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August 10, 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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DOMESTIC NONFINANCIAL DEVELOPMENTS

Available evidence suggests that the economy's strong upward thrust has carried into the third quarter. The industrial sector continues to look especially robust, but employment gains in other areas over recent months also have been substantial. Inflation in the first half of 1988 continued at about the same pace as last year while the employment cost index pointed to an acceleration in compensation during the first half.

Employment and Unemployment

Nonfarm payroll employment advanced 285,000 in July, and June's increase was revised up substantially to show a gain of more than 530,000. Coupled with a rise in the average workweek, the strong employment gains pushed up aggregate hours of production and nonsupervisory workers 0.7 percent in July to a level 1 percent above the second-quarter average.

In the payroll survey, hiring in the manufacturing sector looked especially strong, with an increase of 68,000 in July despite strikes in shipbuilding and lumber that reduced reported factory payroll growth by about 13,000. Most of the advance in manufacturing occurred in the durable goods sector, where further gains in the metals and machinery industries are consistent with a brisk pace of orders and shipments. Continued increases in employment in retail trade and services also contributed greatly to overall payroll growth.

In the household survey, employment was little changed in July after an extraordinarily large increase in June. The pattern of

CHANGES IN EMPLOYMENT¹
(Thousands of employees; based on seasonally adjusted data)

	1987	1988		1988		
		Q1	Q2	May	June	July
-Average Monthly Changes-						
Nonfarm payroll employment ²	286	340	334	208	532	283
Strike-adjusted	283	343	333	208	535	301
Manufacturing	38	19	47	30	55	68
Durable	21	7	34	18	37	59
Nondurable	16	12	12	12	18	9
Construction	21	25	38	-1	68	14
Trade	68	114	82	63	113	106
Finance and services	114	128	135	59	263	65
Total government	28	38	13	42	10	15
Private nonfarm production workers	208	242	250	90	450	222
Memo:						
Aggregate hours of production workers (percent change)	.3	.3	.5	-.6	.8	.7
Total employment ³	257	120	305	-518	823	41
Nonagricultural	252	123	345	-325	173	81

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.

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

	1987	1988		1988		
		Q1	Q2	May	June	July
Civilian, 16 years and older	6.2	5.7	5.5	5.6	5.3	5.4
Teenagers	16.9	16.0	15.0	15.6	13.6	15.2
20-24 years old	9.7	9.0	8.7	8.9	8.4	8.5
Men, 25 years and older	4.8	4.4	4.1	4.3	4.1	3.9
Women, 25 years and older	4.8	4.4	4.3	4.3	4.2	4.5
White	5.3	4.8	4.6	4.7	4.5	4.7
Black	13.0	12.5	12.0	12.4	11.5	11.4
Fulltime workers	5.8	5.3	5.1	5.2	4.9	5.0
Memo:						
Total National ¹	6.1	5.6	5.4	5.5	5.2	5.4

1. Includes resident armed forces as employed.

employment growth in these two months apparently reflected seasonal adjustment problems associated with the late June survey week. The civilian unemployment rate, which was little affected by this seasonal adjustment problem, edged up 0.1 percentage point to 5.4 percent.

Initial claims for unemployment insurance benefits jumped sharply to 366,000 in the week ending July 23. Although layoffs in the textile industry were reported, the sharp pickup in initial claims appears to be a temporary bulge associated with plant shutdowns for model changeovers in the automobile industry, rather than any widespread increase in layoffs. To the extent that model changeovers account for the bulk of the rise, initial claims should move back down over the next few weeks.

Industrial Production and Capacity Utilization

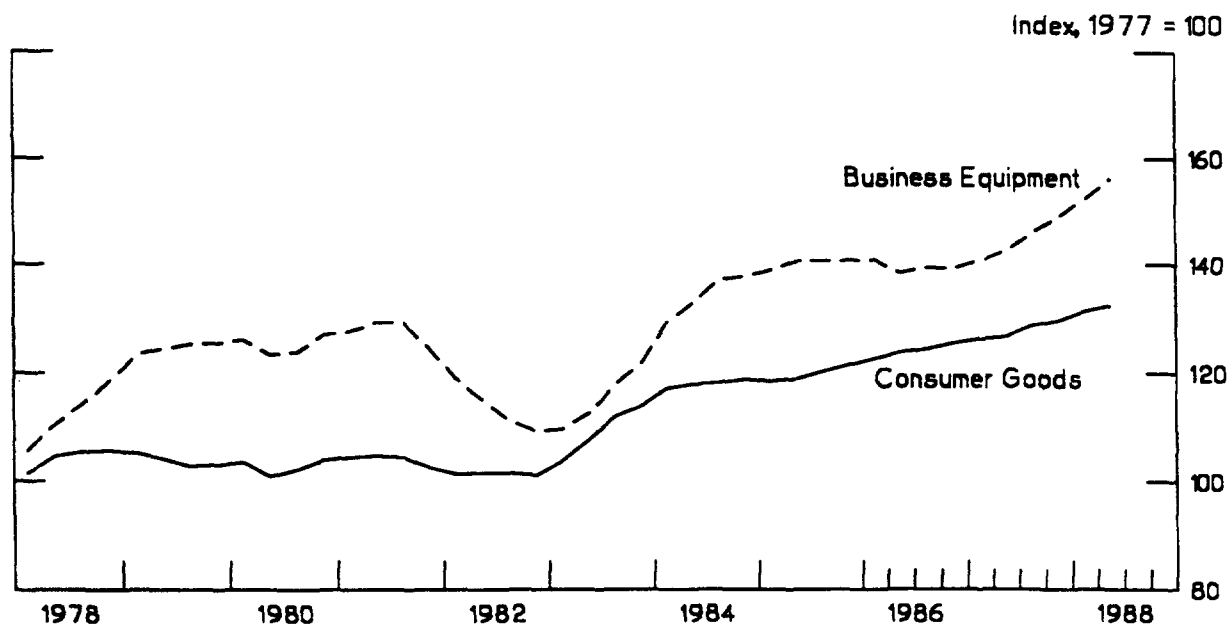
The available information indicates that industrial production continued to grow strongly in July. Physical product data indicate that output of steel, paper and paperboard, and coal rose; however, assemblies of automobiles declined, and production of light trucks was unchanged. Production worker hours for total industry, on a Federal Reserve basis, advanced 0.6 percent in July, the advance reflecting substantial increases within durable manufacturing (especially machinery) and widespread gains in nondurable manufacturing, with the notable exception of apparel.

Industrial production rose nearly 5 percent at an annual rate during the second quarter, boosted by a 1.1 million unit increase in auto assemblies. Output of business equipment remained on the rapid growth track that has been evident for more than a year; gains in

INDUSTRIAL PRODUCTION
(Percentage change from preceding period)

	1986	1987	1988		1988	
			Q1	Q2	May	June
	-----Annual rate-----				-Monthly rate-	
Total Index	1.0	5.8	3.9	4.7	.5	.4
Products	1.8	4.9	6.3	3.6	.4	.3
Final products	.8	4.6	6.0	4.8	.6	.3
Consumer goods	3.3	3.2	5.8	3.3	.6	.1
Durable goods	4.2	4.2	-6.1	13.1	1.8	.0
Automotive products	.5	4.4	-4.5	21.6	3.9	-.2
Home goods	7.0	4.0	-7.3	7.0	.3	.3
Nondurable goods	3.1	2.8	10.1	.2	.1	.1
Equipment	-2.1	6.3	6.4	6.4	.7	.5
Business equipment	-1.1	7.0	9.3	10.5	1.3	.5
Defense & space equip.	5.0	1.9	2.6	-5.4	-.8	.4
Oil & gas well drill	-50.1	37.1	-19.4	2.4	-.9	.3
Intermediate products	5.4	5.9	7.1	.0	-.2	.2
Construction supplies	5.0	4.7	10.9	-.3	-.1	-.4
Materials	-.2	7.2	.3	6.4	.7	.6
Durable goods	-.5	8.0	3.8	8.2	1.4	.3
Nondurable goods	5.7	8.1	-2.1	7.5	.5	.0
Energy materials	-5.2	4.5	-4.7	1.0	-.7	2.0

Industrial Production
Quarterly, seasonally adjusted



industrial machinery and computers were especially large. Also, there were strong advances in the output of industrial materials and home goods, which had shown some weakness earlier in the year. The production of nondurable consumer goods and construction supplies, however, was flat in the second quarter after substantial gains in the first, and the output of defense equipment declined.

The strong output gains for business equipment and related materials have resulted from sustained strength in both domestic capital spending and foreign demand and, recently, from a decline in import penetration. In particular, imports of capital goods other than computing machines changed little during the first half of this year, and increases in imports of computers, although still rapid, trailed the spectacular gains in outlays for domestically produced business machines.

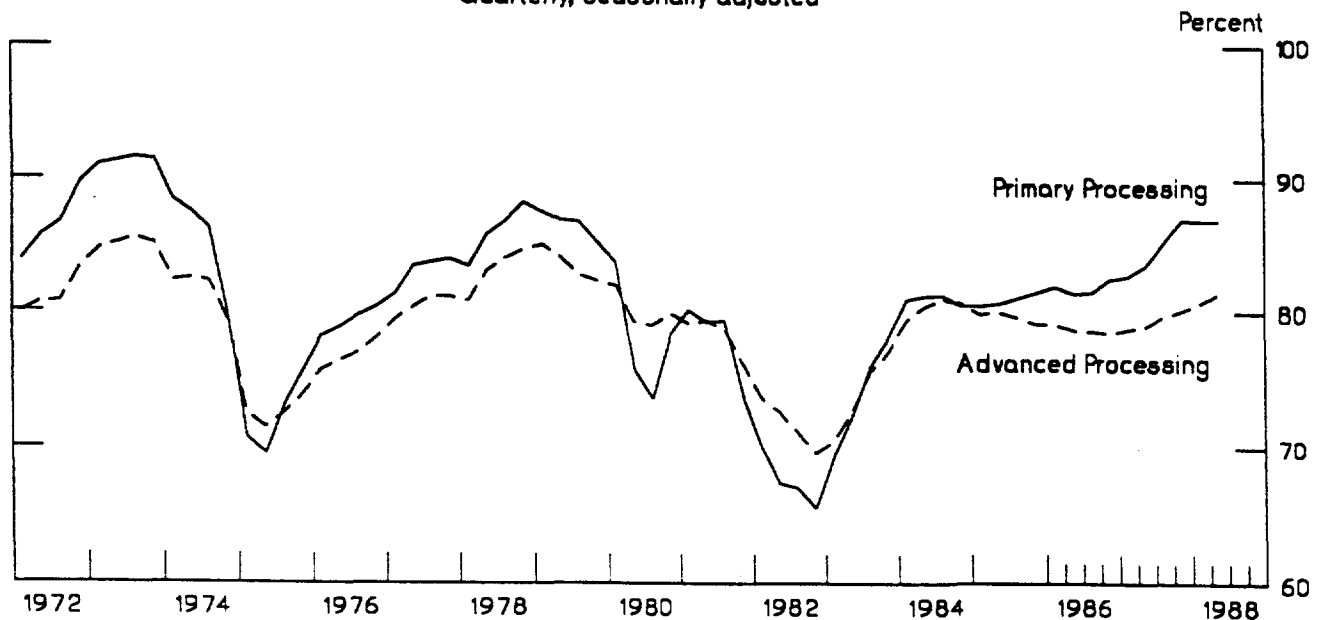
Capacity utilization in manufacturing rose another 0.4 percentage point in the second quarter to 83.1 percent, the highest quarterly level since late 1979; a further increase appears to have occurred in July. Increases in utilization in the first half of the year were concentrated in advanced-processing industries, most notably machinery. Even so, the operating rate for advanced-processing industries is not especially high on a historical basis. In contrast, utilization rates in primary-processing industries, which already were high late last year, held steady at 87 percent during the first half. Among the primary-processing industries that were tight at the end of last year, the aluminum, paper, petrochemical, and steel industries remain so.

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

	<u>1967-87</u>	<u>1973</u>	<u>1978-80</u>	<u>1987</u>	<u>1988</u>	
	Average	High	High	Q4	Q1	Q2
Total index	81.5	88.6	86.9	82.1	82.4	82.9
Manufacturing	80.6	87.7	86.5	82.3	82.7	83.1
Primary processing	81.7	91.9	89.1	86.9	86.9	86.9
Advanced processing	80.1	86.0	85.1	80.1	80.7	81.4
Durable manufacturing	78.7	87.4	86.3	80.0	80.4	81.4
Primary metals	79.6	101.9	97.1	88.8	84.7	86.1
Fabricated metal products	77.8	85.0	87.4	79.9	81.9	82.7
Nonelectrical machinery	78.1	89.0	86.0	76.8	78.7	80.4
Electrical machinery	78.1	85.7	89.9	76.5	76.9	77.5
Nondurable manufacturing	83.5	88.8	87.0	85.6	85.9	85.5
Textile mill products ¹	85.0	92.1	88.3	92.8	91.1	90.7
Paper and products ¹	88.5	95.6	92.7	95.7	95.4	94.6
Chemicals and products ¹	78.9	88.6	82.9	84.8	85.3	86.2
Mining	86.7	92.8	95.2	81.2	80.3	82.0
Utilities	86.9	95.6	88.5	80.6	82.0	80.2
Industrial materials	82.2	92.0	89.1	82.9	82.5	83.4

1. Data for textile mill products, paper and products, and chemicals and products for the second quarter are unpublished and based on estimates for June.

Capacity Utilization in Manufacturing
Quarterly, seasonally adjusted



Utilization in the textiles industry, however, has eased noticeably; orders for fabric fell below the level of shipments some time ago, reflecting the weakness in retail sales of apparel and a buildup of inventories throughout the textile-apparel pipeline.

Agriculture: The Effect of the Drought

The drought intensified in many agricultural regions in the first half of July and, although intermittent relief has been apparent more recently, total crop production is certain to be down substantially this year. Based on the USDA's production estimates of mid-July, the staff projects real crop losses of a bit more than \$10 billion this year. About half of this drop reflects a sharp reduction in the output of corn, the main feed crop. A more definitive tally of crop losses will be possible on August 11, when the USDA is scheduled to release the first set of production estimates based almost entirely on sampling actual field conditions. Recent market talk suggests that the production estimates may be revised down to reflect losses that occurred after mid-July.

Although the annual crop loss is likely to be small relative to GNP, the effect on the growth of GNP in the second half may be sizable, perhaps as much as 1 percentage point at an annual rate in each quarter. (According to BEA, the drought cut 1/2 percentage point from real GNP growth in the second quarter.) Assuming that weather conditions return to normal in 1989, these output losses should be reversed in the first half of next year, adding noticeably to the reported rate of GNP growth.

The spot and futures prices of agricultural crops have remained captive to variations in actual and expected weather. On net, prices of

the main crops--wheat, corn, and soybeans--are well above their levels of the spring, when concerns about the drought were emerging, but they have dropped back from the peak levels recorded earlier in the summer.

Futures prices for livestock began to exhibit some effects from the drought around midyear, when concern about a drought-induced liquidation of cattle inventories drove down the prices of near-term contracts and raised the prices of more distant ones. More recently, however, the prices of near-term contracts have risen, an occurrence that suggests that traders have become less concerned about near-term liquidation of herds. In this regard, there are some reports of cattle being shifted from drought areas to regions where forage is more plentiful rather than being slaughtered. Also, government subsidies to livestock producers seem likely to help limit potential liquidation.

Data through June on consumer prices, apart from those for poultry and eggs, showed little influence of the drought, but greater effects seem likely to surface in coming months. As shown in the following table, the droughts of 1980 and 1983 were followed by an acceleration in overall consumer food prices of about 1 to 2 percentage points in the year following each of those droughts. At a disaggregated level, the patterns of price change varied substantially across the two episodes, presumably reflecting the additional influence of factors other than drought (for example, differing patterns of wage change, variations in

FOOD PRICE ACCELERATION FOLLOWING THE 1980 AND 1983 DROUGHTS

	Rel. imp. in CPI food, Dec., 1987	1980 drought			1983 drought		
		Percent change			Percent change		
		79Q2 to 80Q2	80Q2 to 81Q2	Accele- ration	82Q2 to 83Q2	83Q2 to 84Q2	Accele- ration
Food	100.0	7.0	9.0	+2.0	2.2	3.3	+1.1
Meats, poultry, fish, & eggs	19.9	-3.3	6.5	+9.8	.5	1.5	+1.0
Cereals	8.6	13.0	10.5	-2.5	3.1	4.1	+1.0
Fruits and vegetables	10.6	7.4	13.4	+6.0	-.7	5.9	+6.6
Dairy	7.6	10.5	8.2	-2.3	1.2	.6	-.6
Other foods at home	15.8	12.3	8.6	-3.7	2.0	3.6	+1.6
Food away from home	37.4	10.0	9.3	-.7	4.5	4.2	-.3

Memo:							
GNP fixed-weighted price index	--	9.1	9.4	+3	4.2	4.1	-.1

inventory positions across food industries, alterations in farm policies for different commodities, and shifting patterns of consumer demand).

The drought also will affect farm income through various channels, directly through changes in prices and quantities and indirectly through changes in farm subsidy programs. While the magnitude of these various effects cannot be forecast with precision, at the aggregate level farmers' cash flow probably will be well maintained in the period ahead, as producers take advantage of high crop prices to sell inventories that had accumulated in years of large production and low prices--a pattern similar to the one that was evident after the 1980 and 1983 droughts.¹ With regard to subsidies, farm "deficiency payments" (income support payments that, by formula, vary inversely with the level of crop prices) will be lower in coming quarters than otherwise would have been the case. However, these reductions will be partially offset by increases in drought-relief subsidies provided under new legislation that is expected to be signed into law shortly. Under this legislation, growers who suffer crop losses in excess of 35 percent will be eligible for payments that, in effect, will restore a sizable portion of revenue losses. The bill provides additional benefits to livestock producers who have suffered losses to the feed crops that they grow. Dairy price supports are to be boosted temporarily for a period next year.

1. In contrast to cash income, "net farm income," a USDA series that measures profits from current production, seems likely to fall in 1988, as it did in both 1980 and 1983. These declines result from valuing annual production at annual average prices, portion of which already was history before the drought became a major influence on prices.

Personal Income and Consumption

Personal income posted a substantial increase in nominal terms in the second quarter. Wages and salaries moved up briskly, the movement reflecting both a growth in employment and the pickup in wage rates. Interest income is estimated by BEA also to have posted another sizable gain in response to increases in rates earlier this year. After rising sharply in the three preceding quarters, real disposable income was about flat in the second quarter; however, this flatness reflects primarily a transitory surge in tax payments in April associated in part with the 1986 tax reform and the acceleration in the PCE deflator in the second quarter. The strength of hours worked in July, as well as a return of tax payments to more normal levels, suggests that the growth in real disposable income will pick up again in the third quarter.

Real consumer spending rose at a 2.3 percent annual rate in the second quarter, a slower pace than in the first quarter, but about the same pace as the average over the preceding year. Spending on automobiles and other durables increased sharply, and outlays for services continued to advance. However, expenditures on nondurable goods remained weak as spending on apparel dropped further and purchases of food were essentially unchanged.

Demand for motor vehicles has continued to outstrip most expectations. Despite some scaling back of manufacturers' incentive plans, sales of domestically produced automobiles were at an annual rate of 7-1/2 million units in July, similar to the average pace of the first half, and sales of U.S.-made light trucks remained robust. The new plans offer smaller rebates on many models but larger ones on a few of

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

	1987	1988	1988	1988		
		Q1	Q2	Apr. ^r	May ^r	June ^p
Total personal income	26.3	15.6	18.6	9.9	18.1	27.9
Wages and salaries	16.8	7.1	16.8	19.3	13.2	17.8
Private	14.5	4.8	14.8	17.3	11.2	15.8
Other labor income	1.0	.6	.7	.6	.6	1.0
Proprietors' income	1.4	4.9	-4.6	-13.6	-1.4	1.3
Farm	-.6	5.1	-6.9	-16.2	-3.2	-1.3
Rent, dividends and interest	6.1	-.2	6.2	4.3	7.0	7.2
Transfer payments	2.1	8.1	.6	.6	-.6	1.8
Less: Personal contributions for social insurance	1.1	4.8	1.1	1.2	.8	1.2
Less: Personal tax and nontax payments	4.5	-6.7	-.2	64.0	-63.9	-.7
Equals: Disposable personal income	21.8	22.3	18.8	-54.1	62.0	28.6
Memo: Real disposable income	7.5	11.4	2.9	-60.8	54.5	15.0

r--Revised.

p--Preliminary.

REAL PERSONAL CONSUMPTION EXPENDITURES
(Percent change from preceding period)

	1	1988	1988	1988		
	1987	Q1	Q2	Apr.	May	June
	----Annual rate----			----Monthly rate----		
Personal consumption expenditures	1.8	4.5	2.3	-.1	.2	.7
Durable goods	-2.4	14.7	7.2	.7	.5	1.5
Motor vehicles	-6.6	17.3	9.1	2.4	.4	3.3
Other	1.0	12.7	5.7	-.6	.5	.3
Nondurable goods	.6	1.0	-2.0	-1.1	-.1	.3
Clothing and shoes	1.1	-1.7	-9.4	-3.1	.5	2.1
Food	.0	2.0	-1.3	-1.0	.2	-.8
Other	1.4	1.0	1.3	-.2	-.9	.9
Services	4.2	4.0	3.9	.3	.2	.7
Memo:						
Personal saving rate (percent)	3.2	4.4	3.8	2.7	4.4	4.3

1. Annual changes are Q4/Q4.

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

	1986	1987	1988		1988		
			Q1	Q2	May	June	July
Autos and light trucks ¹	16.1	15.0	15.6	15.6	15.8	16.0	15.4
Autos	11.5	10.3	10.8	10.8	10.7	11.1	10.4
Light trucks	4.7	4.7	4.8	4.9	5.1	4.9	5.0
Domestically produced ²	12.0	11.0	11.8	11.8	12.1	12.1	11.9
Autos	8.2	7.1	7.6	7.6	7.6	7.9	7.5
Light trucks	3.8	3.9	4.2	4.2	4.4	4.3	4.4
Imports	4.2	4.0	3.8	3.8	3.7	3.8	3.5
Autos	3.2	3.2	3.1	3.2	3.1	3.2	2.9
Japanese	2.4	2.2	2.1	2.2	2.1	2.2	2.1
Korean	.2	.3	.5	.5	.4	.5	.3
European	.7	.7	.6	.5	.5	.6	.5
Light trucks	.9	.8	.6	.6	.6	.6	.6

1. Components may not add to totals due to rounding.

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

the less popular makes. Inventory positions at the domestic automakers are running just above 60-days' supply, which is well within the range considered comfortable. Accordingly, a major cleanup campaign looks unlikely this year, and prospects are good that production will be maintained near current levels. Meanwhile, sales of imported models weakened in July, as purchases of autos dropped to an annual rate of 2.9 million units and sales of light trucks were little changed at the reduced rate that has prevailed since early this year.

Business Fixed Investment

Real business fixed investment rose at an annual rate of 14 percent in the second quarter, with sizable increases for both equipment and structures.² Equipment spending remained on the sharp uptrend that has been evident since early last year, as real outlays for computing equipment continued to rise at an annual rate of almost 40 percent and gains in spending on transportation, industrial, and other equipment also were substantial.

Real outlays for nonresidential construction rose at an annual rate of 12 percent in the second quarter, the rise offsetting about half of the drop in the previous quarter. The increase, while widespread, was especially large for the industrial component, which has been spurred by the export-led improvement in manufacturing activity. Office construction has remained surprisingly buoyant in the face of continued high vacancy rates in many urban areas.

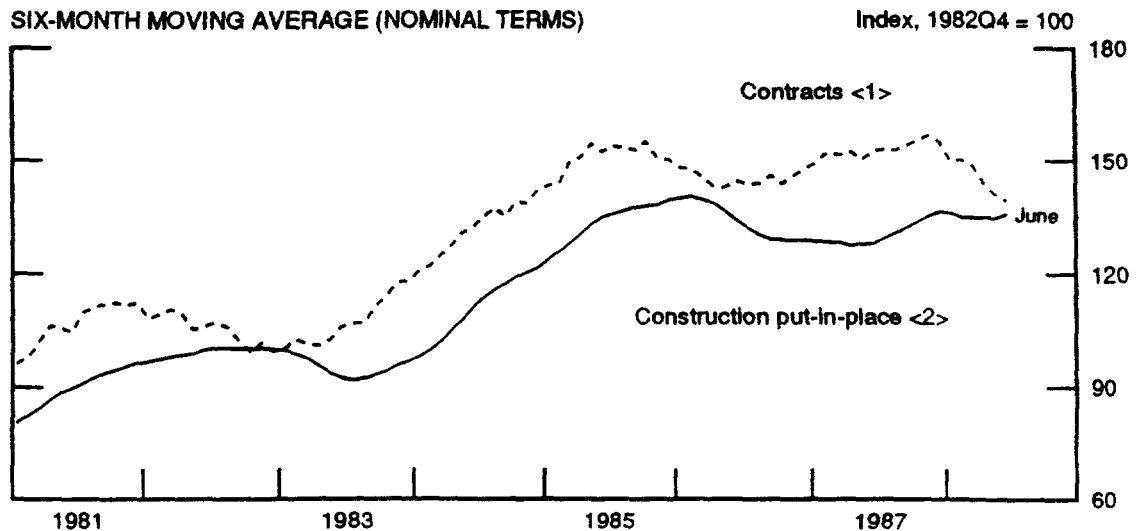
2. The recent revisions of the data on investment expenditures are discussed in a special appendix on the July revision of the NIPA.

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

	1987	1988		1988		
	Q4	Q1	Q2	Apr.	May	June
<u>Producers' durable equipment</u>						
Shipments of nondefense capital goods	2.4	5.3	1.9	-2.0	2.5	.2
Excluding aircraft and parts	1.1	6.0	1.2	-1.3	2.2	.1
Office and computing equipment	-3.2	18.9	-3.9	-9.3	5.3	4.4
All other categories	2.1	3.1	2.5	.7	1.4	-9
Shipments of complete aircraft ¹ (from CIR)	-21.8	34.4	n.a.	-1.0	35.4	n.a.
Sales of heavy-weight trucks	5.5	8.8	-.6	-3.1	3.2	-4.2
Orders for nondefense capital goods	3.4	7.0	-.2	3.1	-5.7	13.2
Excluding aircraft and parts	.5	6.9	.9	-.4	1.6	.6
Office and computing equipment	-6.6	19.1	-1.2	.8	.5	3.9
All other categories	2.2	4.3	1.5	-.6	1.8	-.2
<u>Nonresidential structures</u>						
Construction put-in-place	2.2	-5.5	4.3	-.3	3.3	2.6
Office	2.6	-3.1	4.1	1.2	4.6	-.3
Other commercial	-.1	-8.4	6.7	3.1	.6	-.1
Public utilities	3.4	-8.8	2.5	-2.5	5.6	3.1
Industrial	-2.2	-2.6	15.0	4.7	3.4	6.3
All other	5.2	-2.0	-1.6	-5.5	2.4	5.8
Rotary drilling rigs in use	-3.7	-2.1	6.7	2.2	-2.0	-.7

1. 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. The CIR does not provide information on aircraft orders.

Nonresidential Construction Put-in-Place and Construction Contracts



<1> From F.W.Dodge. Includes industrial, commercial, and institutional construction.

<2> Includes the building components of nonresidential construction, i.e., industrial, commercial, institutional, and hotels and motels.

Leading indicators of investment in equipment continue strong. Orders for computers, which already were at a high level in the spring, increased sharply in June, while bookings for other equipment generally have continued to trend up.³ Unfilled orders for commercial aircraft have risen markedly and are extremely large; consequently, aircraft production should continue to rise for quite some time. New contracts and permits for nonresidential construction, however, declined over the first half.

Business Inventories

The accumulation of business inventories slowed sharply during the spring, apparently reflecting the strength in factory shipments, a curtailment of imports, and efforts by retailers of nondurable goods to trim excess stocks. The slower pace of stockbuilding damped real GNP growth in the second quarter, but with ratios of inventories to sales now lower, inventories are unlikely to be an impediment to--and may be a positive factor in--production growth in coming months.

Manufacturers' inventories posted only a moderate increase in the second quarter. Strong factory shipments depleted stocks of finished goods held by producers of primary metals, fabricated metal products, electrical machinery, and chemicals. However, stockbuilding at earlier stages of fabrication remained brisk and contributed to the high level of capacity utilization and the strong prices in primary-processing industries this year. Given recent orders and labor market information,

3. Annual revisions to the data on orders will be released in late August and reportedly will show substantial revisions in orders for computers during the first quarter. Monthly changes in the data from May onward will not be affected by this revision.

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

	1987	1988		1988		
	Q4	Q1	Q2	Apr.	May	June
Current cost basis:						
Total	81.4	41.0	--	46.5	47.9	--
Total ex. auto	67.1	62.6	--	38.4	31.1	--
Manufacturing	27.9	23.6	20.9	16.2	28.6	17.9
Wholesale	23.8	26.5	12.1	21.6	-1.3	15.9
Retail	29.6	-9.1	--	8.7	20.7	--
Automotive	14.2	-21.6	--	8.0	16.8	--
Ex. auto	15.3	12.5	--	.7	3.9	--
Constant dollar basis:						
Total	57.6	37.9	--	10.5	10.0	--
Total ex. auto	44.4	48.0	--	3.6	.1	--
Manufacturing	14.4	15.8	--	-3.0	7.7	--
Wholesale	18.1	20.7	--	11.2	-5.0	--
Retail	25.1	1.5	--	2.4	7.3	--
Automotive	13.2	-10.1	--	7.0	9.9	--
Ex. auto	11.9	11.6	--	-4.6	-2.6	--

INVENTORIES RELATIVE TO SALES¹
(Months supply; based on seasonally adjusted data)

	Range in		1987	1988		1988		
	Preceding 12 months: low high		Q4	Q1	Q2	Apr.	May	June
Current cost basis:								
Total	1.48	1.54	1.53	1.53	--	1.51	1.51	--
Total ex. auto	1.46	1.51	1.49	1.51	--	1.49	1.49	--
Manufacturing	1.58	1.64	1.60	1.62	1.58	1.59	1.58	1.56
Wholesale	1.21	1.30	1.27	1.31	1.30	1.30	1.30	1.28
Retail	1.56	1.64	1.65	1.60	--	1.59	1.60	--
Automotive	1.77	2.06	2.06	1.76	--	1.78	1.84	--
Ex. auto	1.47	1.55	1.54	1.55	--	1.54	1.53	--
Constant dollar basis: ³								
Total	1.49	1.55	1.53	1.54	--	1.53	1.53	--
Total ex. auto	1.48	1.53	1.51	1.53	--	1.52	1.52	--
Manufacturing	1.63	1.68	1.64	1.67	--	1.65	1.64	--
Wholesale	1.22	1.31	1.29	1.31	--	1.32	1.32	--
Retail	1.51	1.59	1.61	1.57	--	1.57	1.58	--
Automotive	1.65	1.93	1.93	1.73	--	1.74	1.79	--
Ex. auto	1.45	1.53	1.52	1.53	--	1.52	1.52	--

1. Ratio of end-of period inventories to average monthly sales for the period.

2. Highs and lows are specific to each series and are not necessarily coincidental. Range is for the 12-month period preceding the latest month for which data are available.

3. Ratios in this panel may change when benchmark-revised data, available later this month, are used.

the outlook for the expansion of manufacturers' inventories appears strong.

In the trade sector, the accumulation of wholesale inventories also has been more subdued in May and June. The deceleration occurred mostly in the durable goods category, with declines in stocks of motor vehicles, lumber and construction materials, and hardware. The pace of sales was moderate in the second quarter so that the wholesalers' ratio of inventories to sales was little changed from earlier in the year.

Nonauto retail inventories declined an average of \$3-1/2 billion (annual rate) in April and May, after rising \$11-1/2 billion in the first quarter. In particular, inventories at apparel and general merchandise stores, which appeared excessive earlier in the year, were pared; nevertheless, ratios of inventories to sales for these stores remained at high levels because of sluggish sales.

Housing Markets

Housing starts rose 5 percent in June to 1.45 million units at a seasonally adjusted annual rate, retracing about half of the large decline in May. A rebound in single-family construction more than offset a continued falloff in multifamily construction. Issuance of building permits increased 4 percent in June.

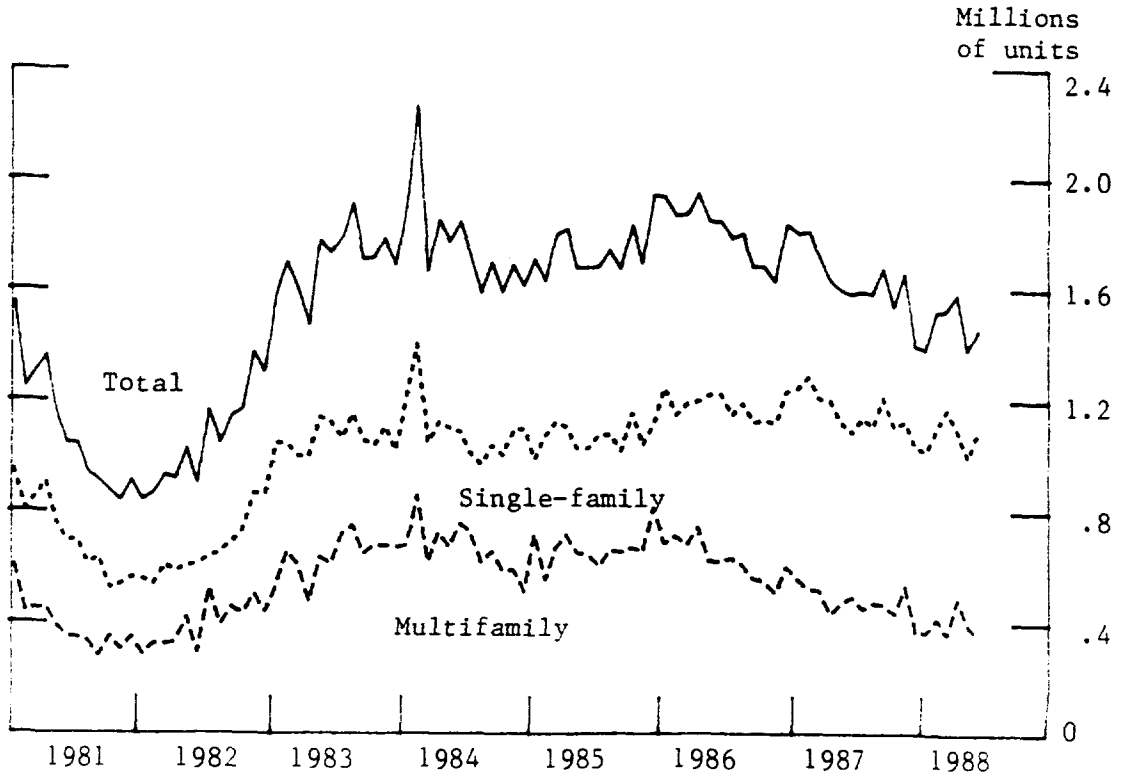
Single-family starts in June bounced back to an annual rate of 1.1 million units after a surprisingly large decline in May. The June level was about the same as the average for the first four months of 1988, but 3 percent below the 1985-87 average. Home sales recently have

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

	1987	1987	1988		1988		
	Annual	Q4	Q1	Q2 ^P	Apr. ^r	May ^r	June ^P
All units							
Permits	1.53	1.43	1.38	1.46	1.45	1.44	1.49
Starts	1.62	1.53	1.48	1.47	1.58	1.38	1.45
Single-family units							
Permits	1.02	.96	.98	.98	.96	.98	1.00
Starts	1.15	1.09	1.10	1.06	1.09	1.00	1.10
Sales							
New homes	.67	.62	.63	.70	.68	.68	.73
Existing homes	3.53	3.39	3.25	3.63	3.52	3.59	3.78
Multifamily units							
Permits	.51	.47	.40	.48	.49	.45	.49
Starts	.47	.44	.38	.41	.49	.39	.36

p--preliminary estimates.
r--revised.

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



been quite brisk, with new home sales up 8 percent in June and sales of existing homes at their strongest pace in a year and a half. The spurt in home sales may reflect, in part, a speedup of purchases timed to avoid increases in prices and mortgage rates that a growing proportion of consumers reportedly regard as likely.

In contrast to the rebound in the single-family sector, multifamily housing starts dropped 8 percent in June to 356,000 units, the lowest level in six years. The June estimate of multifamily starts, however, seems to be lower than even the weak fundamentals in this market would imply. Permits, which typically are measured more reliably than starts, rebounded in June.

Increases in home prices apparently have continued to moderate. In the second quarter, the median price of new homes sold was 9 percent higher than it had been a year earlier, while the median price of an existing home was up 3 percent. Over the four quarters of 1987, the advance for median prices of new homes and existing homes respectively were 17 and 6 percent. Based on data available only through the first quarter of 1988, some slowing of prices occurred in several large markets in the Northeast, including Boston and New York, where prices previously had risen very rapidly. In contrast, price increases accelerated in Washington, D.C., and Los Angeles. The "constant-quality" price index of new homes has shown little change over the past year, a situation that indicates that changes in housing quality and in the geographic composition of sales accounted for most of the recent rise in the selling prices of new homes.

Federal Sector

The federal government recorded a total budget surplus of \$9.5 billion in June, compared with a deficit of \$22.5 billion in May. The swing largely reflects seasonal patterns in tax payments--both corporations and individuals are required to make quarterly estimated income tax payments in June.⁴ On the outlay side of the budget, defense spending continued at a rate that is well above the administration's budget projections.⁵ Other noteworthy developments in outlays in June included a decline in agriculture spending that was only about in line with recent seasonal patterns (no effects of the drought were evident) and large net outlays by FSLIC (but not FDIC).

The administration's Mid-Session Review was released late in July. It showed a deficit of \$152 billion for FY1988 as a whole, \$5 billion above the February forecast. An upward revision of about \$4 billion in receipts, largely owing to the greater strength in the economy, was swamped by technical revisions that raised outlays. Deposit insurance costs that were higher than anticipated and the postponement of some anticipated asset sales (counted as negative outlays) were the major factors that more than offset a net reduction of \$3 billion in estimated

4. Beginning with this year, the corporate tax payments will tend to be concentrated even more in June because the Omnibus Budget Reconciliation Act of 1987 included a "safe harbor" provision that allows the deferral of some corporate payments (on current year liability) from April to June without penalty.

5. On an NIPA basis, however, real defense purchases fell further in the second quarter and now stand 3 percent below their mid-1987 high. In the NIPA, much big-ticket defense equipment is not recorded as purchased by the government until delivery occurs, even though progress payments previously may have been made--and reflected in the total (unified) budget. The drop in NIPA-based real defense purchases reflects the leveling-off or the end of deliveries of several major weapons systems (B1 bombers and MX missiles) that have been a major part of the military buildup in the eighties.

MID-SESSION REVIEW OF THE BUDGET.

Budget Totals
(Billions of dollars)

	Fiscal years					
	1988	1989	1990	1991	1992	1993
Outlays	1066	1097	1157	1218	1259	1299
Receipts	913	974	1054	1132	1194	1265
Deficit	152	123	102	85	65	34

Note: Totals, as reported in the Mid-Session Review, include on-budget accounts plus the Social Security trust fund that is legally categorized as off-budget.

Economic Assumptions

	Calendar years					
	1988	1989	1990	1991	1992	1993
-----Percent change, Q4 to Q4-----						
Nominal GNP	6.6	7.1	6.9	6.3	5.8	5.3
Real GNP	3.0	3.3	3.3	3.2	3.2	3.2
GNP deflator	3.5	3.7	3.5	3.0	2.5	2.0
-----Percent, annual average-----						
Civilian unemployment rate	5.6	5.3	5.2	5.1	5.1	5.1
Interest rate						
(3-month Treasury bills)	6.0	5.5	5.0	4.5	4.0	3.5
(10-year Treasury notes)	8.5	8.1	7.0	6.0	5.0	4.5

Gramm-Rudman-Hollings Targets
(Billions of dollars)

	Fiscal years				
	1989	1990	1991	1992	1993
Target	136	100	64	28	0
Trigger	146	110	74	38	0
Memo:					
G-R-H baseline estimate					
February Budget	143				
Mid-Session Review	140				

Source: Office of Management and Budget, Mid-Session Review of the Budget, July 1988.

agricultural program costs. The estimate of defense outlays in the Mid-Session Review remains the figure agreed upon in last fall's Summit, and thus does not reflect the stronger trend in defense spending observed recently.

The administration now projects a deficit of \$123 billion for FY1989, a projection based on essentially the same policy proposals as those in the February Budget (including more deficit reduction than in the Summit agreement); this new estimate is \$7 billion lower than previously projected. Largely as a result of the new economic assumptions, expected receipts were increased by \$9 billion; this gain was partially offset by considerably higher interest outlays. Technical reestimates on the outlay side were dominated by a net downward revision of \$5 billion in estimated spending under current law for agricultural programs (CCC payments \$6 billion lower as prices of covered crops rise, partially offset by higher outlays for credit and crop insurance). These revisions do not take into account the drought-relief bill that was just passed by Congress.⁶

The FY1989 deficit on a Gramm-Rudman-Hollings basis was estimated to be \$140 billion, \$6 billion below the \$146 billion trigger that determines whether across-the-board budget cuts (sequestration) are to

6. President Reagan has said that he will sign the bill. The reported budget estimate places the bill's cost at about \$4 billion, although it could well turn out to be higher.

Some other categories of spending were revised upward in the Mid-Session Review, particularly medical insurance and aid for financial institutions. An allowance was made in FY1988 for FDIC assistance in the restructuring of First Republic Bank, but it now appears that these outlays will exceed the allowance. They may be deferred, however, until FY1989; such a deferral would lower the FY1988 deficit but raise the FY1989 deficit. The recently signed legislation on catastrophic health insurance was taken into account on both receipts and outlay sides of the budget, but the effects are largely in years beyond 1989.

be invoked. This estimate takes into account authorizing legislation now enacted and--because 1989 appropriations are not yet in place--this year's appropriations adjusted for inflation; it excludes the deficit effects of one-time transactions such as asset sales. The \$6 billion leeway between the current G-R-H estimate and the trigger represents the margin available for new legislation, including the drought relief bill as well as any deviation of finally enacted appropriations from the estimated amounts. This margin will not be affected by subsequent economic events or budget reestimates of a technical nature.

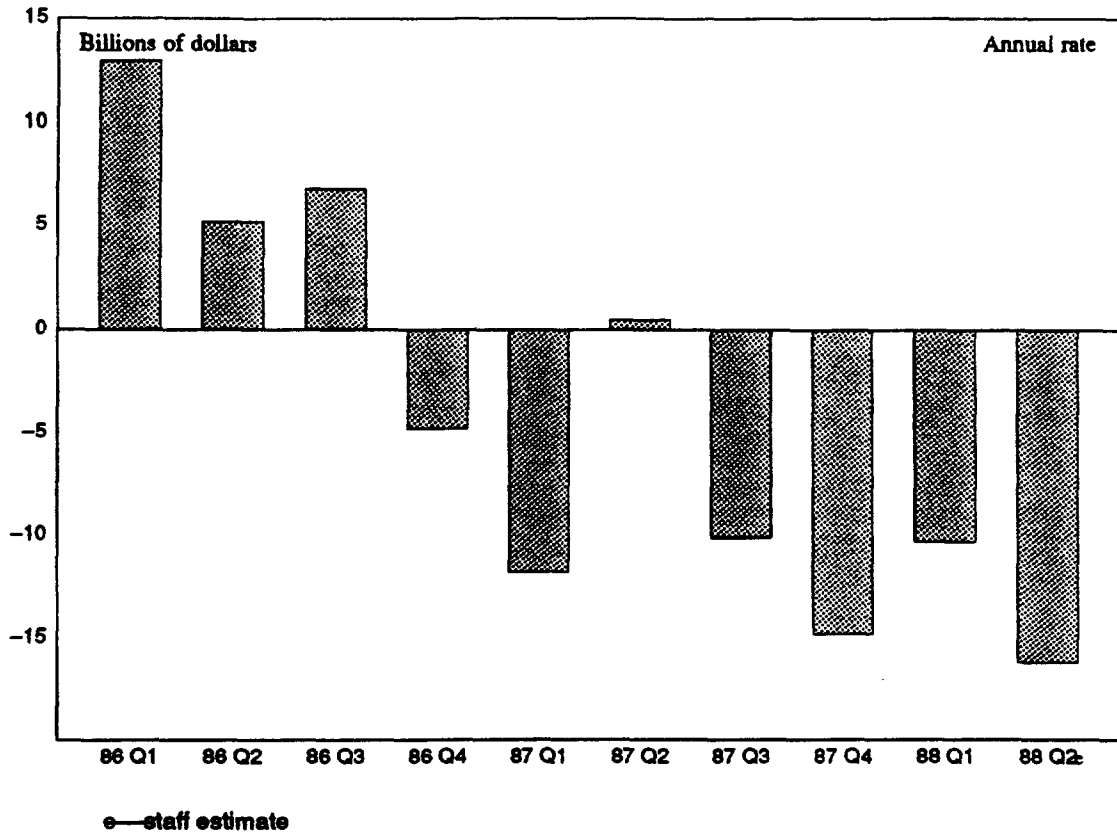
State and Local Government Sector

Real purchases of goods and services by state and local governments are estimated to have increased at an annual rate of 3 percent in the second quarter, a little below the 3.5 percent rise in the first quarter. Receipts appear to have advanced more slowly than expenditures, resulting in a further deepening of the deficit in the operating and capital accounts (excluding social insurance funds).

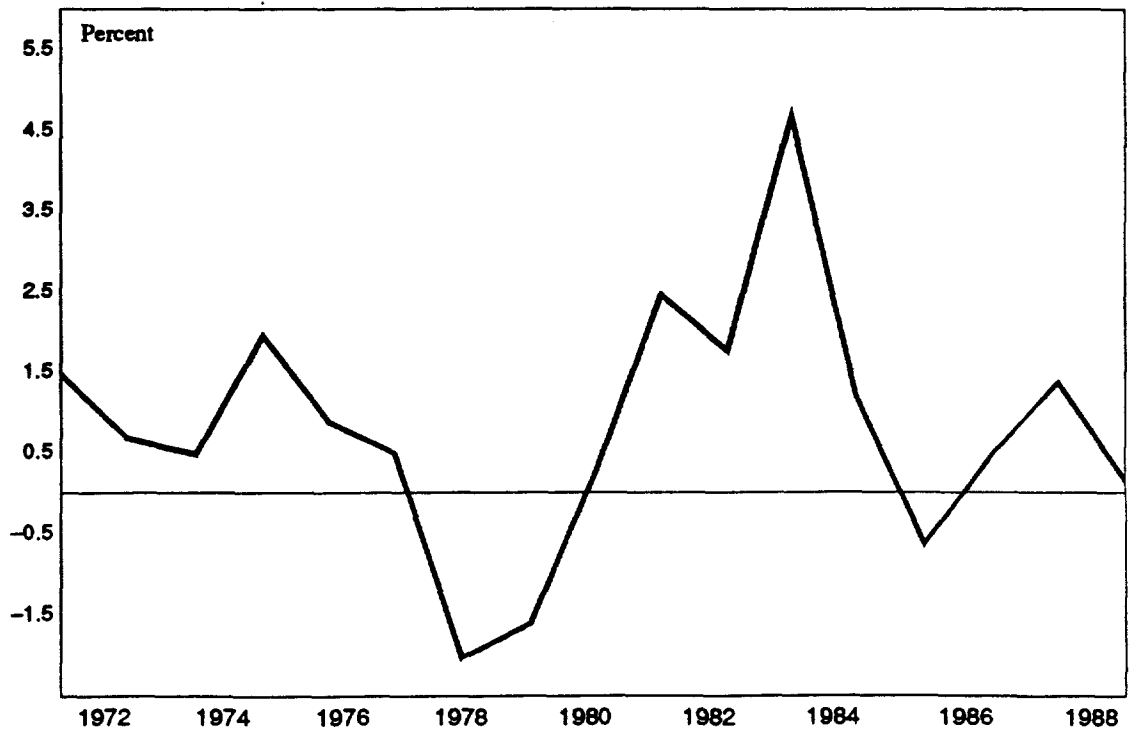
State and local deficits have been sizable since late 1986.⁷ The deficits have persisted even though many troubled states and localities have taken corrective measures in the past few years. So far in 1988, several states have raised taxes, mainly for general sales and motor fuels. However, these actions are expected to result in a relatively small increase in revenue--just \$600 million, compared with a net tax

7. Although the July NIPA revisions show higher levels of state and local surpluses in the aggregate, the upward revision was attributable to larger surpluses in the social insurance funds. The recent operating and capital accounts deficits appear slightly wider than thought previously.

STATE & LOCAL GOVERNMENT OPERATING & CAPITAL ACCOUNT SURPLUS (DEFICIT)
 (Excludes social insurance funds)



LEGISLATED STATE TAX CHANGES
 (As a percent of tax revenue, fiscal years)



Sources: The National Conference of State Legislatures, The Tax Foundation, and the U.S. Bureau of the Census.

increase of \$3.3 billion in 1987. Also, a recent survey of city officials indicated that nearly 60 percent of them had raised fees and charges for services and almost 40 percent had increased property taxes.

Prices

The rate of price inflation was little changed in June, as declines in energy prices offset some part of the increase in food costs. The consumer price index for all urban consumers rose 0.3 percent, the same as in May. So far this year, the CPI has risen at an average annual rate of 4-1/2 percent, equal to the pace in 1987 despite marked differences among components. Producer prices of finished goods were up 0.4 percent in June and 3-1/2 percent over the first half.

The CPI for food rose 0.6 percent in June. Although the effect of the drought on the consumer's overall food budget was relatively small, there were some sharp drought-related increases for poultry and eggs. (The effects of the drought were discussed more fully in the section on agriculture.)

Retail energy prices edged down 0.2 percent in June, after large increases in April and May. On net, the CPI for energy has registered little change so far this year. Despite the increased volatility of spot prices of crude oil since the announcement of peace initiatives in the Iran-Iraq War, domestic posted prices remain lower than in late June, a situation that indicates the likelihood of some near-term downward pressure on consumer prices of petroleum products.

Excluding food and energy items, the CPI rose 0.4 percent in June, about the average pace thus far this year. The commodities component

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

	Relative Importance Dec. 1987	1987 1987	1988			1988	
			Q4	Q1	Q2	May	June
			----Annual rate----			-Monthly rate-	
All items ²	100.0	4.4	3.2	4.2	4.5	.3	.3
Food	16.1	3.5	2.8	1.4	7.1	.4	.6
Energy	7.6	8.2	-3.9	-4.9	4.2	.5	-.2
All items less food and energy	76.3	4.2	4.4	5.4	4.3	.2	.4
Commodities	25.8	3.5	2.5	4.7	3.9	.2	.2
Services	50.6	4.5	5.0	5.9	4.5	.4	.5
Memorandum:							
CPI-W ³	100.0	4.5	2.8	3.5	4.9	.4	.3

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

2. Official index for all urban consumers.

3. Index for urban wage earners and clerical workers.

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

	Relative Importance Dec. 1987	1987 1987	1988			1988	
			Q4	Q1	Q2	May	June
			---Annual rate---			-Monthly rate-	
Finished goods	100.0	2.2	-1.9	2.3	5.0	.5	.4
Consumer foods	25.9	-.2	-5.7	5.6	9.8	.9	1.1
Consumer energy	9.6	11.2	-9.6	-19.6	6.2	.2	-1.6
Other consumer goods	40.1	2.7	1.7	5.3	2.8	.3	.3
Capital equipment	24.4	1.3	-.7	3.2	3.6	.4	.4
Intermediate materials ²	95.0	5.4	4.3	3.9	7.8	.6	.6
Excluding energy	82.5	5.2	7.2	7.8	7.3	.5	.5
Crude food materials	39.5	1.8	-4.8	16.7	31.5	2.4	4.2
Crude energy	41.9	10.7	-15.2	-23.6	11.5	1.3	-1.0
Other crude materials	18.6	22.6	18.0	13.8	-5.3	-1.7	.2

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

2. Excludes materials for food manufacturing and animal feeds.

was up only 0.2 percent as apparel prices, reflecting extensive discounting after their climb earlier this spring, receded somewhat. Over the first half of this year, apparel prices rose 7-1/2 percent at an annual rate and were largely responsible for the acceleration in the CPI for nonfood, nonenergy goods--from about 3-1/2 percent last year to a 4-1/4 percent rate so far this year. With the major exception of apparel, import prices rose further from March to June. The March-June increase in the BLS index for imported consumer goods other than food was 1.8 percent (not annualized), about the pace observed over the past year.⁸

Producer prices of capital equipment were up 0.4 percent in June for the second month, the rise reflecting large increases for transportation equipment and some machinery items. Over the first six months of this year, the PPI for capital equipment has risen at about a 3-1/2 percent annual rate, well above the pace in recent years, likely reflecting strong domestic and export demand as well as higher dollar prices of competing imports.

At earlier stages of processing, prices of intermediate materials less food and energy rose 0.5 percent in June, nearly the average pace registered over the past year. Prices rose rapidly for metals, chemicals, paperboard, motors, and electronic components (a category that includes dynamic random access memory chips, which have been in short supply). However, declines were registered in some other categories, notably fertilizers, leather, and glass. Prices of crude nonfood materials less energy edged up 0.2 percent after declining in

8. These indexes are not seasonally adjusted.

PRICE INDEXES FOR COMMODITIES AND MATERIALS¹

	Last Observation	Percent change ²			
		1988			
		1986	1987	To June 21 [*]	June 21 [*] to date
1. PPI for crude materials ³	June	-8.9	8.9	4.0	n.a.
1a. Ex. food and energy	June	1.8	22.6	2.9	n.a.
1b. Ex. food and energy, seasonally adjusted	June	1.7	22.8	1.9	n.a.
2. IMF commodity index ³	June	-7.9	30.8	12.6	n.a.
2a. Metals	June	-.5	51.9	29.7	n.a.
2b. Nonfood agric.	June	8.5	47.5	-7.5	n.a.
3. Commodity Research Bureau					
3a. Futures prices	Aug. 8	-9.1	11.7	15.6	-7.6
3b. Industrial spot prices	Aug. 5	5.1	19.2	4.6	.2
4. <u>Journal of Commerce</u> industrials	Aug. 5	-1.4	10.7	3.9	-2.4
5. <u>Economist</u> (U.S. dollar index)	Aug. 2	-4.7	42.5	28.9	-16.6
5a. Industrials	Aug. 2	5.8	62.6	32.3	-19.9
6. Dow-Jones Spot	Aug. 8	-8.9	17.0	7.3	-8.4

1. Not seasonally adjusted.

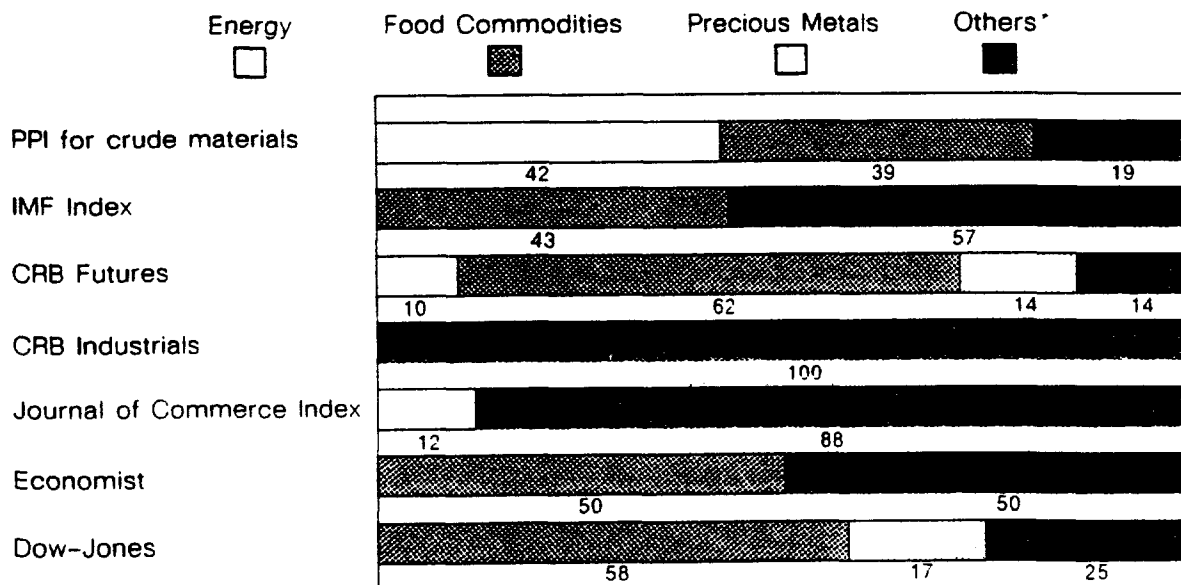
2. Change is measured to end of period, from last observation of previous period.

3. Monthly observations. IMF index includes items not shown separately.

n.a.--Not available.

*Week of the June Greenbook.

Index Weights



*Forest products, industrial metals, and other industrial materials

May. This index, which had climbed rapidly last year and in the first quarter, remained 15 percent above its level a year ago.

More recently, prices have receded in several spot commodity markets. Among the available domestic measures of commodity prices, shown in the table, large declines have been posted by the CRB futures and Dow-Jones spot price indexes, in which agricultural prices are heavily weighted. Prices also have come down, on net, for some industrial materials, particularly for copper, aluminum, and rubber, although prices of steel scrap rebounded. Even after these recent movements, prices of most industrial metals remain at historically high levels. Since the week of the last Greenbook, spot prices also have retreated for precious metals, lumber, and plywood.

The GNP fixed-weight price index accelerated to an annual rate of 4.7 percent in the second quarter, from 3.5 percent in the first quarter, according to BEA's preliminary estimates. This acceleration was mainly the result of a sharp pickup in consumer prices of food and energy.⁹ Prices also rose more rapidly in the second quarter for other consumer items, most notably the hikes in apparel prices in the early spring. Averaging over the first half, the GNP fixed-weight inflation rate has been 4 percent, the same as during 1987. The GNP implicit price deflator has continued to rise at a considerably slower pace than the fixed-weight price measure and has mainly reflected compositional

9. The fixed-weight inflation rate for PCE in the second quarter, of 5.4 percent, compares with a 4.9 percent rate for the CPI (based on quarterly averages, rather than the end-month-of-quarter changes shown in the table for consumer prices). The higher PCE rate was mainly due to the food and energy components, for which the PCE and CPI measures differ in seasonal adjustment and, to some extent, weighting. As can be observed in the table, divergence between PCE and CPI inflation rates for food and energy are frequently reversed in subsequent quarters.

GNP FIXED-WEIGHTED PRICE INDEXES
(Percent change; based on seasonally adjusted data)¹

	1985-Q4	1986-Q4	1987		1988	
	to 1986-Q4	to 1987-Q4	Q3	Q4	Q1	Q2
	-----Annual rate-----					
GNP	2.7	4.0	3.7	3.8	3.5	4.7
PCE	2.5	5.1	4.2	4.6	2.4	5.4
Food ²	4.1	3.8	2.5	2.9	1.7	6.2
Energy	-17.3	8.5	9.0	-2.1	-7.5	5.4
Other ³	4.2	5.0	4.3	5.5	3.5	5.1
Memoranda:						
CPI	1.3	4.4	3.6	3.9	3.2	4.9
Food ³	4.2	3.5	2.9	2.8	2.1	5.7
Energy	-19.0	8.3	8.0	-1.3	-5.7	3.2
Other ²	3.9	4.3	3.8	4.4	4.4	5.0
GNP deflator	2.8	3.1	3.1	2.4	1.7	4.1

1. Data refer to quarterly averages.
2. Includes alcoholic beverages.
3. Excludes alcoholic beverages.

shifts, particularly the sharp increases in expenditures on computers, which have an exceptionally low (1982-based) deflator.

Wages and Labor Costs

Labor costs accelerated in the first half of the year. As measured by the employment cost index for private industry workers, compensation rose 4-1/2 percent over the 12 months ending in June, about 1-1/4 percentage points more than in the preceding two years. The largest contributor to the recent pickup in hourly compensation has been benefit costs, which jumped 6-1/2 percent over the year ending in June, boosted by the increase in January payroll taxes and by sharply higher employer costs for health insurance.¹⁰ Acceleration also has been evident in wages and salaries, as the 3-3/4 percent pace registered over the past year is nearly 1/2 percentage point more than witnessed in 1987.

The acceleration in compensation has been widespread across broad classifications of workers and across major sectors of the economy; it has been most apparent in the goods-producing sector--where increases have been sizable for both manufacturing and construction--and among blue-collar workers. In the service-producing sector, the acceleration also has been fairly broad-based, with notable increases in trade and finance, in which commission payments to sales workers apparently have rebounded, and in services, in which labor shortages have resulted in larger pay hikes for health-care workers.

A separate measure of nonfarm compensation, reported in the BLS

10. According to BLS analysts, lump-sum payments, which are included in the benefit component of the ECI, have risen more than 30 percent over the past year. However, lump-sum payments are such a small proportion of overall compensation that they have no significant effect on changes in the total ECI.

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

August 1988	1985	1986	1987	1988		
				Q1	Q2	July
						Monthly rate
<u>Employment cost index¹</u>						
Compensation, all persons	3.9	3.2	3.3	3.9	4.5	--
By occupation:						
White collar	4.8	3.5	3.7	3.7	4.4	--
Blue collar	3.2	2.7	3.1	4.4	4.7	--
Service workers	3.0	3.1	2.4	2.9	3.6	--
By bargaining status:						
Union	2.6	2.1	2.8	3.9	4.3	--
Nonunion	4.6	3.6	3.6	4.0	4.5	--
Wages and salaries, all persons	4.1	3.1	3.3	3.3	3.7	--
Benefits, all persons	3.5	3.4	3.5	5.8	6.4	--
<u>Labor costs and productivity, all persons²</u>						
Total						
Compensation per hour	4.5	4.2	4.1	3.5	4.1	--
Output per hour	1.5	1.2	1.9	3.4	-1.7	--
Unit labor costs	2.9	3.0	2.1	0.1	5.9	--
Manufacturing						
Compensation per hour	4.9	3.3	1.6	5.4	2.9	--
Output per hour	4.5	2.8	3.4	3.2	3.5	--
Unit labor costs	.4	.5	-1.8	2.2	-1.6	--
<u>Major collective bargaining agreements³</u>						
First-year wage adjustments	2.3	1.2	2.2	--	2.6	--
Total effective wage change	3.3	2.3	3.1	--	3.0	--
<u>Hourly earnings index, wages of production workers²</u>						
Total private nonfarm						
Manufacturing	3.1	2.3	2.6	3.1	3.8	.5
Nonmanufacturing	3.3	1.7	1.9	1.6	2.9	.1
	3.0	2.6	3.0	3.8	4.2	.7

1. Changes for final month of quarter indicated from a year earlier.

2. Changes are from final quarter of preceding period to final quarter of period indicated; seasonally adjusted data.

3. Agreements covering 1,000 or more workers; not seasonally adjusted. Second quarter figures refer to first six months of 1988.

release on productivity and costs, rose 4.1 percent at an annual rate in the second quarter and was up 4.6 percent from a year earlier, a pace similar to that of the employment cost index. Productivity in the nonfarm business sector fell at an annual rate of 1.7 percent in the second quarter, retracing half of a sharp first-quarter advance, and unit labor costs were up at a 5.9 percent rate after having been little changed in the first quarter. The fluctuations in productivity this year reflect large swings in the hours of self-employed workers, which depressed growth in overall hours in the first quarter and boosted it in the second. On average, productivity so far this year has risen at about an annual rate of 1 percent.

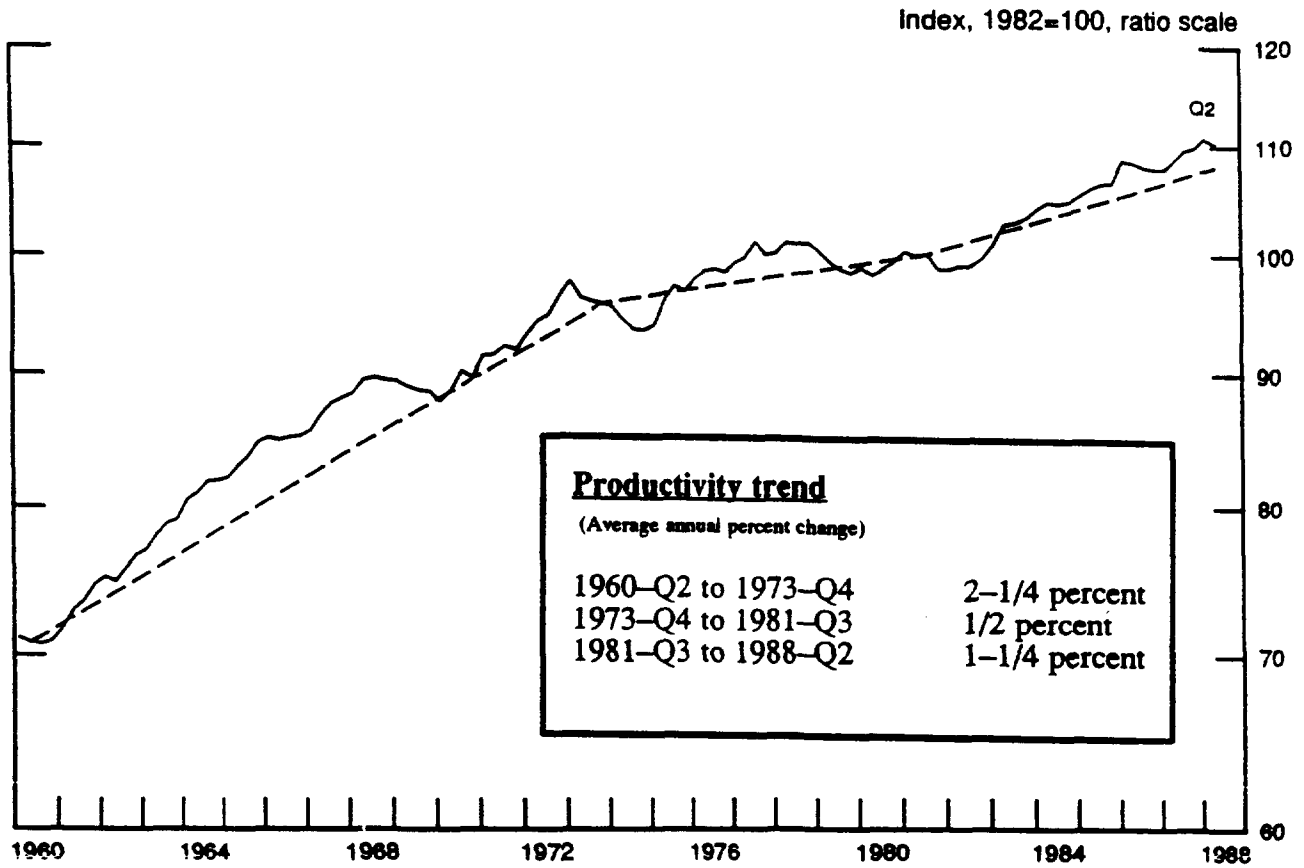
In the manufacturing sector, productivity grew 3.5 percent at an annual rate in the second quarter. Coupled with an increase of 2.9 percent in hourly compensation, the productivity improvements in manufacturing led to a decline of 0.6 percent in unit labor costs in the second quarter.

Estimates of productivity and costs have been revised back to 1985 to reflect the revisions to the national income and product accounts and to the employment data compiled from the establishment survey. The largest changes were to the figures on compensation per hour, which now is shown to have continued growing at about 4 percent per year through 1987, in contrast to the sharp deceleration indicated by the earlier estimates. Productivity growth also was revised up, especially in 1987, but this change was enough to raise only marginally the staff estimate of the trend rate of productivity growth, which still stands at about 1-1/4 percent per year. With the revision to productivity falling short

of the change to compensation, increases in unit labor costs were raised as well--to 3 percent in 1986 and 2 percent in 1987, compared with previous estimates of 2 percent and 1-1/2 percent respectively.

In the manufacturing sector, increases in both productivity and compensation in 1987 were revised up about 1/2 percentage point. As a result, the decline in unit labor costs remained just below 2 percent.

**Productivity
Nonfarm Business Sector**



PRODUCTIVITY AND COSTS IN THE NONFARM BUSINESS SECTOR

(Percent change from preceding period at compound annual rates;
based on seasonally adjusted data)

	1985 ¹	1986 ¹	1987 ¹	1988	
				Q1	Q2
1. Output per hour	1.5	1.2	1.9	3.4	-1.7
<i>Previous</i>	1.0	1.5	1.3	3.6	-
2. Compensation per hour	4.5	4.2	4.1	3.5	4.1
<i>Previous</i>	4.6	3.4	2.8	3.4	-
3. Unit labor costs	2.9	3.0	2.1	0.1	5.9
<i>Previous</i>	3.7	1.9	1.5	-0.2	-

¹ Percent change from fourth quarter to fourth quarter.

APPENDIX

ANNUAL REVISIONS TO THE NATIONAL INCOME AND PRODUCT ACCOUNTS

The annual revisions to the National Income and Product Accounts were released by the Commerce Department in July. The revision incorporates new source data and revised estimates of seasonal adjustment factors for the past three years. On the expenditure side of the accounts, the changes largely reflect revisions to Census Bureau data on the trade sector, services, manufacturing, and state and local government finances. Revisions to the income side of the accounts were based primarily on information from the state unemployment insurance system, business income from the Internal Revenue Service, and farm statistics from the Department of Agriculture.

The pattern of real activity now shows an even sharper acceleration in 1987 than was previously estimated. Real GNP growth was revised upward a full percentage point in 1987 to 5 percent, with much of the adjustment occurring in the first half of last year. In contrast, only minor changes were made to GNP growth during the two preceding years; the increase in real GNP in 1985 was revised up 1/4 percentage point to 3-1/2 percent and growth in 1986 was reduced by 1/4 percentage point to 2 percent. Inflation rates were not substantially affected by the revision. The GNP fixed-weighted price index is estimated to have picked up to a 4 percent rate in 1987--unchanged from the previous estimate--after increasing 3-1/4 percent in 1985 and 2-3/4 percent in 1986.

The upward revision to growth in 1987 resulted entirely from a stronger pace of domestic demand, with essentially no adjustment to the large gains previously estimated for net exports. About half of the upward revision to domestic spending reflected somewhat stronger growth for consumer spending, which now is estimated to have risen 1-3/4 percent. Outlays for food were revised upward considerably, eliminating the suspicious drop that was indicated by earlier data. Moreover, service consumption is now estimated to have increased 4-1/4 percent, about 1/2 percentage point more than previously estimated. However, even with this revision, consumer spending decelerated sharply last year from the rapid gains in 1985 and 1986.

Another significant change was a sharp upward adjustment to outlays for producers' durable equipment, which now show nearly a 10 percent gain last year. On the basis of a revised series for shipments and new information showing sharper price declines, the BEA now estimates that growth in computer purchases was stronger last year. In addition, some of the exceptional rise in computers that was previously estimated to have occurred in the first quarter of this year has been moved into the fourth quarter of 1987 and the second quarter of 1988.

Revisions to inventory investment were small in the aggregate, though there were sizable changes to the major components. The pace of nonfarm inventory accumulation was revised up, but with sales also stronger, the ratio of inventories to sales at year-end was little changed. Meanwhile, the incorporation of data from the Department of Agriculture have led the BEA to show a decline in farm inventories in 1987, rather than the accumulation indicated by their previous estimate;

previous estimates had implied an implausibly high level of farm output last year.

On the income side, the principal upward adjustment appears in wages and salaries and comes as a result of linking the NIPA series to the payroll figures collected under the unemployment insurance system. In addition, net interest and rental income were revised up enough to offset lower estimates of proprietors' income last year, according to information taken from IRS tabulations of business tax returns. On balance, real personal disposable income is now estimated to have increased 3 percent last year, 1 percentage point more than estimated initially. Nevertheless, for 1987 as a whole, the upward revision to the level of consumption was a bit larger than to income, and the saving rate for 1987 was revised down 0.6 percentage point to 3.2 percent--an extremely low level by historical standards. Despite the lower annual average, the saving rate shows essentially the same quarterly pattern as in the pre-revision data. The saving rate averaged 3.0 percent for the four quarters before the October stock market break, but has averaged 4.2 percent for the subsequent three quarters.

The level of corporate economic profits was revised up considerably in late 1985 and 1986, mainly as a result of reestimates of the capital consumption adjustment, which converts depreciation charges for tax purposes to an economic measure of depreciation. However, by the end of 1987, the revision to the level of corporate profits was slight, and the profit share of GNP in recent quarters was little changed. Although the picture of corporate profitability is not dramatically altered by the revisions, the contour of the share of profits in GNP has shifted;

rather than remaining flat over the past three years, as indicated by the previous estimates, the profit share evidently has been drifting lower.

Before the revisions, there appeared to be a larger decline in unemployment than could be explained by Okun's Law relationships. In the last Greenbook, it was argued that this discrepancy most likely resulted from an underestimate of the level of GNP, but statistical problems with the household survey or faster growth in potential output could not be ruled out. As expected, the revisions to output, particularly in the first half of 1987 where the discrepancy had been especially large, have brought the Okun's Law prediction of the unemployment rate (seen in the chart) into better alignment with the actual unemployment rate.

National Income Account Revisions
(change in billions of 1982 dollars, fourth quarter to fourth quarter)

	Revision		
	1985	1986	1987
GNP	11.5	-8.3	39.0
Consumption	3.7	2.0	21.4
Business Fixed Investment	-4.3	-11.6	15.1
Residential Structures	-.3	-2.2	-1.8
Nonfarm Inventory Investment	6.5	-7.6	17.8
Farm Inventory Investment	2.7	2.2	-14.8
Net Exports	4.0	5.4	.4
Federal Purchases	-4.7	.6	4.2
State and Local Purchases	3.7	3.2	-3.3

National Income	8.4	17.2	32.9
Compensation	-3.3	18.7	43.3
Proprietors Income	-3.8	.2	-13.1
Rental Income	-2.3	-2.7	4.6
Net Interest	4.8	2.8	8.6
Corporate Profits With IVA and CCA	13.6	-.8	-9.7
Less: Personal Contributions to Social Insurance	.7	.1	.6

Saving Rate (Annual Average)	-.1	-.3	-.6

REAL GROSS NATIONAL PRODUCT AND RELATED ITEMS

(Percent change from previous period)

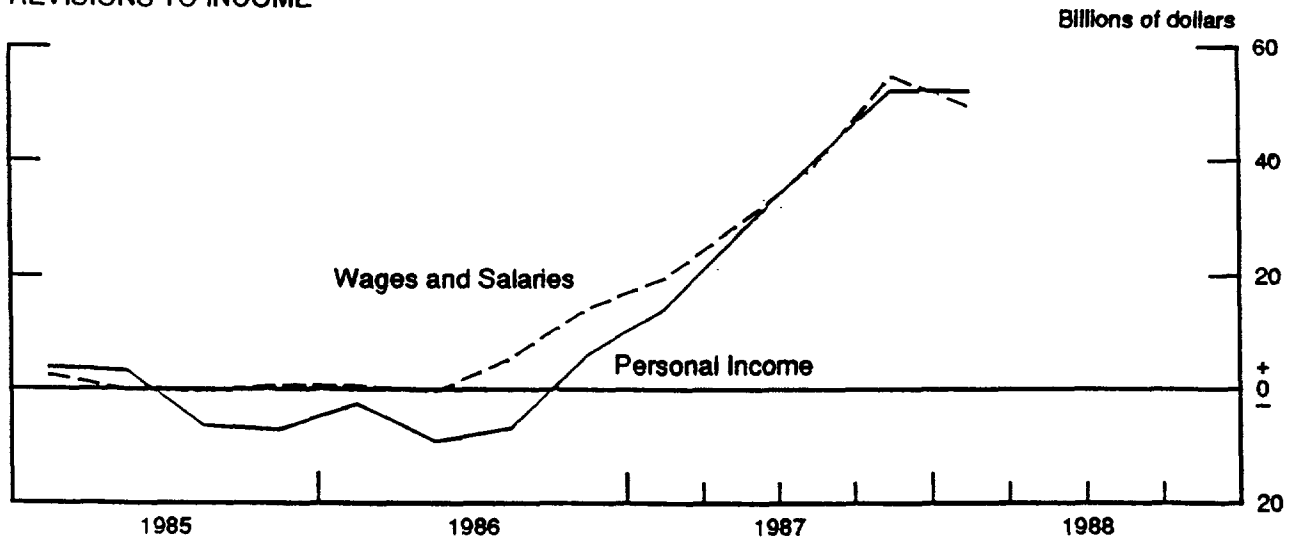
	1984-Q4 to 1985-Q4	1985-Q4 to 1986-Q4	1986-Q4 to 1987-Q4
1. Gross national product	3.6	2.0	5.0
<i>Previous</i>	(3.3)	(2.2)	(4.0)
2. Gross domestic purchases	4.3	2.4	4.4
<i>Previous</i>	(4.1)	(2.7)	(3.4)
3. Personal consumption expenditures	4.6	4.2	1.8
<i>Previous</i>	(4.5)	(4.1)	(1.0)
4. Producers' durable equipment	4.6	-2.4	9.6
<i>Previous</i>	(7.0)	(.2)	(5.4)
5. Nonresidential structures	1.9	-17.4	6.7
<i>Previous</i>	(.1)	(-15.4)	(4.2)
6. Residential structures	5.8	11.3	-3.5
<i>Previous</i>	(6.0)	(12.5)	(-2.6)
7. Government purchases	8.6	2.9	2.3
<i>Previous</i>	(8.7)	(2.4)	(2.2)

ADDENDA:			
8. Change in nonfarm inventories ¹	23.2	1.2	68.2
<i>Previous</i>	(16.7)	(2.3)	(51.5)
9. Net exports ¹	-125.3	-142.4	-126.0
<i>previous</i>	(-129.3)	(-151.8)	(-135.8)
10. Nominal GNP	6.6	4.8	8.3
<i>Previous</i>	(6.6)	(4.5)	(7.5)
11. GNP implicit price deflator	2.9	2.8	3.1
<i>Previous</i>	(3.1)	(2.2)	(3.3)
12. GNP fixed-weight price index	3.3	2.7	4.0
<i>Previous</i>	(3.6)	(2.3)	(4.0)
13. Real disposable personal income	2.7	3.4	3.0
<i>Previous</i>	(2.8)	(3.6)	(2.2)

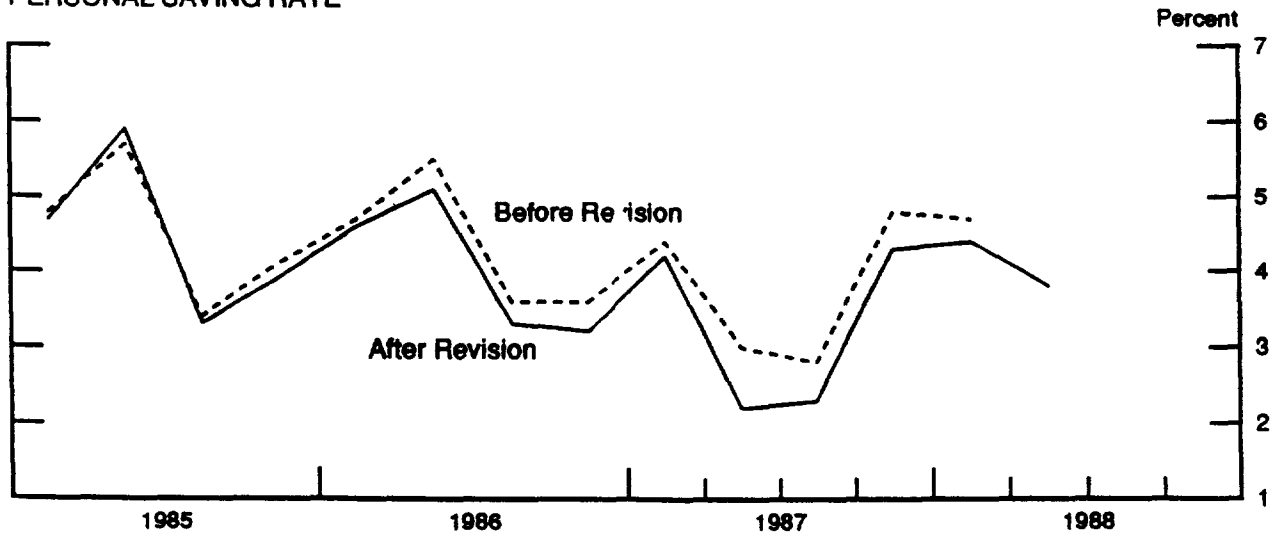
1. Billions of 1982 dollars, end of period.

Revision to National Income

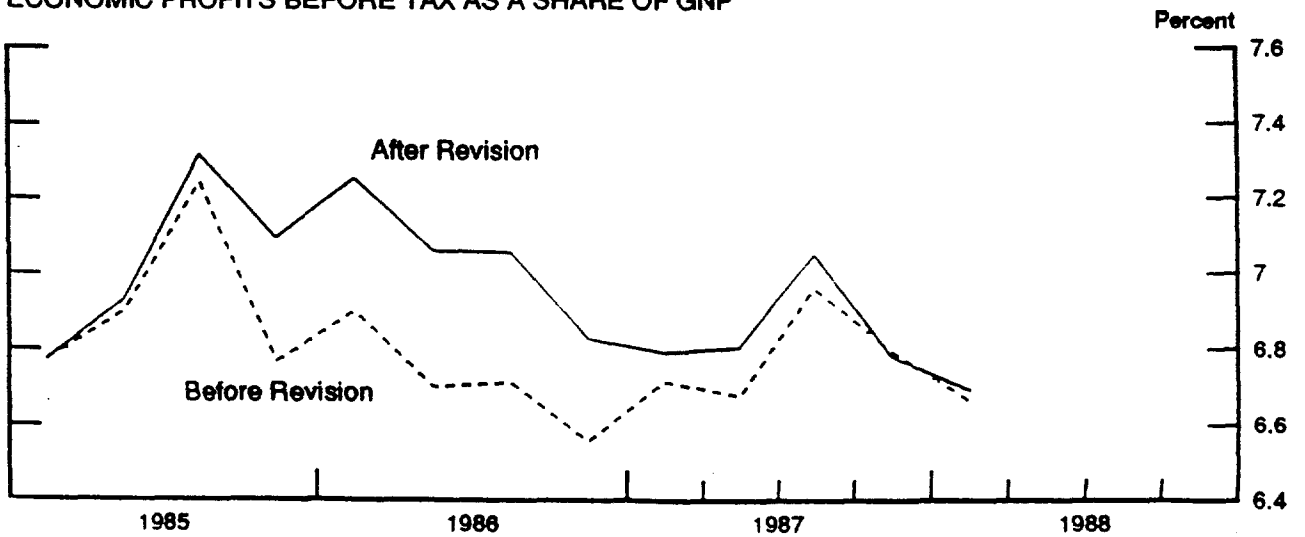
REVISIONS TO INCOME



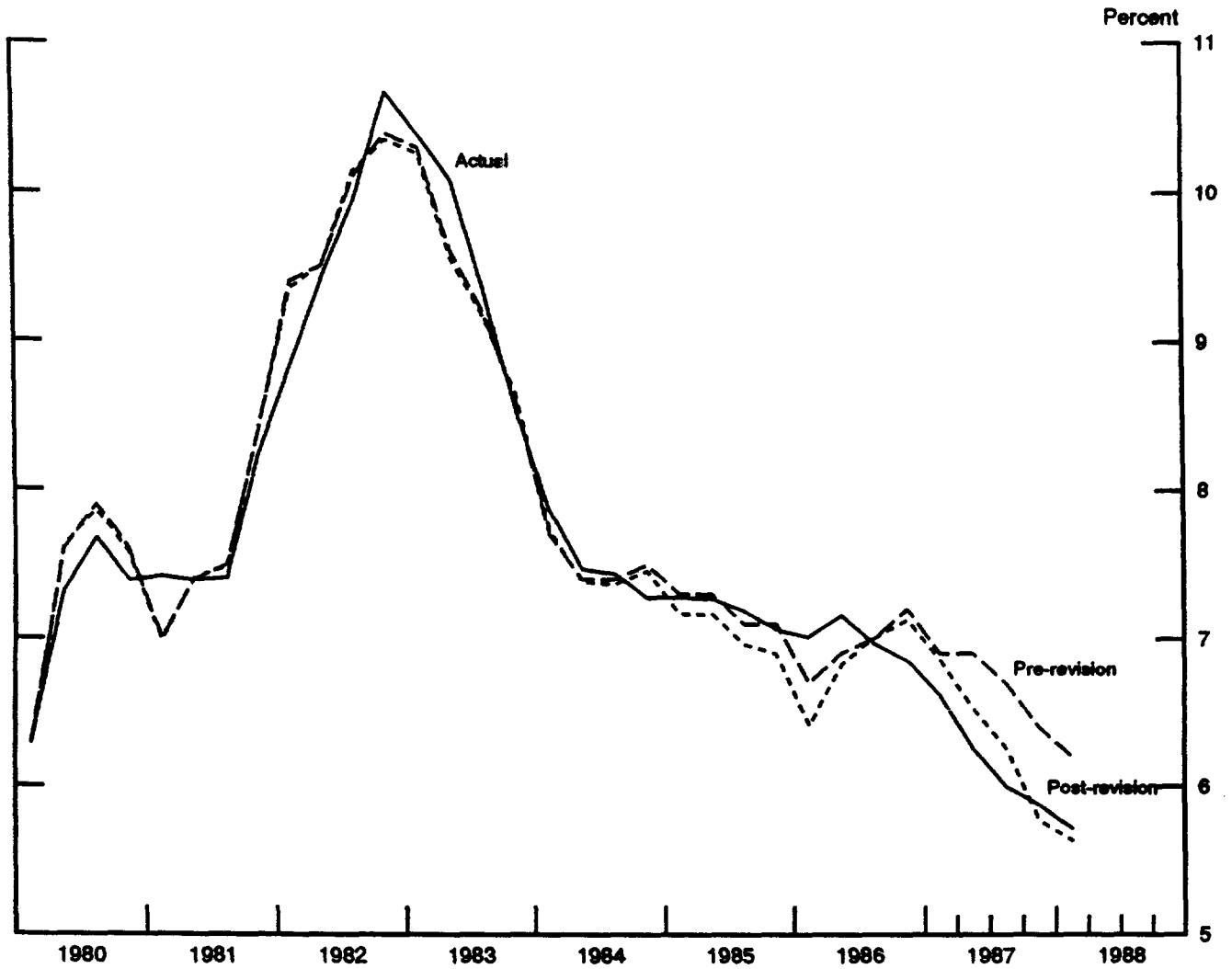
PERSONAL SAVING RATE



ECONOMIC PROFITS BEFORE TAX AS A SHARE OF GNP



Actual and Okun's Law Projection of the Unemployment Rate



Simulation begins in 1980 Q1, and potential GNP growth is assumed to be at an annual rate of 2.4 percent.

DOMESTIC FINANCIAL DEVELOPMENTS

III-T-1

SELECTED FINANCIAL MARKET QUOTATIONS¹
(Percent)

	1987		1988			Change from:
	Jan.-Feb. lows	Oct. 16 ²	Feb lows	FOMC June 30	Aug 9	FOMC June 30
Short-term rates						
Federal funds ³	5.95	7.59	6.38	7.58	7.79	.21
Treasury bills ⁴						
3-month	5.30	6.93	5.59	6.56	7.06	.50
6-month	5.31	7.58	5.77	6.71	7.40	.69
1-year	5.35	7.74	6.10	6.98	7.58	.60
Commercial paper						
1-month	5.81	7.94	6.41	7.62	7.94	.32
3-month	5.73	8.65	6.45	7.61	8.14	.53
Large negotiable CDs ⁴						
1-month	5.85	7.92	6.44	7.57	7.87	.30
3-month	5.80	8.90	6.49	7.65	8.15	.50
6-month	5.78	9.12	6.55	7.77	8.44	.67
Eurodollar deposits ⁵						
1-month	6.00	7.79	6.60	7.65	7.99	.34
3-month	6.00	8.69	6.69	7.69	8.25	.56
Bank prime rate	7.50	9.25	8.50	9.00	9.50	.50
Intermediate- and long-term rates						
U.S. Treasury (constant maturity)						
3-year	6.34	9.52	7.28	8.18	8.72	.54
10-year	7.01	10.23	8.11	8.82	9.20	.38
30-year	7.29	10.24	8.32	8.87	9.21	.34
Municipal revenue ⁶ (Bond Buyer)	6.92	9.59	7.76	8.12	8.05	-.07
Corporate A utility (recently offered)	8.78	11.50	9.63	10.30e	10.42e	.12
Home mortgage rates ⁷						
S&L fixed-rate	9.10	11.58	9.84	10.39	10.44	.05
S&L ARM, 1-yr.	7.52	8.45	7.59	7.81	7.90	.09

	1986	1987		1988		Percent change from:
	Year-end	Record highs	Lows	FOMC June 30	Aug. 9	FOMC June 30
Stock prices						
Dow-Jones Industrial	1895.95	2722.42	1738.74	2141.71	2079.13	-2.92
NYSE Composite	138.58	187.99	125.91	154.47	150.66	-2.47
AMEX Composite	263.27	365.01	231.90	309.25	301.12	-2.63
NASDAQ (OTC)	348.83	455.26	291.88	394.66	384.23	-2.64

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 maintenance period closest to date shown except lows shown which are one-week average ending Feb.25 and Feb.10, respectively. Last observation is average to date for maintenance period ending 8/10/88.

4. Secondary market.

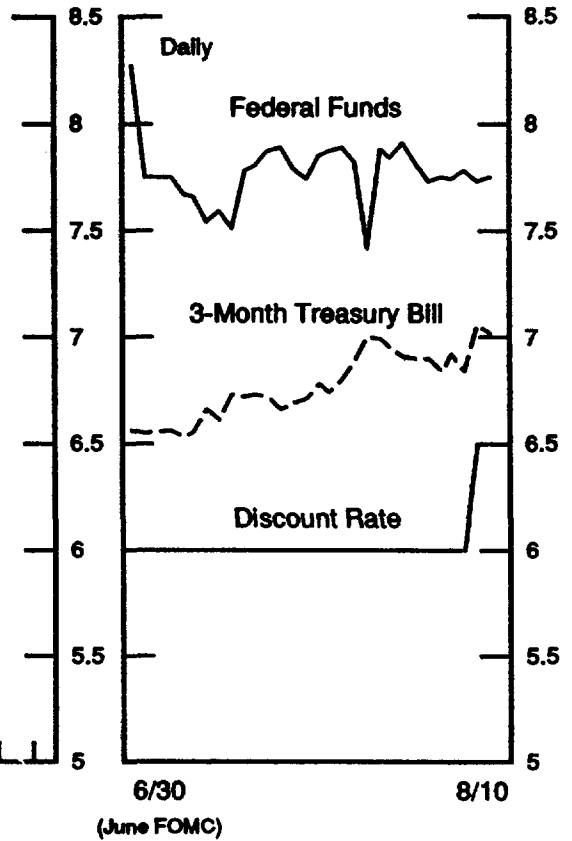
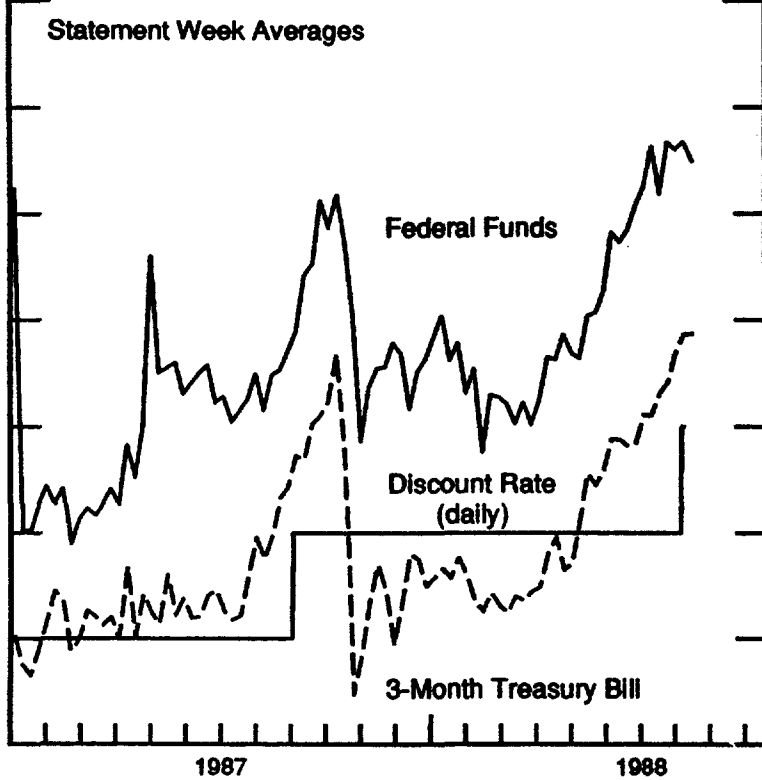
5. Average for statement week closest to date shown.

6. One-day quotes for Thursday.

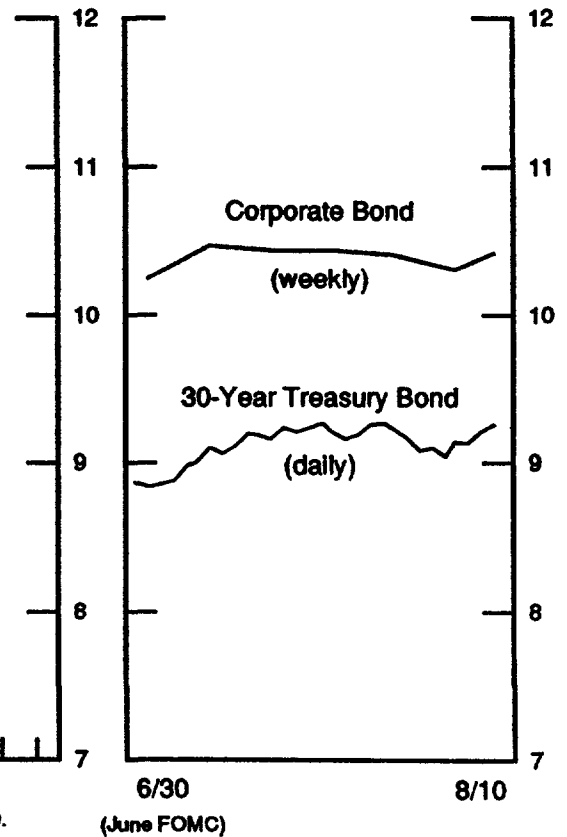
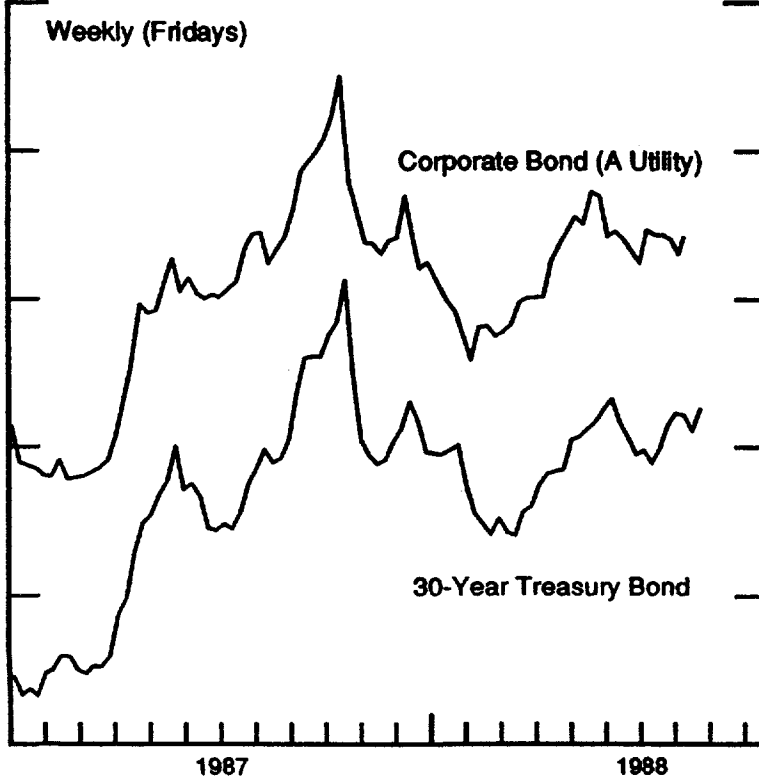
7. Quotes for week ending Friday closest to date shown.
e--estimate.

Selected Interest Rates* (percent)

Short-Term



Long-Term



*--Last points plotted incorporate quotes for mid-day Wednesday, August 10.

DOMESTIC FINANCIAL DEVELOPMENTS

Interest rates have continued to trend upward since the last FOMC meeting, under the influence of surprisingly strong economic activity and the Federal Reserve's efforts to reduce inflationary pressures. Much attention was given to Chairman Greenspan's Humphrey-Hawkins testimony, which was interpreted as emphasizing that inflation concerns could lead the Federal Reserve to tighten further, a prospect that was reinforced by incoming information on real activity and wage and price behavior. The money markets may have firmed somewhat ahead of System reserve actions; these anticipations, together with some uncertainty about where federal funds might eventually trade, seem to have contributed to a fairly subdued response in short-term credit markets to the August 9 hike of one-half percentage point in the discount rate.

On balance for the intermeeting period, short-term rates generally are up about 1/2 percentage point or more. In long-term markets, however, rates have risen considerably less, owing in part to a firmer dollar. Supply conditions also have influenced the pattern of long-term rate increases: reduced supplies of new corporate and municipal bonds have held down their yields, while restrictions on the Treasury's long bond authority have limited the advance in rates on 30-year bonds in relation to shorter maturities. Among administered rates, banks raised the prime 1/2 percentage point to 9-1/2 percent on July 14, and mortgage rates have posted only slight increases.

III-2

MONETARY AGGREGATES

(based on seasonally adjusted data unless otherwise noted)

	1987 ¹	1988 Q1	1988 Q2	1988 May	1988 Jun	1988 Jul p	Growth Q4 87- Jul 88p
-----Percent change at annual rates-----							
1. M1	6.2	3.8	6.3	0.2	9.8	9.1	5.8
2. M2	4.0	6.7	7.9	4.7	5.5	3.7	6.7
3. M3	5.4	7.0	7.1	4.3	6.5	5.7	6.8
							Levels bil. \$ Jul 88p
-----Percent change at annual rates-----							
<u>Selected components</u>							
4. M1-A	2.8	1.4	3.9	-4.1	9.2	4.8	504.1
5. Currency	8.7	9.4	8.4	6.5	7.7	8.2	206.3
6. Demand deposits	-1.0	-4.4	1.0	-11.6	10.4	2.9	290.6
7. Other checkable deposits	13.6	8.3	10.6	8.0	11.0	16.6	278.2
8. M2 minus M1 ²	3.3	7.7	8.4	6.2	4.0	1.8	2243.8
9. Overnight RPs and Eurodollars, NSA	4.1	-13.3	3.6	67.4	-13.3	-57.0	76.2
10. General purpose and broker/dealer money market mutual fund shares, NSA	5.8	19.3	4.5	-17.3	-15.0	3.1	230.4
11. Commercial banks	2.5	7.2	6.8	0.9	9.0	5.3	958.9
12. Savings deposits, SA, plus MMDAs, NSA ³	1.8	2.8	3.2	-3.5	11.1	1.8	548.7
13. Small time deposits	3.5	13.7	11.8	6.6	6.2	10.0	410.2
14. Thrift institutions	3.5	8.7	9.2	6.5	3.7	2.2	973.9
15. Savings deposits, SA, plus MMDAs, NSA ³	0.8	-7.3	2.3	0.9	4.8	1.8	404.0
16. Small time deposits	5.6	21.3	14.1	10.5	2.7	2.7	569.9
17. M3 minus M2 ⁴	10.8	7.9	4.2	3.3	10.3	13.6	793.0
18. Large time deposits	8.5	7.3	7.2	7.3	13.6	16.5	508.4
19. At commercial banks, net ⁵	11.2	3.4	6.4	7.7	20.5	25.6	340.5
20. At thrift institutions	3.4	15.7	8.8	5.7	0.0	-1.4	167.9
21. Institution-only money market mutual fund shares, NSA	3.0	44.0	-30.6	-24.8	-49.3	-20.9	84.8
22. Term RPs, NSA	29.9	3.4	8.9	33.3	-1.1	-5.4	110.5
23. Term Eurodollars, NSA	13.8	-24.3	19.4	31.1	23.7	20.7	94.4
-----Average monthly change in billions of dollars-----							
<u>MEMORANDA:⁶</u>							
24. Managed liabilities at commercial banks (25+26)	6.1	1.2	7.0	12.4	3.3	4.7	595.9
25. Large time deposits, gross	3.5	2.3	1.5	2.4	4.1	6.2	406.7
26. Nondeposit funds	2.6	-1.1	5.5	10.0	-0.8	-1.5	189.2
27. Net due to related foreign institutions, NSA	2.9	-6.1	4.0	7.8	-0.9	1.0	9.9
28. Other ⁷	-0.3	5.1	1.4	2.1	0.1	-2.4	179.3
29. U.S. government deposits at commercial banks ⁸	0.3	-0.4	-1.0	2.9	-2.7	-1.8	20.2

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 grew during June and July at rates of 12.9 percent and 8.9 percent, respectively. At thrift institutions, savings deposits excluding MMDAs grew during June and July at rates of 9 percent and 6.5 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-quarter basis.

7. Consists of borrowing 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 borrowing 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

Expansion in the monetary aggregates slowed a bit in July, with M2 and M3 growing at 4 and 6 percent annual rates, respectively. M1 continued to advance briskly last month boosted by large inflows to OCDs. With household deposits in M2 continuing to expand moderately, the deceleration of M2 owed primarily to declines in overnight Eurodollars and RPs, the latter of which partly reflected a steep decline in commercial bank holdings of government securities.

Overall private credit expansion appears to have edged off a bit from its second-quarter pace. Borrowing by businesses apparently fell sharply in July: gross bond issuance by nonfinancial firms slowed markedly from the elevated June pace, bank loans grew less rapidly, and commercial paper contracted. In the household sector, mortgage lending appears to have continued its moderate advance last month, and consumer lending at banks edged down. Municipal bond issuance in July dropped back to the level seen earlier this year, and is expected to weaken further in August. In contrast, federal borrowing is expected to pick up strongly in the third quarter, reflecting a widening of the budget deficit from near balance in the second quarter.

Monetary Aggregates and Bank Credit

M2 and M3 decelerated slightly in July, but remained in the upper halves of their annual ranges. The deceleration primarily reflected weakness in the nontransactions component of M2, which slowed to a 2 percent annual rate of increase. M1 slowed only a little from June, and continued growing at a strong pace, as a pickup in OCD growth largely offset a sharp drop-off in demand deposit growth.

COMMERCIAL BANK CREDIT AND SHORT- AND INTERMEDIATE-TERM BUSINESS CREDIT¹
 (Percentage changes at annual rates, based on seasonally adjusted data)¹

	1986:Q4	1988					Levels
	to						bil.\$
	1987:Q4	Q1	Q2	May	June	July ^P	July ^P
----- Commercial Bank Credit -----							
1. Total loans and securities at banks	7.9	7.8	11.9	13.0	11.1	4.7	2353.1
2. Securities	5.0	5.4	8.9	5.1	10.6	-9.8	543.8
3. U.S. government securities	9.1	6.8	12.9	10.1	13.5	-17.2	344.8
4. Other securities	-1.3	2.9	2.0	-3.6	5.5	3.0	199.0
5. Total loans	8.8	8.6	12.9	15.4	11.2	9.2	1809.2
6. Business loans	7.5	2.7	16.7	17.6	14.3	12.9	600.8
7. Security loans	1.0	76.6	-12.1	22.0	-6.2	-24.9	37.8
8. Real estate loans	18.1	10.8	13.8	16.3	12.3	11.6	624.9
9. Consumer loans	4.9	10.4	7.2	5.3	5.3	3.9	341.7
10. Other loans	-2.3	5.4	13.2	21.9	11.9	5.9	204.0
----- Short- and Intermediate-Term Business Credit -----							
11. Business loans net of bankers acceptances	7.6	2.3	17.0	18.2	14.4	13.0	597.3
12. Loans at foreign branches ²	-4.1	115.8	4.1	61.9	-35.3	-54.5	18.9
13. Sum of lines 11 & 12	7.2	5.2	16.6	20.0	12.5	10.8	616.2
14. Commercial paper issued by nonfinancial firms	-1.6	8.8	12.2	28.0	-7.8	-21.0	89.8
15. Sum of lines 13 & 14	6.0	5.7	16.0	20.9	10.0	6.7	706.0
16. Bankers acceptances: U.S. trade related ^{3,4}	13.3	-11.6	-9.5	-24.9	-10.9	n.a.	32.8 ⁵
17. Line 15 plus bankers acceptances: U.S. trade related	6.3	4.9	14.8	18.5	9.0	n.a.	734.9 ⁵
18. Finance company loans to business ³	16.6	8.4	12.1	11.6	8.7	n.a.	221.2 ⁵
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	8.4	5.6	14.2	17.2	8.9	n.a.	956.1 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. June data.

n.a.--not available

p--preliminary

The composition of M2 growth in recent months has been somewhat at odds with movements in retail deposit rates. Expansion in OCDs and savings deposits has been higher relative to growth in small time deposits than would have been suggested by the wide spreads between small time and liquid deposit rates. Several factors may be restraining small time deposit growth. Some households may be temporarily parking funds in liquid deposits in anticipation of future increases in rates on small time deposits. In addition, suggested by the strength in noncompetitive tenders for Treasury securities, others may be shifting into market instruments, whose rates have been rising relative to small time deposit rates. Also, small time deposit rates at several large thrifts in the Eleventh District have not increased as much since May as elsewhere, possibly owing to pressures exerted on troubled thrifts to price small time deposits less aggressively.

Expansion of large time deposits picked up in July, boosted by stronger growth at banks and a turnaround at thrifts. But this rise did not fully offset the slowdown in M2, and as a result M3 growth slackened. Reduced sources of funds to banks accompanied reduced uses, as bank credit expansion weakened to a 4-3/4 percent annual rate last month. Bank holdings of U.S. government securities, which had risen at a 13 percent rate over the second quarter, fell at a 17 percent rate, dragging down growth of overall bank credit last month. Growth in holdings of other securities also slowed somewhat.

Total loans increased at a 9-1/4 percent annual rate, down from the 11-1/4 percent pace of June, as the volatile security loan component

contracted and expansion in the other major loan categories decelerated. Nevertheless, real estate loans continued to expand at a double-digit rate during a period in which home sales were at their highest level in more than a year. Consumer loans expanded at just a 4 percent pace in July, down from 5-1/4 percent in June. The recent slowdown in consumer borrowing at banks is, however, considerably sharper than these figures suggest: issuance of consumer credit-backed securities during May and June removed a large volume of loans from bank balance sheets, but such issuance was off considerably in July. As shown in the table, consumer loan growth was about 3 percentage points higher in the second quarter when these securities are added back, indicating continued strong consumer lending at banks through June. The slowing in this adjusted measure of consumer lending at banks last month may reflect, in part, the scaling back of cash rebate incentives on autos in July.

Consumer Loan Growth at Banks: Effects of Security Issuance¹
(percent S.A.A.R.)

Period	Not Security Adjusted	Security ² Adjusted
Quarterly ³		
1988 Q1	10.4	10.8
Q2	7.2	10.3
Monthly		
Apr.	10.8	11.9
May	5.3	8.0
June	5.3	10.7
July	4	5-1/4

1. Consumer loans booked at commercial banks in the U.S.
2. Adjusted for the issuance of consumer credit-backed securities.
3. Calculated on an end-month-of-quarter basis.

Business loans at U.S. offices of commercial banks grew at a 13 percent annual rate in July, the fourth straight month of double-digit growth. Despite the mid-July prime rate increase, the prime-LIBOR spread narrowed, on average, reducing LIBOR-based borrowing from foreign offices of U.S. banks in favor of prime-based domestic bookings.

Business Finance

Total borrowing by nonfinancial businesses appears to have fallen off sharply in July, with most of the decline occurring in bond issuance. Overall business loan growth--including loans booked at foreign branches of U.S. banks--remained relatively robust at a 10-3/4 percent annual rate and continued to be boosted by financings of mergers and restructurings of nonfinancial firms. But commercial paper of nonfinancial businesses ran off at a 21 percent rate, in large part reflecting a sizable paydown in late June by a firm that used proceeds of a divestiture. The sum of commercial paper and business loans grew at a 6-3/4 percent rate, less than half the pace of the second quarter. Nonfinancial corporate bond issuance declined steeply last month, in the aftermath of a June surge prompted by lower rates. In view of the large external financing needs expected by the staff for the third quarter, the apparent slowdown in overall borrowing last month may represent only a temporary pause.

Although new announcements and completions of large deals fell off last month after an extremely heavy June, merger-related funding from banks remained strong, and issuance of junk bonds continued to run above the pace of the first half. The weakness of bond supply last month was

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

	1987	1988				
	Year	Q1	Q2 ^P	May ^P	June ^P	July ^P
Corporate securities - total ¹	24.08	23.54	24.56	23.25	29.21	17.15
Public offerings in U.S.	21.89	22.15	22.07	21.41	25.90	15.40
Stocks--total ²	4.45	3.89	3.58	3.91	4.10	4.40
Nonfinancial	2.32	.76	1.69	1.37	2.60	1.70
Utility	.57	.32	.28	.15	.20	.10
Industrial	1.75	.44	1.41	1.22	2.40	1.60
Financial	2.12	3.13	1.89	2.54	1.50	2.70
Bonds--total ¹	17.44	18.26	18.49	17.50	21.80	11.00
Nonfinancial	6.61	6.58	7.84	7.00	9.65	4.20
Utility	2.02	2.25	2.53	2.20	3.05	1.20
Industrial	4.59	4.33	5.31	4.80	6.60	3.00
Financial	10.83	11.68	10.65	10.50	12.20	6.80
By quality ³						
Aaa and Aa	3.27	3.83	3.04	2.90	2.90	1.40
A and Baa	5.20	7.05	7.06	6.70	8.45	2.30
Less than Baa	2.77	1.33	2.85	2.10	4.75	3.00
No rating (or unknown)	.07	.16	.15	.20	.04	.20
Memo items:						
Equity-based bonds ⁴	.87	.13	.37	.06	.80	.50
Mortgage-backed bonds	5.19	5.47	4.12	4.24	3.50	3.30
Variable-rate notes	1.88	1.44	1.35	2.33	.62	.90
Bonds sold abroad - total	2.03	1.34	2.30	1.80	2.90	1.55
Nonfinancial	.94	.39	.83	.82	.87	.50
Financial	1.09	.95	1.47	.98	2.03	1.05
Stocks sold abroad - total	.16	.05	.19	.04	.41	.20
Nonfinancial	.12	.04	.14	.04	.33	.20
Financial	.04	.01	.05	.00	.08	.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.

instead in investment-grade issues, where offerings were about one-third their June volume. Average issuance for June and July together was near the rate of the first half.

The light supply of investment-grade bond issues is likely responsible for some narrowing of their spreads vis-a-vis government bonds. Since the June FOMC meeting, the spread has narrowed about 1/4 percentage point, even as advances in long Treasury yields were being restrained by the prospective absence of new bond issues. Broad measures of corporate-Treasury yield spreads appear to have been unaffected by recent publicity about losses to some bondholders. Losses suffered by holders of bonds issued by Revco, which became the first large LBO to file for bankruptcy, had little apparent effect on the prices of bonds of other LBO issuers. Nor did the losses of First Republic Bank Corporation's debtholders appear to have any major impact on bank holding company bonds.

Although equity offerings by nonfinancial firms also declined from the June totals, new stock issuance in July was near the average pace of the 1980s. The volume of initial public offerings, excluding closed-end mutual funds, rose to a post-crash high, though it is still 40 percent below the average for the first nine months of 1987. More generally, the supply of new issues has been supported by continued high share prices, which have remained near spring peaks, with price-earnings ratios still well above those of the 1970s and early 1980s. Over the intermeeting period, major stock price indexes are down a little, but remain near post-crash highs.

TREASURY AND AGENCY FINANCING¹
(Total for period; billions of dollars)

	1988			1988		
	Q1	Q2	Q3 ^e	Jul. ^P	Aug. ^e	Sep. ^e
<u>Treasury financing</u>						
Total surplus/deficit (-)	-37.0	.9	-40.1	-25.8	-22.4	8.1
Means of financing deficit:						
Net cash borrowing from the public	42.8	18.7	29.6	4.1	16.3	9.2
Marketable borrowings/repayments (-)	34.1	11.2	27.6	3.6	15.8	8.2
Bills	3.2	-10.4	11.1	.4	9.5	1.2
Coupons	30.9	21.5	16.5	3.2	6.3	7.0
Nonmarketable	8.7	7.5	2.0	.5	.5	1.0
Decrease in the cash balance	-.4	-16.6	0.5	15.6	8.1	-23.2
Memo: Cash balance at end of period	23.0	39.6	39.2	24.1	16.0	39.2
Other ²	-5.4	-3.0	10.0	6.2	-2.1	5.9
<u>Federally sponsored credit agencies, net cash borrowing</u> ³						
FHLBs	2.5	-.5	--	1.5	--	--
FNMA	2.8	4.9	--	1.0	--	--
Farm Credit Banks ⁴	.9	-.7	--	-.9	--	--
FAC	--	--	--	.5	--	--
FHLMC	2.5	-1.5 ^P	--	.4	--	--
FICO	.7	1.1	--	.6	--	--
SLMA	1.8	1.0	--	2.0	--	--

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.

4. Financial Assistance Corporation, an institution within Farm Credit System, was created in January 1988 by Congress to provide financial assistance to Farm Credit Banks. It first issued bonds in July 1988.

e--staff estimate.

p--preliminary.

Note: Details may not add to totals due to rounding.

Treasury and Sponsored Agency Financing

The federal budget deficit is expected to widen to about \$40 billion in the third quarter from near balance in the second quarter. As a result, the staff projects that net marketable Treasury borrowing in the third quarter will pick up to \$28 billion from \$11 billion in the second quarter, and that the Treasury's cash balance will decline roughly \$3 billion, to end the quarter at more than \$36 billion. In contrast, nonmarketable borrowing is expected to fall from last quarter's level as SLGS issuance continues to be restrained, reflecting a very light volume of refunding issues by states and municipalities.

The usual 30-year bond auction was not a component of the August midquarter refunding, because the Treasury had just \$1.7 billion in remaining authority to issue bonds at interest rates above 4-1/4 percent. Although the Senate Finance Committee and the full House have passed separate tax adjustment bills that include amendments to repeal the limitation on long bond authority, a final bill is not expected to reach the President until the fall. To compensate for part of the consequent funding shortfall, the size of each of the two other components of the August refunding--the three- and ten-year notes--was raised \$2.25 billion above the previous refunding to \$11 billion. In addition, the Treasury will issue a \$7 billion 248-day cash management bill scheduled to mature after the April tax date. Apparently, the Treasury decided to use a longer-term cash management bill to get a start on its considerably larger fourth-quarter borrowing needs, especially given the possibility that its long bond authority will not be enhanced in time for

the November refunding. The Treasury also has raised the gross size of its weekly bill auctions by \$800 million, while increases in the one-year bill and two- and seven-year note auctions have been only \$250 million each.

The Financial Assistance Corporation, set up early this year by Congress to recapitalize the Farm Credit Banks (FCBs), brought its first offering of bonds to market in mid-July. The \$450 million of 15-year securities, which are fully guaranteed by the U.S. Treasury, were priced to yield 32 basis points above ten-year Treasury notes. Amid concerns about the effect of the drought on the financial condition of the FCBs, spreads on their new short-term debenture offerings rose slightly in July and are now at the highest levels of the year.

In its first public offering since March, the Financial Corporation (FICO) issued \$600 million of 30-year bonds in late July at a spread of 118 basis points over Treasury bonds. This spread is 14 basis points above the spread in the March sale, which in turn was up from previous offerings by about the same amount. The deterioration in the spread coincides with adverse publicity about the FSLIC and the savings and loan industry, which has raised investor concerns about both the credit risk of the bonds and the potential for significantly larger supplies. More recently, FICO issued \$250 million of debt in a private placement, thereby exhausting its \$3.75 billion issuance authority for its fiscal year ending this month.

Municipal Securities

After a surge to nearly \$14 billion in June, gross offerings of long-term municipal debt fell back in July to \$8 billion, about the average for the first five months of 1988. The drop-off largely reflected a very weak volume of refunding issues, which were at their lowest monthly level since January 1986.

Yields on long-term municipal bonds have been quite steady over the intermeeting period, and as a result, the ratio of the Bond Buyer yield to the 30-year Treasury fell to .89 in early August, down from .91 at the time of the last FOMC meeting and .92 at the beginning of this year. The recent decline in supply probably has held down increases in municipal rates.

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

	1986	1987	1987	1988		1988		
	Year	Year	Q4	Q1	Q2	May	June	July ^P
Total offerings ¹	14.39	10.44	9.99	8.68	11.73	9.01	17.16	9.25
Total tax-exempt	14.04	10.05	9.38	8.46	11.41	8.39	16.98	9.18
Long-term	12.25	8.53	7.84	7.94	9.20	7.85	13.91	8.06
Refundings ²	5.29	3.80	2.16	3.05	3.18	2.66	4.98	.88
New capital	6.96	4.73	5.68	4.89	6.02	5.19	8.93	7.18
Short-term ³	1.79	1.52	1.54	.52	2.21	.54	3.07	1.12
Total taxable	.35	.39	.61	.22	.32	.62	.18	.07

p--preliminary.

1. Includes issues for public and private purposes; also includes taxable issues.

2. Includes all refunding bonds, not just advance refundings.

3. Does not include tax-exempt commercial paper.

GROWTH IN MORTGAGE DEBT OUTSTANDING, BY TYPE OF PROPERTY
(Seasonally adjusted annual percentage rate)

Period	Total	Residential			Commercial	Farm
		Total	1-4 family			
1984	12.0	11.4	10.9	18.2	-.8	
1985	11.7	12.0	11.5	15.1	-5.3	
1986	13.3	14.0	13.8	15.5	-7.9	
1987	11.6	12.4	12.8	12.2	-6.3	
1987-Q3	10.4	11.1	11.5	10.4	-4.6	
Q4	10.4	10.2	10.7	12.8	-2.4	
1988-Q1	8.1	9.2	9.4	6.3	-4.8	
Q2	9.1	9.8	10.2	8.4	-2.8	

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

	Mortgage transactions		Net change in mortgage assets ¹		
	Originations	Sales	Total	Mortgage loans	Mortgage- backed securities
1985	16.4	8.2	4.1	4.2	-.1
1986	22.2	14.1	4.7	1.3	3.4
1987	21.1	12.5	6.1	2.4	3.7
1987-Q3	20.0	9.6	6.1	2.5	3.6
Q4	19.5	7.0	9.1	4.9	4.2
1988-Q1	18.6	7.7	2.6	3.6	-1.0
Q2 p	19.5	9.9	6.1	3.6	2.5
1988-Apr. r	18.7	10.4	5.8	2.8	3.1
May r	19.5	9.4	5.4	3.7	1.7
June p	20.3	9.9	7.1	4.4	2.7

1. Net changes are adjusted to account for structural changes caused by mergers, acquisitions, liquidations, terminations, or de novo institutions.

r--revised. p--preliminary.

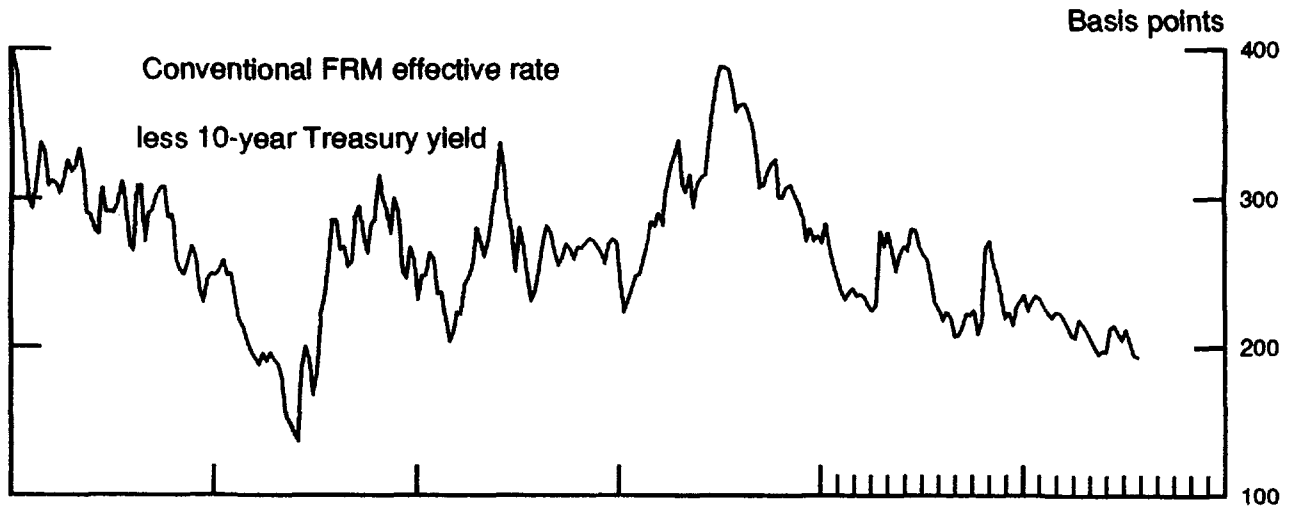
Mortgage Markets

Total mortgage lending volume in the second quarter picked up a bit from the reduced first-quarter pace while remaining moderate by the standard of recent years. One-to-four family mortgage debt, which accounts for about two-thirds of all mortgage credit outstanding, expanded at about a 10 percent annual rate in the second quarter despite a flat dollar volume of new home construction. Home mortgage borrowing was boosted by heavier resale activity. Adjustable-rate mortgages continued to account for a little more than half of all conventional loans originated for home purchase.

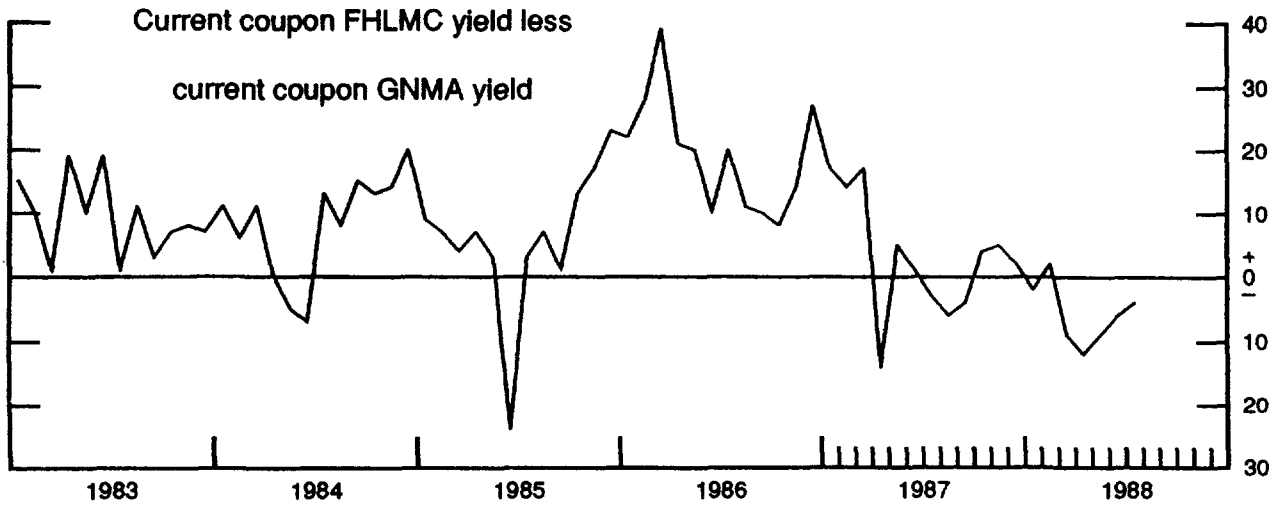
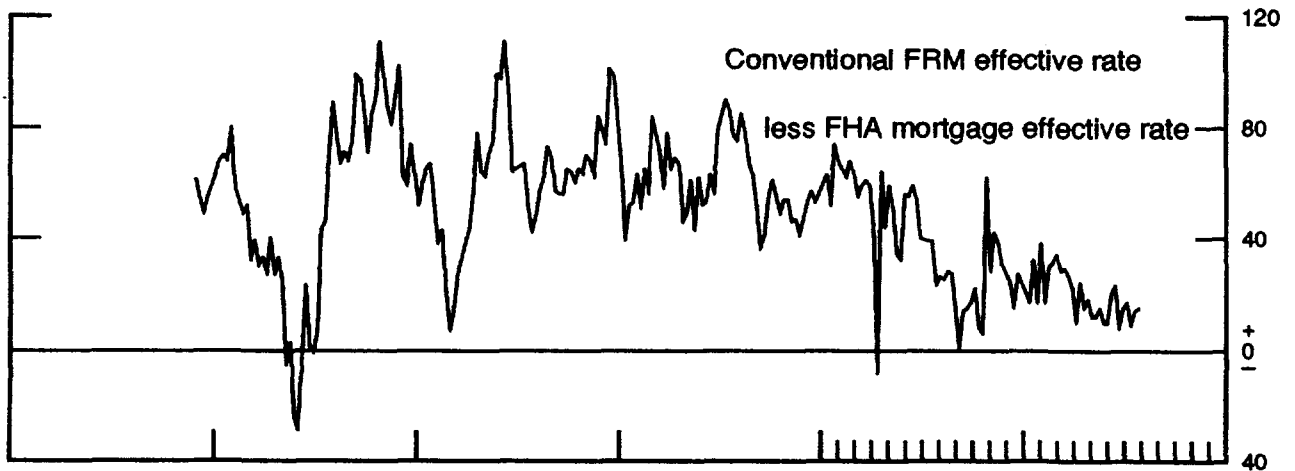
Mortgage investment by thrift institutions accounted for much of the pickup in overall mortgage debt growth in the second quarter. S&Ls and savings banks provided more than 40 percent of all mortgage funds advanced, up from an unusually low 10 percent share a quarter earlier. Sizable increases were posted in holdings of both loans and securitized mortgages. More ARMs are being securitized--spurred by new programs at Fannie Mae and Freddie Mac--and depository institutions presumably are carrying some of their ARMs in this form to enhance their value as collateral for borrowings. About half of the unsecuritized mortgages bore fixed rates, in contrast to previous quarters in which all of the net additions to thrift loan portfolios bore adjustable rates.

Interest rates on fixed-rate home loans are up only a few basis points from their level at the time of the June FOMC meeting. The spread over Treasuries of comparable maturity has remained historically

INTEREST RATE SPREADS



Note: The mortgage rate is adjusted to a bond equivalent.



narrow (top panel of chart). The narrower spread reflects reduced interest rate volatility, and consequently lessened prepayment uncertainty, as well as strong demand for CMO collateral, which has boosted demands for pass-throughs and, in turn, primary mortgages.

In the primary market, the typical spread of rates on conventional loans over those on FHA loans has nearly vanished this year (middle panel), owing partly to developments in the secondary market, into which almost all FHA mortgages and a large share of conventional mortgages are sold. Since early 1987, Freddie Mac participation certificates--backed by conventional mortgages--have been trading at yields lower than those on GNMA pass-throughs--issued against FHA and VA mortgages (bottom panel). Because GNMA's are backed by the U.S. government while the FHLMC securities carry only the corporate guarantee of Freddie Mac, differential credit risk alone should cause investors to require a higher return on the FHLMC pass-throughs. However, other factors, including changing expectations of prepayment rates, have increased relative yields on GNMA's since early 1987. Moreover, increased demand for FHLMC and FNMA pass-throughs as collateral for CMOs has pushed these yields down even further relative to GNMA's. Recently, over a third of all CMOs have been issued by FHLMC and FNMA, and these institutions now use only their own pass-throughs as collateral.

Consumer Credit

Consumer installment credit expanded at a 10 percent annual rate in June, bringing growth for the second quarter to 8 percent. Commercial banks accounted for most of the June pickup, and by type of

CONSUMER INSTALLMENT CREDIT
(Seasonally adjusted)

	Percent change (at annual rate)						Net change (billions of dollars)		Memo: Outstandings (billions of dollars)
	1986	1987	1988		1988		1988		1988
			Q1	Q2 ^P	May ^r	June ^P	May ^r	June ^P	June ^P
Total ¹	10.4	7.2	10.7	7.8	5.7	10.2	2.98	5.43	641.8
Total, excluding auto	5.7	6.2	8.0	8.2	7.2	10.1	2.13	3.02	359.9
Selected types									
Auto	17.4	8.6	14.4	7.3	3.7	10.4	.85	2.42	281.8
Revolving	11.8	16.8	15.9	15.4	12.9	20.2	1.80	2.85	172.0
All other	1.7	-1.5	1.2	1.8	2.1	1.1	.33	.17	187.9
Selected holders									
Commercial banks	8.5	7.4	13.2	12.8	9.7	18.5	2.38	4.56	300.1
Finance companies	20.4	4.8	11.4	1.9	-.5	2.4	-.06	.29	144.7
Credit unions	5.9	6.4	7.6	10.1	9.8	11.4	.68	.80	84.7
Savings institutions ²	14.5	12.4	7.1	-.1	2.3	-8.3	.11	-.46	65.1

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)

	1985	1986	1987	1988				
				Feb.	Mar.	Apr.	May	June
At commercial banks ¹								
New cars (48 mo.)	12.91	11.33	10.46	10.72	10.55	...
Personal (24 mo.)	15.94	14.83	14.23	14.46	14.40	...
Credit cards	18.69	18.26	17.92	17.80	17.78	...
At auto finance cos. ²								
New cars	11.98	9.44	10.73	12.26	12.24	12.29	12.29	12.32
Used cars	17.59	15.95	14.61	14.75	14.77	14.82	14.81	14.83

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.

credit, revolving credit increased the most rapidly. The second-quarter pace of installment credit growth, while down from that of the first quarter, remained more rapid than last year's rate.

The generally firmer pace of installment borrowing this year has been accompanied by weakness in noninstallment consumer credit, leaving total consumer credit expansion about 2 percentage points below the growth of installment credit alone. One factor at work is a substitution away from single-payment loans and toward home equity lines and unsecured personal lines of credit (the latter of which is classified as installment credit). These revolving plans give the borrower more flexibility than single-payment loans.

SECURITIZATION OF CONSUMER LOANS, 1985-88
(Gross issuance in billions of dollars)

	1985	1986	1987	1988 H1	Cumulative total
Total	.90	9.94	9.22	4.96	25.01
Auto loans	.90	9.94	6.37	2.02	19.23
Banks	.16	.58	1.69	.72	3.03
Finance companies	.53	8.97	4.19	.86	14.55
Savings institutions	.21	.38	.50	.44	1.64
Credit cards	--	--	2.41	2.53	4.94
Banks	--	--	2.20	2.03	4.23
Savings institutions	--	--	.21	--	.21
Retailers	--	--	--	.50	.50
"Other" loans	--	--	.43	.41	.84
Savings institutions	--	--	.43	.41	.84

Suppliers of consumer credit have been broadening their own sources of funding in recent months through securitization of consumer loans. Banks have been particularly active lately in securitizing credit card receivables, raising \$2 billion by that means in the first half of 1988. As shown in the table, this is nearly twice the pace of last year, when the first card-backed offering was made. In June alone, banks securitized \$1.4 billion of credit card receivables, and in July, Banc One Corporation entered into an agreement with a Merrill Lynch subsidiary to sell the subsidiary up to \$1.0 billion in receivables. Bank One, as is typical in such arrangements, will continue to service the credit card accounts.

Until last year, only auto loans were securitized, but credit-card issues have become more popular, and the first offerings backed by "other" consumer loans have been made. Consumer-loan securitizations totaled \$25 billion from 1985 through the first half of 1988, of which about \$18 billion is estimated to be outstanding currently, representing about 3 percent of total consumer installment credit outstanding.

INTERNATIONAL DEVELOPMENTS

U.S. Merchandise Trade

In May, the seasonally adjusted U.S. merchandise trade deficit was \$10.9 billion (Census basis, CIF valuation), compared with a \$10.3 billion (revised) deficit in April. The deficit increased as imports rose slightly more than exports (see table below). Data for June will be released on August 16.

U.S. MERCHANDISE TRADE
(Billions of dollars, monthly rates, Census basis)

	Exports	Imports	Balance	Exports	Imports	Balance
		CIF	CIF		CIF	CIF
	Not seasonally adjusted			Seasonally adjusted		
1988-Jan	23.0	34.5	-11.5	24.5	35.8	-11.3
Feb	24.1	37.1	-13.0	24.5	38.9	-14.4
Mar	29.1	38.6	-9.5	26.9	38.6	-11.7
Apr ^r	26.3	36.5	-10.2	26.0	36.3	-10.3
May ^p	27.3	38.0	-10.7	26.6	37.6	-10.9

r-revised

p-preliminary

For the combined April-May period, the trade deficit was substantially less than that recorded in the first quarter; exports rose and imports declined. These data, at a seasonally adjusted annual rate and on a balance-of-payments basis, are shown in the table on the next page in both current and constant 1982 dollars.

In constant dollars, the rate of growth of nonagricultural exports in the April-May period (8 percent from the first-quarter level) was close to the strong rates recorded during the previous four quarters. In current dollars, total exports in April-May rose 5 percent from the

first quarter level. The strongest increases were in agricultural products (especially corn and wheat to the Soviet Union), civilian aircraft, automotive parts (about half of the rise was to Canada), telecommunications equipment, lumber, fuels, metals, and various consumer goods. Partly offsetting these increases were declines in exports of a wide variety of machinery (particularly generators, engines, construction machinery, agricultural machinery, and computers).

U.S. MERCHANDISE TRADE
(Billions of dollars, annual rates, BOP basis, seasonally adjusted)

	Exports			Imports			Balance
	Total	Ag.	Nonag.	Total	Oil	Non-oil	
- - - - - Current Dollars - - - - -							
1985	216	30	186	338	50	288	-122
1986	224	27	197	369	34	335	-144
1987	250	30	220	410	43	367	-160
1987-1	227	26	201	387	35	352	-159
-2	239	28	211	398	40	357	-158
-3	260	33	226	418	51	367	-159
-4	272	31	242	437	45	392	-165
1988-1	299	36	263	442	40	403	-144
A/M ^e	314	39	275	432	42	390	-118
- - - - - Constant 1982 Dollars - - - - -							
1987-1	249	31	218	422	69	353	-173
-2	261	34	227	425	72	353	-164
-3	282	40	242	448	87	360	-166
-4	293	35	258	461	81	380	-168
1988-1	317	40	277	464	82	382	-147
A/M ^e	339	40	299	451	85	366	-112

e/ FR staff estimates.

The volume of nonoil imports dropped by 4 percent in April-May from the first-quarter level and prices (discussed below) rose. In terms of value, the decrease was 3 percent with the decline widespread among trade categories. Areas showing significant declines included foreign cars (especially from Japan and Germany), consumer goods (particularly apparel, and TVs and VCRs), non-oil industrial supplies (especially copper, steelmaking and steel mill products, lumber, and textile supplies), machinery (other than semiconductors), and foods (particularly meat). The only significant offsets to this widespread decline in imports were strong increases in imports of semiconductors (which are in short supply in the domestic economy), civilian aircraft (several airbuses were delivered), and oil.

The volume of oil imports rose in both April and May, with imports in the two-month period growing at a 5 percent higher rate than in the first quarter. The rise in imports occurred as abnormally large inventory accumulations offset the slowdown in consumption. Conditions in world oil markets continued to be volatile as fluctuations in the volume of production by OPEC countries led to price changes. While

OIL IMPORTS
(BOP basis, seasonally adjusted, value at annual rates)

	1987				1988		
	1987	Q2	Q3	Q4	Q1	April	May
Value (Bil. \$)	42.88	40.30	51.04	45.15	39.93	38.67	44.52
Price (\$/BBL)	17.33	17.58	18.26	17.46	15.24	14.65	15.43
Volume (mbd.)	6.78	6.28	7.66	7.08	7.16	7.21	7.88

prices of imports rose by about 80 cents per barrel from April to May, prices in spot and contract markets suggest that prices of imported oil declined slightly in June and fell sharply in July.

Import and Export Prices

Prices of both imports and exports (as measured by BLS and shown in the upper part of the table that follows) increased more rapidly during the second quarter than in recent quarters. Much of the acceleration was attributable to a surge in prices of oil, other industrial supplies, and grain.

Prices of imported industrial supplies other than oil jumped 22.8 percent (at an annual rate), with particularly strong increases in metals and agricultural products. The price of imported oil also rose strongly in the second quarter, following sharp declines in the previous two quarters. Prices of imported capital goods rose at a 7 percent annual rate, marginally stronger than in the first quarter. Excluding computers, the rise in prices of other imported capital goods was slightly slower than in the first quarter, particularly for electric machinery, telecommunications equipment, and scientific equipment -- each of which showed strong increases in the previous two quarters. Prices of imported consumer goods (particularly apparel) and automotive products also rose at somewhat slower rates than in previous quarters. Prices for imported foods, feeds and beverages were virtually unchanged during the second quarter, following four quarters of moderate increases.

Prices of agricultural exports jumped substantially during the second quarter, primarily due to sharply higher prices for grains; over the year ending in June, these export prices rose 17 percent. Prices of exported industrial supplies also rose strongly, particularly prices of fuel oil, metals, plastic materials, and inorganic chemicals. In

IMPORT AND EXPORT PRICE MEASURES
(percentage change from previous period, annual rates)

	1987			1988		1988Q2
	Q2	Q3	Q4	Q1	Q2	1987Q2
- - - - - BLS Prices ¹ - - - - -						
<u>Imports</u> , Total	13.8	3.3	5.9	4.7	11.4	6.2
Oil	47.8	3.3	-32.9	-36.7	33.4	-12.6
Non-oil	10.2	3.5	11.7	10.0	9.7	8.7
Food, Feed, Bev.	10.3	4.5	11.9	5.8	-0.4	5.4
Industrial Supplies	15.1	11.0	11.1	14.6	22.8	14.8
Capital Goods	12.3	-1.0	16.3	6.5	7.0	7.0
Computers & Accessories	10.1	4.2	6.9	0.0	3.4	3.6
Other Capital Goods	12.1	-1.9	16.8	8.0	7.2	7.3
Autos and Parts	6.7	0.0	7.6	10.7	7.3	6.3
Consumer Goods	9.8	4.5	11.3	9.6	7.2	8.1
<u>Exports</u> , Total	9.5	2.4	8.4	6.2	11.3	7.0
Agricultural	27.2	-16.1	32.8	3.3	64.4	17.3
Nonagricultural	7.7	3.9	6.3	5.8	7.6	5.9
Industrial Supplies	22.7	11.8	10.3	8.9	15.2	11.5
Capital Goods	0.8	0.8	1.2	4.8	3.1	2.5
Computers & Accessories	0.4	-1.2	-4.9	1.7	-2.9	-1.9
Other Capital Goods	0.8	1.5	1.5	5.8	4.2	3.3
Autos and Parts	0.8	1.6	1.9	-0.8	1.5	1.1
Consumer Goods	1.5	2.3	4.2	8.0	1.8	4.0
- - - - - Prices in the GNP Accounts - - - - -						
Fixed-Weighted						
Exports, Total	3.8	3.7	3.3	8.7	6.5	5.5
Imports, Total	13.8	7.4	4.7	3.3	5.8	5.3
Imports, Non-oil	8.2	6.0	8.7	12.8	7.2	8.6
Deflators						
Exports, Total	-1.3	-0.7	0.1	2.6	5.0	1.7
Imports, Total	7.7	-3.2	5.2	1.6	0.0	0.8
Imports, Non-oil	4.6	-0.0	3.8	8.1	3.6	3.8

1. Not seasonally adjusted, surveyed last month of each quarter.

contrast, prices of exported capital goods, consumer goods, and automotive products all registered increases of under 3 percent at an annual rate.

Other measures of prices of U.S. imports and exports -- the implicit deflators and fixed-weighted price indexes reported in the GNP accounts -- showed smaller increases in prices of imports and exports in the second quarter than the BLS series (see the bottom half of the table). The GNP data differ substantially from BLS data due to different treatment of prices of agricultural products, industrial supplies, aircraft exports, and especially imports and exports of computers. Even after revisions to take into account additional data (which will probably result in a small upward revision to non-oil import prices), the GNP price measures are likely to continue to show substantially smaller increases in overall prices of imports and exports through the second quarter than the BLS data.

U.S. International Financial Transactions

The increase in foreign official reserve assets held in the United States was large again in May, \$7.7 billion. (See line 4 of the Summary of International Transactions Table.)

. OPEC reserves continued to fall.

. However, partial information from FRBNY indicates substantial net declines in official assets held by G-10 countries in June and July.

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

	1986	1987	1987				1988			
	Year	Year	Q1	Q2	Q3	Q4	Q1	Mar.	Apr.	May
<u>Private Capital</u>										
Banks										
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	22.3	47.1	13.1	-6.1	31.2	10.3	0.4	1.5	16.8	-2.4
Securities										
2. Private securities transactions, net <1>	65.9	36.6	16.6	15.5	11.5	-6.9	-2.2	0.4	2.7	2.7
a) foreign net purchases (+) of U.S. corporate bonds	53.5	26.4	8.5	7.5	7.5	2.8	2.6	2.1	1.2	4.3
b) foreign net purchases (+) of U.S. corporate stocks	18.0	16.8	10.1	8.7	5.4	-7.4	*	0.3	1.3	-2.2
c) U.S. net purchases (-) of foreign securities	-5.5	-6.5	-2.1	-0.7	-1.5	-2.3	-4.8	-1.9	0.2	0.7
3. Foreign net purchases (+) of U.S. Treasury obligations	4.0	-7.3	-2.8	-2.3	-2.8	0.6	7.0	1.8	-0.3	3.3
<u>Official Capital</u>										
4. Changes in foreign official reserves assets in U.S. (+ = increase)	33.5	47.7	15.3	11.6	0.9	19.9	24.8	8.4	2.1	7.7
a) By area										
G-10 countries (incl. Switz.)	30.8	38.8	15.7	13.2	-5.7	15.6	18.2	3.9	3.2	1.8
OPEC	-8.3	-8.9	-2.7	-2.0	-1.3	-2.9	-1.6	-0.2	-0.4	-0.4
All other countries	10.8	17.8	2.3	0.5	7.9	7.1	8.2	4.7	-0.7	6.3
b) By type										
U.S. Treasury securities	34.4	43.2	12.2	11.1	0.8	19.2	27.7	11.2	2.4	6.3
Other <2>	-1.0	4.4	2.9	0.6	0.1	0.7	-2.9	-2.8	-0.3	1.4
5. Changes in U.S. official reserve assets (+ = decrease)	0.3	9.1	2.0	3.4	*	3.7	1.5	0.5	0.3	0.2
<u>Other transactions (Quarterly data)</u>										
6. U.S. direct investment (-) abroad <3>	-27.8	-44.5	-10.7	-6.2	-7.9	-19.7	-4.8	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S. <4>	34.1	42.0	8.0	7.2	15.0	11.7	10.2	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) <3> <4>	-9.1	4.8	2.6	4.7	-1.5	-2.4	-0.1	n.a.	n.a.	n.a.
9. U.S. current account balance <4>	-138.8	-154.0	-37.6	-40.9	-42.0	-33.5	-39.8	n.a.	n.a.	n.a.
10. Statistical discrepancy <4>	15.6	18.5	-6.5	13.1	-4.4	16.3	3.0	n.a.	n.a.	n.a.

MEMO:

U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)

-144.5 -160.3 -39.9 -39.6 -39.7 -41.2 -35.9 n.a. n.a. n.a.

<1> These data have not been adjusted to exclude commissions on securities transactions and therefore, do not match exactly the data on U.S. international transactions as published by the Department of Commerce.

<2> Includes deposits in banks, commercial paper, acceptances, borrowing under repurchase agreements, and other securities.

<3> 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 adjustments to the data made by the Department of Commerce and revisions of the data in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.

<4> Includes seasonal adjustment for quarterly data.

<*> Less than \$50 million.

NOTE: Details may not add to total because of rounding.

Germany, in particular, facing strong downward pressure on the foreign exchange value of the mark, reduced its holdings at FRBNY by about \$9 billion during these two months.

Private foreigners made net purchases in May of both Treasury obligations (\$3.3 billion, line 3) and U.S. corporate securities (\$2.1 billion, lines 2a plus 2b). In the first category, residents of Japan accounted for purchases of \$0.8 billion, with another \$0.9 billion coming from World Bank transactions. Foreigners sold corporate stocks again net (\$2.2 billion), after the year's first strong month of purchases in April (line 2b). Similarly, U.S. residents sold foreign stocks net (line 2c). In contrast, there were significant net purchases of corporate bonds in May of \$4.3 billion (line 2a); this coincided with a pick-up in new Eurobond issues by U.S. corporations in April (\$2.1 billion) and May (\$1.6 billion). In June, new bond issues by U.S. corporations in both the Euro and domestic bond markets were even stronger; however, the volume fell sharply in July, probably as a result of higher interest rates.

Banks reported a small net outflow in May of \$2.4 billion, after massive inflows in April (line 1). The monthly average of daily data on the net claims position of U.S. banking offices with their foreign affiliates and IBFs gives a considerably different picture of the changes in May -- a net inflow of \$9.5 billion. (See line 1 of the International Banking Table.) The discrepancy between the two series is largely accounted for by the particular daily pattern of the net claims data. Data for June through July 23 suggest that net banking claims were essentially flat for the period: a small capital outflow for June and a

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1985	1986	1987			1988				
	Dec.	Dec.	June	Sept.	Dec.	Mar.	April	May	June	July 2/
1. Net Claims of U.S. Banking Offices (excluding IBFS) on Own Foreign Offices and IBFS	28.2	22.3	5.0	-7.8	-10.9	8.7	3.9	-5.6	-4.7	-5.7
(a) U.S.-chartered banks	32.4	31.7	16.3	12.6	15.2	27.8	25.0	17.4	17.0	15.6
(b) Foreign-chartered banks	-4.2	-9.4	-11.3	-20.3	-26.1	-19.0	-21.1	-23.0	-21.7	-21.3
2. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	18.7	16.8	15.6	17.1	15.8	19.1	19.2	20.0	19.7	18.7
3. Eurodollar Holdings of U.S. Nonbank Residents <1>	111.1	124.5	135.7	141.1	132.6	128.6	129.0	135.1	136.0	135.0

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

<2> Through July 25, 1988.

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.

similarly small inflow in the first three weeks of July (line 1 of the International Banking Data Table).

Foreign Exchange Markets

Since the June FOMC meeting, the weighted-average foreign-exchange value of the dollar against the other G-10 currencies has appreciated nearly 4 percent, as shown in Chart 1. The dollar rose sharply in mid-July in reaction to U.S. trade data for May, which prompted continued optimism about external adjustment. These gains were subsequently eroded amid perceptions that Germany, Japan, and the United States were intervening in a concerted fashion to contain the dollar's rise

The dollar moved higher late in the intermeeting period as additional U.S. economic data showed stronger-than-expected employment and spending, and then shot up to within nearly 2 percent of last summer's peak after the Federal Reserve raised its discount rate.

Among individual currencies, the dollar appreciated 1 percent against the yen and the Canadian dollar, and somewhat more against sterling. The mark weakened sharply, falling 5-1/4 percent against the dollar, and hit a post-war low against the yen. Furthermore, the mark depreciated even as interest rates on mark-denominated assets increased substantially

Although the German economy certainly is less buoyant than other major economies outside of continental Europe, German economic data released during the intermeeting period generally were better-than expected.

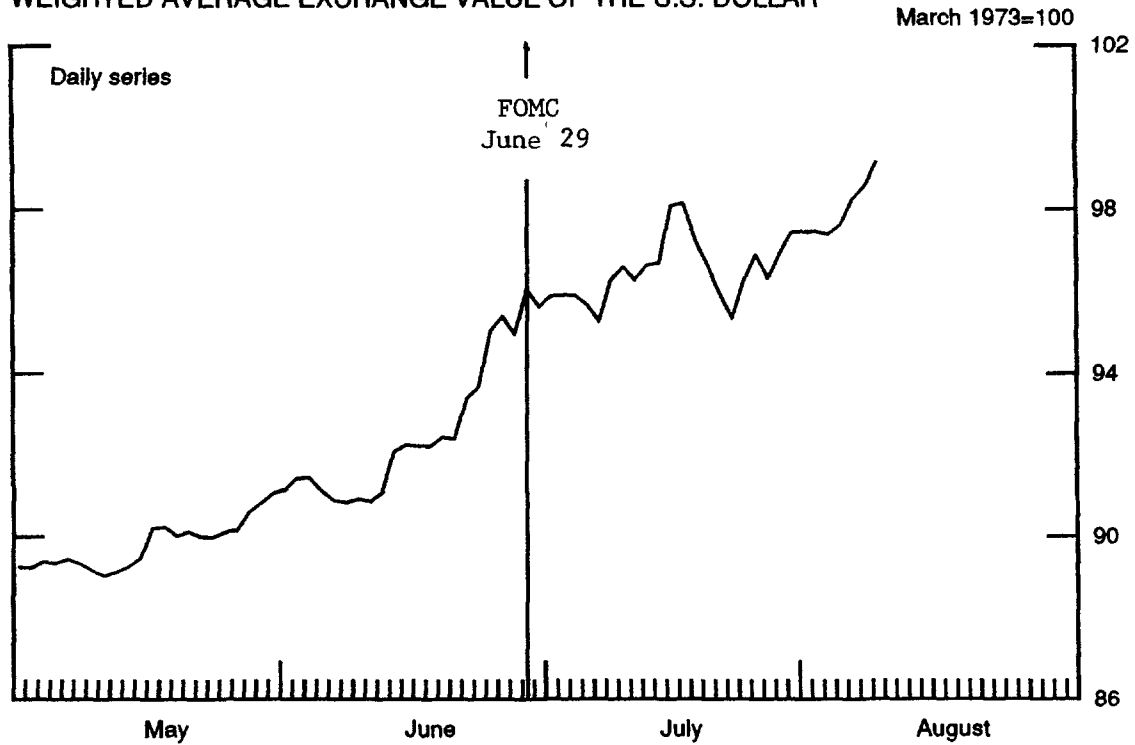
Short-term interest rates worldwide generally rose during the intermeeting period, but the increase was most pronounced in Europe. Three-month interbank rates in the United Kingdom -- shown in the panel at the bottom of the chart -- climbed 130 basis points, as the Bank of England boosted its money market dealing rates 150 basis points to 10-7/8 percent, bringing the total increase since early June to 350 basis points. In Germany, three-month rates moved up 85 basis points. The Bundesbank raised its discount and Lombard rates 1/2 percentage point each to 3 and 5 percent, respectively, and increased its RP rate in three steps a total of 3/4 percentage point to a level of 4-1/4 percent. This followed a 1/4 percentage point rise in mid-June. The Swiss National Bank raised its Lombard rate and the Austrian National Bank raised its discount and Lombard rates in tandem with the Bundesbank's moves. Dutch and Belgian authorities hiked key money market rates about 3/4 percentage point. Notable exceptions were the Bank of France and the National Bank of Denmark, which cut official money market rates slightly early in the period.

Elsewhere, three-month interest rates moved up 45 basis points in Canada and about 10 basis points in Japan. The Bank of Japan allowed the two-month commercial bill buying rate to rise 3/16 percentage point during the intermeeting period, bringing the total increase since mid-May to 5/16 percentage point. U.S. CD rates have climbed nearly 60 basis points since the June FOMC meeting.

For longer maturities, yields on 10-year Treasury bonds in the United States are up more than 35 basis points since the last FOMC

Chart 1

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



INTEREST RATES IN SELECTED COUNTRIES

	3-month interbank					long-term ¹		
	U.S. CD's	Japan	Germany	U.K.	Canada	U.S.	Japan	Germany

Daily:

1988

June 29	7.62	3.83	4.45	9.94	9.35	8.88	4.83	6.21
July 8	7.85	3.83	4.65	10.06	9.30	9.04	4.93	6.27
July 15	8.03	3.83	4.95	10.44	9.45	9.08	5.06	6.38
July 22	8.07	3.85	4.95	10.75	9.43	9.11	4.90	6.44
July 29	8.11	3.86	5.30	10.81	9.58	9.12	4.91	6.52
Aug. 10	8.20	3.95	5.30	11.25	9.80	9.25 ^e	5.37	6.50

1. U.S.--10-year constant maturity government bond yields. Japan--yield on #105 benchmark bond. Germany--yield on German public authority bond.

e--estimate.

meeting, somewhat more than bond yields in Germany, while yields in Japan increased more than 50 basis points. In contrast, long-term interest rates in the United Kingdom declined moderately, even as short-term rates moved higher.

the Desk sold more than \$3 billion
against marks

. In a non-market transaction, the Desk purchased \$1-1/2 billion equivalent of yen from the Japanese Ministry of Finance, under an agreement between the Treasury and the MoF to replenish U.S. reserves of yen. According to this agreement, U.S. authorities are scheduled to purchase an additional \$1/2 billion equivalent of yen during the rest of August. Proceeds from all Desk activity were split about equally between the System and Treasury accounts.

Developments in the Foreign Industrial Countries

Economic activity appears to have slowed in most of the major foreign industrial countries in the second quarter. Industrial production declined slightly in both Japan and Germany after strong first-quarter growth. In France, the level of industrial production in April and May was down slightly from the first quarter's pace while in Canada the rate of expansion continued to be moderate. In contrast,

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

	Q4/Q4 1986	Q4/Q4 1987	1987		1988		1988					Latest 3 months from year ago 2/
			Q3	Q4	Q1	Q2	Feb.	Mar.	Apr.	May	June	

Canada												
GDP	1.2	6.1	1.5	1.6	.8	n. a.	*	*	*	*	*	5.3
IP	-5.5	7.5	2.1	2.1	.9	n. a.	-2.2	.8	.0	.8	n. a.	6.6
France												
GDP	1.9	2.8	.8	.8	1.1	n. a.	*	*	*	*	*	3.6
IP	-3.3	3.6	.6	1.0	.6	n. a.	.0	.0	-9.9	1.0	n. a.	2.6
Germany												
GNP	2.4	2.3	1.4	.7	1.4	n. a.	*	*	*	*	*	4.3
IP	.6	1.7	.1	.7	1.1	-0.0	.9	-7.7	-7.7	.3	1.8	1.8
Italy												
GDP	3.0	2.9	1.0	.3	.7	n. a.	*	*	*	*	*	3.1
IP	2.8	5.7	-2.8	3.3	2.6	n. a.	-4.4	.5	2.3	n. a.	n. a.	3.3
Japan												
GNP	2.0	5.5	2.0	1.8	2.7	n. a.	*	*	*	*	*	6.7
IP	-6.6	8.1	3.6	3.4	3.2	-5.5	2.4	.5	-9.9	-2.3	2.6	10.0
United Kingdom												
GDP	4.4	4.3	1.9	.7	.7	n. a.	*	*	*	*	*	4.0
IP	2.3	4.1	1.5	1.0	-7.7	n. a.	-2.1	2.0	1.0	.6	n. a.	3.5
United States												
GNP	2.0	5.0	1.1	1.5	.8	.8	*	*	*	*	*	4.3
IP	1.0	5.8	2.1	1.7	1.0	1.1	.0	.2	.5	.5	.4	6.1

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	1987				1988		1988				Latest 3 months from year ago
			Q1	Q2	Q3	Q4	Q1	Q2	Apr.	May	June	July	
Canada													
CPI	4.3	4.2	.9	1.4	1.2	.7	.8	1.3	.4	.6	.1	n. a.	4.0
WPI	.3	4.3	.5	1.3	1.4	1.1	.8	.7	.3	.5	.2	n. a.	4.0
France													
CPI	2.1	3.2	1.2	.9	.6	.5	.5	1.0	.5	.2	.3	n. a.	2.5
WPI	-3.4	2.6	.7	.3	.5	1.0	1.1	n. a.	*	*	*	*	2.9
Germany													
CPI	-1.0	1.0	.6	.4	.0	.0	.5	.5	.2	.2	.2	-.1	1.0
WPI	-9.0	-.7	-.2	.0	-.4	-.2	.1	1.1	.5	.3	.9	n. a.	.6
Italy													
CPI	4.7	5.2	1.3	1.0	1.1	1.7	1.1	1.0	.3	.3	.3	.3	4.9
WPI	-2.4	4.6	1.5	1.0	.8	1.2	1.1	n. a.	.6	.5	n. a.	n. a.	4.4
Japan													
CPI	.1	1.1	-.3	1.2	-.2	.4	-.2	.6	.5	-.1	-.2	-.1	.6
WPI	-9.1	-.6	-.7	-.7	1.3	-.4	-1.2	-.3	-.3	-.1	.3	n. a.	-.6
United Kingdom													
CPI	3.4	4.1	1.2	1.5	.2	1.1	.5	2.4	1.6	.4	.4	n. a.	4.3
WPI	4.2	3.9	1.2	1.1	.5	1.1	1.3	1.5	.8	.3	.3	.1	4.5
United States													
CPI (SA)	1.3	4.4	1.3	1.2	.9	.9	.8	1.2	.4	.3	.3	n. a.	3.9
WPI (SA)	-1.9	2.5	.7	1.1	.7	.0	.2	1.1	.4	.5	.4	n. a.	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	1987				1988		1988			
			Q1	Q2	Q3	Q4	Q1	Q2	Apr.	May	June	July
Canada												
Trade	7.1	8.3	2.4	2.1	2.3	1.6	1.9	n. a.	.5	.6	n. a.	n. a.
Current account	-6.7	-8.0	-1.4	-1.9	-2.1	-2.6	-1.2	n. a.	*	*	*	*
France												
Trade	.1	-5.2	-1.1	-2.0	-1.0	-1.0	-.7	-.8	-.4	-.2	-.2	n. a.
Current account	3.0	-4.9	-.0	-1.2	-1.0	-2.6	1.3	n. a.	*	*	*	*
Germany												
Trade (NSA)	52.5	65.9	15.1	15.5	15.2	20.1	15.0	n. a.	5.7	6.1	n. a.	n. a.
Current account (NSA)	39.7	45.4	11.4	10.9	7.8	15.3	8.6	n. a.	5.1	4.5	n. a.	n. a.
Italy												
Trade	-1.9	-8.9	-1.1	-2.7	-2.7	-2.5	-2.9	n. a.	-.4	n. a.	n. a.	n. a.
Current account (NSA)	2.9	-.8	-2.8	-.9	2.8	.1	n. a.	n. a.	*	*	*	*
Japan												
Trade	82.4	79.5	23.8	19.5	17.8	18.3	20.8	16.7	6.4	5.1	5.2	6.3
Current account 2/	85.8	87.0	25.3	21.3	19.9	20.5	23.1	17.6	6.4	6.0	5.2	n. a.
United Kingdom												
Trade	-12.4	-15.9	-1.7	-3.9	-5.0	-5.3	-6.6	n. a.	-2.3	-3.1	n. a.	n. a.
Current account	.1	-3.0	1.2	-.5	-1.4	-2.3	-5.0	-5.3	-1.4	-2.1	-1.8	n. a.
United States												
Trade 2/	-144.5	-160.3	-39.9	-39.6	-39.7	-41.2	-35.9	n. a.	*	*	*	*
Current account	-138.8	-154.0	-37.6	-40.9	-42.0	-33.5	-39.8	n. a.	*	*	*	*

1. The current account includes goods, services, and private and official transfers. Asterisk indicates that monthly data are not available.

2. Annual data are subject to revisions and therefore may not be consistent with quarterly and/or monthly data.

industrial production increased sharply in the United Kingdom in both April and May, and in Italy in April. Inflation remained low abroad, but has increased somewhat in recent months in some countries, the United Kingdom and Canada in particular.

Compared with the same period last year, the cumulative net trade surplus of the major foreign industrial countries is lower in 1988. Cumulative trade surpluses in Japan, and Canada have been reduced, while cumulative trade deficits in the United Kingdom and Italy have increased. In contrast, in France, the cumulative trade deficit has improved considerably so far this year, while the trade surplus in Germany has increased slightly.

Individual country notes. In Japan, the pace of real economic activity appears to have slowed in the second quarter from the exceptionally strong growth of previous quarters. Industrial production fell nearly 1/2 percent (s.a.) in the second quarter after a sharp increase in the first quarter. Nevertheless, the index in the second quarter was 10.6 percent above last year's level. Despite the slower growth of output, signs of labor market tightening persist. In June, the unemployment rate fell to 2.4 percent (s.a.), the lowest since November 1982, while the job-offers-to-applicants ratio rose to its highest level in 14 years. A sign of weakness was a decline in housing starts of 4.7 percent (s.a.) in the second quarter. In contrast, consumer spending continued to expand, with retail sales increasing about 2-1/2 percent (s.a.) in the second quarter.

Consumer price inflation remained low but increased slightly compared with last year. In July, the Tokyo index of consumer prices (n.s.a.) rose 0.8 percent above last year's level after being 1/2 percent higher in the two preceding months. Wholesale prices in the second quarter continued to stand below their year-earlier level, but less so than in the first quarter.

Japan's customs-cleared trade surplus (s.a.) rose sharply in July to \$6.2 billion, bringing the cumulative surplus for the first seven months to \$75 billion (s.a.a.r.) compared with a surplus of \$79.5 billion for 1987 as a whole. The July surplus was the first year-on-year increase in 15 months. Japan's trade surplus with the United States in the first seven months of 1988 was \$4 billion lower than during the comparable period last year. Imports from the United States grew 21 percent while exports to the United States increased only 4 percent. The current account surplus declined in June for the fifth consecutive month to \$5.2 billion, bringing the cumulative total for the first half to \$81.6 billion (s.a.a.r.) compared with a 1987 surplus of \$87 billion for the year as a whole.

The pace of Japanese money growth has slowed in recent months. The broad aggregate M2+CDs grew 11 percent from a year earlier in the second quarter, down from 12 percent in the first quarter. The Bank of Japan attributed the slowdown to a decline in cash and deposits and to sluggish growth in housing and other real estate-related loans.

The Liberal Democratic Party (LDP) and the opposition parties reached agreement on the personal income tax reductions for this year

and the Diet has passed a compromise plan. The number of income tax brackets will be reduced from 12 to 6, with tax rates ranging from 10 to 60 percent, retroactive to January 1988. The range of tax rates is little changed from the present system, but the compression in tax brackets, along with an increase in the minimum taxable income for workers doing contract work at home, will result in a total income tax reduction of 1.3 trillion yen (\$10 billion) this year. The Cabinet has submitted to the Diet for consideration the remainder of the tax reform package, including the introduction of an indirect tax due to take effect next April.

Economic activity in Germany slowed in the second quarter after a surge of activity in the previous quarter. Industrial production increased 1.8 percent (s.a.) in June, after several months of weakness. Even with this sharp increase, the level of production in the second quarter was slightly below the first-quarter's pace. This weakness was also reflected in labor markets, with the unemployment rate remaining at 8.9 percent (s.a.) in June, unchanged from the jobless rate in April and May. The volume of total new manufacturing orders increased about 1 percent (s.a.) in June. Domestic orders rose 1 percent, and foreign orders increased 0.7 percent.

Consumer prices declined 0.1 percent (n.s.a.) in July bringing inflation for the seven-month period ending in July to 1.7 percent (a.r.). Consumer price inflation was slightly less than 1 percent measured from July 1987, however. Wholesale prices increased 0.9

percent (n.s.a.) in June, and were 1.2 percent above last June's level. Import prices (n.s.a.) in May were 2.1 percent above a year earlier.

The trade surplus increased in May to \$6.1 billion (n.s.a.) bringing the cumulative surplus to \$26.8 billion, slightly larger than last year's surplus over the comparable period. The current account surplus declined in May to \$4.5 billion (n.s.a.), bringing the cumulative surplus to \$18.2 billion, compared with a surplus of \$19.9 billion over the comparable period in 1987.

Growth in the average monthly level of M3 in June was 7.1 percent (s.a.a.r.). The average level of M3 in June stood 7.5 percent above the target base period of 1987-Q4, exceeding the target range of 3 to 6 percent.

In early July, the government announced its budget for 1989 and projected a budget deficit of DM32 billion (about 1.5 percent of GNP), down from the 1988 deficit of DM39.7 billion. Included in the 1988 deficit projection was a supplementary budget making up for a decline in Bundesbank profits and greater payments to the EC totalling DM9.7. The projected 1989 deficit is lower than originally planned, though the reduction falls short of earlier assertions that the 1989 deficit would be reduced by the amount of the 1988 overrun to DM30 billion. Also in July, the German parliament approved the government's 1990 tax reform bill after a compromise was reached by the ruling coalition party regarding federal subsidies to some of the economically distressed states.

In the United Kingdom, mounting evidence of economic overheating has prompted authorities to raise official interest rates seven times by a total of 3-1/2 percentage points since the beginning of June. Industrial production and the value of retail sales have recorded strong increases recently, and the unemployment rate declined for the 23rd consecutive month in June, falling to 8.4 percent. The 12-month rate of consumer price inflation rose to 4.6 percent in June and is expected by British authorities to continue to rise for another year. The trade deficit in June was only slightly below the record high level of the previous month. For the first half of the year, the cumulative trade deficit was \$29.1 billion (s.a.a.r.), substantially above the \$11.3 billion deficit in the first half of last year.

Preliminary data indicate that French economic activity proceeded at a moderate pace in the second quarter of 1988. Principal French commercial banks lowered their base lending rates for the first time in more than 2 years in response to the government's lowering of intervention rates and some jawboning by Finance Minister Berezovoy. In July, the newly formed French cabinet agreed on two bills that would institute a wealth tax, similar to the one abolished two years ago, and establish a new minimum social income for the poorest households. This legislation is quite controversial, and is expected to generate heated debate in the National Assembly this fall.

In Italy, the cabinet approved revenue measures to reduce the projected 1988 state sector budget deficit by \$5.7 billion to reach the target of 11 percent of GDP. Roughly half of this revenue will result

from adjustments to value added tax rates to bring them into line with those proposed by the European Commission as part of the 1992 liberalization program. In addition, the Cabinet approved a spending freeze through the end of the year.

Economic Situation in Major Developing Countries

The syndication of Brazil's financing package among foreign creditor banks is proceeding following the recent IMF Executive Board approval of a new stand-by arrangement and the completion of a Paris Club rescheduling. Argentina recently announced a new package of economic measures aimed at reducing the public sector deficit and stemming inflation. The Mexican anti-inflation program is approaching a critical stage as price and wage distortions increase and the peso continues to appreciate in real terms. In response to declines in foreign exchange reserves, Venezuela is seeking external credits. Ecuador suspended negotiations with commercial banks in regard to a \$350 million loan agreed to last October.

Individual country notes. At the end of July, the IMF Executive Board approved in principle an SDR 1.2 billion stand-by arrangement and the Paris Club rescheduled \$3.9 billion in principal and \$1.1 billion in interest for Brazil. The Paris Club rescheduling covers principal arrears from January 1987 through July 1988, as well as 70 percent of interest due and all principal due between August 1988 and March 1990. Also, end-July, Brazil received from the BIS and U.S. Treasury a \$500 million loan to bridge to the first two tranches from the IMF stand-by. Commitments to the commercial bank new money agreement reached more than

90 percent of the \$5.2 billion total by August 8, spurred in part by the incentive of an early participation fee of $\frac{3}{8}$ of a percent of the amount each bank committed by August 5. Banks that commit financing between August 5 and September 2 receive a $\frac{1}{8}$ of a percent fee.

Consumer prices rose 24 percent in July, following increases of 20 percent in June and 18 percent in May. The demand for dollars also continued to intensify during July. The spread between the parallel and official dollar rates has increased steadily since February, rising from about 25 percent to almost 50 percent at present. The trade surplus continues to run at a record rate, reaching \$1.8 billion in June. The surplus for the first six months of 1988 was \$8.6 billion, compared with \$3.5 billion for the same period in 1987.

On August 3, Argentina announced a new package of economic measures aimed at reducing the public sector deficit and stemming inflation. These included: an increase in public sector tariffs and fuel prices of 30 percent on average; a 10.5 percent devaluation of the commercial exchange rate; the implementation of a new exchange rate for industrial exports that is the average of the commercial exchange rate and the financial exchange rate; the reduction of the value-added tax from 18 to 15 percent; the freezing of prices at their August 2 levels until August 15, after which prices can be raised 1.5 percent during the second half of August and 3.5 percent in September; increases of public sector wages by 25 percent to be followed by a two-month freeze; and the implementation of twice daily auctions of foreign exchange by the central bank to smooth fluctuations in the financial or free-market austral/dollar exchange rate. In support of these measures, the U.S.

Treasury announced August 4 that it would help to arrange a loan of up to \$500 million consisting of BIS and U.S. Treasury funds to bridge to future World Bank policy loans. Argentina's stand-by arrangement with the IMF is presently inoperative; negotiations toward a new stand-by are continuing.

Inflation accelerated from an average monthly rate of 13 percent over the first quarter of 1988 to an average of 19 percent in the second quarter. Tax receipts over the first seven months of 1988 were 7 percent below the same period last year in real terms, despite the passage of new revenue measures by Congress in January. Argentina's trade surplus totalled \$578 million in the first four months of 1988, up from \$345 million a year earlier.

Since last December, the CPI in Mexico has risen by over 40 percent, while minimum wages have been raised by only 24 percent. The CPI increase occurred even though public sector prices and some private sector prices were frozen at that time, and even though import barriers have been sharply lowered and the peso/dollar exchange rate has changed little in the past seven months. As a result of the weaker showing by the government party (the PRI) in the July 6 general elections, pressures to relax the wage freeze are increasing.

The trade surplus is continuing to shrink. In May, it was less than \$500 million, the lowest since July 1986, and about half as large as in June 1987. Imports exceeded \$1.5 billion, the highest level since March 1982, and were 56 percent higher than in May 1987, while exports were only 6 percent higher than a year earlier. Non-petroleum exports in May 1988 were 17 percent higher than last year at that time, but oil

exports were 9 percent lower, owing to weaker oil prices. International reserves turned down in May and continued to fall in June and July. The reserve drain in these three months was about \$4.5 billion. In addition to the shrinking trade surplus, the drain reflects capital flows stemming from uncertainty arising from the elections and their outcome and nervousness regarding future exchange rate policy. Also, the relative attractiveness of Mexican financial instruments deteriorated when nominal interest rates in Mexico declined this spring. Since early June, when the decline in these rates stopped, the return on Mexican 30-day bank promissory notes, adjusted for the spread between the buying and selling rates for dollars, has been less than the return on a one-month CD in New York.

Venezuela's liquid operating foreign exchange reserves stood at \$2.5 billion in mid-July, a decline of \$300 million since mid-June and \$1 billion since the end of 1987. In response to this loss of reserves, Venezuela is seeking new short-term trade credits, exporting non-monetary gold to raise \$300 million this year, and issuing new international bonds. The government also intends to seek new money from banks this year, but is not requesting a formal reopening of the amended rescheduling agreement that became effective in November 1987.

After slowing sharply from an average monthly rate of 2.9 percent in 1987 to an average rate of 0.4 percent in the first five months of 1988, CPI inflation rose to 5 percent in June. The spread between the free-market and official exchange rates has been widening in recent months. After nine months of relatively stability at about 30 bolivars per dollar, the free-market exchange rate depreciated over the past

three months to about 37 bolivars per dollar. The main official exchange rate has been fixed at 14.5 bolivars per dollar since December 1986.

Ecuador suspended negotiations with commercial banks in early July with regard to the \$350 million loan agreed to in October 1987 but never fully subscribed. Talks were postponed pending the inauguration of new President Rodrigo Borja on August 10.