks may reflect a response by producers to attempts by retailers to control stocks. In contrast, output of other nondurable consumer goods has been strong in recent months, boosted by advances for both chemical and paper products (the former includes drugs and medicines, and the latter, periodicals and books).

The strength in production of nondurable consumer goods is surprising, as real spending for those goods declined at an annual rate of 2-1/2 percent during the fourth quarter, and appears to have weakened further during the current quarter. Domestic producers apparently benefited somewhat in the second half of 1987 from the depreciation of the dollar, which contributed to a decline in real imports of nondurable consumer goods, but not nearly enough to offset the weakness in domestic spending. In this light, the recent gains in output do not appear to be sustainable unless spending picks up.

Production of materials, which had soared during the second half of last year, slipped a little for a second month in February. This edging off is attributable to declines in a number of industries, including basic metals, which surged during the second half of last year, and parts for durable consumer goods. In addition, production of textile materials has been weak since last fall, mirroring the weakness in output of clothing and automobiles. In contrast, output of chemicals and parts for capital goods has continued to rise.

Capacity utilization in February remained at 82.4 percent, the same as in the preceding two months. Operating rates have moderated somewhat in a few industries--particularly textiles and primary metals--where utilization rose last year and producer prices accelerated. Nevertheless, capacity constraints still are evident in some materials industries, most notably paper, aluminum, and specialty steel. In contrast, utilization rates in a number of advanced-processing industries that are benefiting from the depreciation in the dollar--for example, nonelectrical machinery, instruments, and miscellaneous manufacturing (which includes jewelry and toys)--are not high by historical standards.

Business Inventories

After a substantial runup in the fourth quarter, the rate of business inventory accumulation appears to have slowed early this year. In current cost terms, inventories in all manufacturing and trade rose at an annual rate of $48 billion in January, considerably less than the $82 billion accumulation during the fourth quarter.

The recent slowing in inventory accumulation resulted in large measure from a substantial liquidation at auto dealers. Domestic manufacturers cut auto assemblies sharply during the first two months of this year, to an annual rate of about 6 million units. Consequently, with the pickup in sales, much of the inventory overhang in this sector was quickly eliminated. Dealer stocks at the end of February were down to a 62-day supply relative to the average selling pace over the past 12 months. Domestic automakers have scheduled production at a 7 million unit annual rate in the second quarter, up about 3/4 of a million units from the first-quarter rate. Indeed, production plans for the second quarter have been revised up repeatedly since early January, coincident with the rebound in sales.

The weakness in production of other consumer goods, such as apparel and appliances, also appears consistent with some trimming of retail stocks. Although the data lag a month, stocks held at apparel stores, which were burdensome through much of the holiday selling season, showed a significant decline in January. For the overall G.A.F. grouping (which includes general merchandise, apparel, and furniture and appliance stores), stocks were little changed in January after a sizable

CHANGES IN MANUFACTURING AND TRADE INVENTORIES
(Billions of dollars at annual rates; based on seasonally adjusted data)

	1987 Q2	1987 Q3	1987 Q4	1987 Nov.	1987 Dec.	1988 Jan.
Current Cost Basis:						
Total	49.2	33.9	81.8	67.2	80.7	48.0
Manufacturing	6.1	20.2	27.9	39.1	22.1	35.0
Wholesale	14.1	.6	24.3	7.9	24.4	29.9
Retail	29.0	13.1	29.6	20.2	34.1	-16.9
Automotive	9.8	4.5	14.2	12.3	7.3	-16.7
Ex. auto	19.2	8.6	15.3	7.9	26.8	-.2
Constant Dollar Basis:						
Total	20.7	5.3	43.5	37.9	18.9	--
Manufacturing	-4.4	12.1	7.3	21.6	-.6	--
Wholesale	9.6	1.2	9.1	3.2	-.6	--
Retail	15.5	-8.0	27.1	13.2	20.1	--
Automotive	3.0	-11.9	17.0	7.0	7.9	--
Ex. auto	12.5	3.9	10.1	6.2	12.2	--

INVENTORIES RELATIVE TO SALES[1]
(Months supply; based on seasonally adjusted data)

	Range in Preceding 12 months:[2] low	Range in Preceding 12 months:[2] high	1987 Q2	1987 Q3	1987 Q4	1987 Nov.	1987 Dec.	1988 Jan.
Current Cost Basis:								
Total	1.48	1.56	1.51	1.49	1.52	1.51	1.51	1.53
Manufacturing	1.58	1.69	1.63	1.62	1.60	1.60	1.58	1.62
Wholesale	1.18	1.28	1.23	1.20	1.24	1.23	1.25	1.27
Retail	1.54	1.64	1.60	1.59	1.65	1.64	1.64	1.63
Automotive	1.77	2.15	1.94	1.86	2.06	2.06	2.03	1.94
Ex. auto	1.47	1.53	1.50	1.51	1.54	1.52	1.53	1.54
Constant Dollar Basis:								
Total	1.47	1.54	1.51	1.49	1.52	1.52	1.52	--
Manufacturing	1.60	1.67	1.63	1.63	1.61	1.61	1.60	--
Wholesale	1.23	1.30	1.27	1.24	1.28	1.29	1.29	--
Retail	1.43	1.60	1.57	1.54	1.63	1.62	1.61	--
Automotive	1.42	2.05	1.88	1.68	1.93	1.92	1.91	--
Ex. auto	1.42	1.52	1.49	1.50	1.54	1.53	1.53	--

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 necessary coincident.

accumulation during the latter part of 1987, and the inventory-sales ratio held steady at the relatively high level that has prevailed since October of last year.[1] In contrast to the slowing in stockbuilding at the retail level, inventories of merchant wholesalers, especially of durable goods such as motor vehicles, electrical goods, and machinery, have risen significantly further in recent months, and the aggregate inventory-sales ratio has moved higher.

Stock accumulation in the manufacturing sector continued at a brisk pace in January, but inventories are not high relative to shipments by historical standards. A considerable portion of the January inventory runup was in the nondefense capital goods category, where production and sales appear fairly strong. In contrast, some manufacturing industries--for example, producers of appliances and textiles--may have begun to curtail their stock expansion efforts, apparently in response to the weakness in consumer spending.

Personal Income and Consumption

Income growth remained relatively strong early in the year, providing continued support for consumer spending. Total personal income was affected by a host of special factors in January, including lower farm subsidy payments, higher personal contributions for social insurance, and an increase in federal transfer payments owing to COLA

1. As a result of the Census Bureau's revisions to retail sales and inventories, inventory-sales ratios for apparel and general merchandise stores are slightly lower in 1987 than those shown previously, but the current levels of stocks in these sectors still appear to be excessive. In particular, the large runup last year in stocks at apparel stores is still evident in the revised data, and the inventory-sales ratio for general merchandise stores has trended up, on balance, since last spring.

and other adjustments. However, even abstracting from these factors, personal income in January continued to grow at about the pace of late last year, reflecting, in part, continued sizable increases in wages and salaries. In addition, a drop in personal tax payments attributable to the Tax Reform Act of 1986 boosted disposable personal income in January to a level nearly 1 percent above the fourth-quarter average.

Spending on domestic motor vehicles has been surprisingly strong. Sales of domestically produced cars have averaged 7.9 million units (annual rate) since early February, while domestic light truck sales have been 4.3 million units. This recent pace of sales is well above the rate prevailing in December and January, and probably reflects at least in part the continued availability of sales incentives. Those available from Ford and GM, which now cover about three-fourths of their models, were scheduled to expire at the end of February, but have been extended until the end of April and mid-May, respectively. Chrysler's incentive programs, which cover about 80 percent of their models, are open-ended. In contrast to the strength in sales of domestic makes, foreign cars and light trucks currently are selling at rates below those registered during the fourth-quarter.

Excluding motor vehicles, consumption spending apparently remained relatively sluggish early in the quarter, despite strong income growth.[2] Retail sales data for January and February show declines in

2. Last week, the Census Bureau released revised estimates of retail sales back to 1983. Revisions for the 1983-86 period, which were based on information from the 1986 Annual Retail Survey, mostly were small. However, revisions for 1987, which reflected new information on the status of firms in the sample, were much larger. The revised data show stronger growth in sales for the year as a whole; however, a slowdown in spending during the latter part of the year is still evident in the revised data. BEA will incorporate these revisions into the national income accounts at the time of the July annual benchmarking.

PERSONAL INCOME
(Average monthly change at an annual rate; billions of dollars)

	1986	1987	1987 Q3	1987 Q4[r]	1987 Nov.[r]	1987 Dec.[r]	1988 Jan.[p]
Total personal income	14.2	21.1	22.6	27.7	-15.9	27.1	12.2
Wages and salaries	7.5	12.2	13.6	13.7	14.3	9.1	15.1
Proprietors' income	2.6	2.6	1.3	5.4	-37.0	11.7	-8.1
Farm	.5	.4	-.7	3.2	-40.0	10.4	-10.5
Transfer payments	2.5	1.9	1.8	1.4	-.6	.5	12.9
Less: Personal contributions for social insurance	.8	1.0	.9	.9	.9	.5	14.2
Less: Personal tax and nontax payments	3.2	3.6	3.9	4.9	4.5	5.7	-8.1
Equals: Disposable personal income	11.0	17.5	18.7	22.9	-20.4	21.4	20.3
Memo: Real disposable income	6.3	4.5	5.9	13.3	-23.4	17.2	--

r--Revised.
p--Preliminary.

SALES OF AUTOMOBILES AND LIGHT TRUCKS
(Millions of units at an annual rate; FRB seasonals)

	1986	1987	1987 Q3	1987 Q4	1987 Dec.	1988 Jan.	1988 Feb.
Autos and light trucks	16.1	15.0	16.3	14.7	15.6	14.7	15.9
Autos	11.5	10.3	11.4	10.0	10.8	10.2	11.1
Light trucks	4.7	4.7	4.9	4.7	4.7	4.5	4.8
Domestically produced[1]	12.0	11.0	11.9	10.5	11.4	10.9	12.2
Autos	8.2	7.1	7.8	6.6	7.3	7.1	7.9
Light trucks	3.8	3.9	4.1	3.9	4.1	3.8	4.3
Imports	4.2	4.0	4.4	4.1	4.2	3.7	3.7
Autos	3.2	3.2	3.6	3.4	3.6	3.0	3.2
Japanese	2.4	2.2	2.4	2.4	2.6	2.0	2.1
Korean	.2	.3	.5	.3	.3	.4	.5
European	.7	.7	.7	.7	.7	.6	.6
Light trucks	.9	.8	.8	.8	.7	.7	.6
Memo: Auto production	7.8	7.1	6.3	7.0	6.5	6.0	6.1

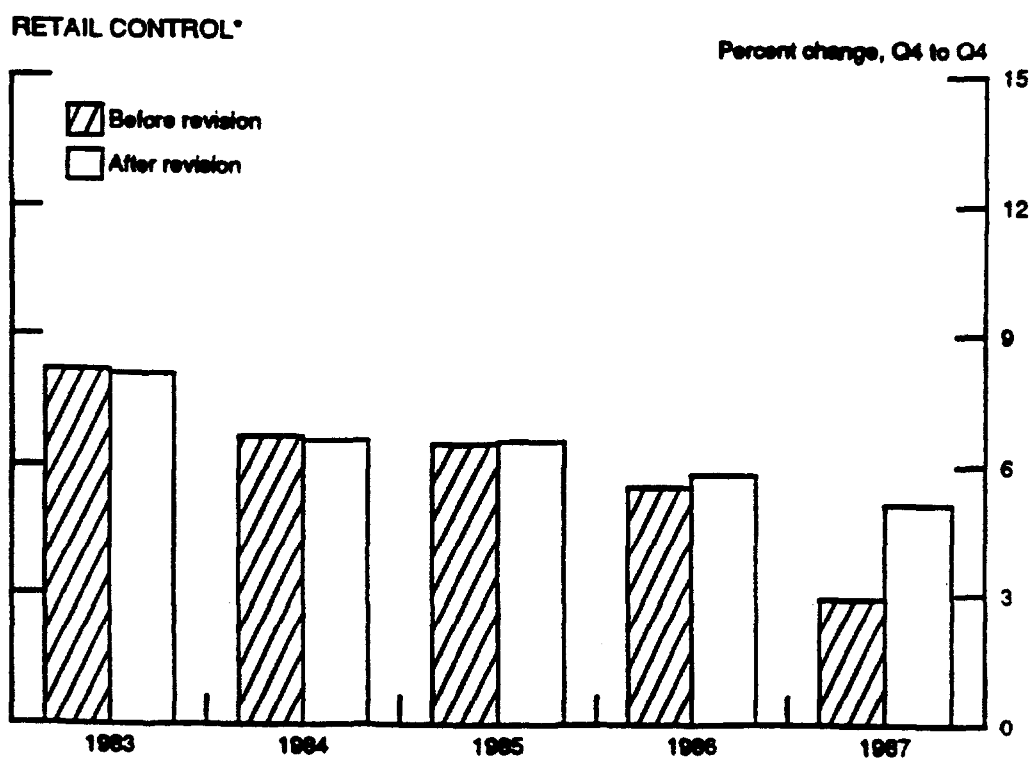
1. Includes vehicles produced in Canada and Mexico for General Motors, Ford, and Chrysler.

RETAIL SALES
(Seasonally adjusted percentage change)

	1987[1]	1987 Q3	1987 Q4	1987 Dec.	1988 Jan.	1988 Feb.
Total sales	4.2	2.4	-.6	1.1	.0	.4
Total less auto dealers, nonconsumer stores, and gasoline stations	5.1	1.0	.4	.9	-.6	.2
GAF[2,3]	4.7	1.3	.2	1.1	-.3	-.7
Durable	1.4	4.6	-2.2	2.0	1.2	1.5
Automotive dealers & parts	.7	6.7	-3.9	2.6	2.2	1.3
Furniture and appliances	-.1	1.6	-2.3	-.5	3.2	.5
Other durable goods	9.9	1.7	2.1	4.5	-3.3	2.5
Nondurable	5.9	1.1	.3	.5	-.7	-.2
Apparel	4.8	2.4	-.3	1.7	-3.0	.5
General merchandise[3]	7.1	.6	1.6	1.6	-.7	-1.9
Gasoline stations	12.6	3.4	-1.4	-.8	.5	-1.9
Other nondurables	5.7	.4	-1.5	-.4	-2.1	.0

1. From fourth quarter to fourth quarter.
2. General merchandise, apparel, furniture and appliance stores.
3. Does not include mail order sales.

Benchmark Revisions to Retail Sales



*Total less auto dealers, building materials and supplies, and gasoline.

ominal spending on nondurables. However, outlays for durables outside f motor vehicles appear to have retraced part of their fourth-quarter decline. (More complete information on personal income and consumer spending through February, will be available in the Greenbook supplement.)

Business Fixed Investment

After edging down last quarter, spending for business equipment appears to have strengthened considerably in the current quarter, led by substantial gains for office and computing equipment. Shipments of such equipment jumped 25 percent between November and January, before declining somewhat in February. Industry sources confirm that demand for computing equipment is healthy, and production of business machines has advanced strongly since last fall. Demand also appears to be solid for most other types of equipment. Excluding office and computing equipment (as well as the aircraft group), shipments in January and February stood 2-1/2 percent above the fourth-quarter average, despite the decline in shipments recorded last month. Further, aircraft shipments--as computed by BEA's methodology--have risen sharply from the fourth quarter.[3] This widespread resilience of shipments suggests that any adverse impact from the stock-market crash on domestic equipment demand has been minor.

3. The table on the next page, "Business Capital Spending Indicators," includes an innovation in our reporting of the data on shipments; the industry detail has been aggregated in a memo item in such a way as to replicate better the BEA's technique for translating shipments into GNP expenditures. In particular, the BEA does not use the M3 report to estimate shipments of aircraft. Instead, BEA employs the shipments data contained in the Current Industrial Report entitled "Civil Aircraft and Aircraft Engines" and applies its own seasonal factors to this series.

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

	1987			1987	1988	
	Q2	Q3	Q4	Dec.	Jan.	Feb.
Producers' durable equipment						
Shipments of nondefense cap. goods	2.7	5.1	2.4	7.4	-.4	-2.4
Aircraft and parts	4.1	-1.0	13.0	41.9	-28.9	2.1
Excluding aircraft and parts	2.5	5.8	1.1	3.2	4.3	-2.9
Office and computing equip.	2.4	6.2	-3.2	6.7	18.8	-8.9
All other categories	2.6	5.8	2.1	2.4	1.1	-1.3
Memo on shipments:						
PDE items excluding aircraft[1]	2.2	5.7	.9	5.6	.7	.4
Complete aircraft (from CIR)[2]	-9.5	29.2	-21.8	27.5	41.6	n.a.
Orders for nondefense cap. goods	9.0	3.3	3.4	12.6	2.5	-5.9
Aircraft and parts	30.5	-5.3	21.2	59.0	-17.0	4.6
Excluding aircraft	5.9	4.9	.5	4.4	7.7	-8.1
Office and computing eq.	13.4	4.3	-6.6	6.3	28.4	-16.1
All other categories	4.2	5.1	2.2	4.0	3.4	-6.1
Sales of heavy-weight trucks (thousands of units, A.R.)	299	303	320	313	319	370
Nonresidential structures						
Nonresidential construction	.8	3.6	2.8	-1.2	-2.0	n.a.
Office	-4.0	4.6	5.1	-1.7	-.1	n.a.
Other commercial	3.5	.0	3.7	-7.4	-3.0	n.a.
Industrial	6.6	8.3	1.1	-5.4	-1.8	n.a.
All other	.4	3.9	1.7	3.0	-2.4	n.a.
Rotary drilling rigs in use	9.5	17.1	-3.7	-5.1	-.2	.4

1. Computed as a weighted sum of 25 shipments series from the Census M-3 report. This aggregate includes all of the series making up nondefense capital goods, minus aircraft and parts, plus 10 other series used by BEA to estimate spending for producers' durable equipment. The weight for each series represents the proportion of shipments in that category that BEA allocates to PDE rather than to other final demands or to intermediate input.

2. From the Current Industrial Report (CIR) entitled "Civil Aircraft and Aircraft Engines". To estimate PDE spending for aircraft, BEA uses the aircraft shipments shown in that report, not the corresponding M-3 series. Note that the CIR does not provide information on aircraft orders.

Looking ahead, orders for nondefense capital goods have remained robust, on balance, and point to further near-term gains in equipment outlays. Excluding aircraft and parts, the average level of nondefense capital goods or iers in January and February was up 5 percent from the fourth quarter of last year.

In contrast to the recent gains in equipment outlays, spending for nonresidential construction has been weak. Construction put-in-place, which covers all nonresidential structures except oil and gas wells, fell in both December and January, after posting solid gains last autumn. Outlays for industrial and "other commercial" projects were especially weak around year-end. However, both of these categories are volatile on a monthly basis. The value of new construction contracts has trended up since the middle of last year, suggesting that outlays in this sector will rebound in coming months. The only areas where the fundamenta s point to particular sluggishness are the office and hotel sectors, where vacancy rates remain extremely high in many locales. In addition, petroleum drilling activity could decline a bit further in the near term, owing to the softness in oil prices since last summer.

Despite these pockets of weakness, surveys of capital spending plans indicate that the outlook for business investment is fairly bright this year. The most recent survey, conducted by McGraw-Hill between late January and early March, indicates that nominal outlays are expected to rise 8-3/4 percent in 1988. This gain is a bit larger than those reported last fall by the McGraw-Hill and Commerce Department surveys. All of the surveys taken since last fall show that manufacturers plan substantial increases in spending this year, reflecting, in part, pressures on capacity in a number of industries.

Housing Markets

Total housing starts rebounded 9 percent in February to a 1.49 million unit annual rate, with sizable increases in both the single- and multifamily sectors. In addition, issuance of building permits firmed. The pattern of activity in recent months may reflect, in part, some fallout from the stock-market crash; however, winter weather and the difficulties in seasonal adjustment also may have played a role in the surprising December-January weakness.

The positive effect of the recent decline in interest rates appears to be showing through, especially in the single-family market where starts in February were slightly above the fourth-quarter average. The reduction in rates since October has pushed the average annual mortgage payment for a new home, priced on a quality-adjusted basis, back down almost to the six-year low recorded last spring. In addition, homebuilder views of the prospects for new house sales over the next six months reportedly turned more optimistic in January and February, and may have resulted in an increase in "speculative" single-family starts.

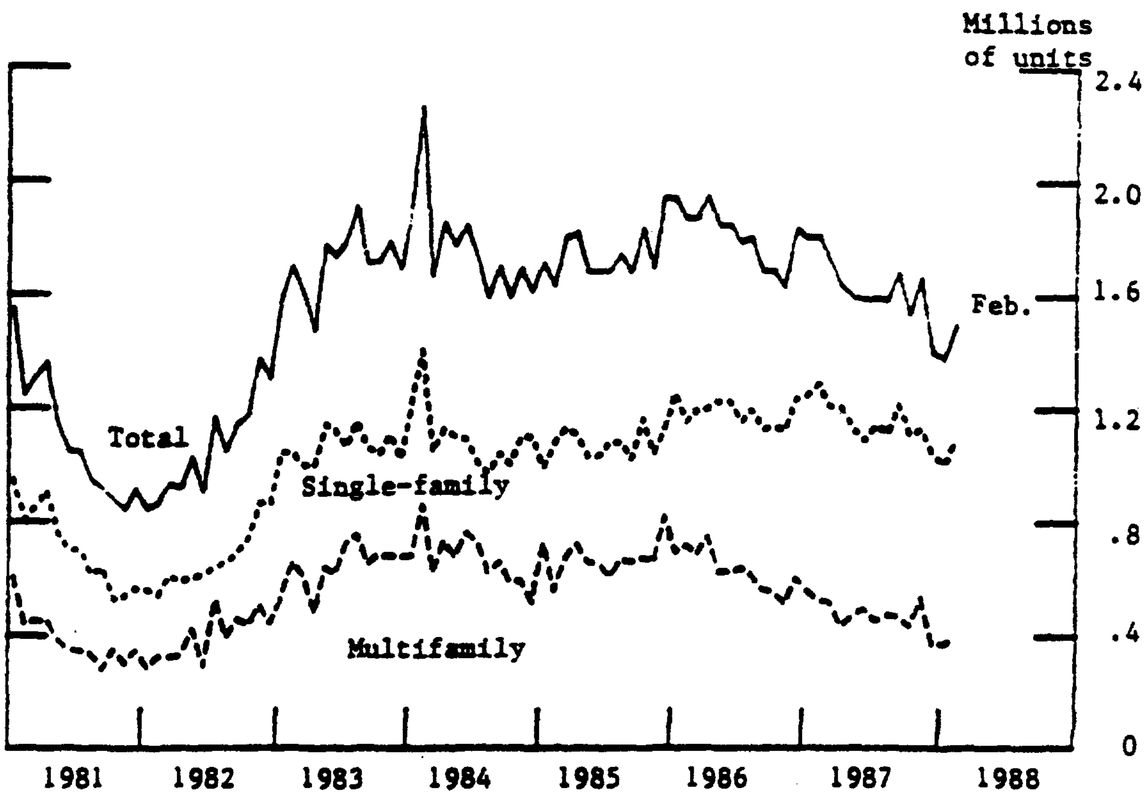
Despite the rise in February, multifamily housing starts were still 10 percent below the fourth quarter of last year. The low level of activity in this sector stems largely from the combined effects of near record-high vacancy rates and tax law changes, which lowered the rate of return on investment in rental properties.

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

	1987	1987				1987	1988	
	Annual	Q1	Q2	Q3	Q4	Dec.[r]	Jan.[r]	Feb.[p]
All units								
Permits	1.54	1.68	1.54	1.50	1.43	1.36	1.26	1.40
Starts	1.62	1.79	1.61	1.62	1.53	1.40	1.37	1.49
Single-family units								
Permits	1.04	1.15	1.04	1.00	.98	.97	.92	1.00
Starts	1.15	1.25	1.14	1.15	1.09	1.04	1.00	1.10
Sales								
New homes	.67	.73	.67	.66	.62	.59	.54	n.a.
Existing homes	3.53	3.64	3.64	3.44	3.39	3.33	3.21	n.a.
Multifamily units								
Permits	.49	.54	.50	.49	.45	.39	.34	.40
Starts	.47	.53	.47	.47	.44	.36	.37	.40

p--Preliminary estimates.
r--Revised.
n.a.--Not available.

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



FEDERAL BUDGET DEFICIT PROJECTIONS
(Fiscal years; billions of dollars)

	1988	1989
President's budget proposal	147	130
CBO baseline	157	176
CBO reestimate of the President's budget proposal	161	165
Memo: Gramm-Rudman-Hollings deficit target	144	136

MONTHLY BUDGET TOTALS FOR FISCAL YEARS 1987 AND 1988
(Billions of dollars; not seasonally adjusted)

	Revenues		Outlays		Deficit	
	1987	1988	1987	1988	1987	1988
October	59.0	62.4	84.2	93.1	25.2	30.7
November	53.0	57.0	79.9	83.9	27.0	26.9
December	78.0	85.5	90.0	109.7	12.0	24.2
January	81.8	81.8	83.9	65.7	2.1	-16.0
February	55.5	60.4	83.5	84.3	28.1	23.9
Total, fiscal year to date	327.2	347.0	421.6	436.7	94.4	89.7

Over a longer horizon, a number of factors should work to support construction in the multifamily market. Assuming that the household formation and homeownership rates remain close to their 1983-87 averages, population trends suggest there will be a moderate demand for rental units in the next few years. About two-fifths of existing rental units were built prior to 1940; replacement of aging structures should provide some impetus for construction. Furthermore, construction of multifamily units for sale (condominiums) has remained near the 1986 pace, and absorption of newly built condominiums has been high. Taken together, these factors are expected to bolster construction in the multifamily sector over the next few years.

Federal Government

The President sent his FY1989 budget proposals to the Congress on February 18. The budget, which is described in more detail in the appendix, estimates that the FY1988 deficit will total $147 billion and proposes a $130 billion deficit for FY1989. The 1989 budget assumes that the deficit will be cut $46 billion by full implementation of last fall's budget summit agreement, and it proposes an additional $9 billion of deficit reductions.

In contrast, the Congressional Budget Office projects baseline deficits of $157 billion and $176 billion for fiscal 1988 and 1989, respectively. These estimates are higher than the administration's, primarily because the CBO uses less favorable economic assumptions, and, for 1989, it estimates that only $36 billion of the reductions in the budget summit agreement have been implemented. In a separate analysis, the CBO estimates that under its economic and technical assumptions the President's budget proposals would result in a deficit of $161 billion in 1988 and $165 billion in 1989.

Under the administration's economic and technical assumptions, the President's proposals meet the $136 billion Gramm-Rudman-Hollings deficit target for 1989. Under the CBO assumptions, the administration would miss the mark--even with the $10 billion leeway--and Congress would be required to propose at least $30 billion more of deficit reductions in its Budget Resolution. However, the House Budget Committee has used the administration's assumptions for its Budget Resolution, and estimates a deficit of $134 billion in 1989 without proposing new deficit reductions that go beyond last fall's summit agreement. House floor action on this version of the Budget Resolution is expected on March 23, and the Senate Budget Committee is required to report a Budget Resolution by April 1. The need for a sequester will be determined by the administration's budget estimates in July.

The federal deficit during the first five months of the current fiscal year was $90 billion, down $5 billion from the corresponding FY1987 total. Outlays have risen a moderate 3.6 percent during the first five months of the current fiscal year. Significant declines from year-earlier levels have been recorded in international affairs, agriculture, and income security functions. These declines have been offset by large increases in outlays for deposit insurance programs and net interest, the effects of a somewhat larger COLA for Social Security, than in 1987, and small increases in most other major categories. For some of these categories, sizable year-over-year increases in net outlays may emerge late in the current fiscal year, when year-earlier outlays were depressed by a bunching of asset sales. After accounting for a one-time shift in the military pay date from the end of FY1987 to the start of FY1988, defense outlays are about unchanged from a year earlier.

Revenues during the first five months of the current fiscal year increased 6.1 percent from a year earlier. However, there is much uncertainty about the trend of revenues, because the income tax filing season, when the bulk of nonwithheld income taxes are collected, has just started. Early data suggest a small year-to-year decline in revenues from final income tax settlements. The final estimated tax payment for 1987, which was due on January 15 and may be an indicator of the final tax payments that are due on April 15, was down slightly from a year earlier. Payments in the previous year had surged owing to large realizations of capital gains, which were induced by tax reform. On the other hand, tax refunds are running a bit above last year's level. Daily Treasury data suggest that the final corporate payment on the 1987 liability will be up about 10 percent, which is about in line with recent increases in corporate estimated tax payments.

State and Local Government

Real purchases of goods and services by state and local governments rose rapidly in the fourth quarter of last year, reflecting a surge in real construction spending. However, preliminary evidence suggests that weakness in building has reemerged. Construction outlays fell more than 6 percent in January, with declines registered in almost every category. In contrast, despite budget-cutting measures that were enacted in about half the states in 1987, employment has continued to grow.

The recent weakness in state and local construction appears to be out of line with many estimates of infrastructure needs. Recently, the federally mandated National Council on Public Works Improvement characterized the nation's roads, airports, mass transit, water supply, and waste disposal facilities as "inadequate," and called for a doubling of investment. Despite a surge in construction during the mid-1980s, the stock of real public capital provided by state and local governments, on a per capita basis, has been little changed on net during the past 10 years.

The current slowing in construction spending likely reflects, in part, efforts by many states to deal with erosion in their budgetary positions. The states appear to have been experiencing fiscal difficulties since 1986, when, in the aggregate, they reported nearly a $3 billion deficit. In contrast, local governments, whose own-source revenue comes largely from property tax receipts (which are fairly stable), have enjoyed sound fiscal positions since 1981.

Prices

Inflation remained relatively moderate over the first two months of this year, held down in part by declining energy prices and a relatively small rise in food prices. The consumer price index for all urban consumers rose 0.3 percent in January and 0.2 percent in February, slightly below the pace in the second half of last year. Producer prices of finished goods increased 0.4 percent in January, but then dropped back 0.2 percent in February, mainly reflecting volatility in the food component.

On balance, the CPI for food was little changed early this year, and, like the CPI total, was a bit lower than its average pace over the preceding six months. However, there were marked, though largely offsetting, swings in the major food groupings. In February, retail meat prices turned up, reflecting the pass-through of higher cattle prices, while fresh vegetable prices dropped back, reversing part of a

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

	Relative Importance Dec. 1987	1986	1987	1987 Q3	1987 Q4	1988 Jan.	1988 Feb.
				-Annual rate-		-Monthly rate-	
All items[2]	100.0	1.1	4.4	3.9	3.2	.3	.2
Food	16.1	3.8	3.5	2.1	2.8	.3	-.2
Energy	7.6	-19.7	8.2	6.0	-3.9	-.7	-.6
All items less food and energy	76.3	3.8	4.2	3.8	4.4	.5	.2
Commodities	25.8	1.4	3.5	2.9	2.5	.4	.1
Services	50.6	5.2	4.5	4.3	5.0	.6	.4
Memo: CPI-W[3]	100.0	.6	4.5	4.0	2.8	.3	.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. 1987	1986	1987	1987 Q3	1987 Q4	1988 Jan.	1988 Feb.
				-Annual rate-		-Monthly rate-	
Finished goods	100.0	-2.3	2.1	3.8	-2.6	.4	-.2
Consumer foods	25.9	2.8	-.3	-1.8	-5.7	1.7	-1.1
Consumer energy	9.6	-38.1	10.3	16.5	-12.5	-4.5	-.8
Other consumer goods	40.1	3.0	2.6	4.6	1.4	.6	.3
Capital equipment	24.4	2.1	1.3	4.0	-.7	.2	.2
Intermediate materials[2]	95.0	-4.5	5.5	5.6	4.8	.3	.0
Excl. energy	82.5	.1	5.3	5.3	7.6	.9	.2
Crude food materials	39.5	-1.5	1.7	-4.8	-5.2	.9	2.3
Crude energy	41.9	-27.6	10.5	5.9	-15.7	-3.8	-.3
Other crude materials	18.6	1.8	22.4	39.4	16.9	1.3	.8

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

late 1987 surge that was associated mainly with a temporary disruption in lettuce supplies. Price increases for other food items, which constitute about 70 percent of the CPI food total, picked up a bit in January, but then moderated again last month. At the farm level, the index for crude foods rose more than 2 percent in February, with large increases for livestock and grains. Movements in farm prices have been mixed since the February PPI pricing date.

Retail energy prices declined further in February, led by another steep decline in gasoline prices. With world oil prices under downward pressure into the second week of March, energy prices should remain a moderating influence on the CPI over the near term.

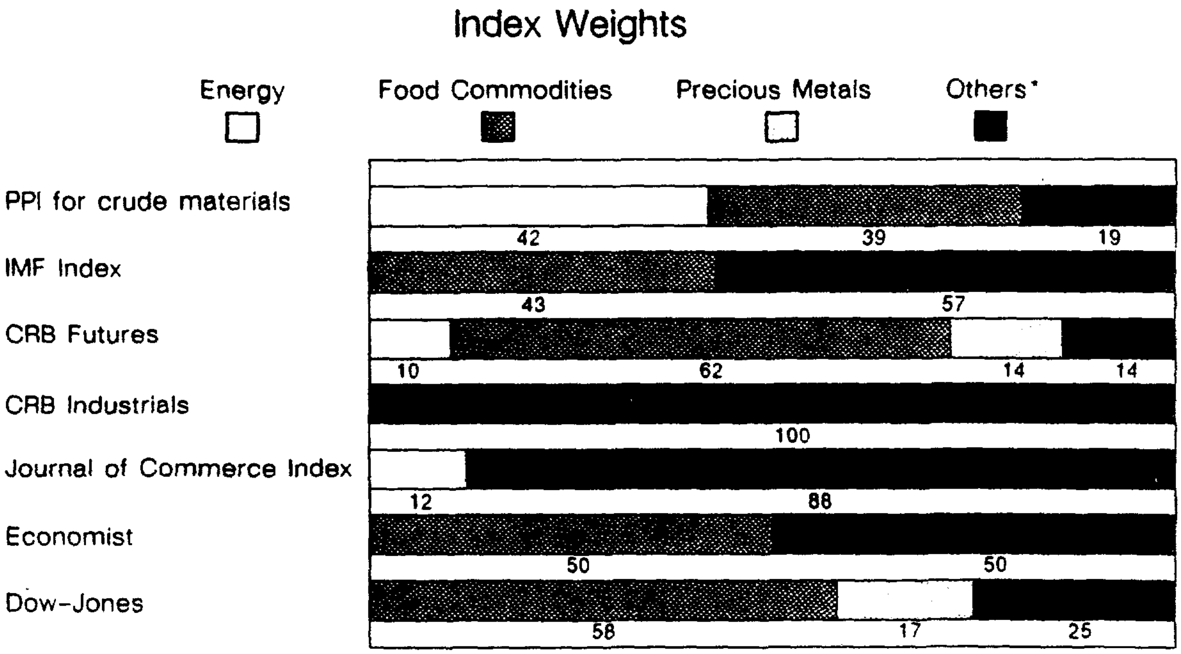
Excluding food and energy, the CPI rose 0.5 percent in January, but then slowed to just 0.2 percent in February. Swings in apparel prices--owing to the timing of discounts--have accounted for much of the fluctuation in the index for consumer commodities excluding food and energy. With the markdowns in February, prices of retail apparel goods are now down 1-1/4 percent from their November level. The February index for nonenergy services rose 0.4 percent, after a larger increase in January. In February, particularly large increases were posted for medical, educational, and local telephone services.

At the producer level, the PPI for finished consumer goods less food and energy also slowed in February, after a pickup in January. Capital equipment prices continued to rise at a moderate pace. Prices of intermediate materials less food and energy, which rose rapidly through January, advanced only 0.2 percent in February. This index was held down by fairly widespread declines, most notably by a dropback for a variety of copper products. The PPI for crude nonfood materials less energy was up 0.8 percent in February. Since the February PPI pricing

PRICE INDEXES FOR COMMODITIES AND MATERIALS[1]

	Last Obser-vation	Percent change[2] 1986	1987	To Feb. 2*	Feb 2* to date
1. PPI for crude materials[3]	Feb.	-8.9	8.8	.3	n.a.
1a. Ex. food and energy	Feb.	1.8	22.4	2.8	n.a.
1b. Ex. food and energy, seas. adj.	Feb.	1.7	22.5	2.1	n.a.
2. IMF commodity index[3]	Feb.	-7.9	30.8		n.a.
2a. Metals	Feb.	-.5	51.9		n.a.
2b. Nonfood agric.	Feb.	8.5	47.5		n.a.
3. Commodity Research Bureau					
3a. Futures prices	Mar. 21	-9.1	11.7	-1.5	-.1
3b. Industrial spot prices	Mar. 18	5.1	19.0	-2.5	1.0
4. Journal of Commerce industrials	Mar. 21	-1.4	10.7	-1.4	2.0
5. Economist (U.S. dollar index)	Mar. 15	-4.7	42.5	-5.1	6.1
5a. Industrials	Mar. 15	5.8	62.6	-7.6	10.8
6. Dow-Jones Spot	Mar. 21	-8.9	17.0	-3.2	.3

1. Not seasonally adjusted.
2. Change is measured to end of period, from last observation of previous period.
3. Monthly observations. IMF index includes items not shown separately.
n.a.--Not available.
*Week of the February Greenbook.



*Forest products, industrial metals, and other industrial materials.

date, prices in spot commodity markets have moved up sharply for aluminum and hides, but have declined for steel scrap and lead. Although domestic commodity price indexes for industrial materials have registered net increases over the latest period, they are little changed for the year to date.

Wages and Labor Costs

Despite the rapid growth in employment, wage trends have changed little in recent months. The hourly earnings index rose 0.2 percent, on average, in the first two months of the year, roughly in line with last year's pace. Nonetheless, higher payroll taxes have boosted employer contributions for social insurance significantly, and this is expected to add around 1 percentage point, at an annual rate, to the overall rise in hourly compensation in the first quarter.

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

	1986	1987	1987 Q2	1987 Q3	1987 Q4	1987 Dec.	1988 Jan.	1988 Feb.
			-----Annual rate-----			- --Monthly rate---		
Total private nonfarm	2.3	2.7	2.6	2.7	3.5	-.1	.4	.0
Manufacturing	1.7	2.0	2.1	2.1	2.3	.2	.1	.2
Durable	1.3	1.8	2.1	2.6	2.2	.1	.1	.2
Nondurable	2.3	2.3	2.2	1.2	2.4	.2	.0	.4
Contract construction	2.2	.8	3.4	.2	2.4	-1.4	1.5	-1.0
Transportation and public utilities	2.8	2.5	3.5	2.3	1.1	.1	.0	.4
Finance, insurance and real estate	4.4	4.7	.5	3.4	5.3	-.6	1.6	.5
Total trade	1.8	2.3	2.5	3.5	2.5	.2	.2	-.1
Services	3.1	4.7	3.2	4.6	6.8	-.1	.6	.0

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

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

	1986[1]	1987[1]	1987 Q1	1987 Q2	1987 Q3	1987 Q4
Output per hour	1.5	1.6	.4	1.4	4.2	.3
Compensation per hour	3.4	2.8	1.1	3.0	3.6	3.4
Unit labor cost	1.9	1.2	.8	1.5	-.6	3.1

1. Changes are from final quarter of preceding period to final quarter of period indicated.
2. The nonfinancial corporate sector includes all corporations doing business in the United States with the exception of banks, stock and commodity brokers, and finance and insurance companies; the sector accounts for about two-thirds of business employment.
n.a.--Not available.

APPENDIX

FEDERAL BUDGET DEVELOPMENTS[1]

On February 18, the administration submitted its budget proposals for fiscal 1989. The broad outlines already had been shaped by the summit agreement reached at the end of last year with the bipartisan congressional leadership; they are reflected in the budget aggregates shown in table 1. Although the summit called for roughly $30 billion of deficit reduction for the current year, the administration projects this year's deficit (third line) to be only slightly below last year's $150 billion. For 1989, the administration sees the deficit falling further, to $130 billion, if the summit agreement and additional policy proposals are fully implemented.

The budget plan appears to be roughly consistent with the FY1989 Gramm-Rudman deficit target. Under the amendments enacted last summer, the deficit is not to exceed $136 billion. However, there is a $10 billion margin; sequestration would be avoided if OMB estimates this summer and autumn show that the deficit will be less than $146 billion. Another feature of the Gramm-Rudman revision was to exclude certain one-time savings from the calculation. Embedded in the administration's budget is about $10 billion of such savings, in the form of asset sales. Therefore, adjusting for the asset sales, the deficit for Gramm-Rudman purposes is in the neighborhood of $140 billion, somewhat above the target but below the trigger point.

The lower panel of table 1 shows the policy assumptions incorporated in the 1989 budget. The summit agreement called for $46 billion in deficit reducing actions for 1989. Thirty-eight billion dollars of this deficit reduction is scored by the administration as already implemented through the two omnibus budget bills enacted on December 22. These included revenue increases, defense and nondefense discretionary program cuts, and entitlement savings. The contributions from defense and nondefense discretionary programs result from the carry-over effects for FY1989 of the appropriations enacted for FY1988. The summit agreement also included limits, or "caps," on defense and nondefense discretionary budget authority yet to be enacted for 1989. These caps would force spending $3 billion below this year's level after full adjustment for inflation. Other additional summit measures, totaling $5 billion, also remain to be authorized; these include asset sales of $3-1/2 billion.

1. This appendix was prepared by Albert Teplin, Senior Economist, Division of Research and Statistics.

Beyond the summit agreement, the administration is proposing further program reductions and some expansions. These proposals include changes requested in preceding years, such as decreases in funding or elimination of programs in the housing, surface transportation, and energy areas, and cutbacks in funding for the Postal Service, the District of Columbia government, and park land purchases. Increased funding is requested for space and other science programs, air traffic control, law enforcement and drug interdiction, as well as highly targeted education initiatives associated with proposed welfare reform.

The slight decline in the projected deficit for 1988 and the downward trajectory for deficits forecast for subsequent years are dependent both on the administration's policy proposals and on their economic assumptions. Table 2 compares the economic assumptions of the administration and CBO. For the next two years, the administration has a more optimistic view than CBO of real GNP growth and inflation. Their longer-run projections reflect a more favorable assessment of potential output growth and their view that inflation can continue to decelerate even as the unemployment rate drifts down below 5-1/2 percent. The administration also sees less of a boost to the CPI relative to the GNP deflator. (The CPI is the inflation measure relevant for major indexed outlay programs.) The administration anticipates more reduction in the unemployment rate (lines 7 and 8) principally as a result of their considerably stronger GNP projection; at the end of the projection horizon, the administration has assumed an unemployment rate of 5-1/4 percent compared with the 5-3/4 percent for CBO.

Interest rate assumptions, shown on lines 9 and 10, are particularly important for budget projections; a percentage point difference, persisting for a year, now has nearly a $10 billion annual effect on federal outlays. In part, the differences between the levels of projected interest rates reflect the differences between inflation projections; however, the implied ex post real Treasury bill rates differ by about one percentage point in 1988 and 1989.

The administration's current services budget estimates, which include the summit agreement in full but not the additional policy initiatives, are shown on table 3, along with CBO's updated baseline budget projection.[2] The CBO estimates exclude $10 billion of the summit accord that is not yet implemented. There are also a few other conceptual differences between the current services and baseline definitions. Nevertheless, both the current services and baseline concepts are designed to illustrate what would happen to the budget under laws

2. After release of the President's budget, CBO made minor technical revisions to the baseline budget projections that had been released earlier in their annual report. These revisions, which resulted largely from bringing an accounting definition into line with OMB practice this year, added about $4 billion and $2 billion to their FY1988 and FY1989 deficits, respectively.

and policies now in place if the economy performed reasonably well. The figures diverge principally because of different technical estimating methods as well as the different economic assumptions discussed above.

On March 10, the Congressional Budget Office released its analysis of the President's budget, which included a reestimate of the budget proposal using CBO's economic assumptions and technical estimating methods (table 4). The technical differences are primarily on the outlay side; in the near term, CBO anticipates higher spending than the administration for deposit insurance, Medicare, and income security programs. It also foresees lower proceeds from asset sales and loan prepayments. The differences in economic assumptions dominate the reestimates. Because lower real growth and higher inflation have largely offsetting effects on receipts, the economic differences also are concentrated on the outlay side of the budget where CBO expects unemployment-sensitive programs and programs that are indexed for inflation to be more costly. In addition, the larger size of deficits estimated by CBO for the early years of the projection period contributes, along with higher interest rates, to substantially higher debt service costs in the 1990s.

Despite CBO's less optimistic economic assumptions, their reestimates of the President's budget also show gradually declining deficits beyond 1989. Most of this decline is dependent on the new deficit-reducing measures proposed by the President. As shown in table 3, CBO's baseline budget deficit rises from the 1987 level of $150 billion to a peak of $177 billion in FY1989 and does not fall back below the 1987 level until the last year of the projection horizon. The deficit in 1987 was depressed, however, by transitory effects of tax reform, which reverse in 1988 and 1989; sizable outlay savings of a one-time nature also occurred in 1987. If these transitory factors are removed, along with the effects of the very slight further decline in the unemployment rate that CBO projects (on an annual average basis), their "standardized-employment" baseline deficit is estimated to have fallen by about 0.9 percent of potential GNP between 1986 and 1987 and is expected to fall further by a similar amount in 1988. Thereafter, it is about flat as a percent of potential GNP through 1991.

Long-range budget deficit estimates by both the administration and CBO are now considerably smaller than those that were being made a few years ago. As recently as 1985, the baseline budget projections showed deficits approaching $300 billion by 1990, or more than 5 percent of GNP, despite some further cyclical expansion then built into GNP projections. In large part, the improved deficit picture results from policy changes that have already taken place over the last several years. These changes, however, have accompanied longer-run budget trends, shown on the chart, that leave a substantial challenge to further deficit reduction.

Despite actions that have slowed outlay growth recently, federal spending as a portion of GNP--the solid line on the top panel--has remained at historically high levels, averaging nearly 23 percent over the last decade. Nondefense discretionary expenditures--outlays for programs that are subject to annual appropriations or to loan obligation limits imposed by appropriation acts--shouldered a substantial portion of recent budget restraint. As shown in the middle panel, such spending has fallen from nearly 6 percent of GNP in the seventies to less than 4 percent currently; in the CBO baseline it is about flat through 1990. Meanwhile, the early-1970s downtrend in military spending was reversed in the eighties; national defense outlays now equal 6-1/2 percent of GNP, after having fallen to 4-3/4 percent in 1979. Current policy, however, suggests defense outlays will turn down slightly relative to GNP--from about 6 percent to 5-1/4 percent in the next decade as the buildup yields to maintenance and replacement. The portion of outlays devoted to interest on the national debt has about doubled in the past 10 years; it is now about 3 percent of GNP and its future course will depend heavily on the balance between receipts and outlays in the rest of the budget. In the CBO baseline, it edges up to 3.5 percent by 1990.

Entitlement and other mandatory spending dominates the budget, accounting for nearly half of total outlays. By far the largest component of entitlement spending is for social security and Medicare. The aging of the population, benefit liberalizations, the effects of inflation, and adverse cyclical experience drove entitlement spending up to nearly 11 percent of GNP by the early 1980s. More recently, budget restraint, particularly the 1983 social security and Medicare reforms, and comparatively low inflation and unemployment have kept this category from rising further relative to output. However, the growing proportion of elderly in the population will continue to impose a floor for entitlement spending under current laws and may intensify pressures for program expansion. In CBO's projections, entitlement spending hovers around 10-3/4 percent of GNP over the five-year projection horizon.

Trends on the receipts side of the budget also are noteworthy. Social insurance taxes, which are devoted to paying for certain entitlements and now account for more than a third of revenues, have risen from less than 4 percent of GNP in 1963 to 7 percent last year. Nevertheless, overall receipts as a percent of GNP have averaged about 19 percent for several decades, with relatively small fluctuations around that figure. Many of the tax measures enacted over the last quarter century have kept this ratio from growing despite an aggregate elasticity of federal taxes with respect to income that tended to be greater than one--especially before indexation of some features of the personal income tax code in 1981. Thus, there appears to be a significant tension between public preference as manifest in tax legislation and the pressures--in part, from demographic sources--that sustain spending.

Table 1

ADMINISTRATION FY1989 BUDGET
(Billions of dollars, fiscal years)

	1987a	1988	1989
Receipts	854	909	965
Outlays	1005	1056	1094
Deficit	**150**	**147**	**130**
G-R-H Target	144	144	136

a--actual

POLICY CHANGES TO FY1989 DEFICIT FORECAST SINCE FALL
(Billions of dollars)

Pre-summit baseline[1]	185
Summit agreement	46
Enacted	38
Discretionary caps	3
Other to be enacted	5
Program expansions	-3
Proposed reductions	12
Administration budget	130

1. Based on administration's February economic and technical estimating assumptions.

Table 2

ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS

	Near-term projections		Long-run assumptions			
	1988	1989	1990	1991	1992	1993
	- - - - Percent change, calendar year average - - - -					
Real GNP						
1. Administration	2.9	3.1	3.5	3.4	3.3	3.2
2. CBO	2.3	2.6	2.6	2.6	2.7	2.7
GNP deflator						
3. Administration	3.5	3.8	3.6	3.2	2.7	2.2
4. CBO	3.4	4.1	4.1	4.1	4.1	4.1
CPI-W						
5. Administration	4.3	4.1	3.6	3.2	2.7	2.2
6. CBO	4.5	4.9	4.6	4.4	4.4	4.4
	- - - - Percent, calendar year average - - - -					
Civilian unemployment rate						
7. Administration	5.9	5.7	5.5	5.4	5.3	5.3
8. CBO	6.2	6.1	6.0	5.9	5.9	5.8
3-Month Treasury bill rate						
9. Administration	5.3	5.2	5.0	4.5	4.0	3.5
10. CBO	6.2	6.7	6.6	6.4	6.1	5.9

Table 3

ADMINISTRATION CURRENT SERVICES AND CBO BASELINE BUDGETS
(Billions of dollars, fiscal years)

	1988	1989	1990	1991	1992	1993
Revenues						
1. Administration	909	964	1043	1123	1189	1257
2. CBO	898	954	1036	1111	1181	1261
Outlays						
3. Administration	1056	1102	1154	1209	1252	1296
4. CBO	1059	1131	1206	1271	1335	1400
Deficit						
5. Administration	148	139	111	86	63	39
6. CBO	161	177	170	159	154	139
Memo: Deficit as a percent of GNP						
7. Administration	3.1	2.8	2.1	1.5	1.0	.6
8. CBO	3.4	3.5	3.1	2.8	2.5	2.1

Table 4

CBO AND ADMINISTRATION ESTIMATES OF THE ADMINISTRATION'S BUDGET PROGRAM
(By fiscal year, in billions of dollars)

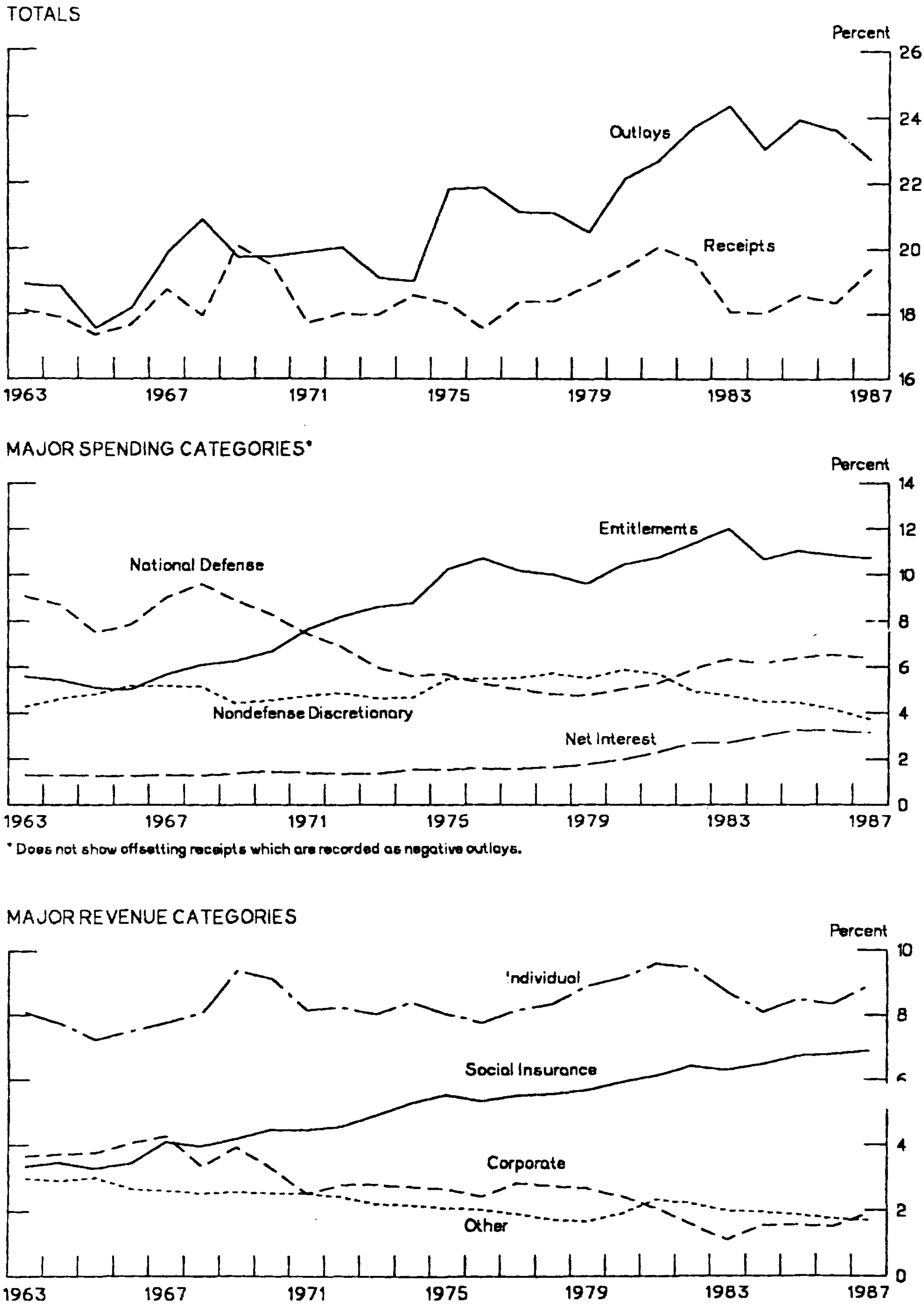
	1988	1989	1990	1991	1992	1993
Revenues						
Administration	909	965	1,044	1,124	1,190	1,258
CBO	899	955	1,038	1,113	1,182	1,262
Outlays						
Administration	1,056	1,094	1,148	1,204	1,241	1,281
CBO	1,060	1,120	1,195	1,253	1,313	1,371
Deficit						
Administration	147	130	104	79	51	23
CBO	161	165	157	140	131	109
	--- CBO less Administration Estimates and Source of Difference ---					
Revenues						
Technical	-3	-2	2	-1	*	2
Economic	-7	-8	-8	-11	-9	2
Total	-10	-10	-6	-12	-8	4
Outlays						
Technical	1	9	14	1	6	1
Economic	3	17	33	48	66	88
Total	4	26	46	49	72	90
Deficit						
Technical	4	11	12	2	5	*
Economic	10	25	41	59	75	86
Total	15	36	53	61	80	86

*--less than $500 million.

Chart 1

Revenues and Outlays as a Percent of GNP

(Fiscal years)



SELECTED FINANCIAL MARKET QUOTATIONS[1]
(Percent)

	1987 Jan.-Feb. lows	1987 Oct. 16[2]	1987 FOMC Dec. 16	1988 FOMC Feb. 10	1988 Mar. 22	Change from: Oct. 16[2]	Change from: FOMC Feb. 10
Short-term rates							
Federal funds[3]	5.95	7.59	6.71	6.57	6.54	-1.05	-.03
Treasury bills[4]							
3-month	5.30	6.93	5.94	5.61	5.78	-1.15	.17
6-month	5.31	7.58	6.40	5.83	5.95	-1.63	.12
1-year	5.35	7.74	6.71	6.10	6.31	-1.43	.21
Commercial paper							
1-month	5.81	7.94	8.22	6.41	6.56	-1.38	.15
3-month	5.73	8.65	7.93	6.45	6.62	-2.03	.17
Large negotiable CDs[4]							
1-month	5.85	7.92	8.09	6.46	6.56	-1.36	.10
3-month	5.80	8.90	7.81	6.51	6.62	-2.28	.11
6-month	5.78	9.12	7.81	6.57	6.82	-2.30	.25
Eurodollar deposits[5]							
1-month	6.00	7.79	8.41	6.71	6.70	-1.09	-.01
3-month	6.00	8.69	8.13	6.81	6.73	-1.96	-.08
Bank prime rate	7.50	9.25	8.75	8.50	8.50	-.75	.00
Intermediate- and long-term rates							
.S. Treasury (constant maturity)							
3-year	6.34	9.52	8.15	7.28	7.58	-1.94	.30
10-year	7.01	10.23	9.00	8.11	8.46	-1.77	.35
30-year	7.29	10.24	9.14	8.35	8.73	-1.51	.38
Municipal revenue[6] (Bond Buyer)	6.92	9.59	8.47	7.76	8.09	-1.50	.33
Corporate A utility (recently offered)	8.78	11.50	10.59e	9.66e	10.04e	-1.46	.38
Home mortgage rates[7]							
S&L fixed-rate	9.10	11.58	10.69	9.84	9.92	-1.66	.08
S&L ARM, 1-yr.	7.52	8.45	7.99	7.61	7.49	-.96	-.12

	1986 Year end	1987 Record highs	1987 Lows	1988 FOMC Feb. 10	1988 Mar. 22	Change from: Record highs	Change from: FOMC Dec. 16
Stock prices							
Dow-Jones Industrial	1895.95	2722.42	1738.74	1962.04	2066.15	-24.11	5.31
NYSE Composite	138.58	187.99	125.91	144.42	151.52	-19.40	4.92
AMEX Composite	263.27	365.01	231.90	272.65	298.80	-18.14	9.59
NASDAQ (OTC)	348.83	455.26	291.88	349.32	379.76	-16.58	8.71

1. One-day quotes except as noted.
2. Last business day prior to stock market decline on Monday, October 19, 1987.
3. Average for two-week reserve maintenance iod closest to date shown except Jan.-Feb. which is one-week average ending Feb. 25. Last observation is average to date for maintenance period ending Mar. 23, 1988.
4. Secondary market.
5. Average for statement week closest to date shown.
6. One-day quotes for closest Thursday.
7. Quotes for week ending Friday closest to date shown.
e--estimate.

Interest rates have risen on balance since the February FOMC meeting, the larger increases being registered in the bond markets. Although the federal funds rate has remained around 6-1/2 percent and the dollar has been relatively stable on exchange markets, the general structure of interest rates has shifted upward as incoming information has dispelled expectations of an early stall-out in economic expansion and shifted the focus to inflation risks.

Most key short-term rates are up between an eighth and a quarter percentage point. The Texas banking difficulties seem to have had little effect on the money markets. In longer-term markets, both Treasury and corporate bond yields have risen around 3/8 percentage point. The rise in interest rates has not prevented stock prices from registering sizable net gains over the intermeeting period; share prices have now recovered roughly a third of the decline from their August 1987 highs to their autumn lows.

Reflecting the effects of earlier declines in market rates, inflows to retail nontransactions instruments remained strong and M2 and M3 have expanded rapidly; these aggregates are in the top halves of their annual growth ranges. M1 continues to behave erratically, apparently rebounding in March after being virtually unchanged in February.

Growth of the domestic debt aggregate looks to be running well within the FOMC's monitoring range. Business borrowing has remained sizable, with the pace of bond issuance rising in March; corporate

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

	1987<1>	1987 Q3	1987 Q4	1987 Dec.	1988 Jan.	1988 Feb.	Growth Q4 87 - Feb. 88p
	---Percentage change at annual rates---						
1. M1	6.3	0.8	4.0	-2.9	12.8	1.1	3.3
2. M2	4.0	2.8	4.0	1.8	9.7	8.7	6.7
3. M3	5.4	4.5	5.5	1.4	8.2	10.2	7.0
Selected components							Levels bil. $ Feb. 88p
4. M1-A	2.8	-1.6	4.0	-4.1	9.5	-2.4	494.5
5. Currency	8.7	7.3	9.9	9.2	11.6	5.4	199.3
6. Demand deposits	-1.0	-7.5	0.1	-13.6	7.9	-8.7	287.8
7. Other checkable deposits	13.6	5.2	4.0	-0.9	19.0	7.7	265.1
8. M2 minus M1<2>	3.3	3.5	4.0	3.6	8.5	11.3	2187.0
9. Overnight RPs and Eurodollars, NSA	4.0	18.9	7.5	-25.6	63.2	-79.0	76.6
10. General purpose and broker/dealer money market mutual fund shares, NSA	6.3	4.6	13.7	7.1	21.6	31.8	232.2
11. Commercial banks	2.5	1.9	3.5	4.1	6.3	10.0	933.5
12. Savings deposits, SA, plus MMDAs, NSA<3>	1.8	-1.7	-4.2	0.2	3.1	4.7	539.9
13. Small time deposits	3.5	7.4	14.8	9.4	10.6	17.3	393.6
14. Thrift institutions	3.5	3.0	3.4	6.6	7.2	13.2	947.5
15. Savings deposits, SA, plus MMDAs, NSA<3>	0.8	-4.3	-11.6	-9.7	-7.7	-5.4	398.7
16. Small time deposits	5.6	9.3	16.0	19.4	18.6	27.1	548.8
17. M3 minus M2<4>	10.8	11.0	11.1	-0.3	2.4	15.9	771.9
18. Large time deposits	8.5	7.8	14.4	10.5	-5.0	14.4	488.5
19. At commercial banks, net<5>	11.2	6.8	10.5	4.5	-12.6	13.1	323.6
20. At thrift institutions	3.4	9.9	22.2	23.5	10.4	17.0	164.9
21. Institution-only money market mutual fund shares, NSA	3.0	2.9	20.2	1.3	64.3	54.7	98.7
22. Term RPs, NSA	29.9	25.6	-4.1	-36.4	2.3	37.5	108.9
23. Term Eurodollars, NSA	13.5	16.6	10.2	-25.7	-78.9	-9.8	84.6
MEMORANDA:<6>	---Average monthly change in billions of dollars---						
24. Managed liabilities at commercial banks (25+26)	6.0	3.7	5.3	5.6	0.3	-2.5	569.1
25. Large time deposits, gross	3.5	0.3	5.4	2.2	-0.1	5.4	394.5
26. Nondeposit funds	2.6	3.4	-0.1	3.4	0.4	-2.9	174.6
27. Net due to related foreign institutions, NSA	2.9	4.5	1.0	7.3	-6.9	-6.4	1.9
28. Other<7>	-0.3	-1.1	-1.1	-3.9	7.3	3.5	172.7
29. U.S. government deposits at commercial banks<8>	0.3	-0.7	0.4	-9.6	-7.5	4.0	22.6

1. Amounts shown are from fourth quarter to fourth quarter.
2. Nontransactions M2 is seasonally adjusted as a whole.
3. Commercial bank savings deposits excluding MMDAs increased during January and February at rates of 5.4 percent and 13.4 percent, respectively. At thrift institutions, savings deposits excluding MMDAs decreased during January and February at rates of 3.6 percent and 0.5 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. Dollar amounts shown under memoranda are calculated on an end-month-of-the-quarter basis.
7. 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.
8. Consists of Treasury demand deposits and note balances at commercial banks.
p--preliminary.

restructuring activity continues to result in massive net equity retirements. Mortgage borrowing by households appears to have slowed a little in recent months, but consumer installment credit likely grew more rapidly. State and local bond offerings have picked up after a slow January, while net issuance of Treasury debt is off about seasonally in the current quarter.

Monetary Aggregates and Bank Credit

In February, M2 and M3 again expanded rapidly, increasing at 8-3/4 and 10-1/4 percent annual rates, respectively. Available data suggest that this strength has persisted into March. Growth appears to have been boosted, at least in part, by a reduction of opportunity costs of holding monetary assets: deposit rates have yet to match the drop in market rates since last fall.

In contrast to strength in the broader aggregates, M1 was virtually unchanged in February; however, incoming data suggest renewed expansion in March. All of the components of M1 decelerated in February. Currency, which had been exceptionally strong after the October 19 crash, returned to a pace of expansion more in line with the underlying growth of spending. Demand deposits fell last month, more than reversing January's increase; the weakness, on balance, in this component over the post-crash period has been widespread by size and type of depository institution. OCD growth slowed to a 7-3/4 percent annual rate in February, after a 19 percent surge in January.

Among the nontransactions components of M2, patterns of growth have been shaped by the still large rate advantage of small time accounts

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

	1986:Q4 to 1987:Q4	1987 Q3	1987 Q4	1987 Dec.	1988 Jan.	1988 Feb.[p]	Levels bil. $ Feb.[p]
	Commercial Bank Credit						
1. Total loans and securities at banks	7.9	7.0	2.9	-1.0	5.9	8.3	2257.5
2. Securities	5.0	6.0	3.1	4.1	-2.7	3.8	529.8
3. U.S. government securities	9.1	12.4	.2	7.2	3.2	-0.4	334.0
4. Other securities	-1.3	-4.5	4.7	-1.2	-12.9	11.1	195.8
5. Total loans	8.8	7.3	2.8	-2.5	8.5	9.7	1727.8
6. Business loans	7.5	3.4	4.7	5.1	6.2	3.6	570.2
7. Security loans	1.0	19.1	-108.5	-174.0	110.7	166.8	41.8
8. Real estate loans	18.1	13.5	14.5	12.1	9.1	11.0	592.3
9. Consumer loans	4.9	5.8	4.5	3.7	6.3	8.8	330.2
10. Other loans	-2.3	1.0	-12.2	-42.2	-0.1	-4.3	193.3
	Short- and Intermediate-Term Business Credit						
11. Business loans net of bankers acceptances	7.6	2.9	5.4	5.4	5.8	3.8	566.9
12. Loans at foreign branches[2]	-4.1	25.3	-38.1	-127.1	134.2	92.3	18.2
13. Sum of lines 11 & 12	7.2	3.5	4.2	1.5	9.1	6.4	585.1
14. Commercial paper issued by nonfinancial firms	-1.6	-5.1	24.4	58.4	-2.7	-1.3	90.2
15. Sum of lines 13 & 14	6.0	2.3	6.8	8.9	7.7	5.2	675.3
16. Bankers acceptances: U.S. trade related[3,4]	13.3	19.8	7.1	-20.5	-13.9	n.a.	34.9[5]
17. Line 15 plus bankers acceptances: U.S. trade related	6.3	3.2	6.9	7.7	6.3	n.a.	707.3[5]
18. Finance company loans to business[3]	16.6	14.2	14.5	7.2	16.8	n.a.	202.7[5]
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	8.4	5.5	8.6	7.6	8.6	n.a.	910.0[5]

1. Average of Wednesdays.
2. Loans at foreign branches are loans made to U.S. firms by foreign branches of domestically chartered banks.
3. Based on average of data for current and preceding ends of month.
4. Consists of acceptances that finance U.S. imports, U.S. exports, and domestic shipment and storage of goods.
5. January data.
n.a.--not available

over more liquid interest-bearing deposits. Small time accounts have expanded at a double-digit pace each month since last September; by contrast, the sum of savings, MMDAs, and OCDs has grown weakly in the first quarter after contracting in the fourth quarter.

M2 growth also has been bolstered by sizable inflows to retail-type money market mutual funds. Yields on shares of these funds have been relatively attractive compared with competing bank deposits. Investors also may be continuing to favor money market funds over bond and stock mutual funds. Net inflows to bond and equity funds strengthened somewhat in January (latest available) but remained well below the pace evident prior to the plunge in stock prices last October, and reports indicate that transfers into money market funds from bond and equity funds in the same family group continued in early 1988.

M3 was boosted in February by its non-M2 component as well as by strong M2 growth; however, the non-M2 component appears to be weakening in March. Inflows to institution-only MMMFs continued strong in February, reflecting the very attractive yields that were available on these instruments relative to market alternatives, but have shown signs of reversing in March. Growth of large time deposits has weakened in March after being very strong in February. Heavy issuance in February evidently helped fund relatively strong asset expansion at both commercial banks and thrifts. To some extent, though, CD issuance by banks also constituted a substitution for funds previously obtained by domestic offices from offshore branches; the decline of $6 billion in these funds in February may be linked indirectly to a shifting of

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

	1986	1987			1988		
	Year	Year^p	Q3	Q4^p	Jan.^p	Feb.^p	Mar.^e
Corporate securities - total[1]	28.18	24.08	26.50	15.68	21.19	21.40	23.50
Public offerings in U.S.	24.48	21.89	23.72	14.78	19.90	19.50	22.50
Stocks--total[2]	5.15	4.45	5.07	1.52	2.50	3.50	4.50
Nonfinancial	2.51	2.32	2.36	.73	.80	.90	.60
Utility	.64	.57	.71	.14	.10	.25	.20
Industrial	1.87	1.75	1.65	.59	.70	.65	.40
Financial	2.64	2.13	2.71	.79	1.70	2.60	3.90
Bonds--total[1]	19.33	17.44	18.65	13.26	17.40	16.00	18.00
Nonfinancial	9.62	6.59	6.62	4.71	5.85	5.90	7.60
Utility	3.61	2.01	2.45	2.03	1.35	2.00	3.20
Industrial	6.01	4.58	4.17	2.68	4.50	3.90	4.40
Financial	9.71	10.85	12.03	8.55	11.55	10.10	10.40
By quality[3]							
Aaa and Aa	4.70	3.27	2.79	4.74	4.45	3.25	3.50
A and Baa	6.05	5.20	4.43	4.03	7.90	5.30	7.60
Less than Baa	3.42	2.77	3.67	1.32	.38	1.60	1.70
No rating (or unknown)	.20	.07	.05	.03	.01	.10	.20
Memo items:							
Equity-based bonds[4]	.86	.87	.47	.35	.20	.10	.10
Mortgage-backed bonds	4.14	5.19	6.36	1.96	4.65	5.50	3.00
Variable-rate notes	1.02	1.87	2.75	.66	.75	1.45	1.50
Bonds sold abroad - total	3.55	2.03	2.51	.85	1.24	1.80	1.00
Nonfinancial	1.50	.94	1.27	.39	.20	.50	.50
Financial	2.05	1.09	1.24	.46	1.04	1.30	.50
Stocks sold abroad - total	.15	.16	.27	.05	.05	.10	.00
Nonfinancial	.09	.12	.16	.05	.05	.06	.00
Financial	.06	.04	.11	.00	.00	.04	.00

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 or Standard and Poors if unrated by Moody's. Excludes mortgage-backed and asset-backed bonds.
4. Includes bonds convertible into equity and bonds with warrants that entitle the holder to purchase equity in the future.
p--preliminary.
e--staff estimate.

investments by foreign central banks from the Eurodollar market to U.S. Treasury securities.

The pickup in bank credit growth in February reflected acquisitions for portfolio of mortgage-backed securities as well as stronger loan demand. Security loans--comprising mostly credit extended to brokers and dealers--soared for the second straight month and have returned almost to pre-crash levels. Among other loan categories, credit demands appear to have been most robust in the real estate and investment areas; business lending was weak at U.S. banking offices. Data available through early March suggest a slowing of growth of bank credit at large banks, reflecting runoffs of holdings of U.S. Treasuries and declines in security loans; however, real estate and consumer lending remain relatively strong.

Business Finance

Business borrowing has remained sizable in the first quarter of 1988, owing partly to greater merger and buyout activity. Renewed interest in corporate acquisitions may have been stimulated to some extent by the lower stock prices of potential targets and the improved liquidity of a number of prospective acquirers; but, in addition, the lower dollar has encouraged foreign purchasers. Merger and buyout deals, along with continuing share repurchases, have boosted net share retirements to an estimated $100 billion annual rate in the first quarter--a level not seen since the fourth quarter of 1986.

Growth of the sum of business loans and nonfinancial commercial paper appears to have picked up in early March after some slowing in

February. Despite increased merger financing, business loans at U.S. banks (including foreign branches) slowed to a 6-1/2 percent rate of growth in February, and partial data suggest a further slowing at large banks in March. By contrast, nonfinancial commercial paper outstanding has been strong thus far in March after contracting slightly in February.

The overall pace of securities issuance by nonfinancial businesses changed little in February but appears to have picked up in March. In the bond market, yields have moved up over the intermeeting period, in line with advances on comparable Treasuries, but remain lower than they were over most of the past year. The volume of issues with longer maturities, in particular, has responded to the relatively low rates. Activity in the junk bond market also has increased, with spreads over higher-grade issues narrowing a bit and issuance for purposes of corporate restructuring picking up.

Gross issuance of new shares by nonfinancial corporations has remained sluggish since the market crash last October. Moreover, while equity issuance by financial institutions has been expanding briskly, the bulk of the activity has been in shares of new closed-end mutual funds set up to invest in U.S. and foreign government and corporate bonds.

The failure of nonfinancial equity offerings to rebound comes despite a strong rise in stock prices since early December, particularly in the Amex and NASDAQ indexes; however, prices of utility stocks have lagged because of disappointing rate increases granted by state regulators. On the financial side, S&L share prices have been depressed by adverse publicity regarding the need for further action to bolster FSLIC's reserves. In the last couple of weeks, some indexes of bank stock prices have slipped, perhaps reflecting adverse publicity about Texas banking; while the federal safety net has been extended to the creditors of the banking affiliates of First RepublicBank Corporation, shareholders remain exposed.

Treasury and Sponsored Agency Financing

The combined deficit of the federal government is expected to total about $34 billion in the first quarter of calendar 1988, down from $80 billion in the fourth quarter of 1987. Net cash borrowing from the public is expected to be about $41 billion this quarter, most of which is accounted for by issuance of marketable coupon securities, although these have been scaled back a bit recently.[1] Exchange market intervention earlier this year and efforts to extend maturities of existing holdings have continued to bolster requests by foreign official institutions for noncompetitive "add-ons" to Treasury auctions. These add-ons, which have totaled $14 billion thus far in 1988 as compared with $30.3 billion for all of 1987, have enabled the Treasury to cut back the volume of long-term bill and coupon issues being sold competitively to the general public. Two shorter-term coupon issues that settle at the end of this month will involve paydowns, apart from

1. The Treasury is expected to receive only $532 million of cash from the sale of nonmarketable foreign series bonds to the Mexican government. The 20-year zero-coupon bonds issued will have a total face value of about $2.6 billion.

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

	1987 Q4[p]	1988 Q1[e]	1988 Jan.[p]	1988 Feb.[p]	1988 Mar.[e]
Treasury financing					
Total surplus/deficit(-)	-80.4	-34.3	16.1	-23.9	-26.4
Means of financing deficit:					
Net cash borrowing from the public	60.8	40.8	5.3	20.4	15.1
Marketable borowings/ repayments(-)	48.6	34.0	5.0	16.5	12.5
Bills	11.0	3.3	.5	.0	2.8
Coupons	37.6	30.7	4.5	16.5	9.7
Nonmarketable	12.2	6.8	.2	3.9	2.6
Decrease in the cash balance	14.0	-2.1	-17.5	11.1	4.4
Memo: Cash balance at end of period	22.4	24.5	39.9	28.9	24.5
Other[2]	5.6	-4.5	-3.8	-7.6	6.9
Federally sponsored credit agencies, net cash borrowing[3]	19.8	4.0	1.0	3.5	.3
FHLBs	11.3	2.2	1.7	.1	.4
FNMA	4.4	2.0	.1	1.4	.5
Farm Credit Banks	-.6	-.6	-.5	.6	-.7
FHLMC	3.3	.2	.1	.1	0
FICO	1.2	.7	0	.7	0
SLMA	.1	.3	-.4	.7	0

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.
e--staff estimate.
p--preliminary.
Note: Details may not add to totals due to rounding.

add-ons, while very temporary cash needs prior to the influx of April tax payments will be covered by cash management bills.

Borrowing by federally sponsored credit agencies is projected to slow significantly in the first quarter of 1988 from its rapid pace in the previous quarter. Most of the slowdown is attributable to the housing-related agencies--the Federal Home Loan Banks, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. Debt retirement by the Farm Credit Banks appears to be continuing at the more moderate rate established in the last quarter of 1987; loan demand at these institutions may not be weakening as much as earlier, given the improvement in the farm economy and the protection now afforded borrowers on the value of their stock investments in system units. This protection was part of legislation providing for federal assistance to the Farm Credit System, which was passed late last year. Since then, interest rates on its issues have declined relative to yields on Treasury securities. At the system's most recent offering in late February, the spread of the yield on the six-month issue over the six-month Treasury bill was 47 basis points, the smallest in 13 months.

Municipal Securities Markets

Tax-exempt revenue bond yields have risen around 30 basis points in recent weeks as new-issue volumes have been greater than had been expected. Gross offerings of municipal securities were boosted in February by bonds issued to finance transportation projects. Total tax-exempt issuance for March is expected to increase further as the volume of refundings has picked up to a pace well above that recorded in the second half of 1987, although remaining far below the average monthly volume in the years 1984 to 1986.

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

	1986	1987	1987		1987	1988		
	Year	Year	Q3	Q4	Dec.	Jan.	Feb.[p]	Mar.[f]
Total tax-exempt	14.04	9.29	8.16	8.49	8.41	6.00	8.41	9.50
Short-term[1]	1.79	1.37	1.83	1.26	.74	.59	.52	.50
Long-term	12.25	7.92	6.33	7.23	7.67	5.41	7.89	9.00
Refundings[2]	5.29	3.45	1.69	1.87	2.32	2.55	2.46	--
New capital	6.96	4.47	4.63	5.36	5.35	2.86	5.43	--
Total taxable	.35	.32	.15	.58	.75	.41	.33	--

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

In general, the ratios of yields on tax-exempts to yields on taxables at both long and short maturities have been higher subsequent to passage of tax reform legislation in 1986, which lowered marginal tax rates and thereby reduced the tax benefits from owning tax-exempt securities. For instruments of one-year maturity, which are perceived to have relatively little default risk, the ratio of prime-grade tax-exempts to Treasuries rose from less than 56 percent in 1983-84 (the first two years of the current expansion) to more than 66 percent in 1987. At longer maturities, changes in ratios of tax-exempt to taxable yields have been smaller and the net effects of tax reform less clear.

Mortgage Markets

Mortgage interest rates have changed little since the February FOMC meeting. In the primary market, the average contract rate on new commitments for 30-year, fixed-rate conventional home mortgages is about unchanged, while the average initial rate quoted on one-year adjustable-rate mortgages (ARMs) indexed to the one-year, constant maturity Treasury yield has declined 15 basis points. On balance, since last October, the fixed-rate loan rate is down more than 1-1/2 percentage points, and the ARM rate has fallen about a point.

Through January, however, there was no obvious response to the decline in mortgage interest rates. Consistent with movements in home sales and construction, the volume of mortgage loans closed at FSLIC-insured institutions declined in January to a seasonally adjusted $17.4 billion, the lowest level since September 1985. Both refinancings and purchase loans were down; moreover, new commitments to originate mortgages at thrifts declined for the fourth consecutive month to a seasonally adjusted $18.6 billion.[2]

Data on lending activity by thrifts in February are not yet available, but total applications for FHA-insured mortgages at all lenders were up nearly 30 percent from the modest January level. Some caution is appropriate in interpreting these data, because it is quite possible that the FHA activity could have reflected some shifting back toward fixed-rate lending rather than a pickup in overall mortgage debt formation. Between early December and early February, the ARM share of conventional loan originations already had fallen from 69 percent to 63 percent.

2. The proportion of mortgages closed at FSLIC-insured thrifts that were for refinancing fell to 19 percent, roughly in line with the average share for the latter half of 1987 and well below the peak share of 40 percent registered last March.

MORTGAGE ACTIVITY AT ALL FSLIC-INSURED INSTITUTIONS[1]
(Monthly averages, billions of dollars, seasonally adjusted)

	Mortgage transactions		Net change in mortgage assets[2]		
	Originations	Sales	Total	Mortgage loans	Mortgage-backed securities
1984	14.5	5.2	7.9	6.5	1.4
1985	16.4	8.2	4.1	4.2	-.1
1986	22.2	14.1	4.7	1.3	3.4
1987-Q1	21.8	12.9	1.8	-.5	2.3
Q2	23.1	12.7	7.2	2.6	4.6
Q3	20.0	9.6	6.1	3.4	2.7
Q4 r	19.5	6.8	9.2	5.2	4.0
1987-Oct.	19.7	7.3	9.4	4.8	4.5
Nov.	19.4	6.3	9.7	5.1	4.6
Dec. r	19.6	6.9	8.8	5.7	3.1
1988-Jan. p	17.4	5.8	4.7	4.8	-.1

1. All quarterly and monthly back data are revised due to incorporation of new seasonal factors.
2. Net changes are adjusted to account for structural changes caused by mergers, acquisitions, liquidations, terminations, or de novo institutions.

NEW ISSUES OF MORTGAGE-BACKED PASS-THROUGH SECURITIES
BY FEDERALLY RELATED AGENCIES
(Monthly averages, billions of dollars)

	Seasonally adjusted				Not seasonally adjusted
Period	Total	GNMAs	FHLMCs	FNMAs	Total
1984	5.0	2.3	1.6	1.1	5.0
1985	9.0	3.8	3.2	2.0	9.0
1986	21.6	8.2	8.4	5.0	21.6
1987	19.7	8.2	6.2	5.3	19.7
1987-Q1	26.7	10.8	10.1	5.9	24.0
Q2	26.8	9.7	9.6	7.5	24.8
Q3	16.2	7.4	4.7	4.0	17.7
Q4 p	11.8	5.0	2.6	4.2	12.2
1987-Oct.	11.9	5.0	2.8	4.1	12.1
Nov.	10.7	4.9	2.7	3.1	10.0
Dec. r	12.5	5.0	2.2	5.3	14.5
1988-Jan. p	8.3	4.0	2.4	1.9	7.4
Feb. p	9.3	3.5	2.8	3.0	7.4

r--revised. p--preliminary.

As had been the case in prior months, thrift activity in the secondary mortgage market in January reflected the preference of these institutions for retaining the ARMs they originate. Sales of mortgages by FSLIC-insured thrifts dropped to $5.8 billion, the lowest monthly level since November 1984. Net acquisitions of mortgage-related assets also declined in January to $4.7 billion, as holdings of pass-through securities fell for the first time since mid-1986. ARMs again accounted for all of the increase in unsecuritized mortgages.

The marketwide slowdown in the pace of fixed-rate lending in late 1987 affected the volume of new mortgage pass-through securities early this year. Issuance of federally related mortgage-backed pass-throughs declined in January to a seasonally adjusted $8.3 billion, while preliminary data for February suggest only a slight pickup to $9.3 billion, which was well below the average monthly pace registered in 1987. In contrast, offerings of derivative mortgage securities have rebounded to a monthly pace of about $5 billion. Notable among recent offerings was a $100 million FNMA issue with four tranches. This ninth offering by FNMA through a Real Estate Mortgage Investment Conduit (REMIC) raised Fannie Mae's total REMIC issuance to about $3 billion. Although it is currently authorized to issue up to $15 billion in REMICs, FNMA has petitioned HUD for unlimited issuing authority. Freddie Mac, meanwhile, made its initial foray into the REMIC market, selling two issues of about $400 million each on successive days in late February.

CONSUMER INSTALLMENT CREDIT
(Seasonally adjusted)

	Percent change (at annual rate)						Net change (billions of dollars)		Memo: Outstandings (billions of dollars)
			1987		1987	1988	1987	1988	1988
	1986	1987[r]	H1	H2[r]	Dec.[r]	Jan.[p]	Dec.[r]	Jan.[p]	Jan.[p]
Total[1]	10.5	5.9	3.5	8.3	7.9	10.6	3.98	5.42	617.5
Total, excluding auto	5.7	5.4	3.0	7.7	5.7	13.3	1.67	3.88	354.5
Selected types									
Auto	17.8	6.7	4.1	9.0	10.7	7.1	2.32	1.55	263.0
Revolving	10.6	8.1	3.6	12.4	19.3	16.5	2.31	2.00	147.9
All other	2.6	3.5	2.5	4.4	-3.7	11.0	-.64	1.88	206.6
Selected holders									
Commercial banks	8.1	5.1	2.1	8.0	11.9	12.6	2.69	2.88	277.8
Finance companies	20.7	5.3	2.3	8.3	8.6	3.7	1.02	.44	144.2
Credit unions	8.0	8.4	7.0	9.4	-.5	6.8	-.32	.48	84.9
Savings institutions[2]	10.7	11.6	10.1	12.5	5.3	22.1	.29	1.19	66.0

1. Includes items not shown separately.
2. Savings and loans, mutual savings banks, and federal savings banks.
r--revised. p--preliminary.
Note: Details may not add to totals due to rounding.

CONSUMER INTEREST RATES
(Annual percentage rate)

				1987			1988	
	1985	1986	1987	Oct.	Nov.	Dec.	Jan.	Feb.
At commercial banks[1]								
New cars (48 mo.)	12.91	11.33	10.46	...	10.86	...	...	10.72
Personal (24 mo.)	15.94	14.83	14.23	...	14.58	...	...	14.46
Credit cards	18.69	18.26	17.92	...	17.82	...	...	17.80
At auto finance cos.[2]								
New cars	11.98	9.44	10.73	10.31	12.24	12.23	12.19	...
Used cars	17.59	15.95	14.61	14.76	14.90	14.97	14.56	...

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

Consumer Installment Credit

Consumer installment credit outstanding grew at a 10-1/2 percent annual rate in January, up from the 8 percent pace recorded in December and on average over the second half of last year. The pickup in growth was wholly attributable to a surge in the sizable "other" component after a December decline, a turnabout that may only reflect instability in the pronounced seasonal patterns around Christmas. Growth in automobile and revolving (credit card) debt slowed a bit from December, although the latter maintained its position as the strongest component of installment credit since mid-1987.

The rebound in growth of revolving credit since last June, after nine months of sluggish expansion, likely is related in part to the slowdown in growth of loans taken down under home equity lines of credit. Previously reported survey results have indicated that banks became less aggressive in marketing home equity lines last summer and that the most common initial use of home equity lines is to repay outstanding debts, especially credit card balances. Other households may simply have used available liquid assets to repay consumer loans on which interest payments were no longer fully tax deductible, and such activity also seems likely to have diminished over time.

The household sector apparently experienced some increase in debt servicing problems during the fourth quarter. Delinquency rates on mortgage and consumer loans and the number of personal bankruptcies all rose fairly sharply after previous uptrends appeared to have flattened out earlier last year. According to the Mortgage Bankers Association, home mortgages past due 60 days or more jumped to 1.71 percent, erasing two-thirds of the previous quarter's steep decline. An American Bankers Association series, covering various types of closed-end consumer loans delinquent for 30 days or more, climbed to 2.56 percent in the quarter after holding for several quarters near the midpoint of its 13-year range of 1.80 to 2.80 percent. The major automobile finance companies reported no change in the car-loan delinquency rate in the fourth quarter, but experienced an increase in January to 2.14 percent. Personal bankruptcies were up again in the fourth quarter and rose 10 percent for 1987 as a whole.

HOUSEHOLD DELINQUENCY RATES AND BANKRUPTCIES
(Seasonally adjusted)

	1986	1987	1987 Q3	1987 Q4	1988 Jan.
Delinquency rates					
First mortgage loans (60 days or more; MBA series)	1.93	1.73	1.57	1.71	n.a.
Consumer loans (30 days or more; closed-end at commercial banks)	2.34	2.42	2.35	2.56	n.a.
Automobile loans (30 days or more; auto finance cos.)	1.95	1.92	1.93	1.93	2.14
Personal bankruptcy filings (thousands, annual rate)	449	494	501	519	n.a.

n.a.--not available.

Foreign Exchange Markets

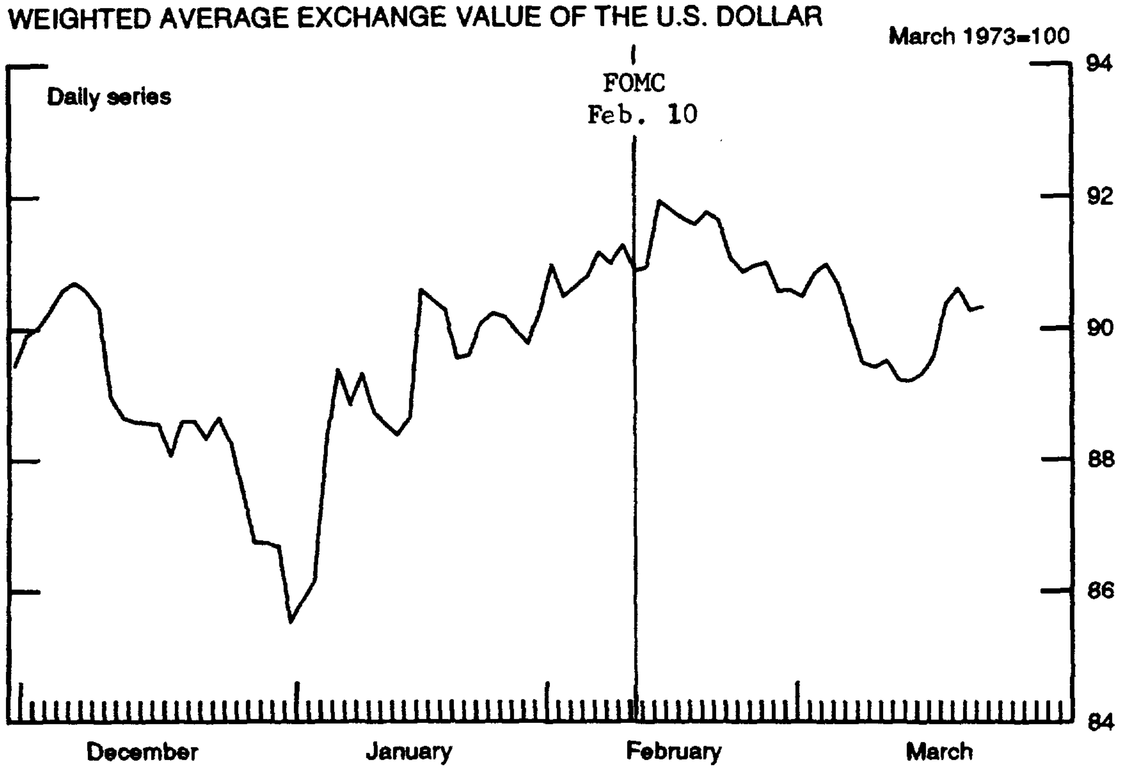
The dollar has eased a net 3/4 percent on a weighted-average basis against the other G-10 currencies since the last FOMC meeting, as shown in the upper panel of Chart 1. The dollar's decline principally reflected a nearly 4 percent fall against sterling and a 1-1/2 percent drop against the Canadian dollar and the yen, shown in the lower panel. In terms of the mark and other EMS currencies, the dollar was little changed on balance.

During the intermeeting period, the dollar primarily reacted to changes in the outlook for U.S. external adjustment. A sharp appreciation early in the period, in response to better than expected U.S. trade data for December, was subsequently eroded as data began to signal stronger U.S. demand. These concerns, in turn, subsided somewhat following the release in mid-March of another month of favorable trade data.

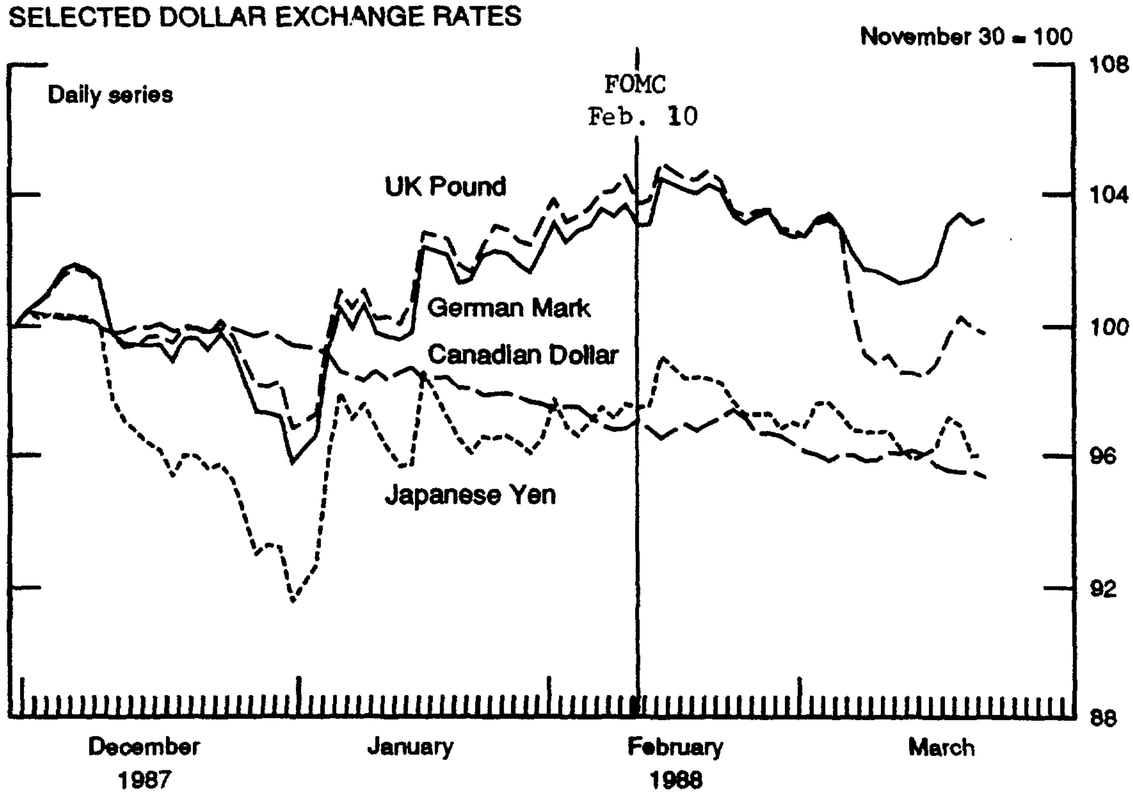
All three currencies -- sterling, the Canadian dollar, and the yen -- benefited from the robust performance of their economies and, in the case of sterling and the Canadian dollar, from statements by officials indicating that steps would be taken, if necessary, to counter inflationary pressures. Previously, Bank of Canada Governor Crow emphasized that the central bank's objective, rather than merely a low rate of inflation, is a steady price level. The Bank of England raised its money market intervention rates 1/2 percentage point in early February and further tightening was expected.

Chart 1

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



SELECTED DOLLAR EXCHANGE RATES



. U.K. officials stressed that interest rates would be used to counter inflationary pressures and would not be reduced to halt sterling's rise. As upward pressure on sterling persisted, the Bank of England

cut its money market intervention rates by 1/2 percentage point to 8-3/8 percent. In attempting to reconcile these actions with previously stated policy objectives, Prime Minister Thatcher cited recent U.K. monetary data showing modest increases in the broader aggregates and suggested that the decline in official rates was not inconsistent with a firm monetary stance given sterling's appreciation.

Short-term interest differentials favoring dollar-denominated assets were little changed on average during the intermeeting period. Interest rates on U.S. CDs were flat, and comparable interest rates in Japan and Germany showed little change. Three-month interbank rates in the United Kingdom fell 60 basis points, but interest rates were up sharply in France and Italy. For longer maturities, interest differentials between dollar and yen assets were little changed, while interest rates on dollar assets became relatively more attractive vis-a-vis rates on sterling and mark assets. Long-term interest differentials favoring the Canadian dollar widened during the intermeeting period.

U.S. International Financial Transactions

Net sales of U.S. corporate stocks by foreigners, which totaled $9.4 billion in the two months after the October crash, were virtually zero in January. (See line 2b of the Summary Table of U.S. International Transactions.) For 1987 as a whole, record net purchases in the first three quarters of the year were followed by large sales in the fourth quarter, resulting in a net inflow for the year only slightly below the 1986 level of $18 billion. Net purchases of U.S. corporate bonds by foreigners were also small, on a payments basis, in January (line 2a), but a pickup in new Eurobond issues by U.S. corporations in January and February suggests increased purchases as the first quarter progresses.

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

	1986 Year	1987 Year	1987 Q1	Q2	Q3	Q4	Nov.	Dec.	1988 Jan.
Private Capital									
Banks									
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	22.3	49.5	13.1	-1.2	25.3	12.4	0.3	12.9	-4.6
Securities									
2. Private securities transactions, net	65.5	37.4	16.7	15.9	11.7	-6.9	-7.6	-2.1	-0.8
a) foreign net purchases (+) of U.S. corporate bonds	53.5	26.5	8.5	7.5	7.7	2.8	0.4	1.1	0.1
b) foreign net purchases (+) of U.S. corporate stocks	18.0	16.8	10.2	8.7	5.4	-7.5	-6.7	-2.7	*
c) U.S. net purchases (-) of foreign securities	-5.9	-6.0	-1.9	-0.3	-1.4	-2.3	-1.2	-0.5	-0.9
3. Foreign net purchases (+) of U.S. Treasury obligations	4.0	-7.0	-2.8	-2.1	-2.8	0.6	6.0	-0.2	-0.2
Official Capital									
4. Changes in foreign official reserves assets in U.S. (+ = increase)	33.5	47.8	15.3	11.6	0.7	20.1	1.6	5.6	6.8
a) By area									
G-10 countries (incl. Switz.)	30.8	38.8	15.7	13.2	-5.7	15.7	1.9	6.4	6.8
OPEC	-8.3	-8.9	-2.7	-2.0	-1.4	-2.8	-1.3	-0.5	-1.1
All other countries	10.8	17.8	2.3	0.5	7.8	7.2	1.0	-0.3	1.0
b) By type									
U.S. Treasury securities	34.4	43.4	12.2	11.1	0.8	19.2	5.6	8.0	6.7
Other <1>	-1.0	4.4	3.1	0.6	-0.1	0.8	-4.0	-2.5	0.1
5. Changes in U.S. official reserve assets (+ = decrease)	0.3	9.1	2.0	3.4	*	3.7	1.0	2.3	1.3
Other transactions (Quarterly data)									
6. U.S. direct investment (-) abroad 3/	-28.0	-38.2	-10.0	-5.6	-6.2	-16.4	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S. 3/	25.1	40.6	7.7	9.5	12.3	11.1	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) 2/ 3/	-5.2	-0.4	0.1	2.9	-0.8	-2.6	n.a.	n.a.	n.a.
9. U.S. current account balance 3/	-141.4	-160.7	-36.9	-41.3	-43.4	-39.0	n.a.	n.a.	n.a.
10. Statistical discrepancy 3/	23.9	21.9	-5.2	6.9	3.2	17.0	n.a.	n.a.	n.a.
MEMO:									
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-144.3	-159.2	-38.9	-39.7	-40.4	-40.2	n.a.	n.a.	n.a.

1. Includes deposits in banks, commercial paper, acceptances, borrowing under repurchase agreements, and other securities.
2. Includes U.S. government assets other than official reserves, transactions by nonbanking concerns, and other banking and official transactions not shown elsewhere. In addition, it includes amounts resulting from revisions of the data in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.
3. Includes seasonal adjustment for quarterly data.
* Less than $50 million.
NOTE: Details may not add to total because of rounding.

After large net purchases in November, private foreigners made small net sales of U.S. Treasury securities in both December and January (line 3).

U.S. net purchases of foreign securities continued strong, reaching $920 million in January. (See line 2c.) This total was entirely accounted for by purchases of foreign bonds, some of which were issued directly in the United States. U.S. residents continued to sell foreign equities net in January, as they had during the fourth quarter of 1987.

Official reserves held in the United States showed a further large increase of $6.8 billion in January (line 4),

. Substantial increases in official reserves held in the Unites States were registered by the G-10 countries,

. Preliminary information from the FRBNY indicates further sizable increases in G-10 official holdings in the United States in February and early March, particularly in the form of Treasury bonds and notes.

. The reserves of OPEC countries in the United States dropped significantly again in January ($1.1 billion). After declining a total of $8.8 billion in 1987, total OPEC reserves in the United States stood at $27.4 billion at the end of January, down almost $40 billion from their peak in 1982.

Banks reported that net outflows in January were $4.6 billion (line 1). Preliminary data for February, covering transactions with own foreign offices, show a continued outflow at least as high. (See line 1

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1983	1984	1985	1986	1987				1988	
	Dec.	Dec.	Dec.	Dec.	Mar.	June	Sept.	Dec.	Jan.	Feb.
1. Net Claims of U.S. Banking Offices (excluding IBFS) on Own Foreign Offices and IBFS	44.5	33.0	28.2	22.3	9.1	5.0	-7.8	-10.9	-4.1	2.3
(a) U.S.-chartered banks	40.5	32.1	32.4	31.7	21.6	16.3	12.6	15.2	18.4	22.4
(b) Foreign-chartered banks	4.0	.9	-4.2	-9.4	-12.4	-11.3	-20.3	-26.1	-22.5	-20.1
2. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	18.6	20.7	18.7	16.8	16.0	15.6	17.1	15.8	16.1	18.1
3. Eurodollar Holdings of U.S. Nonbank Residents 1/	124.3	117.6	111.1	124.5	134.0	135.7	141.1	133.0	130.1	125.4

1. Includes term and overnight Eurodollars held by money market mutual funds.

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 an average of daily data for the overnight component and an average of Wednesday data for the term component.

of the International Banking Data table.) One factor in these outflows was probably the rapid growth of core deposits relative to bank credit in these two months. Another factor may have been the shift of large amounts out of the Euromarkets into U.S. Treasury securities by official monetary authorities.

The recently released data for direct investment in the fourth quarter show very large flows in both directions (lines 6 and 7). For the year, inflows were a record $40.6 billion, up over $15 billion from both 1986 and the previous record year of 1984. A large share of the total inflow came from the United Kingdom ($19.0 billion) and Japan ($7.4 billion); the rest of Western Europe accounted for an additional $11 billion and Canada was next with $1.4 billion. Inflows from the United Kingdom have been strong in recent years ($7.8 billion in 1986), frequently being linked to large acquisitions (e.g., the British Petroleum purchase of 45 percent of Sohio in 1987 for $7.6 billion). Outflows in 1987 at $38.2 billion approached the level of inflows. However, this figure was inflated by $11 billion in capital gains associated with the depreciation of the dollar. The largest share of the direct investment outflow (including capital gains) went to Western Europe ($19.7 billion), with $6 billion going to the United Kingdom. Sizable outflows also went to Canada ($6.6 billion) and to finance affiliates in the Netherlands Antilles ($3.1 billion).

U.S. Merchandise Trade

Last week the Commerce Department released U.S. merchandise trade figures for January. The not-seasonally-adjusted deficit, shown in column 8 in the summary table on the next page, was slightly larger than that recorded in December. On a seasonally adjusted basis, the staff estimates a slight improvement in the trade position (column 7). All of the seasonal factors for merchandise exports and imports are currently being revised; new seasonally adjusted data (including historical figures) will be released on a regular basis beginning in June when data for the month of April become available.

Merchandise exports in January were 7 percent below the strong December level and about equal to the average rate of exports in the fourth quarter. The decline in January was largely in manufactured goods and was broadly spread among industrial supplies, capital goods, automotive products, and undocumented shipments to Canada. Domestic demand continued to advance in major U.S. trading partners through the first quarter, though at a reduced pace compared with the fourth quarter of 1987. In recent quarters, about one-fourth of U.S. nonagricultural exports were shipped to Canada, another fourth to countries in Western Europe, 10 percent each to Japan and to the Asian NICs, 6 percent to Mexico, and the remaining 25 percent largely to other countries in Latin America and Asia. Much of the increase in nonagricultural exports to the Asian NICs since last October was due to nonmonetary gold shipments to Taiwan; in November, December, and January, U.S. gold exports to Taiwan totaled $807 million, compared with less than $1 million during the first 10 months of 1987.

Agricultural exports in January were at rates higher than in either December or the fourth quarter. Much of the strength is attributed to

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March 23, 1988

U.S. MERCHANDISE TRADE
(Billions of dollars, annual rates)

	Balance-of-payments basis, seasonally adjusted							CIF Value nsa
	Exports			Imports				
	Total	Ag.	Nonag.	Total	Oil	Non-oil	Balance	Balance
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Years								
1984	220	38	182	332	57	275	-112	-122
1985	216	30	186	338	50	288	-122	-134
1986	224	27	197	369	34	335	-144	-156
1987	251	30	221	410	42	368	-159	-171
Quarters								
1986-1	216	28	187	355	41	314	-140	-152
2	228	25	202	362	30	332	-135	-163
3	226	27	200	375	32	343	-149	-179
4	228	28	200	382	32	350	-154	-172
1987-1	227	26	201	383	35	348	-156	-157
2	239	28	211	398	40	359	-159	-171
3	260	33	227	422	50	371	-161	-185
4	276	31	245	437	44	393	-161	-172
Months	(Monthly BOP data = official use only)							
1987								
Apr.	237	28	209	386	34	352	-148	-156
May	233	28	205	394	40	354	-160	-168
Jun.	248	29	219	416	46	370	-168	-189
Jul.	266	35	231	432	53	378	-166	-198
Aug.	255	32	223	416	53	363	-162	-188
Sep.	261	34	228	418	45	373	-157	-169
Oct.	258	33	226	441	50	391	-183	-212
Nov.	275	29	247	426	44	382	-150	-159
Dec.	295	31	264	444	40	404	-149	-146
1988								
Jan.-e	275	35	240	415	40	375	-140	-149

e/ BOP basis data are FR staff estimates.
Note: Details may not add to totals because of rounding.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census.

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large shipments of wheat and feedgrains to the Soviet Union and China. Soviet destinations accounted for 40 percent of January wheat shipments, and China another 8 percent. Wheat shipped to these two countries was sold under Export Enhancement Programs, which means that prices paid were well below the world price for wheat. Purchases already agreed to by the Soviet Union and China should raise the level of shipments through May.

The value of imports in January was well below rates recorded in either December or the fourth quarter as a whole. There were declines in imports of capital goods and industrial supplies in January from unexpectedly strong rates during the fourth quarter; there were also equally strong declines in imports of consumer goods and automotive products. Imports of passenger cars from Asia and Europe, which had declined in the fourth quarter (on a seasonally adjusted basis), fell further in January.

The value of oil imports in January was about the same as in December. (See the table below.) A 9 percent increase in volume was offset by a drop in the average price of imported oil by nearly $1.00 per barrel. The volume of oil imports rose in January as stock drawdowns were offset by higher consumption; weekly data suggest that

OIL IMPORTS

	1987					1987	1988
	Year	Q1	Q2	Q3	Q4	Dec.	Jan.-e
Value (Bil.$, SAAR)	42.32	34.68	39.78	50.45	44.38	39.57	40.94
Price ($/BBL)	17.17	15.64	17.32	18.06	17.39	16.85	15.92
Volume (Mbd)	6.75	6.07	6.29	7.65	6.99	6.43	7.06

e/ FR Staff estimate.

the volume of imports in February may have been at about the same rate as in January. Prices in spot markets suggest further significant declines in the price of imported oil in February.

U.S. Current Account in 1987-Q4 and Year 1987.

1987-Q4. The U.S. current account deficit decreased to $156 billion at an annual rate in the fourth quarter of 1987 from $174 billion (revised) in the third quarter. (See the table below.) A sharp increase in capital gains (line 6) on the book value of U.S. direct investments abroad (due to the decline in the value of the dollar) accounted for virtually all of the reduction in the current account deficit. Also contributing to the reduction in the deficit were an

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

	1987 Year	1987 Q3	1987 Q4	$ Change Q4-Q3
1. Trade balance	-159.2	-161.5	-160.7	0.8
2. Exports	250.8	260.4	276.2	15.8
3. Imports	410.0	421.9	436.9	15.0
4. Investment income, net	14.5	1.2	28.4	27.2
5. Direct investment, net	35.3	23.1	54.0	30.9
6. Capital gains or losses 1/	11.0	0.9	24.8	23.9
7. Other D.I. income	24.3	22.1	29.2	7.0
8. Portfolio income, net	-20.8	-21.9	-25.6	-3.7
9. Military, net	-2.1	-2.9	-5.3	-2.4
10. Other services, net	-0.4	1.2	-0.7	-1.8
11. Unilateral transfers	-13.5	-11.7	-17.6	-5.9
12. Current Account Balance	-160.7	-173.8	-156.0	17.8
Memo:				
Statistical discrepancy, not AR	21.9	-8.5	11.7	

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

increase in net income receipts from other direct investments (line 7) and a slightly smaller trade deficit (line 1). On the other hand, there were increased net payments to foreigners in a variety of areas. Net portfolio income payments rose (line 8), reflecting, in part, growing U.S. liabilities to foreigners. Also, military sales declined further in the fourth quarter; military exports in the second half of 1987 were well below first-half levels reflecting completion during the first half of major scheduled deliveries of equipment. Unilateral transfers increased sharply as a country in the Middle East drew, in the fourth quarter, nearly all of the the U.S. Government grant funds provided for the fiscal year begun in October.

Year 1987. The U.S. current account was in deficit by $160.7 billion in 1987, compared with a deficit of $141.4 billion in 1986. The merchandise trade deficit rose to $159.2 billion in 1987 from $144.3 billion in 1986 (the value of imports rose more than that of exports). Worsening positions in net portfolio income payments and miscellaneous service transactions were partly offset by increased receipts from direct investments abroad (some of this was capital gains, but most of it was other earnings) and a reduced amount of unilateral transfers during the year.

U.S. bank lending to foreigners. The (nominal) dollar value of U.S.-chartered banks' claims on foreigners decreased $7.6 billion in the fourth quarter of 1987. The foreign exchange value of the dollar in terms of other G-10 currencies fell on average 13.3 percent during the period. After adjustment for the effect of exchange rate changes on nondollar claims, total claims on foreigners are estimated to have declined by about $21 billion in the fourth quarter, and by about $30 billion for 1987 as a whole.

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

	Changes (no sign = increase)						Out-standing
	1985	1986	1987	1987			
	Year	Year	Year	Q2	Q3	Q4	12/31/87
Total, all countries	-14.5	-1.6	-5.5	-7.8	0.6	-7.6	384.1
Non-OPEC developing countries	-6.7	-5.4	-2.9	0.4	-2.9	-0.6	96.8
of which:							
(Latin America)	-3.1	-1.0	-2.7	0.5	-1.4	-1.8	69.9
(Asia and Africa)	-3.5	-4.4	-0.1	0.1	-1.8	1.3	27.0
OPEC countries	-3.3	-2.0	-2.3	-1.3	0.2	-2.1	17.3
Eastern Europe	-0.2	-1.0	-0.2	0.3	0.0	-0.4	3.0
Smaller developed countries	-3.2	-4.2	0.0	-0.3	1.1	-0.6	26.2
G-10 countries	0.4	9.5	3.9	-2.7	-5.0	5.1	161.9
Offshore banking centers	-1.0	-1.4	-3.4	-2.5	4.0	-11.8	54.8
Miscellaneous	-0.4	2.9	4.4	-1.8	3.4	2.8	24.2
Memorandum:							
Total, adjusted for exchange rate changes (staff estimates)	-29	-11	-30	-9	1	-21	

Total U.S. bank claims on foreigners began their recent decline during 1985. In the period from the end of 1984 to the end of 1987, total claims have fallen by approximately $20 billion in nominal terms, and by approximately $70 billion after adjustment for exchange rate effects. Both U.S. and foreign banks have shifted lending toward borrowers from the G-10 countries. U.S. banks, however, have more than offset nominal increases in loans to these borrowers by reducing claims on virtually all other standard country groupings of borrowers.

The value of claims on non-OPEC developing countries fell by $600 million in the fourth quarter. This represented declines in claims on most countries in that group, with the notable exceptions of Argentina and Taiwan. Argentina made a $500 million drawing on its 1987 new money package during the quarter. This increased U.S. bank claims on that country by approximately $100 million. Claims on Taiwan increased by over $2 billion in the fourth quarter, as residents borrowed U.S. dollars and engaged in other financial transactions in anticipation of continued domestic currency appreciation.

Claims on most of the non-OPEC developing countries fell during 1987 as a whole. The largest percentage declines were concentrated on countries with outstanding loans from U.S. chartered banks valued at under $5 billion. Loans to eight of these countries were reduced by over 20 percent. (These countries were: Zaire, Israel, Egypt, Malaysia, South Korea, Peru, (Mainland) China, and Thailand.) Taiwan and India were the only non-OPEC developing countries to increase their (gross) borrowing from U.S. banks.

Recent data suggest that indicative prices for loans to most of the heavily indebted developing countries have fallen somewhat compared with estimates available prior to the last FOMC meeting. The largest decline has been in prices of loans to Argentina, which fell approximately 10 percent over the period.

INDICATIVE PRICES FOR BANK LOANS TO
HEAVILY INDEBTED DEVELOPING COUNTRIES
(Average of bid and offer price, expressed
as a percentage of par value)

	12/2/86	9/21/87	12/31/87	1/20/88	3/2/88	Change from 1/20/88 to 3/2/88 (percent)
Argentina	66.0	37.5	34.5	32.0	28.8	-10
Brazil	75.5	39.5	46.5	46.5	46.4	0
Chile	68.0	57.0	61.8	61.8	59.3	-4
Colombia	86.5	79.5	66.5	66.5	66.0	-1
Mexico	56.5	47.6	50.5	50.5	48.0	-5
Philippines	73.5	59.8	50.4	50.5	51.0	+1
Venezuela	74.5	54.5	58.0	55.0	53.9	-2

Source: Salomon Brothers.

Developments in Foreign Industrial Countries

Economic activity in the major foreign industrial countries slowed somewhat on average in the fourth quarter from its very strong third-quarter pace, although in Canada the pace of GDP growth accelerated. In Japan, growth in domestic demand accelerated in the fourth quarter while a sharp drop in net exports drew down overall GNP growth. Growth in fourth-quarter real GNP in the United Kingdom was below the exceptionally high third quarter rate but consumption and fixed investment spending remained strong, while in Germany and France, growth of GNP slowed to about half the third-quarter rate. Recent indicators for Germany suggest that growth in the first quarter of 1988 has continued at about the moderate pace of the fourth quarter, while

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

			1987				1987			1988		
	Q4/Q4 1986	Q4/Q4 1987	Q1	Q2	Q3	Q4	Oct.	Nov.	Dec.	Jan.	Feb.	Latest 3 months from year ago 2/
Canada												
GDP	1.8	5.7	1.5	1.3	1.3	1.5	*	*	*	*	*	5.7
IP	-.5	7.8	1.6	1.4	2.1	2.4	.8	.9	.1	n.a.	n.a.	7.8
France												
GDP	2.0	2.3	-.2	1.1	1.0	.4	*	*	*	*	*	2.3
IP	-.3	3.6	.3	1.6	.6	1.0	.0	.0	1.0	.0	n.a.	5.0
Germany												
GNP	2.4	2.3	-.5	.7	1.4	.7	*	*	*	*	*	2.3
IP	.6	1.3	-2.0	2.2	.3	.8	.6	-.1	.5	2.0	n.a.	3.5
Italy												
GDP	2.4	n.a.	-.1	1.8	.5	n.a.	*	*	*	*	*	2.4
IP	2.8	5.7	3.3	2.0	-2.8	3.2	4.4	-1.1	-4.0	n.a.	n.a.	5.7
Japan												
GNP	2.0	5.3	1.5	.0	2.0	1.7	*	*	*	*	*	5.3
IP	-.5	9.2	1.4	-.2	3.6	4.1	1.2	.8	2.0	.6	n.a.	10.0
United Kingdom												
GDP	4.4	4.3	1.0	.8	1.9	.7	*	*	*	*	*	4.3
IP	2.6	3.8	.3	.7	1.7	1.1	1.1	.0	.3	-.6	n.a.	4.1
United States												
GNP	2.2	3.9	1.1	.6	1.1	1.2	*	*	*	*	*	3.9
IP	1.0	5.7	.8	1.1	2.1	1.7	1.1	.5	.5	.3	.1	5.9

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

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

	Q4/Q4 1986	Q4/Q4 1987	1986 Q3	1986 Q4	1987 Q1	1987 Q2	1987 Q3	1987 Q4	1987 Nov.	1987 Dec.	1988 Jan.	1988 Feb.	Latest 3 months from year ago
Canada													
CPI	4.3	4.2	1.2	1.0	.9	1.4	1.2	.7	.4	.1	.2	n.a.	4.2
WPI	.3	4.3	.3	.6	.5	1.3	1.4	1.1	.5	.3	.8	n.a.	4.7
France													
CPI	2.1	3.2	.6	.7	1.2	.9	.6	.5	.1	.1	.2	.2	2.6
WPI	-3.4	3.0	-.7	-.7	.7	.5	.7	1.2	*	*	*	*	3.0
Germany													
CPI	-1.0	1.0	-.5	-.3	.6	.4	.0	.0	.0	.2	.2	.4	.9
WPI	-9.0	-.7	-2.9	-1.6	-.2	.0	-.4	-.2	-.2	.0	.2	n.a.	-.5
Italy													
CPI	4.7	5.2	.6	1.2	1.3	1.0	1.1	1.7	.3	.2	.5	.3	5.0
WPI	-2.4	4.6	-.8	.7	1.5	1.0	.8	1.2	.3	.3	.3	n.a.	4.4
Japan													
CPI	.1	1.1	-.5	.0	-.3	1.2	-.2	.4	-.4	.1	-.2	-.1	1.2
WPI	-9.1	-.6	-2.6	-1.0	-.7	-.7	1.3	-.4	-.5	-.5	-.7	-.1	-1.1
United Kingdom													
CPI	3.4	4.1	.1	1.3	1.2	1.5	.2	1.1	.5	-.1	.0	n.a.	3.7
WPI	4.2	3.9	.4	.8	1.3	1.1	.5	1.1	.3	.3	.7	.5	3.9
United States													
CPI (SA)	1.3	4.4	.6	.7	1.3	1.2	.9	.9	.3	.2	.3	.2	4.3
WPI (SA)	-1.9	2.4	-.0	.7	.7	1.1	.7	-.1	.0	-.4	.4	-.2	2.0

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)

	1986	1987	1986		1987				1987		1988	
			Q3	Q4	Q1	Q2	Q3	Q4	Nov.	Dec.	Jan.	Feb.
Canada												
Trade	7.5	7.8	1.7	1.8	2.4	2.3	2.1	1.1	.3	.2	.5	n.a.
Current account	-6.7	-7.3	-1.5	-2.1	-1.2	-1.5	-1.9	-2.7	*	*	*	*
France												
Trade	.1	-5.3	.0	.4	-1.0	-2.2	-1.1	-1.1	-.1	-.2	-.1	n.a.
Current account	3.0	-5.0	1.1	.7	-.3	-1.2	-1.3	-2.1	*	*	*	*
Germany												
Trade (NSA)	52.5	65.8	14.1	16.2	15.1	15.4	15.2	20.1	6.5	8.0	n.a.	n.a.
Current account (NSA)	38.5	44.7	9.2	13.8	11.1	10.6	7.8	15.2	5.7	5.5	n.a.	n.a.
Italy												
Trade	-1.5	-7.5	.6	.2	-1.3	-3.7	-1.2	-1.3	-.3	-.8	n.a.	n.a.
Current account (NSA)	3.7	-.0	5.4	1.2	-2.8	-.9	2.8	.9	*	*	*	*
Japan												
Trade	82.5	79.6	23.6	22.5	23.6	19.0	18.3	18.6	5.3	6.7	7.8	6.5
Current account 2/	85.4	86.6	23.5	24.0	25.3	21.3	19.9	20.2	6.7	7.5	8.0	n.a.
United Kingdom												
Trade	-12.4	-15.9	-4.3	-3.7	-1.7	-3.9	-5.0	-5.3	-1.9	-1.8	-2.7	n.a.
Current account	-1.5	-4.1	-1.3	-1.4	.9	-1.1	-1.8	-2.1	-.8	-.7	-1.6	n.a.
United States												
Trade 2/	-144.3	-159.2	-37.1	-38.6	-38.9	-39.7	-40.4	-40.2	*	*	*	*
Current account	-141.4	-160.3	-36.6	-38.0	-36.8	-41.2	-43.4	-39.0	*	*	*	*

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.

Japanese data for the first quarter indicate continued strong expansion. Inflation remains low in most of the foreign G-7 economies and, in early 1988, increases in the level of consumer prices from a year ago either slowed or were unchanged. Data available so far in 1988 indicate little change in the nominal external imbalances of several major foreign economies.

New government budget projections were announced recently in Germany and the United Kingdom. The German budget implies a widening of the federal deficit from 1-1/4 percent of GNP in 1987 to about 2 percent of GNP in 1988. In the United Kingdom, unexpectedly strong GDP growth and sharply falling unemployment in FY 1987 (April through March) allowed the government to announce simultaneously significant reductions in tax rates and a projected budget surplus of more than 1/2 percent of GDP in FY 1988, inclusive of revenues from privatization equal to about 1 percent of GDP.

Individual country notes. In Japan, the strong growth of real economic activity that emerged in the third quarter continued in the fourth quarter and into early 1988. Real GNP in the fourth quarter expanded at a 7 percent rate (s.a.a.r.) compared with the exceptionally robust 8.4 percent rate of the third quarter. Domestic demand grew 10.1 percent, up from 7.7 percent in the third quarter, based on strength in investment spending. Net exports made a negative contribution to growth, as exports declined 6.7 percent and imports grew 9.7 percent. On a fourth-quarter-over-fourth-quarter basis, real GNP grew 5.3 percent, with domestic demand contributing 6.5 percentage points and net exports withdrawing 1.2 percentage points. In January, industrial production (s.a.) increased 0.6 percent and retail sales (s.a.) rose 3.1 percent. While the unemployment rate (s.a.) edged up to 2.7 percent in January from 2.6 percent in December and housing starts (s.a.) fell in December and January from their recent rapid pace, the index of leading indicators pointed to continuing expansion over the first half of 1988.

Consumer price inflation remains low in Japan, with prices unchanged on balance since mid-1987. The all-commodities index of wholesale prices (n.s.a.) declined in each of the past four months. Lower rates on public utilities and lower prices of domestically produced and consumed goods contributed to the declines.

Japan's trade surplus (s.a.) widened on average in dollar terms in the first two months of 1988 relative to the fourth quarter. However, the declining trend in the real trade surplus continued as average growth in import volume in January and February of 21 percent from a year ago outpaced growth in export volume of 2 percent.

In Germany, real GNP growth slowed to 2.8 percent (s.a.a.r.) in the fourth quarter of 1987 from 5.7 percent in the third quarter. Although domestic demand increased sharply, inventory accumulation accounted for most of this growth. Private consumption grew 2.2 percent and construction rose 6 percent, but government outlays and expenditures on machinery and equipment fell. Net exports also declined. Real GNP in the fourth quarter of 1987 was 2.4 percent above the year-earlier level, with domestic demand contributing 3.1 percentage points and net exports withdrawing 0.7 percentage points. In January, industrial production (s.a.) increased 2 percent after a small increase in December. The unemployment rate (s.a.) in February was unchanged from January at 8.7 percent, a reduction from the 1987 year-end rates largely as a consequence of revisions in the labor force data. The volume of total new manufacturing orders rose in January from the monthly average of the fourth quarter, after four consecutive monthly declines. Domestic orders accounted for all of the increase. Capacity utilization (for all sectors except foodstuffs, beverages and chemicals) rose in the fourth quarter of 1987 to 85 percent, an increase of 0.5 percent from the third quarter.

Consumer prices increased slightly in February, rising 1.1 percent from a year ago. Producer prices in January were only 0.1 percent above year-earlier levels, and import prices were 1 percent below year-earlier levels.

The trade surplus (s.a.) increased slightly in December, bringing the trade surplus for 1987 as a whole to $65.8 billion, compared with $52.5 billion in 1986. The current account surplus in 1987 was $44.7 billion, compared with $38.5 billion in 1986. In 1987, export volume rose 2.3 percent on average and import volume rose 5 percent.

Monetary growth in Germany remains rapid. On average in January and February, German M3 grew at an annualized rate of 8-1/4 percent (s.a.) from the target base period of 1987 Q4.

The German cabinet has approved a draft 1990 tax reform bill which is expected to be considered in Parliament by the end of April. The draft proposal includes the last part of a three-stage tax reduction that began in 1986. The bill is expected to reduce the tax burden by a net DM20.6 billion or 0.9 percent of projected nominal GNP in 1990. The enforcement of a 10 percent withholding tax on interest, scheduled as part of the 1989 tax adjustments, has been a contentious issue. Various interest groups are currently seeking exemptions; and in early March, religious and non-profit organizations were granted exemptions.

Economic activity in France slowed in the fourth quarter from the rapid pace of the two previous quarters. Real GDP rose nearly 1.6 percent (s.a.a.r.) in the fourth quarter, after growing by more than four percent in the second and third quarters. Exports and investment spending were the major sources of growth in the fourth quarter. President Mitterrand has yet to announce his candidacy for the April 24 election, but he is expected to run, and in several polls he is ahead of Prime Minister Chirac and former Prime Minister Barre, the two other leading candidates.

Real GDP in the United Kingdom expanded 2.7 percent (s.a.a.r.) in the fourth quarter, as calculated by the average of the output, expenditure, and income measures. This represents a substantial slowdown from the 7.7 percent pace of the previous quarter. Consumption and fixed investment spending remained major sources of strength while the fourth-quarter GDP growth rate was held down by a drop-off of the rate of inventory accumulation from the very rapid pace of previous quarters. Industrial production (s.a.) declined 0.6 percent in January, but remained 4.4 percent above its year-earlier level. The unemployment rate (s.a.) fell to 9.1 percent in February, the 20th consecutive monthly decline and the lowest monthly unemployment rate since 1981. Average earnings continue to rise much more rapidly than consumer prices. In January, the 12-month rate of consumer price inflation was 3.3 percent, while average earnings increased at an 8.7 percent rate.

On March 15, the British government announced its budget for the fiscal year beginning in April. Its most notable feature was a reduction in tax rates amounting to nearly 1 percent of GDP, consisting almost entirely of personal income tax reductions. Despite these tax reductions, continued strong real growth is expected to keep the budget (inclusive of revenues from privatization) in surplus for the second consecutive year. The target range for M0 was lowered by 1 percentage point to 1 to 5 percent. As of February, the 12-month growth rate of M0 was 5.4 percent. However, interest rates, rather than monetary aggregate growth, are currently the focus of monetary policy.

Economic growth in Canada remains rapid. Real GDP grew 6.1 percent (s.a.a.r.) in the fourth quarter, as consumer spending and investment outlays continued to surge. Additions to private sector inventories made a significant contribution to growth. The unemployment rate dropped substantially in February to 7.8 percent, from 8.1 percent during the two previous months. The downward trend in consumer price inflation that started in mid-1987 continued in January.

Leaders of the European Community met in February to discuss reform of EC finances and of the Common Agricultural Policy. Agreement was reached to cap annual budget outlays and restructure budget contributions, to restrain agricultural spending and institute overproduction penalties, and to increase structural aid to the poorest member countries.

Economic Situation in Major Developing Countries

At the end of February, Brazil reached a preliminary agreement with its bank advisory committee on key elements of a financing and rescheduling package. The February 26 auction of Mexican bonds, backed by U.S. Treasury zero-coupon bonds, will enable Mexico to reduce its outstanding debt by $1.1 billion and achieve net savings in external interest payments of about $65 million per year for 20 years. The Argentine economic program is moving ahead with the disbursement of a U.S. Treasury bridge loan and IMF approval of additional drawings under the stand-by arrangement and from the Compensatory Financing Facility.

Individual Country Notes. Brazil paid $356 million from its own reserves as a partial payment of January 1988 interest at the beginning of February. On February 28, Brazil and the Bank Advisory Committee (BAC) announced a preliminary agreement on key elements of a financing package providing Brazil with $5.8 billion in new loans at a spread of 13/16 percent over LIBOR, covering interest arrears for 1987 and net new money needs for 1988 and the first half of 1989. Also, Brazil was, in effect, guaranteed $300-600 million in new short-term credit lines. Brazil made additional interest payments of $520 million on March 3 and $118 million on March 17, bringing total interest payments for interest due in the January-February period to $994 million; about $70 million remains to be paid for those two months. Brazil has announced its intention to make further interest payments as negotiations with the banks progress, but has emphasized its need for a bridge loan from the banks to cover the $1.8 billion in interest payments coming due in April, May and June.

The trade surplus for February was $858 million--a very strong performance since February is generally a seasonally weak month. Inflation accelerated to an 18 percent monthly rate in February; preliminary survey data indicate that inflation may slow to around 16 percent in March. Finance Minister Nobrega was rebuffed in his plans to control the public sector wage bill, and it remains unclear what steps will be taken to reduce the large operational fiscal deficit. The government revised downward its estimate for GDP growth in 1987 to 2.9 percent. Strong performance in the agricultural sector was the most important contributor to growth.

The February 26 auction of new Mexican bonds to retire public sector debt to banks at a discount will enable Mexico to achieve a net reduction of $1.1 billion in outstanding debt and net savings in external interest payments of about $65 million per year for 20 years, based on the current LIBOR. The average discount in the auction was 30.23 percent. Mexico will issue $2.6 billion in new bonds and expects to pay about $532 million to buy U.S. Treasury zero-coupon bonds that will serve as collateral for principal payments on the new Mexican bonds.

The effects of Mexico's anti-inflation program are beginning to be seen. The CPI, which rose by 15.5 percent in January, rose by 8.3 percent in February, and is expected to increase at a lower rate in March. After being held almost unchanged for six weeks, the controlled peso price of the dollar was raised by 2.7 percent during February.

However, the government announced February 29 that this rate would not be changed during March, that the freeze on public sector prices that was to have ended March 1 would continue for another month, and that price increases for private secto goods subject to price control would not be authorized this month. At the same time, the private sector agreed to make efforts not to raise prices of goods not subject to control, and organized labor accepted a 3 percent wage increase for March, abandoning its demand for a 10 percent raise. These moves brought about an inflow of funds from abroad and an appreciation of the free peso exchange rate to within 7/10 of 1 percent of the controlled rate. As the availability of funds increased, interest rates fell sharply. At the March 15 auction, the effective annual yield on 28-day Treasury bills was 136 percent, compared with 320 percent at the auction of February 23.

In late February, Argentina received the first $390 million drawing from a $550 million U.S. Treasury bridge loan that will bridge to future IMF and World Bank disbursements. The balance was disbursed March 15. On March 18 the IMF approved an SDR 165.5 million drawing under the stand-by arrangement and an SDR 130 million CFF drawing.

After declining from the 1987 peak rate of 19.5 percent in October to 3.4 percent in December, the monthly CPI inflation rate rose to 9.1 percent in January and 10.4 percent in February. The spread between the commercial and financial exchange rates has dropped from 38 percent on March 1 to 25.4 percent on March 18. The current account deficit in 1987 is estimated at $4.3 billion, compared with a deficit of $2.8 billion in 1986. Exports declined by about 10 percent in 1987, due in part to low commodity prices and lower crop yields as a result of poor weather. Commodity prices are now substantially above last year's levels, and prospects for harvests of Argentina's principal commodity exports have improved.

Venezuela's foreign exchange reserves dropped about $750 million in the first six weeks of 1988, partly because of the fall in oil export prices, before recovering in the second half of February. At end-February, central bank liquid operating reserves, by the government's definition, were $3.1 billion, compared with $3.5 billion at end-1987. Factors contributing to the recovery in reserves include receipt by the government of the proceeds of a $100 million international bond issue (mostly subscribed by Venezuelan financial corporations to meet foreign currency reserve requirements), sales of non-monetary gold, and a transfer of about $380 million to the central bank from the state-owned Venezuelan Investment Fund. Consumer prices rose 0.4 percent in January and fell 1.9 percent in February, led by a fall in food prices that is largely due to seasonal factors. This halted an acceleration of inflation that brought consumer prices in December 1987 to a level 40 percent above a year earlier.

Ecuador introduced a new exchange rate system on March 3 in response to the dramatic depreciation of the sucre in February. Previously, most private transactions had taken place at the free market rate. The new "free-controlled" rate for the sucre price of the dollar, applicable to most commercial transactions, has been set by the government at a level well below the free market rate. The move followed a series of unsuccessful attempts to relieve pressure on the sucre through more stringent import controls. Commitments to the $350 million commercial bank loan agreed to in October 1987 have reached about $328 million and continue to be sought.

In early March, Peru announced a series of measures to stabilize the country's accelerating inflation and burgeoning trade deficit. Government-controlled prices for gasoline and food staples were raised by 30 to 60 percent, and were then frozen for 120 days. Utility tariffs have also been raised, and the national sales tax was increased. Many import categories have been shifted to classifications subject to more depreciated exchange rates, and a parallel market for transactions not supported by central bank sales of foreign exchange--including tourism and non-priority imports--has been legalized.

Bolivia's commercial bank creditors have agreed to sell back to the government $308 million of debt at 11 percent of face value under an innovative debt-buyback program. The amount represents nearly 50 percent of Bolivia's total commercial bank debt. (Bolivia's total external debt is $4.1 billion.) Of the buyback transaction, $268 million reportedly was sold for cash and $40 million for 25-year bonds, denominated in bolivianos, that can be used for investments in Bolivia. The government will seek to renegotiate the remainder of its commercial bank debt at a later date.

On February 12, Cote d'Ivoire reached an agreement with its commercial bank creditors to reschedule 100 percent of its arrears on principal at end-1987 as well as the principal payments falling due in 1988-95. The banks also agreed to provide new money amounting to $150 million--enough to cover only 1987 interest arrears. A new approach is being considered to force all creditor banks to participate in the agreement in some way. Banks that do not want to provide new money would be given the option to convert their existing loans into exit bonds paying a fixed rate of interest over 25 years. Those banks that neither provide new money nor accept exit bonds would not be allowed to benefit from the clearing of interest arrears, although they would share in principal repayments rescheduled under the arrangement. Implementation awaits confirmation of the arrangement's conformity with existing laws and regulations.