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Confidential (FR) Class III FOMC

November 8, 1989

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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With the service sectors generating healthy gains in employment and income, the economy continued to expand into the fourth quarter. However, industrial activity has declined noticeably recently, owing not only to sluggish demand, but also to supply shocks, including the ongoing strike at Boeing. Signals on inflation trends have been mixed: Consumer prices have risen less rapidly than they rose earlier in the year, largely reflecting declines in the prices of oil and of imported goods, while year-over-year increases in wages and in total compensation have been at least as large as in recent quarters.

Labor Markets

Labor demand continued to grow in recent months, but at a slower pace than that earlier in the year. On a strike-adjusted basis, private sector employment increased 146,000 in October and was up at an average pace of only 115,000 over the past three months, well below the pace of the first half. The slowdown in hiring has been concentrated in manufacturing, where employment has declined since the spring. Job losses have been largest in the metals, machinery, and equipment industries, while employment in most nondurable industries has been little changed on balance. In contrast, employment growth in the service-producing sector has been well maintained. Hiring by state and local governments, largely for school systems, has been robust and accounts for more than a third of the increase in total strike-adjusted employment over the past three months.

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

	1987	1988	1989 Q1	1989 Q2	1989 Q3	1989 Aug.	1989 Sept.	1989 Oct.
	---------------Average Monthly Changes---------------							
Nonfarm payroll employment[2]	268	276	264	240	160	120	201	233
Strike-adjusted	265	275	274	245	174	228	125	238
Private strike-adjusted	238	248	250	203	113	175	24	146
Manufacturing	29	29	30	-10	-31	-5	-88	-13
Durable	16	20	13	-12	-30	2	-74	-28
Nondurable	13	9	17	2	-1	-7	-14	15
Construction	15	14	13	10	13	7	0	8
Trade	61	64	77	32	37	54	16	30
Finance and services	122	128	107	148	78	106	80	85
Total government	27	27	25	42	60	53	99	94
Private nonfarm production workers	199	197	202	151	78	71	48	102
Manufacturing production workers	25	20	19	-14	-26	-9	-80	-10
Total employment[3]	257	189	376	135	-28	138	-141	89
Nonagricultural	252	191	371	172	-82	50	-91	128

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	1989 Q1	1989 Q2	1989 Q3	1989 Aug.	1989 Sept.	1989 Oct.
Civilian, 16 years and older	6.2	5.5	5.2	5.3	5.2	5.2	5.3	5.3
Teenagers	16.9	15.3	15.0	15.1	14.8	14.5	15.1	14.9
20-24 years old	9.7	8.7	8.4	8.3	8.8	8.8	8.9	8.9
Men, 25 years and older	4.8	4.2	4.0	3.9	3.9	3.7	4.1	3.9
Women, 25 years and older	4.8	4.3	4.0	4.3	4.2	4.2	4.1	4.2
White	5.3	4.7	4.4	4.5	4.5	4.5	4.5	4.4
Black	13.0	11.7	11.6	11.2	11.2	11.1	11.6	11.8
Fulltime workers	5.8	5.2	4.9	4.9	4.9	4.9	5.0	4.9
Memo:								
Total National[1]	6.1	5.4	5.1	5.2	5.2	5.1	5.2	5.2

1. Includes resident armed forces as employed.

A number of strikes have affected payroll employment in recent months. These effects are summarized below.

CHANGES IN PRIVATE-SECTOR EMPLOYMENT OWING TO STRIKE ACTIVITY
(Thousands of employees)

	1989		
	Aug.	Sept.	Oct.
Total	-108	78	-7
Mining	20	0	0
Manufacturing[1]	0	-2	-7
Transportation	0	3	0
Communications and public utilities[2]	-136	77	0
Retail trade	8	0	0

1. The approximately 57,000 striking machinists at Boeing are not included in the October strike figures because they were reported at work during the survey week, October 8-14. Although the machinists' strike began on October 4, Boeing reports payroll employment over a two-week pay period, as do many firms, and the striking machinists were on the payrolls for the first 2-1/2 days of the pay period.
2. About 59,000 workers at NYNEX remain on strike.

In the household survey, the civilian unemployment rate stayed at 5.3 percent in October. The levels of unemployment and employment reported in this survey have been little changed since June, while payroll employment has continued to increase. Indeed, since 1985, growth in the household count of persons employed has fallen short of the payroll figures on growth in jobs by 1.7 million. A special supplement to the household survey, conducted in May, suggests that a sharp increase in the number of individuals who hold more than one job explains much of the divergence between the two measures. The survey found that 7.2 million persons were working at more than one job in May 1989, up nearly 1.5 million since May 1985, the last time this survey was conducted. About 1.1 million of these additional multiple jobholders held jobs as nonagricultural wage and salary

GROWTH IN SELECTED COMPONENTS OF INDUSTRIAL PRODUCTION
(Percent change from preceding comparable period)

			1989			1989		
	1987[1]	1988[1]	Q1	Q2	Q3	July[r]	Aug.[r]	Sept.[e]
			---Annual rate---			---Monthly rate---		
Total index	5.8	5.0	2.1	3.3	1.3	.0	.3	-.1
Excluding motor vehicles	5.9	4.9	2.3	4.0	2.4	.2	.2	.0
Products	4.9	5.4	4.3	4.7	1.2	-.3	.4	.0
Consumer goods	3.2	6.0	4.1	3.0	-.9	-.8	.3	.1
Motor vehicles	4.4	8.8	.0	-7.1	-19.9	-4.0	1.6	-.4
Excluding motor vehicles	3.0	5.6	4.6	4.3	1.6	-.4	.1	.2
Business equipment	7.0	8.3	9.6	9.5	1.7	-.4	.6	.0
Motor vehicles	3.9	10.7	-14.1	-12.3	-25.6	-7.7	6.1	-.7
Computers	9.8	8.2	28.6	19.6	-4.5	-1.7	1.1	.2
Other	5.8	6.2	5.5	7.9	7.1	.7	.0	-.1
Materials	7.2	4.6	-1.3	1.1	1.4	.4	.2	-.3
Durable	8.0	6.9	-1.7	1.1	1.9	.4	.1	-.9
Nondurable	8.1	4.1	3.0	2.1	4.8	.9	.0	.2
Energy	4.5	-.1	-5.2	-.1	-3.8	-.2	.8	.7
Memo:								
Manufacturing	5.9	5.6	3.3	3.5	1.5	.0	.3	-.2
Durable	6.0	6.0	2.3	3.2	.0	-.3	.4	-.5
Nondurable	5.7	5.1	4.7	4.0	3.4	.3	.1	.1

1. From the fourth quarter of the previous year to the fourth quarter of the year indicated.
r--revised
e--estimated

PERCENT CHANGE IN ORDERS FOR MANUFACTURED GOODS[1]
(For industries that report unfilled orders; seasonally adjusted)

	1989			1989		
	Q1	Q2	Q3	July	Aug.	Sept.
Durable goods excluding civilian aircraft, defense, and motor vehicles	1.0	2.0	-2.1	-5.6	3.5	1.5
Nondefense capital goods excluding aircraft	4.9	2.9	-4.4	-10.3	4.4	.4
Nondurable goods	.3	2.3	-.1	-2.8	3.0	.5

1. Percent change from previous comparable period.

workers and thus would have been included more than once in the payroll survey.

New claims for unemployment insurance have drifted up to about 350,000 in recent weeks, compared with around 300,000 early this year; this situation likely reflects the cutbacks in jobs reported in manufacturing. Recent experience suggests that an increase in the overall unemployment rate is likely to be associated with a sustained level of claims of about 375,000 to 400,000 per week.

Industrial Production

Growth in industrial production slowed to about 1-1/4 percent at an annual rate in the third quarter, compared with a rise of about 2-3/4 percent in the first half. Output in recent months has been held down by cutbacks in motor vehicle assemblies, but gains in some other major categories also were smaller. The deceleration was especially noticeable in the business equipment area; output of computers showed little net change after a surge in the spring, while production of other equipment (excluding motor vehicles) also leveled out in the past few months. Output of materials remained lackluster in recent months, in part because of weak demand for metals and for parts for consumer goods.

This fall's production figures will be buffeted by several transitory developments. Our early calculations suggest that the strike against Boeing cut roughly 1/2 percent from the level of overall production in October. And perhaps another 1/4 percent was taken off by Hurricane Hugo, which led--among other things--to the closing of an aluminum smelting plant in South Carolina for three months, and the San Francisco earthquake, which led to some temporary plant closings in high technology industries.

CAPACITY UTILIZATION IN INDUSTRY[1]
(Percent of capacity; seasonally adjusted)

	1967-88 Avg.	1973 Avg.	1978-79 Avg.	1988 Sept.	1989 July	Aug.	Sept.
Total industry	81.6	87.9	85.0	83.7	83.8	83.8	83.6
Manufacturing	80.7	87.0	84.4	84.0	84.1	84.1	83.7
Primary processing	82.0	91.3	86.3	87.2	86.7	86.7	85.8
Advanced processing	80.2	85.1	83.3	82.4	82.9	83.0	82.8
Durable manufacturing	78.8	86.2	83.5	82.5	82.5	82.7	82.1
Primary metals	79.9	96.6	87.8	90.9	85.5	85.4	81.4
Iron and steel	79.0	97.9	88.2	90.9	82.8	82.3	77.2
Nonferrous metals	81.5	94.2	87.1	90.9	89.0	89.7	87.0
Motor vehicles & parts	78.2	94.5	83.6	82.6	75.9	78.4	77.4
Nondurable manufacturing	83.6	88.1	85.7	86.2	86.4	86.2	86.0
Mining	86.5	91.4	90.5	82.3	81.8	82.6	83.5
Utilities	86.7	92.8	85.3	80.4	80.7	80.2	81.1
Memo:							
Industrial materials	82.3	91.1	86.7	84.1	83.7	83.8	83.4
Raw steel	80.7	100.4	90.7	97.5	85.4	88.9	82.
Aluminum	87.8	93.8	94.0	100.3	101.2	99.3	97.
Paper materials	92.0	96.8	92.1	97.9	95.0	95.7	94.9
Chemical materials	81.3	91.1	85.9	88.0	89.5	88.6	88.6
Energy materials	88.9	93.7	89.4	85.3	83.7	84.4	85.0

1. Data for iron and steel, nonferrous metals, raw steel, aluminum, paper materials, and chemical materials are unpublished estimates for September.

Aside from these temporary factors, incoming data do not indicate any significant change in industrial production in October. Production worker hours in manufacturing, excluding transportation equipment, were little changed last month. Among the physical product data, those for motor vehicle assemblies were lower than in September, while other readings were mixed.

Forward-looking indicators generally suggest that industrial output will be sluggish over the next few months. In particular, orders for durable goods excluding civilian aircraft and motor vehicles, despite some pickup in August and September, have shown no growth on net since the spring.

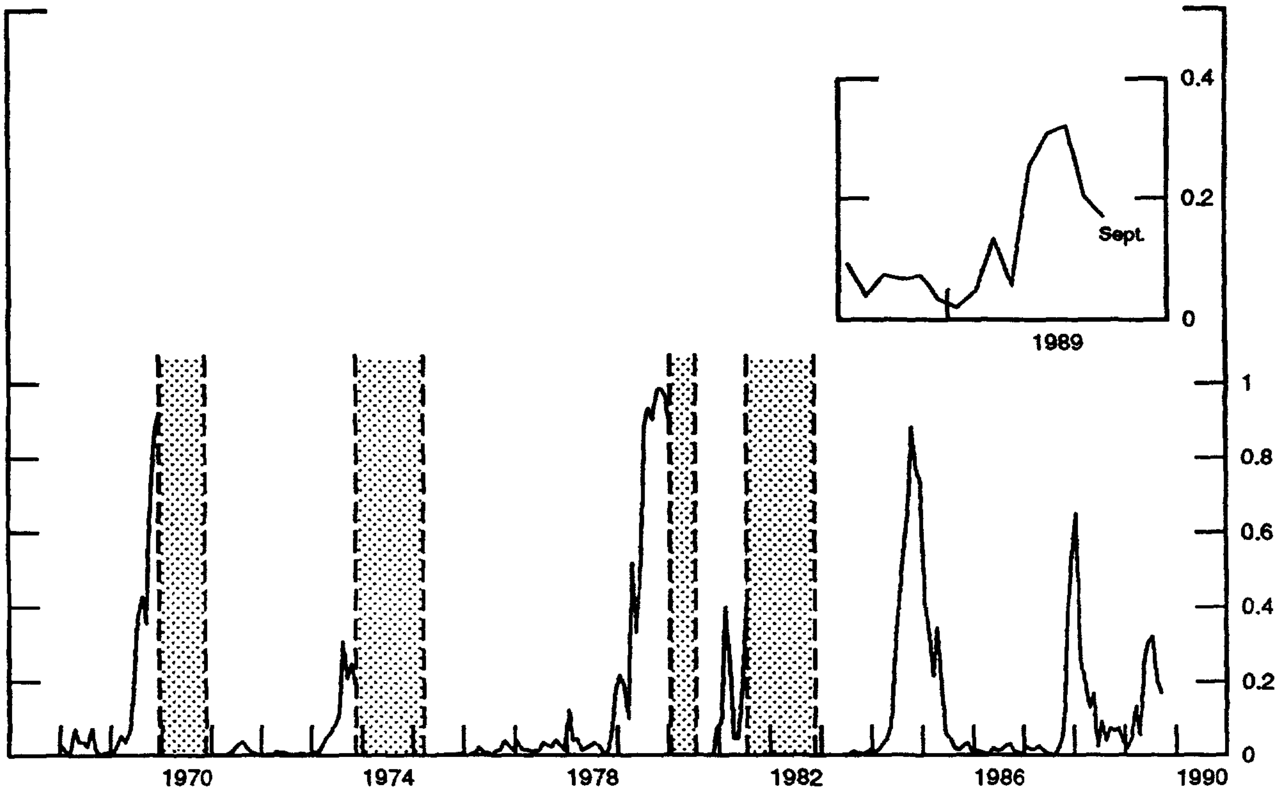
Leading Indicators of Recession

Considerable research in recent years has been devoted to developing econometric procedures to assess the likelihood of a recession. These procedures compare recent movements in an index of leading indicators with the pattern of movements just before and during previous recessions. To a large extent, the leading indicator indexes bring together many of the series routinely reported elsewhere in the Greenbook. The econometric procedures can be thought of as simplified ways of summarizing and interpreting these forward-looking indicators.

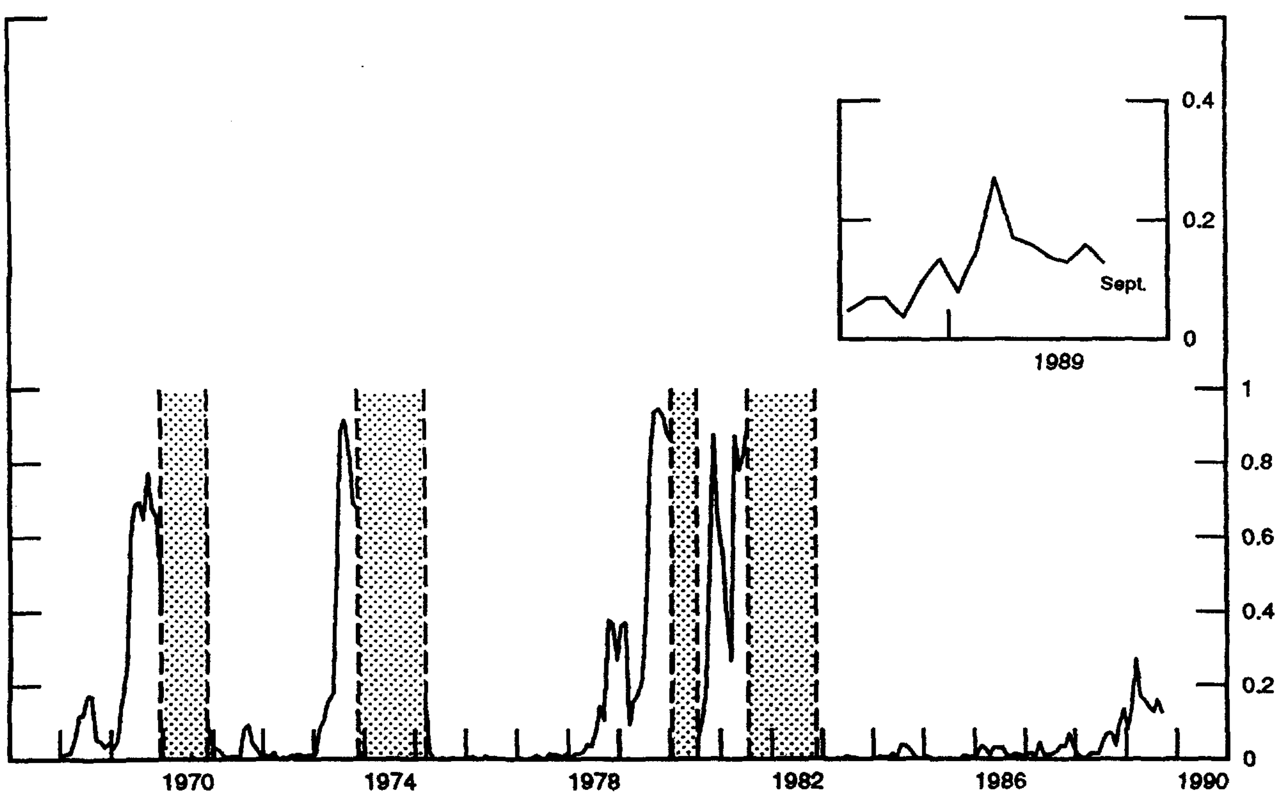
A recession-probability measure based on the Commerce Department's index of leading economic indicators indicates that the probability of a recession developing in the next six months increased last spring but has since declined somewhat; the latest reading, based on the September leading

Probability of a Recession*

GENERATED FROM COMMERCE LEADING INDEX



GENERATED FROM NBER LEADING INDEX



*Each probability represents the likelihood that a recession will begin during the next six months.

indicators report, was 17 percent.[1] A second measure is based on a leading index recently compiled by the NBER, which relies less heavily on data from the manufacturing sector than does the Commerce Department index and does not include stock prices.[2] During the past year, its associated probabilities generally have been in the same range as those from the Commerce Department index; as of September, it showed a 13 percent probability that a recession would start in the next six months.

Personal Income and Consumption

Real disposable income jumped 4-3/4 percent at an annual rate last quarter after edging up less than 1 percent at an annual rate during the second quarter. Most of the pickup in real income growth reflected a sharp deceleration in consumption prices. In addition, personal tax payments dropped back after a second-quarter bulge in nonwithheld taxes. Income gains were held down, however, by smaller increases in interest receipts during the third quarter, and rental income was temporarily depressed by write-offs of property losses associated with Hurricane Hugo.

Real personal consumption expenditures grew 5-3/4 percent at an annual rate during the third quarter--up sharply from the 2 percent pace of the second quarter. In part, the surge in spending reflected an increase in

1. This procedure was proposed by Salih Neftci, "Optimal Prediction of Cyclical Downturns," Journal of Economic Dynamics and Control, vol. 4 (August 1982), pp. 225-41. The implementation used here follows Francis X. Diebold and Glenn D. Rudebusch, "Scoring the Leading Indicators," Journal of Business, vol. 62 (July 1989), pp. 369-91.

2. The seven components of the NBER index are housing permits, manufacturers' unfilled orders for durable goods, exchange rates, part-time workers, 10-year U.S. Treasury bond rate, 6-month corporate to Treasury bond spread, and 10-year to 1-year Treasury bond yield spread. The index and the forecasting procedure are described in James Stock and Mark Watson, "New Indexes of Coincident and Leading Economic Indicators," in S. Fischer, ed., NBER Macroeconomics Annual 1989, vol. 4 (MIT Press).

PERSONAL INCOME
(Average monthly change; billions of dollars)

		1989			1989		
	1988	Q1	Q2	Q3	July	Aug.	Sept.
Total personal income	21.8	51.5	18.9	17.2	26.3	12.6	12.8
Wages and salaries	13.4	20.9	14.1	14.4	23.0	5.7	14.4
Private	11.2	17.3	11.9	12.1	20.7	3.5	12.2
Other labor income	1.5	1.6	1.5	1.6	1.6	1.6	1.5
Proprietors' income	.1	12.4	-5.3	-.5	-2.8	-.2	1.4
Farm	-1.2	11.2	-6.6	-2.5	-4.2	-2.2	-1.1
Rental income	.1	-2.0	-.1	-4.0	-1.0	-.8	-10.2
Dividends	.9	1.1	.5	.6	1.0	.5	.3
Interest	4.5	11.7	6.8	3.6	3.9	3.6	3.3
Transfer payments	3.2	9.5	2.2	2.5	1.7	2.9	2.9
Less: Personal contributions for social insurance	1.8	3.7	.8	.8	1.0	.6	.9
Less: Personal tax and nontax payments	.1	10.3	2.8	3.2	3.8	2.1	3.7
Equals: Disposable personal income	21.6	41.1	16.1	14.1	22.6	10.5	9.1
Memo:							
Real disposable income	8.0	19.7	1.5	6.6	10.4	10.3	-.9

REAL PERSONAL CONSUMPTION EXPENDITURES
(Percent change from preceding period)

		1989			1989		
	1988	Q1	Q2	Q3	July	Aug.	Sept.
		-------Annual rate------			----Monthly rate---		
Personal consumption expenditures	3.8	2.0	1.9	5.8	.6	1.0	.0
Goods	3.9	0.5	.1	7.4	.9	1.5	-.4
Motor vehicles	8.0	-9.6	2.1	38.5	6.6	7.0	-3.6
Furniture	8.6	17.2	8.7	-3.1	-1.7	.7	.9
Food	1.8	3.4	-3.9	1.7	.9	-.5	.4
Apparel	2.9	1.0	2.0	17.2	1.5	2.4	-1.8
Gasoline	3.2	-2.4	-4.4	-2.5	-3.5	1.1	1.7
Other goods	3.1	-6.3	1.1	3.8	.4	1.3	.2
Services	3.6	3.6	3.8	4.2	.3	.5	.3
Memo:							
Real disposable income	4.0	6.6	.8	4.8	.4	.4	.0
Real personal income	3.1	7.9	2.2	3.2	.4	.4	.0
Personal saving rate (percent)	4.2	5.6	5.4	5.1	5.6	4.9	4.9

sales of autos and trucks, as manufacturers cut prices to reduce stocks at the end of the model year. However, outlays for other goods also posted strong gains. Notably, spending on food moved up a bit after dropping sharply the quarter before, and spending on apparel jumped after a lackluster first half. However, the pattern of improvement was not uniform across all categories of spending. For example, outlays for furniture and household equipment fell back in the third quarter after moving up rapidly over the preceding three quarters.

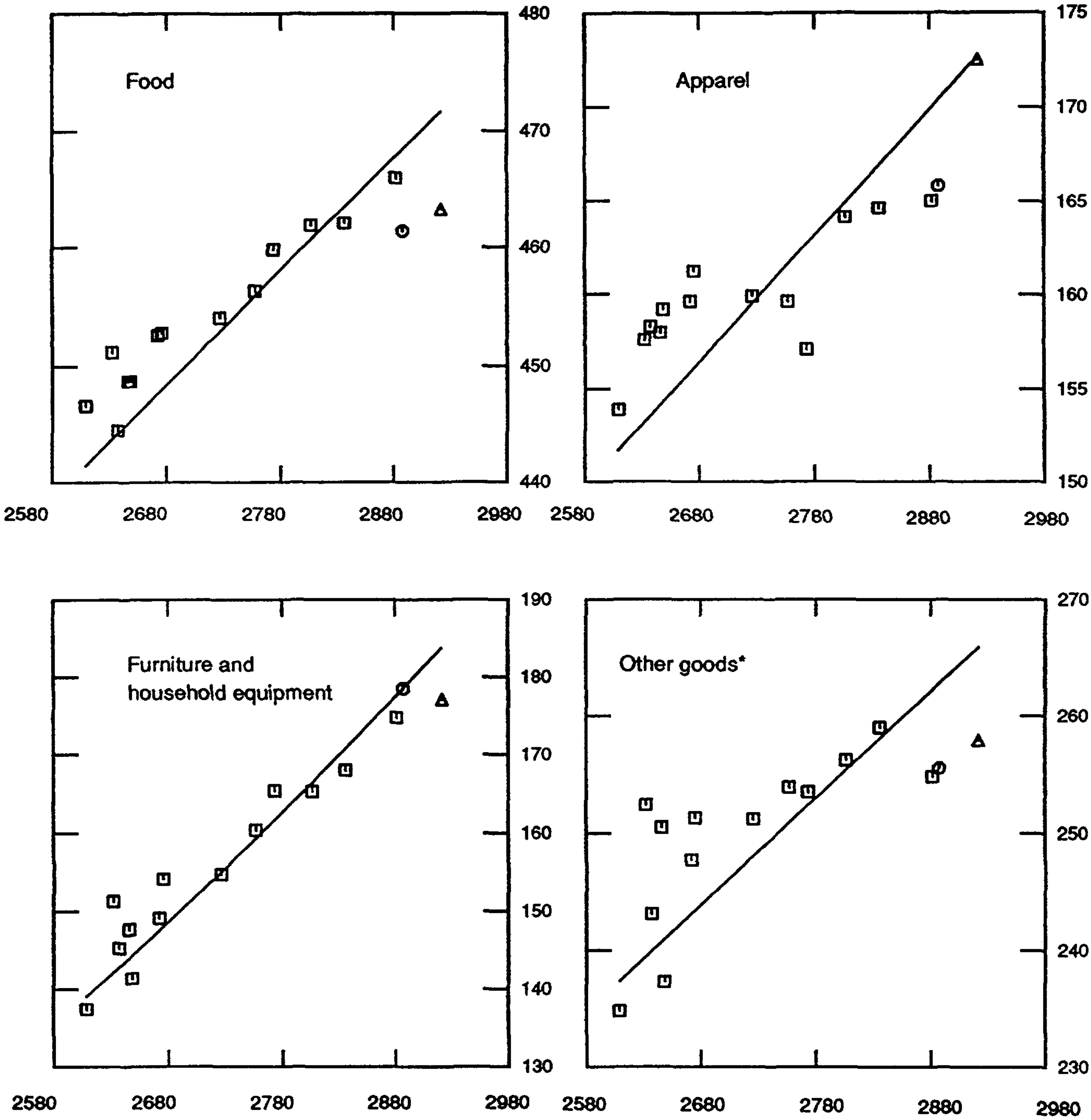
The accompanying chart helps put these various developments in a longer-term perspective. Each panel plots a different component of PCE on the vertical axis against real disposable income on the horizontal axis. For reference, a trend line also is shown in each panel; the trend line shows the average relationship between income and each component of spending and is estimated with data covering the current expansion. In each panel, the third-quarter observation is plotted as a triangle (the second quarter as a circle). As shown in the upper left panel, outlays for food have remained relatively weak compared to income, despite the recent uptick. By contrast, the surge in spending on apparel (upper right panel) has restored spending in that category to its average position relative to income. Recent furniture purchases (lower left panel) have been about in line with the expansion average, while spending on other nonauto goods appears to have fallen below trend.

<u>Autos and Light Trucks</u>

Sales of new cars and light trucks dropped sharply in October from their robust pace in the third quarter; on BEA seasonals, October sales were at a 13 million unit annual rate--down from the third-quarter average of

Consumption and Disposable Income

(Billions of 1982 dollars)



Note: The data points in each panel are quarterly observations from 1986-Q1 to 1989-Q3. The trend lines were estimated by regressing log spending on log income over the period 1982-Q4 to 1989-Q3. 1989-Q3, the most recent observation, is represented by a triangle, while 1989-Q2 is represented by a circle.

*PCE goods excluding motor vehicles, gasoline, food, apparel, and furniture and household equipment.

SALES OF AUTOMOBILES AND LIGHT TRUCKS[1]
(Millions of units at an annual rate, BEA seasonals)

	1988	1989 Q1	1989 Q2	1989 Q3	1989 Aug.	1989 Sept.	1989 Oct.
Autos and light trucks	15.5	14.3	14.9	15.9	17.0	15.8	13.2
Autos	10.6	9.8	10.3	10.8	11.5	10.6	8.8
Light trucks	4.8	4.5	4.6	5.2	5.6	5.2	4.3
Domestically produced[2]	11.7	11.0	11.4	12.4	13.2	12.5	9.9
Autos	7.5	7.0	7.3	7.9	8.3	7.8	6.1
Light trucks	4.2	4.0	4.1	4.6r	4.9	4.6	3.8
Imports	3.7	3.3	3.5	3.5	3.8	3.3	3.2
Autos	3.1	2.8	3.0	2.9	3.1	2.8	2.7
Light trucks[3]	.6	.5	.5	.6	.7	.6	.5

Note: Data on sales of trucks and imported autos for the current month are preliminary and subject to revision.
1. Components may not add to totals due to rounding.
2. Includes vehicles produced in Canada and Mexico and vehicles made in U.S. plants of foreign manufacturers.
3. Based on seasonals for domestic light trucks.
r--revised data, not seasonally adjusted.

16 million units. The slower pace of sales during October had been expected, and it reflected the "payback" of sales that had been moved forward into August and September. The drop in sales was concentrated among domestically produced vehicles, but import sales also fell somewhat.

Overall, incentives to customers and dealers reduced prices of autos built by the three major U.S. manufacturers by an estimated $675 per vehicle during the 1989 model year. The use of incentives was especially heavy during the third quarter (an estimated $1,100 per vehicle) as automakers sought to clear out the 1989 model-year cars. So far, the manufacturers show no sign of moving away from their incentive-based marketing strategy: In the 1990 model year, incentive programs have already been announced for a wide array of cars and trucks at the same time that sticker prices have, on

CONTRIBUTIONS TO GROWTH IN
PRODUCERS' DURABLE EQUIPMENT
(Percentage points at an annual rate)

	Contribution to 1989 PDE Growth[1]		Change in the Contribution
	H1	Q3	
Producers' durable equipment	**12.2**	**5.2**	**-7.0**[2]
Information processing	**9.4**	**.3**	**-9.1**
Office, computing, and accounting	7.9	2.0	-5.9
Communication equipment	1.4	-1.0	-2.4
Industrial equipment	**.8**	**2.3**	**1.5**
Fabricated metals	.0	.3	.3
Metalworking machinery	.2	.8	.6
Special industrial machinery	.2	1.8	1.6
General industrial machinery	.4	-.1	-.5
Electric transmission and distribution	.1	-.4	-.5
Transportation	**.1**	**.6**	**.5**
Trucks, buses, and truck trailer	-1.1	.0	1.1
Passenger cars	.8	-.2	-1.0
Aircraft	.3	.4	.1
Other PDE	**1.9**	**2.1**	**.2**

1. Percentage points of growth in PDE attributable to specified component. H1 calculated from 1988:Q4 to 1989:Q2.
2. Aggregate categories in bold type contain detail not shown separately.

SURVEYS OF PLANT AND EQUIPMENT EXPENDITURES
(Percent change from previous year, current dollars)

	1988	Planned for 1989 Commerce (July-Aug.)	Planned for 1990 ECAP (Sept.-Oct.)
All business	10.5	10.0	3.0
Manufacturing	14.0	9.4	3.4
Durable	10.3	5.0	.4
Nondurable	17.5	13.2	5.7
Nonmanufacturing	8.5	10.3	2.8

average, been raised substantially. Many of the foreign automakers also are offering incentives on their cars and trucks.

Business Fixed Investment

Real business fixed investment rose at a 5 percent annual rate in the third quarter, down from the 8 percent pace in the first half. The slowing was more than accounted for by a deceleration in outlays for producers' durable equipment, from 12 percent growth in the first half, to 5 percent in the third quarter.[3] In contrast to the deceleration in equipment purchases, real outlays for nonresidential structures increased nearly 6 percent in the third quarter, after several quarters of declines, mainly because of a sharp rise in BEA's measure of oil and gas drilling activity.

The deceleration in PDE last quarter reflected a flattening in outlays for information-processing equipment after a strong first-half advance (table). In contrast, spending was up at a somewhat faster pace last quarter for most major types of industrial equipment, and transportation equipment also made a positive contribution to growth after a flat first half.

Indicators of investment plans do not imply much strength in the near term. Nondefense capital goods orders, weighted to include only the fraction that are final business purchases, fell another 3/4 percent in the third quarter, suggesting that equipment outlays will remain sluggish in the

3. Recently released data on shipments excluding aircraft are somewhat weaker than BEA's third-quarter assumption. However, BEA's assumption for aircraft shipments in September seems too low, given information from sources at Boeing. A more reasonable assumption for September suggests a sizable upward revision to purchases of aircraft in the third quarter. On balance, we expect about a $1.0 billion upward revision to producers' durable equipment in the third quarter, which would raise the growth rate to about 6 percent at an annual rate.

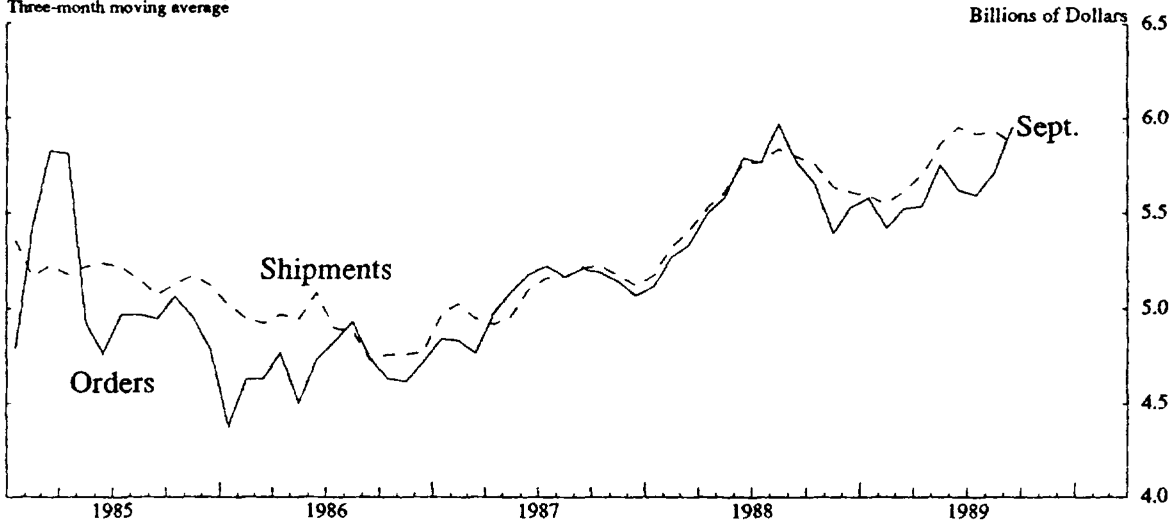
BUSINESS CAPITAL SPENDING INDICATORS
(Percentage change from preceding comparable periods;
based on seasonally adjusted data)

	1989			1989		
	Q1	Q2	Q3	July	Aug.	Sept.
Producers' durable equipment						
Shipments of nondefense capital goods	3.2	3.0	2.4	-1.4	5.5	-.5
Excluding aircraft and parts	3.2	3.0	.1	-2.1	4.2	-1.6
Office and computing equipment	.0	6.1	-1.4	-6.7	2.0	1.8
All other categories	4.0	2.3	.3	-1.0	4.7	-2.6
Weighted PDE shipments[1]	3.0	3.1	1.4	-1.2	4.2	-1.1
Shipments of complete aircraft[2]	1.2	14.7	--	-8.4	53.2	--
Sales of heavy-weight trucks	-3.6	-3.7	-2.2	1.2	2.4	-10.7
Orders of nondefense capital goods	5.3	1.0	-2.6	5.9	-10.4	-5.2
Excluding aircraft and parts	4.9	2.9	-4.4	-10.3	4.4	.4
Office and computing equipment	-.1	1.8	5.9	1.1	6.7	4.6
All other categories	6.1	3.1	-6.7	-12.7	3.8	-.6
Weighted PDE orders[1]	2.4	.8	-.7	-4.1	5.0	.7
Nonresidential structures						
Construction put-in-place	2.1	-.8	1.8	-.8	3.1	-1.6
Office	4.5	-3.4	-3.4	-4.4	2.8	-.2
Other commercial	2.7	-6.5	3.6	1.1	1.9	-6.9
Public utilities	-2.6	3.8	.0	.1	-.7	1.6
Industrial	1.6	3.9	6.1	-.5	6.5	.8
All other	5.1	.3	4.8	-.8	6.9	-2.4
Rotary drilling rigs in use	-5.4	18.2	2.6	-.1	-1.5	2.7

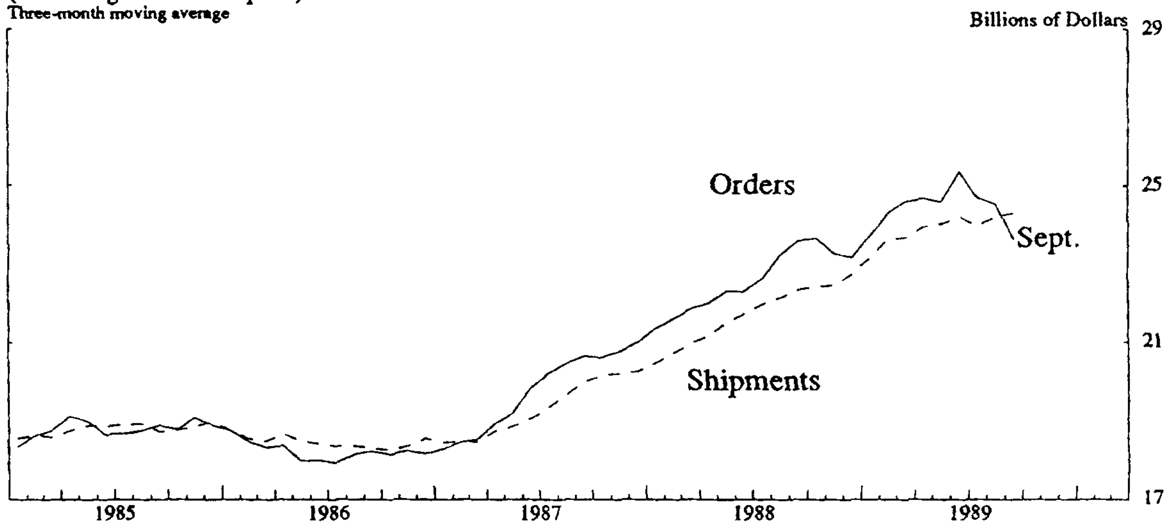
1. Computed as a weighted sum of 25 individual equipment series (excluding aircraft) from the Census M-3 report with weights equal to the fraction of final business spending for each type of equipment.
2. From the Current Industrial Report (CIR) titled "Civil Aircraft and Aircraft Engines." Seasonally adjusted with BEA seasonal factors. To estimate PDE spending for aircraft, BEA uses the aircraft shipments shown in that report, not the corresponding Census M-3 series. The CIR does not provide information on aircraft orders.

INDICATORS OF BUSINESS FIXED INVESTMENT

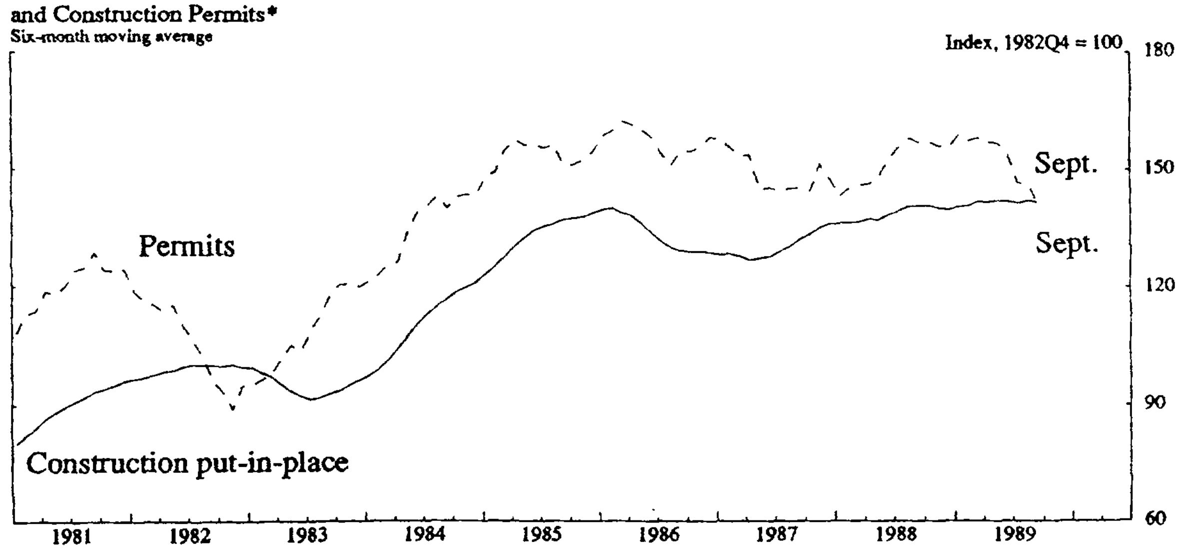
Office and Computing Equipment
Three-month moving average



Other Nondefense Capital Goods
(Excluding aircraft and parts)
Three-month moving average



Nonresidential Construction Put-in-Place
and Construction Permits*
Six-month moving average



* Includes industrial, commercial, and institutional construction; derived from source data that are in current dollars.

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

	1989 Q1	1989 Q2	1989 Q3	1989 July	1989 Aug.	1989 Sept.
Current-cost basis:						
Total	47.1	61.2	--	81.4	22.3	--
Excluding autos and aircraft[1]	31.1	38.3	--	60.1	9.0	--
Manufacturing	27.9	21.4	18.7	51.7	8.2	-3.9
Wholesale	5.5	11.5	1.7	16.8	-5.1	-6.6
Retail	13.8	28.3	--	12.8	19.2	--
Automotive	4.9	13.6	--	.3	12.4	--
Excluding auto	8.9	14.7	--	12.5	6.8	--
Constant-dollar basis:						
Total	10.1	16.2	--	31.0	22.9	--
Excluding autos and aircraft[1]	-6.7	13.4	--	43.7	16.5	--
Manufacturing	3.8	8.3	--	38.3	17.7	--
Wholesale	-2.1	5.2	--	12.0	-1.7	--
Retail	8.4	2.6	--	-19.3	6.8	--
Automotive	9.0	-3.0	--	-28.5	2.7	--
Excluding auto	-.6	5.7	--	9.2	4.1	--

1. All manufacturing and trade excluding transportation equipment in manufacturing, and autos and auto parts at retail dealers.

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

	Range in preceding 12 months:[2] Low	High	1989 Q1	1989 Q2	1989 Q3	1989 July	1989 Aug.	1989 Sept.
Current-cost basis:								
Total	1.48	1.54	1.50	1.51	--	1.54	1.50	--
Excluding autos and aircraft[3]	1.41	1.45	1.43	1.43	--	1.45	1.43	--
Manufacturing	1.53	1.64	1.57	1.57	1.59	1.64	1.56	1.58
Wholesale	1.27	1.31	1.28	1.28	1.28	1.30	1.28	1.27
Retail	1.56	1.63	1.61	1.63	--	1.62	1.62	--
Automotive	1.83	2.06	1.96	2.05	--	2.01	2.00	--
Excluding auto	1.48	1.51	1.51	1.51	--	1.51	1.51	--
Constant-dollar basis:								
Total	1.48	1.52	1.50	1.50	--	1.52	1.48	--
Excluding autos and aircraft[3]	1.42	1.45	1.43	1.43	--	1.45	1.42	--
Manufacturing	1.52	1.63	1.57	1.57	--	1.63	1.55	--
Wholesale	1.32	1.36	1.33	1.33	--	1.34	1.32	--
Retail	1.50	1.56	1.55	1.55	--	1.52	1.51	--
Automotive	1.68	1.93	1.93	1.88	--	1.76	1.73	--
Excluding auto	1.43	1.46	1.45	1.46	--	1.46	1.45	--

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. All manufacturing and trade excluding transportation equipment in manufacturing, and autos and auto parts at retail dealers.

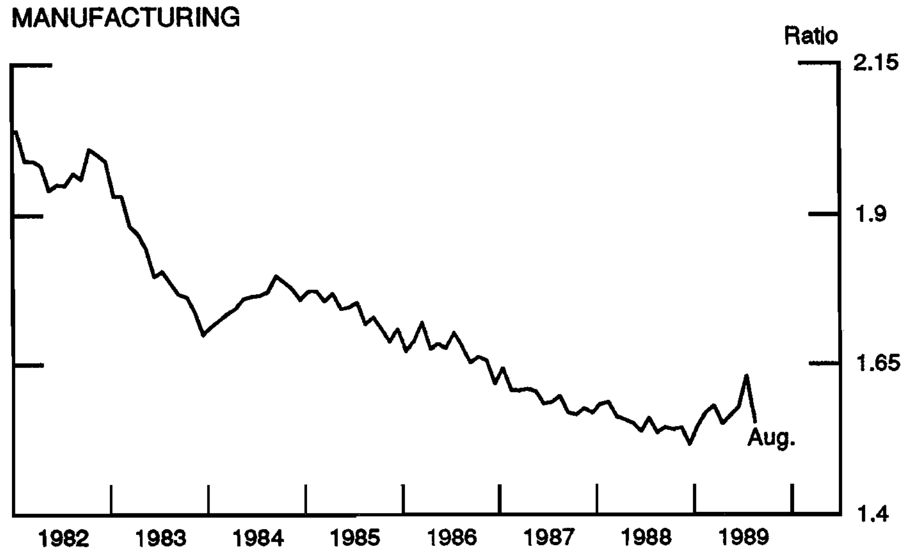
fourth quarter. Indicators for nonresidential structures also are not upbeat. Construction permits have trended down for the past several months (chart), and in the oil industry the Baker-Hughes rig count, which fell 2-1/2 percent in the first three weeks of October from its third-quarter level, suggests that the recent growth in drilling construction has not continued. Finally, shipments of aircraft to domestic airlines are being reduced in the fourth quarter by the Boeing strike, which began in early October.

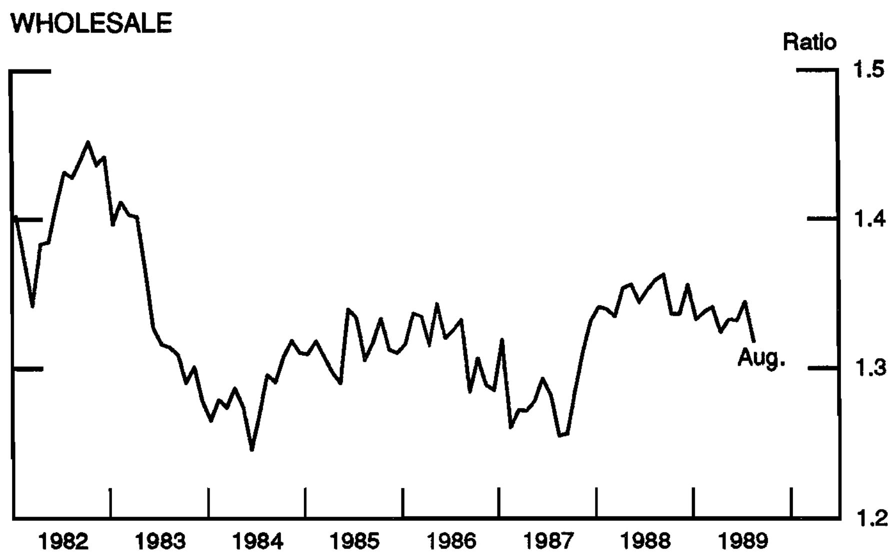
Looking ahead to 1990, the only available survey of planned plant and equipment spending suggests slow growth in nominal terms next year as well. The Economic Consulting and Planning Inc. survey, taken in September and early October, indicates that firms expect to increase nominal outlays 3 percent in 1990 (table), well below the 10 percent rate expected for 1989. This survey, previously conducted by the Merrill Lynch Economic Consulting Group, should be read with considerable caution as it has often made large errors, and ECAP indicated to us that, this year, an unusually large number of respondents did not yet have 1990 spending plans available.

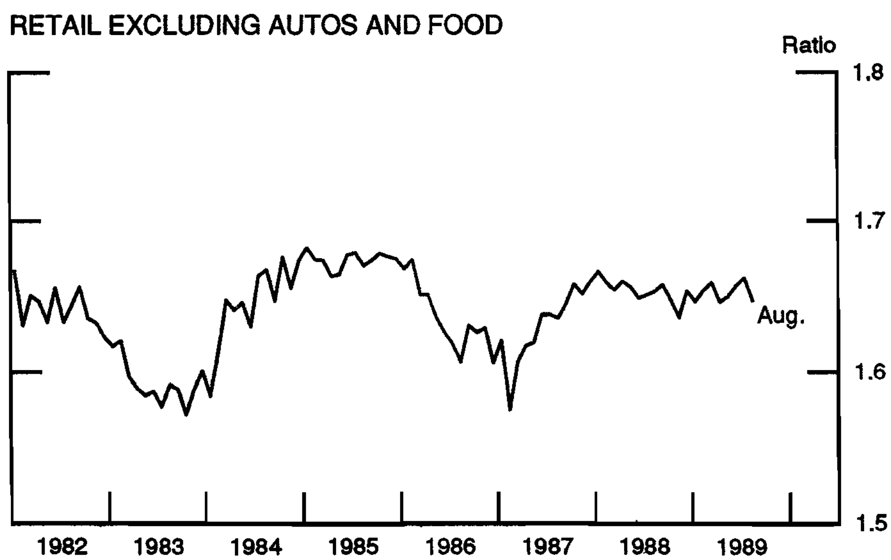
Business Inventories

Inventories apparently accumulated somewhat more rapidly over the summer than in the first half, primarily in the manufacturing sector. In constant-dollar terms, inventories in all manufacturing and trade rose at an annual rate of $27 billion on average in July and August, compared with a rate of $13 billion in the first half. Nonetheless, shipments and sales have, on balance, kept pace with the increases in stocks, and inventory-sales ratios in all major sectors in August were little changed from levels observed during the first half of this year (chart).

Ratio of Inventories to Sales
(Constant-dollar basis)







Manufacturers' inventories were reduced a bit in current-cost terms in September. In constant-dollar terms, these inventories had posted large increases in the previous two months. The steady decline in the manufacturers' inventory-sales ratio that had been evident over the 1984-88 period appears to have stalled so far this year. In part, this pattern has reflected the buildup of work-in-progress stocks at aircraft manufacturers. But although inventories overall have stayed in line with trends in sales, some scattered, small imbalances may be cropping up as firms adjust to an environment of slower growth. For example, the inventory-sales ratio in primary metals--where production has fallen recently--is a bit higher than a year ago. Ratios in a number of nondurable categories, notably paper and chemicals, have also edged up.

In the trade sector, inventory accumulation slowed significantly in August. Wholesale inventories were drawn down a bit, and nonauto retail stocks rose at less than half the pace posted in July. The recent retail inventory increase has been well supported by sales: The inventory-sales ratio for these stores has remained at roughly the same level that has prevailed over the past few years (chart, bottom panel).

Housing Markets

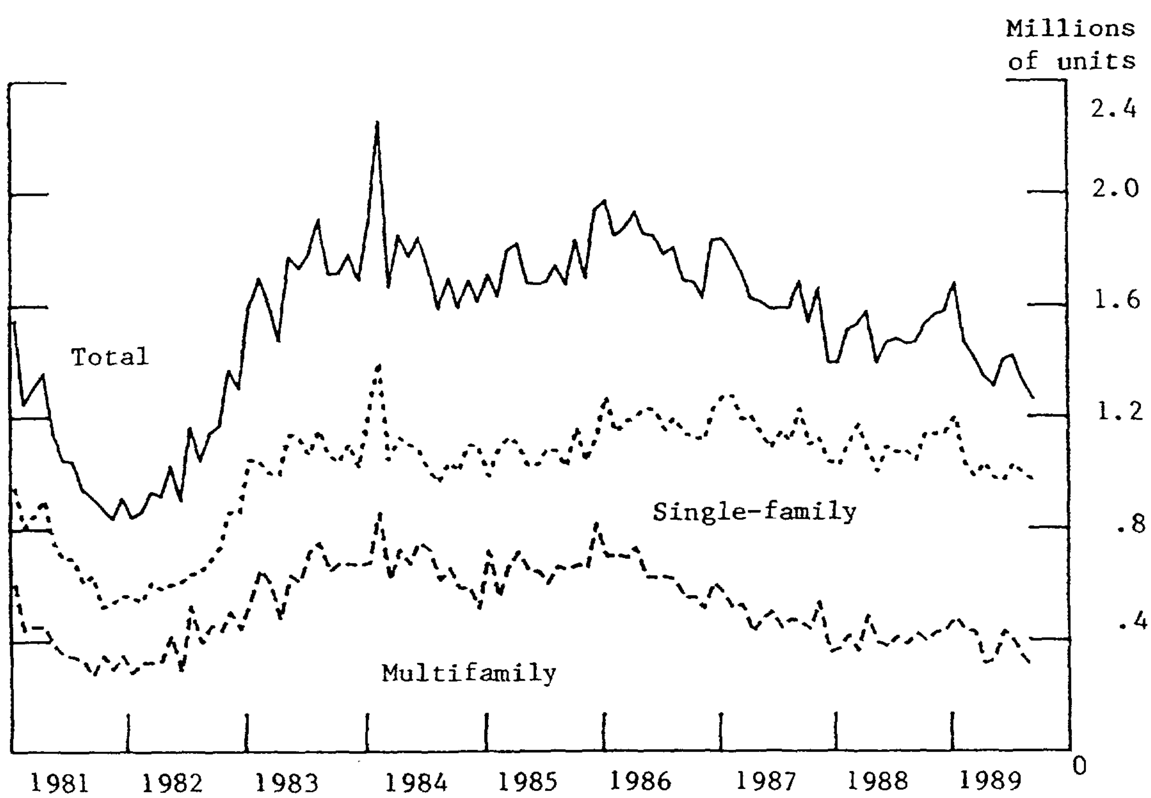
Housing construction has remained weak in recent months. Total private housing starts declined 5 percent in September to 1.26 million units, owing mainly to a drop in multifamily starts. Issuance of building permits roughly paralleled the movement of starts: Multifamily permits fell while single-family permits were essentially flat.

Single-family starts have been little changed in recent months at around 1 million units at an annual rate, even though interest rates on

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

	1988	1989 Q1	1989 Q2	1989 Q3	1989 July	1989 Aug.	1989 Sept.
All units							
Permits	1.46	1.37	1.33	1.30	1.28	1.33	1.30
Starts	1.49	1.52	1.35	1.34	1.42	1.33	1.26
Single-family units							
Permits	.99	.97	.91	.92	.91	.93	.94
Starts	1.08	1.07	.99	1.00	1.03	.99	.97
Sales							
New homes	.68	.63	.64	.69	.74	.72	.62
Existing homes	3.59	3.48	3.32	3.48	3.33	3.48	3.63
Multifamily units							
Permits	.46	.40	.42	.38	.38	.40	.36
Starts	.41	.45	.36	.34	.39	.34	.29

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



fixed-rate mortgage loans have fallen considerably since the spring. Starts have dropped in the Northeast, the only region in which new-home inventories have remained high, judging by historical norms. Starts in the other three major regions appear to have firmed in the third quarter after declining in the first half.

Sales of new homes, which had strengthened substantially in the late spring and summer months, dropped 14 percent in September to 618,000 units at an annual rate. Despite the decline, new home sales averaged a robust 693,000 unit annual rate in the third quarter, compared with 630,000 units in the first half. In addition, sales of existing homes increased 4 percent in September, to 3.6 million units at an annual rate, the highest level since late 1988.

In the multifamily sector, starts dropped 14 percent in September to 292,000 units, the lowest level since mid-1982, and permit issuance fell sharply as well. These multifamily starts and permits figures for September seem surprisingly low, even in light of the adverse effects of 1986 tax law changes on the after-tax profitability of investment in rental housing and the persistent overstock of multifamily units.

<u>Federal Government</u>

In September, the federal government recorded a budget deficit of $6.2 billion, bringing the total FY1989 budget deficit to $152.1 billion on a budget basis.[4] Outlays surged in September, in part because of the Resolution Trust Corporation's (RTC) net outlays of $5.8 billion. Nevertheless, RTC's spending for the year as a whole fell almost $10 billion

4. An overview of the federal budget in FY1989 and the status of legislation for FY1990 are presented in the appendix.

short of the amount authorized in FIRREA.[5] In addition, a military pay date was shifted from October into September, adding about $3 billion to defense outlays. Largely as a result of these factors, outlays reached $105.4 billion in September, about $10 billion above the average for the preceding eleven months of the fiscal year. On the receipts side of the budget, individual income taxes rose about as expected in September, boosted by quarterly estimated tax payments. Corporate payments were consistent with the general picture of sagging profits.

Federal purchases of goods and services declined in the third quarter in the NIPA, owing to a run-off of CCC inventories. Excluding CCC, real purchases rose at a 2.7 percent annual rate. Defense spending rose somewhat from its second-quarter level but remained slightly below a year earlier. Real nondefense purchases excluding CCC were essentially unchanged last quarter, but over the past four quarters they have advanced 4.3 percent, largely owing to spending on the space program. Outlays also have risen in other high priority areas such as health research, tax enforcement, and drug interdiction and crime control, but these increases have been largely offset elsewhere in federal accounts.

Recent natural disasters, namely Hurricane Hugo and the San Francisco area earthquake, are expected to boost federal spending beginning in the fourth quarter. These outlays will fall in a variety of categories, including purchases of goods and services for relief operations, grants to state and local governments for highway and other reconstruction, as well as

5. A large portion of the remaining funds apparently were used in October to sell several deeply insolvent thrifts, negotiations for which could not be completed by the end of September.

some welfare assistance. Disaster loans also are being extended, but these are not included in the NIPA federal sector.

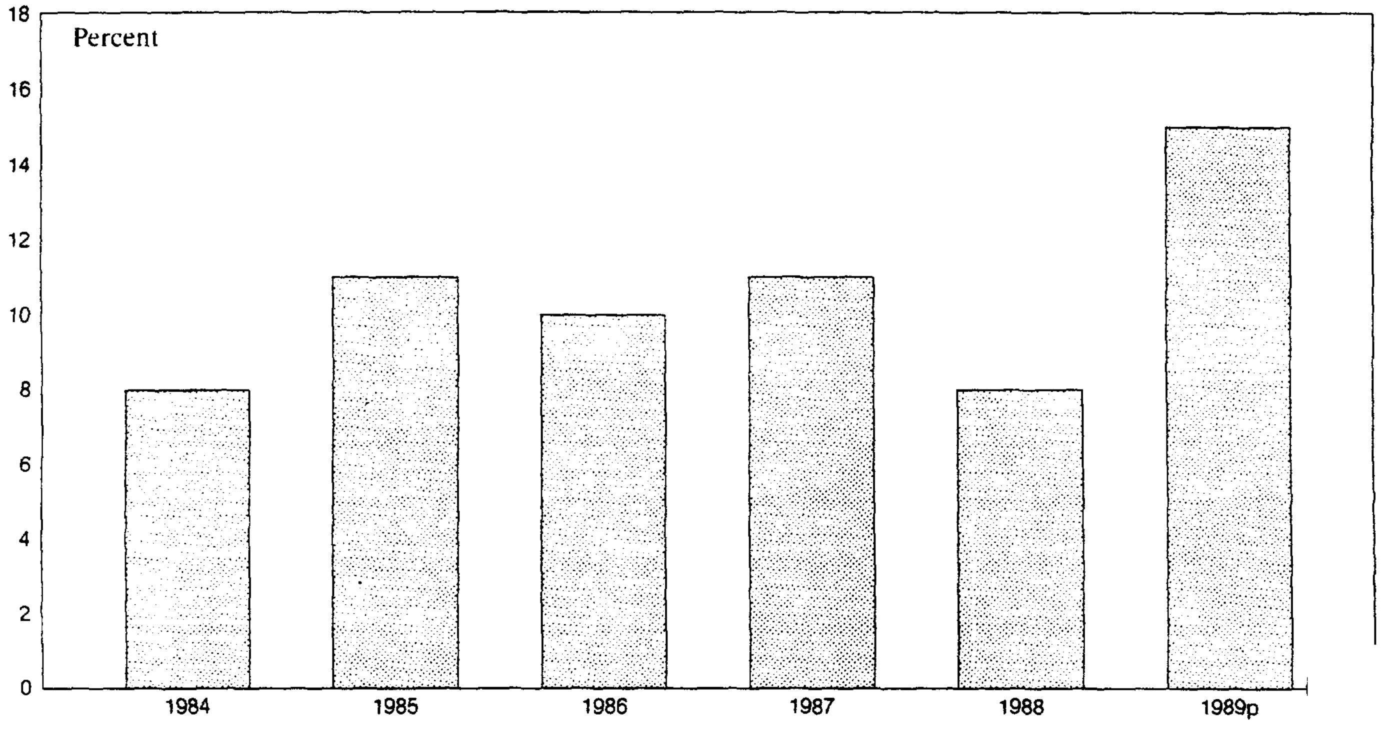
State and Local Governments

BEA estimates that real purchases of goods and services by state and local governments grew at a 2.8 percent annual rate in the third quarter, above the 1.8 percent rise during the first half, but still well below the average increase during the current economic expansion. During the third quarter, real outlays for construction rose slightly, after falling in the first half. In the current quarter, capital investment is likely to be boosted by the start of reconstruction of public works, primarily highways and bridges, that were damaged during the recent earthquake in the San Francisco area. Congress has approved $1 billion in aid through the Federal Highway Administration Emergency Fund.

The budget position of the state and local sector remains quite weak. Trade association and newspaper accounts indicate that many states continue to struggle with fiscal pressures. At the local level, a recent survey of 360 cities indicated that municipal governments also have endured increased stress in their general funds budgets. Indeed, this year has seen a rise in the percent of cities with large deficits (chart). Moreover, the deterioration has come despite widespread attempts to balance budgets. Sixty-nine percent of cities reported increases in existing fees and charges, while 36 percent said they instituted new fees, and 41 percent of the cities hiked property tax rates during the past year. In addition, 36 percent of the cities cut capital spending.

FISCAL SITUATION OF CITIES

(Percent of cities with deficits more than 5 percent of expenditures)



Source: City Fiscal Conditions in 1989, National League of Cities, 1989.

p - projected

Wages, Prices, and Productivity

Wages. A large volume of data on compensation trends has been published in recent weeks. All told, it shows no remission of labor cost pressures, and indeed, suggests that wages may be accelerating gradually.

Hourly compensation of private industry workers as measured by the employment cost index (ECI) increased 4-3/4 percent over the twelve months ended in September, about 1/4 percentage point more than in the preceding year. The twelve-month change in average hourly earnings--the monthly indicator of wages for production and nonsupervisory workers--remained at 4 percent in October, similar to its pace since the turn of the year, but up from its 1988 pace. However, the ECI measure of wages and salaries, which is not influenced by shifts in employment across industries and occupations, rose 4-1/2 percent over the twelve months ended in September and has been accelerating steadily since late 1987. Benefit costs have been rising in excess of 6 percent for the past two years, almost twice the pace of 1987. The large increase this year reflects a double-digit advance in the cost of health insurance.

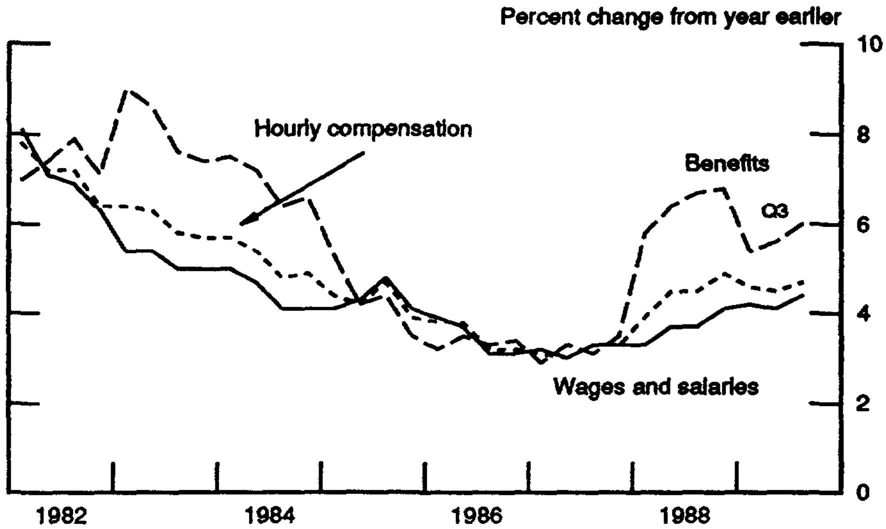
By industry, gains in compensation as measured by the ECI were largest in the service-producing sector, where employment growth has been rapid. In the twelve months ended in September, compensation in this sector was up 5.4 percent. The biggest increase was seen in finance, insurance, and real estate where compensation rose 8.0 percent over the past year, boosted by a large increase in sales commissions. Compensation costs for hospitals also rose sharply--up 6.6 percent over the past year--as demand for health workers remained strong. In the goods-producing sector, compensation was up

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

	1987	1988	1988 Q4	1989 Q1	1989 Q2	1989 Q3	Oct. Monthly
Employment cost index[1]							
Compensation, all persons	3.3	4.9	4.9	4.5	4.8	4.7	--
Wages and salaries, all persons	3.3	4.1	5.1	3.9	3.9	4.5	--
Benefits, all persons	3.5	6.8	4.9	7.1	6.3	5.8	--
Labor costs and productivity, all persons[2]							
Nonfarm business sector							
Output per hour	2.5	1.6	1.9	-1.3	1.1	2.1	--
Compensation per hour	4.0	4.8	5.9	4.9	5.6	5.3	--
Unit labor costs	1.5	3.1	3.8	6.2	4.5	3.2	--
Manufacturing							
Output per hour	3.8	2.9	2.2	2.4	3.7	1.4	--
Compensation per hour	2.4	4.4	5.7	3.5	2.7	6.0	--
Unit labor costs	-1.4	1.5	3.5	1.0	-1.0	4.5	--
Major collective bargaining agreements[3]							
First-year wage adjustments	2.2	2.5	2.6	3.2	3.7	3.7	--
Total effective wage change	3.1	2.6	2.6	2.7	2.8	3.0	--
Average hourly earnings, production workers[2]							
Total private nonfarm	3.0	3.7	4.4	3.6	4.0	4.1	.7
Manufacturing	2.3	3.0	3.4	2.6	2.2	3.6	.2
Services	4.7	4.9	5.2	5.4	6.1	5.7	1.1
Hourly earnings index, wages of production workers[2,4]							
Total private nonfarm	2.6	3.5	4.1	3.0	3.8	3.9	.7

1. Changes are from final month of preceding period to final month of period indicated at a compound annual rate. The data are seasonally adjusted by FRB staff.
2. Changes over periods longer than one quarter are measured from final quarter of preceding period to final quarter of period indicated at a compound annual rate. Seasonally adjusted data.
3. Agreements covering 1,000 or more workers; not seasonally adjusted. The numbers reported are cumulative averages from the beginning of the year through the indicated quarter.
4. Values for the HEI after 1988 were produced by FRB staff.

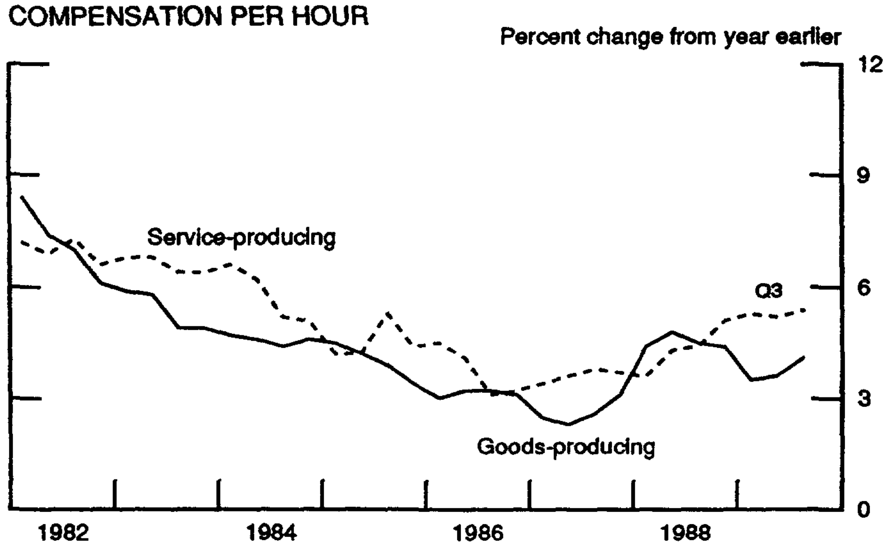
Employment Cost Index
Private Industry Workers



Percent change, annual rate, s.a.*

	Hourly Compen-sation	Wages and Salaries	Benefits
	--- Dec. to Dec. ---		
1987	3.3	3.3	3.5
1988	4.9	4.1	6.8
1988			
Q2	5.1	4.4	5.7
Q3	3.7	3.5	4.1
Q4	4.9	5.1	4.9
1989			
Q1	4.5	3.9	7.1
Q2	4.8	3.9	6.3
Q3	4.7	4.5	5.8

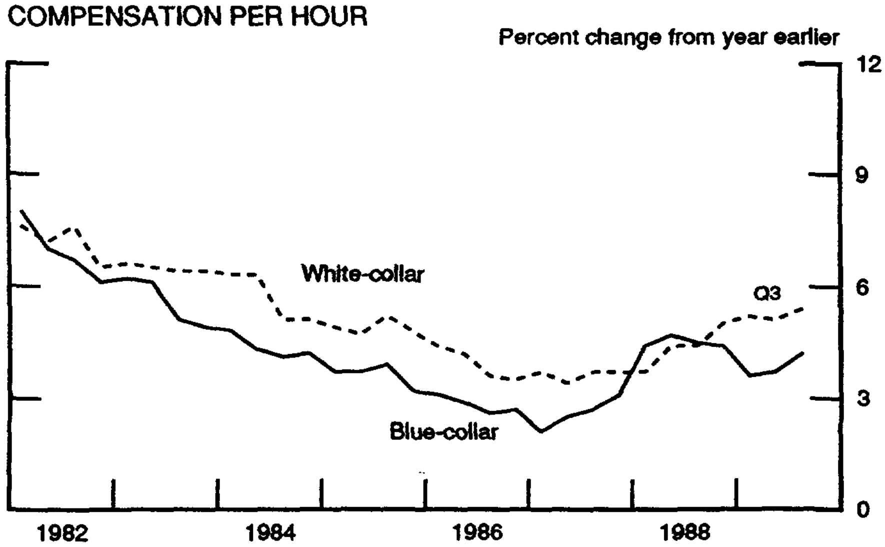
COMPENSATION PER HOUR



Compensation per hour
Percent change, annual rate, s.a.*

	Goods-Producing	Service-Producing
	--- Dec. to Dec. ---	
1987	3.1	3.7
1988	4.4	5.1
1988		
Q2	4.3	5.7
Q3	2.6	4.1
Q4	3.8	6.0
1989		
Q1	3.5	5.5
Q2	4.4	5.1
Q3	4.8	4.8

COMPENSATION PER HOUR



Compensation per hour
Percent change, annual rate, s.a.*

	Blue-collar	White-collar
	--- Dec. to Dec. ---	
1987	3.1	3.7
1988	4.4	5.0
1988		
Q2	4.3	5.4
Q3	2.7	4.0
Q4	3.9	5.9
1989		
Q1	3.5	5.6
Q2	4.6	4.8
Q3	4.8	5.2

*Seasonally adjusted by FRB staff.

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

	Relative importance Dec. 1988	1987	1988	1989 Q1	1989 Q2	1989 Q3	1989 Aug.	1989 Sept.
				----Annual rate----			-Monthly rate-	
All items[2]	100.0	4.4	4.4	6.1	5.7	1.6	.0	.2
Food	16.2	3.5	5.2	8.2	5.6	2.9	.2	.2
Energy	7.3	8.2	.5	10.2	24.8	-13.4	-2.0	-.9
All items less food and energy	76.5	4.2	4.7	5.2	3.8	3.1	.2	.2
Commodities	25.7	3.5	4.0	4.1	2.0	.7	-.3	.4
Services	50.8	4.5	5.0	5.9	4.3	4.5	.3	.2
Memorandum:								
CPI-W[3]	100.0	4.5	4.4	6.2	5.7	1.6	.0	.2

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

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

	Relative importance Dec. 1988	1987	1988	1989 Q1	1989 Q2	1989 Q3	1989 Aug.	1989 Sept.
				----Annual rate----			-Monthly rate-	
Finished goods	100.0	2.2	4.0	10.2	5.1	.4	-.4	.9
Consumer foods	25.8	-.2	5.7	13.1	-2.0	-.7	.3	-.6
Consumer energy	8.8	11.2	-3.6	41.0	31.0	-16.3	-7.3	6.5
Other consumer goods	39.6	2.7	4.8	5.4	5.3	2.9	.5	.6
Capital equipment	25.8	1.3	3.6	4.6	4.1	5.2	.3	1.0
Intermediate materials[2]	94.8	5.4	5.3	8.7	2.5	-.7	-.3	.4
Excluding energy	83.4	5.2	7.2	5.5	.3	-.7	-.1	.1
Crude food materials	43.8	1.8	14.2	16.9	-18.7	-1.1	1.7	-.8
Crude energy	36.9	10.7	-9.5	48.3	22.3	-5.6	-6.7	3.5
Other crude materials	19.3	22.6	7.5	10.3	-9.8	.0	1.2	.3

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

4.1 percent over the past twelve months, a bit less than the gain over the same period last year.

Productivity and costs. Productivity in the nonfarm business sector rose 2.1 percent at an annual rate in the third quarter, but was up only 0.9 percent over the past four quarters, somewhat below our current estimate of its underlying trend rate of 1.4 percent. With the slowing pace of productivity growth and a small pickup in hourly compensation, unit labor costs in the nonfarm business sector have accelerated to 4-1/2 percent over the latest four quarters. Productivity in the manufacturing sector rose only 1.4 percent in the third quarter, substantially below the recent trend, reflecting the slowing in industrial output. Over the past year, productivity growth has edged down slightly in the manufacturing sector, to a 2-1/2 percent gain.

Prices. Recent monthly price reports have given mixed signals about the near-term direction of inflation. The consumer price index rose only 0.2 percent in September, held down by declines in retail energy prices and relatively small increases in other prices. In contrast, producer prices of finished goods jumped 0.9 percent in September, reversing the declines of the three preceding months, as energy prices rebounded at the producer level and seasonal adjustment difficulties caused the index reported for motor vehicle prices to jump sharply.

The CPI for energy was down nearly 1 percent in September. Gasoline prices declined more than 2 percent, reflecting in part the easing of vapor pressure standards at the end of the summer. However, refinery and wellhead prices rose sharply in the September PPI, and both posted and spot prices of crude oil moved up further into mid-October. These higher crude oil costs should show up in retail energy prices, and indeed, a private survey showed increases in gasoline prices in October.

Food prices rose 0.2 percent in the September CPI, the fourth month of relatively small increases after the runup earlier this year. In September, declines in prices of pork, poultry, coffee, and fresh vegetables offset much of the increases for other foods. Producer prices of crude and finished foods were down in September, and the current outlook for farm output and crop inventories appears consistent with moderate increases in retail food prices in coming months. The main exception at present is dairy prices, which have surged in response to a tighter supply situation here and abroad.

Excluding food and energy items, the CPI rose 0.2 percent in September. The services component was held down by a 4-1/2 percent decline for out-of-town lodging, which offset part of the increase in other categories.[6] However, the commodities component, which had declined 0.3 percent in August, turned up 0.4 percent in September, boosted by a 1.8 percent jump in apparel prices. The September increase for apparel, associated with the introduction of fall and winter clothing, followed declines over the preceding three months attributable to unusually heavy discounting of summer items. Car prices fell in September for the fifth consecutive month.

Smoothing through the recent figures, the CPI for commodities excluding food and energy has risen 2-3/4 percent over the past twelve months, a deceleration of about 3/4 percentage point relative to the previous twelve-month period. An important influence on this slowdown has been a moderation

6. The index for lodging out of town also declined in August; the August-September declines more than reversed a sharp increase in July.

in the rate of increase in the prices of imported goods. Although the BLS does not compile separate indexes for the retail prices of foreign and domestically produced goods, inferences can be made about the influence of import prices by examining those components of the CPI with higher-than-average trade shares. As shown in the table, the deceleration has been widespread, but is especially large for items such as new motor vehicles and apparel. In contrast, prices of domestically produced consumer goods other than food and energy, as measured by the producer price index, have risen 4-1/2 percent over the past twelve months, somewhat more than during the preceding year.

At the producer level, motor vehicle prices have continued to dominate month-to-month movements in the PPI for finished goods less food and energy. In September, prices of passenger cars and light trucks were up 3.8 and 3.5 percent, respectively, on a seasonally adjusted basis, accounting for much of the increase in the indexes for both consumer and capital goods. The increases in motor vehicle prices reflect relatively small unadjusted declines, as compared with those "expected" by the PPI seasonals. In past years, motor vehicle manufacturers typically extended substantial end-of-model-year liquidation allowances to dealers in September. This year, widespread incentive programs to reduce inventories were instituted in July, resulting in large price declines in that month.

Prices of intermediate materials excluding food and energy have changed little in recent months, in marked contrast to earlier in the year, when these prices were rising rapidly. At the same time, though, the rate of price increase for finished goods excluding food and energy has been about unchanged. Historical experience suggests that such a deceleration in

CONSUMER PRICE INDEXES
FOR COMMODITIES WITH HIGHER-THAN-AVERAGE IMPORT PROPORTIONS[1]
(Percent changes)

	Relative importance Dec. 1988	Sept. 1986 to Sept. 1987	Sept. 1987 to Sept. 1988	Sept. 1988 to Sept. 1989
New vehicles	5.3	2.9	2.1	.8
Men's and boys' apparel	1.5	2.5	4.2	2.2
Women's and girls' apparel	2.6	6.0	2.4	.8
Infants' and toddlers' apparel	.2	1.3	6.2	-.8
Footwear	.9	3.3	6.1	1.7
Video and audio equipment	.6	-2.7	-1.6	-2.4
Sporting goods	.5	1.4	3.2	2.5
Photographic equipment	.1	7.3	4.8	3.1
Toys, hobbies, and music equipment	.4	2.4	8.0	4.1
Lawn equipment, power tools, etc.	.2	1.5	-1.6	-2.8
Tableware, etc.	.2	.9	1.7	4.3
Clocks, lamps, and decor items	.3	.4	2.0	4.6
Toilet goods and personal care appliances	.7	3.0	3.5	4.5
Wine	.2	4.6	1.6	2.7
Memo:				
Composite Index[2]	13.8	3.0	2.7	1.3
CPI commodities excluding food and energy	25.7	3.5	3.5	2.7
PPI consumer goods excluding food and energy		3.4	4.2	4.5

1. The choice of the items in this table was based on judgmental analysis by BLS.
2. Constructed by the Board staff using December 1988 CPI relative importance weights.

intermediate materials prices usually is associated with some deceleration in finished goods prices as well. Regression analysis indicates that, over the course of a quarter, a one-percentage-point drop in inflation for intermediate materials excluding food and energy typically is accompanied by a 0.3-percentage-point decline in finished goods inflation (excluding food and energy). Such a model predicts that the 7-percentage-point deceleration in intermediate materials prices over the past year normally would be associated with a 2-percentage-point drop in the rate of increase for finished goods prices; these prices actually decelerated by only 1/4 percentage point.[7]

PRODUCER PRICES EXCLUDING FOOD AND ENERGY
(Seasonally adjusted six-month percent changes at an annual rate.)

	1986		1987		1988		1989	
	Mar.	Sept.	Mar.	Sept.	Mar.	Sept.	Mar.	Sept.
Intermediate goods	-.6	.4	2.1	5.0	7.7	7.0	6.1	-.2
Finished goods	3.0	2.4	2.9	2.9	2.8	4.5	4.3	4.2

An important factor in assessing the near-term outlook is the simple relationship that seems to exist between the finished goods and intermediate materials indexes. The linkage is a contemporaneous one; past movements in intermediate materials prices do not have a statistically significant effect on finished goods prices, so that finished goods prices will not tend to "catch up" with the past deceleration in intermediate materials prices. On the other hand, errors in the estimated relationship do not have a tendency to persist, so that the model predicts that the historical relationship

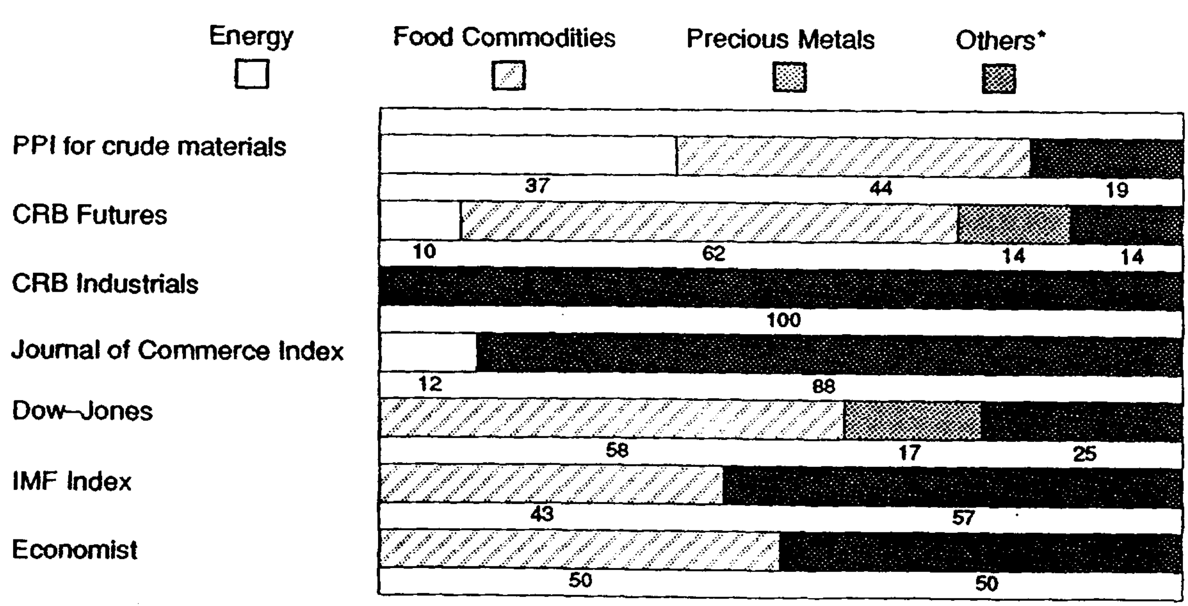
7. These deceleration comparisons refer to the six-month periods ended in September of 1988 and 1989, respectively, at annual rates.

PRICE INDEXES FOR COMMODITIES AND MATERIALS[1]

		Percent change[2]				Memo:
				1989		
	Last observation	1987	1988	to Sept. 26*	Sept. 26* to date	Year earlier to date
1. PPI for crude materials[3]	Sept.	8.9	3.1	4.8	n.a.	5.5
1a. Foods and feeds	Sept.	1.8	14.2	-1.1	n.a.	-3.3
1b. Energy	Sept.	10.7	-9.5	14.4	n.a.	17.8
1c. Excluding food and energy	Sept.	22.6	7.5	.2	n.a.	2.8
1d. Excluding food and energy, seasonally adjusted	Sept.	22.8	7.6	-.1	n.a.	2.8
2. Commodity Research Bureau						
2a. Futures prices	Nov. 7	11.7	8.5	-10.3	.9	-6.9
2b. Industrial spot prices	Nov. 6	19.2	7.3	2.4	-3.1	2.0
3. Journal of Commerce industrials	Nov. 7	10.7	3.8	4.4	.6	8.4
4. Dow-Jones Spot	Nov. 7	17.0	6.9	-9.1	-.1	-4.9
5. IMF commodity index[3]	Sept.	30.8	12.6	-10.6	n.a.	-4.0
5a. Metals	Sept.	51.9	33.7	-15.7	n.a.	2.7
5b. Nonfood agric.	Sept.	47.5	-9.4	-2.1	n.a.	2.0
6. Economist (U.S. dollar index)	Oct. 31	42.5	17.7	-18.1	-1.3	-14.
6a. Industrials	Oct. 31	62.6	18.9	-18.3	-.7	-13.4

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.
*Week of the September Greenbook.
n.a.--Not available.

Index Weights



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

should "come back on track" next period. As a result, if the recent moderation in intermediate materials prices is sustained, finished goods prices can be expected to decelerate as well.

APPENDIX

THE FEDERAL BUDGET IN FY1989 AND THE STATUS OF LEGISLATION FOR FY1990

Fiscal year 1989 closed with a federal budget deficit of $152.1 billion, according to the Monthly Treasury Statement released on October 27. This compares with a deficit of $155.2 billion in FY88, and with OMB and CBO estimates last winter of $161 billion and $160 billion, respectively (table 1). The better-than-expected deficit is entirely attributable to the strong performance of receipts, which grew by 9.1 percent between FY88 and FY89--well in excess of nominal GNP growth--while outlays were boosted to a 7.5 percent growth rate, in part by the unusual amount of thrift insurance activity. Over the 1985-89 period, the deficit has declined relative to GNP and saving, particularly when adjusted for transitory factors, but the prospects for meaningful further improvement in 1990 are uncertain. This appendix reviews the major factors affecting the deficit in FY89, the deficit reduction progress that has been made in recent years, and the status of legislation for FY90.

The unusual strength in federal tax receipts last year was concentrated in individual income tax collections (table 2), which showed surprising strength around the time of the final payments last April and, for the year as a whole, picked up markedly from an already brisk average growth rate over the 1986-88 period. A small part of the 1989 receipts overrun appeared, following the July national income revisions, to reflect more growth of taxable nominal personal income (largely components other than wages and salaries) from 1987 to 1988 than had been estimated previously. However, much of the surprise remains unexplained. Some part of it likely reflects transitory shifts in the timing of realizations of income, induced by the phasing in of the Tax Reform Act of 1986 (TRA), while another part may reflect larger revenue gains than had been anticipated from TRA's base-broadening provisions or a shift of the form in which income is received, from corporate to personal, as relative tax rates have changed. Revenue growth in the 1986-to-88 phase-in period had been very uneven but, on average, already had been relatively strong as base-broadening, and the acceleration of capital gains realizations before the new law became effective, offset some of the revenue losses from TRA's reductions in personal income tax rates. Growth in both social insurance and corporate profits taxes slackened in 1989. This slowing followed two years when a jump in the social security tax rate and TRA's revenue-raising changes in corporate taxes had prompted receipts growth in these categories that was well above trend. Corporate tax receipts also were slowed in the last fiscal year by the deterioration in overall profitability.

On the outlay side of the budget, total spending in FY89 was raised by sizable increases in net interest payments, social security and defense spending. Interest on the debt increased sharply, as outstanding securities rolled over at higher interest rates through most of the year, while debt continued to grow. Growth in social security payments maintained recent trends (the apparent acceleration from the FY86-88 average growth reflects the indexation of benefits for inflation, which was 4.2 percent last year compared with 4.1 and 1.3 percent in the two preceding years). The shift of about $3 billion of military pay from the first of October (a weekend) to the end of September helped to boost defense outlays. Despite the sizable contribution of the defense function to total nominal outlay growth, real spending for defense was about constant, after adjusting for the pay shift.

The budget outcome in FY89 also was influenced by smaller functions or programs. Outlays for deposit insurance net of premium and other income, which are typically quite small, soared to $20.6 billion in FY89 after having amounted to an already sizable $10.2 billion in FY88, as thrift insurance costs jumped to $17.8 billion in FY89 from $8.1 billion in FY88. The FY89 total reflected both a surge of FSLIC note issuance at the end of calendar 1988 (the first quarter of FY89) and $9.0 billion of Treasury-financed RTC spending under FIRREA in August and September. The RTC spending, nevertheless, fell considerably below the $18.8 billion (net) that had been authorized by the law; most of the remaining funds appear to have been spent in October.

In the high priority areas of science and space, education, health and criminal justice spending accelerated further in 1989. Outlays for income security (largely the means tested entitlements) and for energy and natural resources also picked up last year, but only to a relatively moderate pace. Partially offsetting these increases was the absence of growth in agricultural spending; the sharp upswing in subsidy payments associated with the 1988 drought was spread across two fiscal years and was counterbalanced, to some degree, by declines in CCC inventories as the drought raised the level of market prices relative to support prices. Spending for international affairs also continued to decline last year.

Owing largely to the restraint on growth of receipts that occurred during the phase-in of TRA and the surge in thrift-related spending, FY89 marks the third consecutive year in which the deficit has been stalled in the neighborhood of $150 billion. And it has edged down only slowly as a percent of GNP over that period, falling from 3.4 percent in 1987 to 2.9 percent last year (chart). Abstracting from the effects of TRA on the receipts side of the budget and removing certain transitory (largely financial) or purely accounting changes in outlays (e.g. financial asset sales, RTC's FY89 on-budget spending, short-term shifts in the timing of outlays, and movement of some activities to off-budget status) yields an adjusted deficit, also presented in the chart, which shows a significant and somewhat smoother improvement throughout the 1985-89 period. However, progress on permanent deficit reduction is expected to be somewhat slower in 1990 (see the adjusted deficit on the chart). The staff is assuming that the sequester now in effect will be repealed. The reconciliation bill that will take its place is thought likely to provide for somewhat less permanent deficit reduction than either the sequester or the deficit-reducing measures of some recent years. Meanwhile, apart from deficit-reduction and TRA effects, receipts growth slows.

Current estimates of the federal deficit on an NIPA basis show slightly greater improvement than in the budget-basis deficit since 1987, with the deficit as a percent of GNP falling from 3.8 percent to 2.9 percent.[1] Indeed, the movements of the NIPA deficit are somewhat similar to the adjusted deficit because financial transactions such as sales of financial assets, and FSLIC notes and RTC outlays are excluded from the GNP accounts. A substantial amount of the remaining, NIPA-basis growth in federal sector expenditures in recent years reflects the built-in increases in social insurance and net interest accounts, while autonomous increases, especially in defense have slowed. Thus, the staff's NIPA-based measure of autonomous fiscal policy shows a shift from stimulation over the early and mid-1980s to a neutral or a moderately restraining stance in 1988 and 1989.

Nevertheless, although the federal deficit in NIPA terms has fallen significantly relative both to GNP and to saving--from about 70 percent of net domestic nonfederal saving in the 1985-87 period to about half of such saving in the past two years--the deficit-to-saving ratio remains very high in contrast to the 15 percent average from 1965 through 1985. Furthermore, as with the adjusted budget-basis deficit, progress in deficit reduction seems likely to slow on an NIPA basis in 1990 because of the nature of the deficit reduction planned in last spring's Bipartisan Budget Agreement.

The Bipartisan Budget Agreement set levels of spending for defense and international affairs, capped the total for nondefense discretionary programs, and provided for stricter tax enforcement. It also called for some additional user fees, an increase of $5.3 billion in general revenues, and spending reductions generally expected to come largely from savings in Medicare, agriculture and federal employee retirement, and from asset sales and placing the Postal Service off budget. As much as half of this deficit reduction has been thought likely to come from accounting or transitory savings; furthermore, the shift of some military pay into FY89 permits that much additional defense spending for other purposes in FY90.

Appropriations appear to be generally in line with the agreement, which anticipated little reduction of broad spending aggregates from a zero-real-growth baseline. However, since the agreement, new spending addressed to the drug problem is only partially offset by reductions in other outlays, and the additional funds provided for disaster relief after the California earthquake will be a net addition to the budget and deficit. Currently, only three of the 13 regular appropriations bills have been enacted; controversy over the other bills is related largely to nonbudgetary provisions and many of the remaining bills are now in the final stages of the legislative process.

The rest of the agreement was to be implemented in a reconciliation bill. That bill, as passed by the House of Representatives, contained a number of extraneous and highly controversial provisions (including a cut in the capital gains tax, repeal of catastrophic health insurance under

1. The estimate of the deficit for the fiscal year on an NIPA basis includes a staff estimate of corporate profits tax liability for 1989Q3 because this estimate is not yet available from BEA.

Medicare, repeal of "Section 89" tax provisions aimed at preventing discrimination in tax-exempt employer provided fringe benefits, and a package of child care benefits). Many of these and other measures were stripped from the Senate bill and the enactment of the final bill now awaits the achievement of a conference agreement between the two houses. The President has decided not to press capital gains tax reductions at this time and is urging a strengthened deficit reduction package, providing more permanent measures to reduce spending and free of extraneous provisions.[2] The outcome of this process is uncertain at present.

Because the reconciliation bill was not passed before the deadline for the final sequester report that was issued on October 16, a sequester went into effect at that time. The sequester provides for an across-the-board cut in spending totalling $16 billion, in order to achieve the Gramm-Rudman-Hollings target for the estimated FY90 deficit of $100 billion. The sequester reduces defense spending authority by 4.3 percent and nonexempt, nondefense spending authority by 5.3 percent. This sequester order will be repealed if a reconciliation bill is enacted sometime in the next few weeks. (There is precedent for such action in legislation passed late in 1987 pertaining to FY88.) However, if agreement between the two houses of Congress and with the administration cannot be reached, the sequester will remain in place.

The primary difference between these two situations is in the composition of deficit reduction and the permanence of its effects. The reconciliation bill, as passed by either house of Congress, provided for one-time asset sales that would not count toward achieving the Gramm-Rudman-Hollings target, and from some accounting and timing changes as noted above, none of which would affect the NIPA federal deficit. In addition, some of the tax and spending provisions would not reduce deficits in future years. The sequester would reduce discretionary spending directly with most of the effects also reducing the NIPA deficit, and the associated reductions in appropriations would establish a lower base for FY91. In the meantime, enactment of the remaining appropriations bills can affect either the aggregate amount or the composition of spending only marginally. However, whether or not there is a sequester in place, other legislation can be enacted that would cause the deficit to rise above the Gramm-Rudman-Hollings target, if a waiver is obtained in the House of Representatives, if 60 votes are available in the Senate to override a point of order, and if the President signs the bills. And, of course, automatic spending increases or revenue shortfalls can cause the ultimate deficit outcome to exceed the target.

2. Repeal of Section 89 is attached to the increase in the debt ceiling to be signed by the President on November 8. Repeal or modification of catastrophic health insurance is expected to be enacted as a separate bill.

Table 1

FEDERAL BUDGET IN FY1989
(Billions of dollars)

	Actual	OMB projection (January 1989)	CBO projection (February 1989)
Receipts	991	976	983
Individual income taxes	446	425	433
Social insurance	359	364	365
Corporate income	103	107	103
Other	82	79	82
Outlays	1143	1137	1143
National defense	304	298	297
Social Security & Medicare	318	319	320
Net interest	169	166	169
All other (net)[1]	353	354	356
Deficit	152	161	160

1. Includes $20.6 billion of deposit insurance, compared with OMB and CBO projections of $14.7 and $17 billion, respectively. Also includes $16.9 billion of agricultural spending, compared with projections of $20 to $21 billion by CBO and OMB.

Table 2

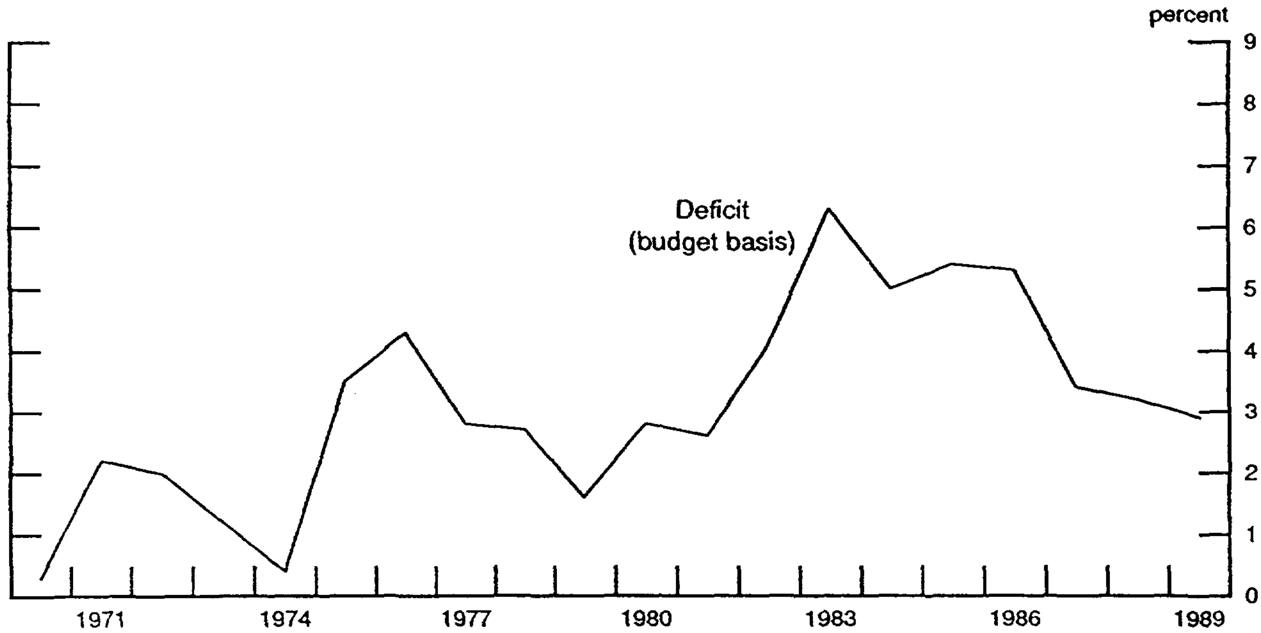
COMPOSITION OF THE FEDERAL GOVERNMENT BUDGET
(Fiscal years)

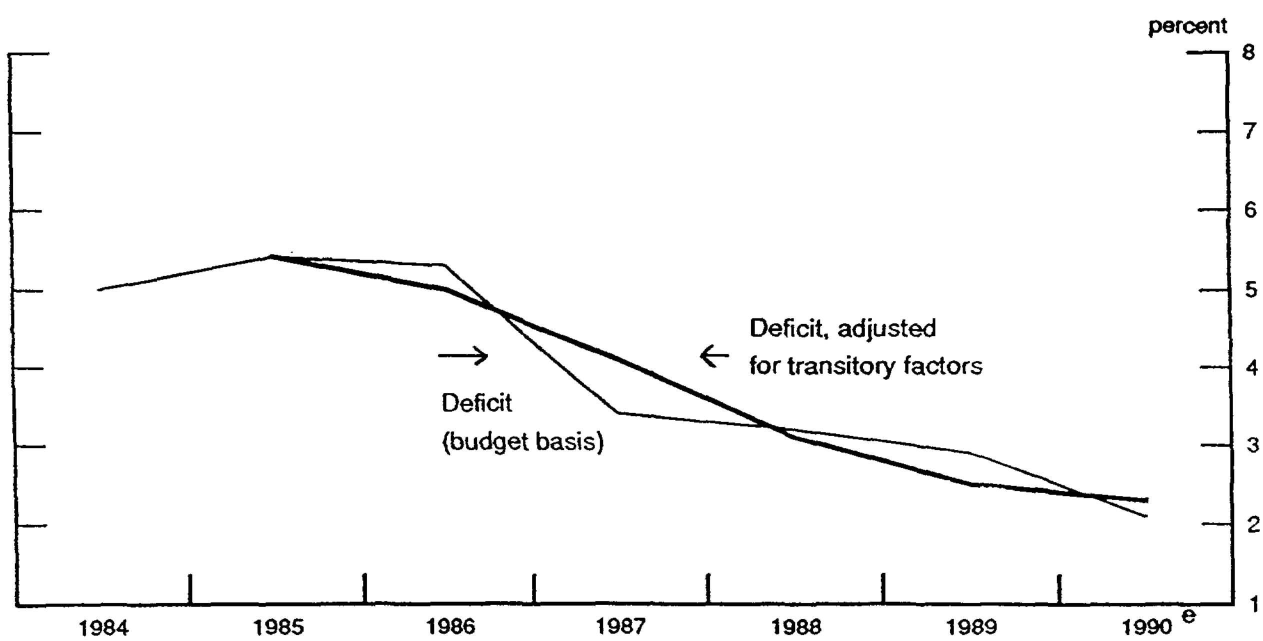
	FY1989 ($ billions)		Memoranda (percent):		
	Level	Annual change	Share of '89 change	Growth in '89	Avg. growth 1986-1988
Total receipts	990.8	82.6	100	9.1	8.7
Individual income taxes	445.7	44.5	54	11.1	7.2
Social insurance	359.4	25.1	30	7.5	8.5
Corporate income taxes	103.3	9.1	11	9.7	22.1
Other[1]	82.4	3.9	5	5.0	3.6
Total outlays	1142.9	79.6	100	7.5	3.6
National defense	303.6	13.2	17	4.5	3.1
Net interest	169.3	17.6	22	11.6	5.6
Social security	232.5	13.2	17	6.0	5.1
Commerce and housing credit[2]	27.8	9.0	11	47.7	97.5
Priority nondefense[3]	106.4	10.7	13	11.2	8.0
Medicare	85.0	6.1	8	7.7	6.0
Other[4]	218.3	9.8	12	4.7	-2.4
Deficit	152.1	-3.1	--	--	-

1. Consists of excise taxes, estate and gift taxes, customs duties, deposi s o earnings by Federal Reserve banks, and miscellaneous receipts.
2. Commerce and housing credit includes net payments by FDIC, FSLIC, and their successors under FIRREA.
3. The sum of four functions that include areas of priority initiative spendin targeted by President Bush: general science, space and technology; education, training, employment and social services; health; and administration of justice.
4. The sum of the remaining functions: international affairs; energy; natural resources and environment; agriculture; transportation; community and regional development; income security; veterans benefits and services; general government and undistributed offsetting receipts (negative).

Federal Budget Deficit As A Percent of GNP

(fiscal years)





Note: in the adjusted deficit, the outlay effects of transitory factors, such as asset sales, shifts in timing of payments, $10 billion of notes assumed from local governments in FY86, and $9 billion of RTC outlays in FY89, are removed; also, receipts are lowered in 1987 and raised in 1988 and 1989 to remove the effects of the Tax Reform Act of 1986.

e- - - preliminary staff estimate for FY90.

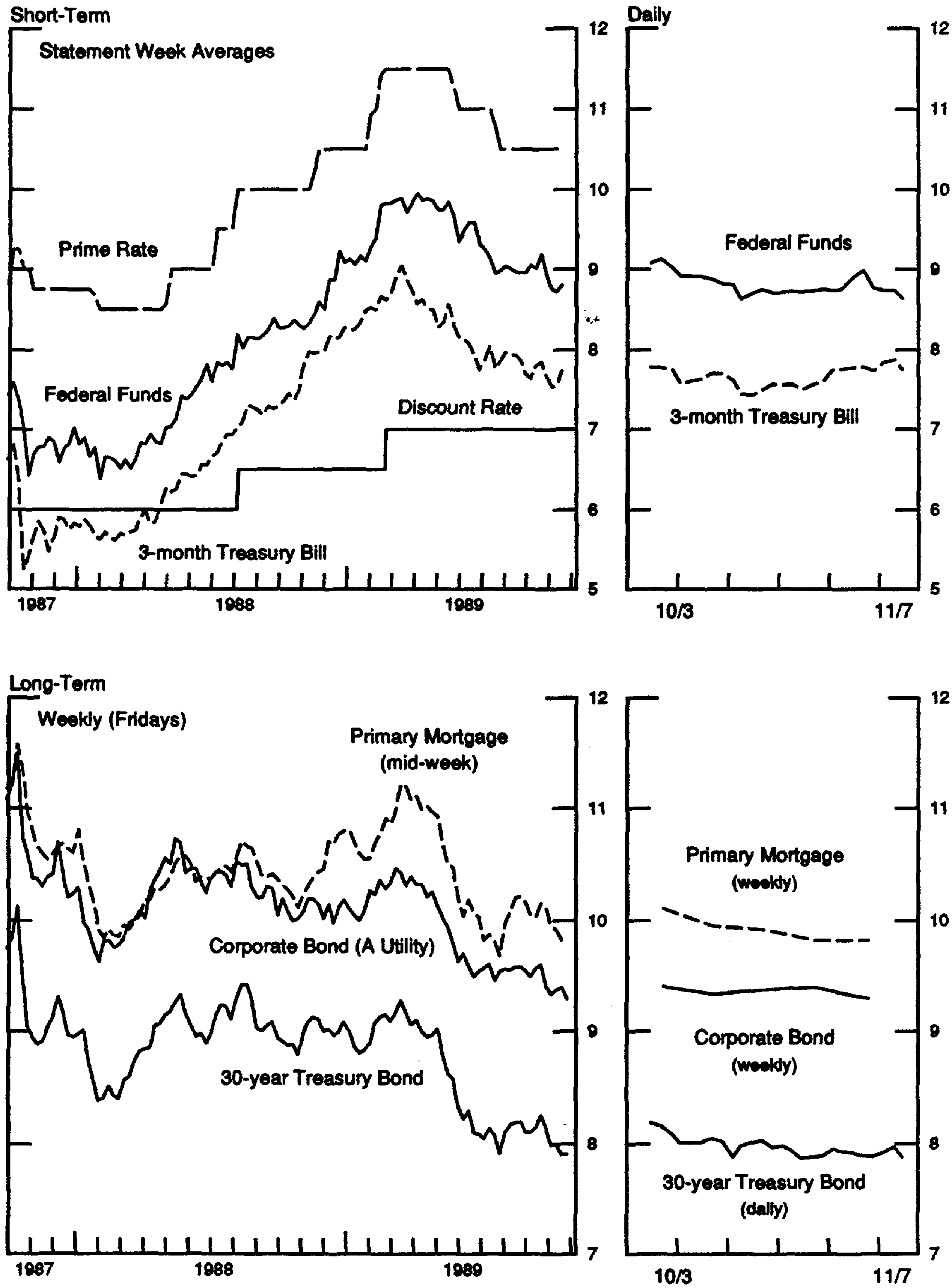
SELECTED FINANCIAL MARKET QUOTATIONS[1]
(Percent)

	1987	1989				Change from:		
	Oct. 16[2]	Mar. highs	Jul-Aug lows	FOMC Oct.3	Nov.7	Mar.89 highs	Jul-Aug lows	FOMC Oct.3
Short-term rates								
Federal funds[3]	7.59	9.85	8.97	9.10	8.73	-1.12	-.24	-.37
Treasury bills[4]								
3-month	6.93	9.09	7.63	7.78	7.75	-1.34	.12	-.03
6-month	7.58	9.11	7.34	7.88	7.58	-1.53	.24	-.30
1-year	7.74	9.05	7.10	7.81	7.35	-1.70	.25	-.46
Commercial paper								
1-month	7.94	10.05	8.52	8.92	8.63	-1.42	.11	-.29
3-month	8.65	10.15	8.24	8.84	8.54	-1.61	.30	-.30
Large negotiable CDs[4]								
1-month	7.92	10.07	8.45	8.89	8.60	-1.47	.15	-.29
3-month	8.90	10.32	8.26	8.94	8.58	-1.74	.32	-.36
6-month	9.12	10.08	8.12	8.85	8.41	-1.67	.29	-.44
Eurodollar deposits[5]								
1-month	8.00	10.19	8.44	8.94	8.63	-1.56	.19	-.31
3-month	9.06	10.50	8.31	9.00	8.69	-1.81	.38	-.31
Bank prime rate	9.25	11.50	10.50	10.50	10.50	-1.00	.00	.00
Intermediate- and long-term rates								
U.S. Treasury (constant maturity)								
3-year	9.52	9.88	7.51	8.38	7.92	-1.96	.41	-.46
10-year	10.23	9.53	7.74	8.23	7.90	-1.63	.16	-.33
30-year	10.24	9.31	7.83	8.19	7.88	-1.43	.05	-.31
Municipal revenue[6] (Bond Buyer)	9.59	7.95	7.17	7.59	7.45	-.50	.28	-.14
Corporate A-utility (recently offered)	11.50	10.47	9.45	9.48	9.31	-1.16	-.14	-.17
Home mortgage rates[7]								
S&L fixed-rate	11.58	11.22	9.68	10.16	9.82	-1.40	.14	-.34
S&L ARM, 1-yr.	8.45	9.31	8.60	8.70	8.55	-.76	-.05	-.15

	1987		1989		Percent change from:		
	highs	lows	FOMC Oct.3	Nov.7	1987 highs	1987 lows	FOMC Oct.3
Stock prices							
Dow-Jones Industrial	2722.42	1738.74	2754.56	2597.13	-4.60	49.37	-5.72
NYSE Composite	187.99	125.91	196.84	185.74	-1.20	47.52	-5.64
AMEX Composite	365.01	231.90	393.02	368.51	.96	58.91	-6.24
NASDAQ (OTC)	455.26	291.88	477.28	449.40	-1.29	53.97	-5.84

1. One-day quotes except as noted.
2. Last business day prior to stock market decline on Monday, October 19, 1987.
3. Average for two-week reserve maintenance period closest to date shown except Feb. low which is the average for the statement week ended 2/10/88. Last observation is average to date for maintenance period ending 11/15/89.
4. Secondary market.
5. Bid rates for Eurodollar deposits at 11 a.m. London time.
6. Based on one-day Thursday quotes and futures-market index changes.
7. Quotes for week ending Friday closest to date shown.

Selected Interest Rates*
(percent)



*--Friday weeks through November 3, Wednesday weeks through November 1.

Interest rates generally have declined roughly 1/4 to 1/2 of a percentage point since the October FOMC meeting, while the October 13 plunge in the stock market has left share prices appreciably lower. Accompanying the easing in the federal funds rate from around 9 percent to 8-1/2 percent most recently, most other money market rates have fallen on net by about the same amount. In longer-term markets, rates on higher-quality issues have tended to decline the most, as something of a flight to quality developed in response to the midmonth drop in the stock market and the continued volatility in both equity and junk bond markets.

Major stock price indexes, which reached record highs early in the intermeeting period, have fallen 6 percent since the October 3 meeting, partly in response to reports of weak third-quarter earnings and to diminished prospects for LBOs and other highly leveraged restructurings. Junk bond prices have been similarly affected, with tiering in that market becoming more pronounced.

The shakeout in the thrift industry continued to affect monetary flows in October. Deposit growth at thrifts and commercial banks diverged further, affected by deposit transfers associated with the sale of RTC-controlled thrifts to banks. The thrift industry experienced a net outflow of retail-type deposits last month and continued to pay down wholesale liabilities. Banks, however, saw a pickup in retail deposit flows, and they stepped up their issuance of managed liabilities to fund stronger bank credit. As a result of the more rapid expansion of bank balance sheets in October, M3 growth rebounded to a 5 percent rate. M2 continued to grow at

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

	1988[1]	1989 Q2	1989 Q3	1989 Aug	1989 Sep	1989 Oct pe	Growth Q4 88- Oct 89pe
	--------Percent change at annual rates--------						
1. M1	4.3	-5.6	1.7	0.6	5.9	10	0
2. M2	5.2	1.2	7.3	7.2	7.5	8	4¼
3. M3	6.3	2.9	4.7	2.2	0.8	5	3¾
	--------Percent change at annual rates--------						Levels bil. $ Sep 89
Selected components							
4. M1-A	2.5	-3.3	1.4	-1.9	1.7	9	503.9
5. Currency	8.1	4.1	3.7	2.2	4.9	2	219.3
6. Demand deposits	-1.2	-8.7	-0.3	-5.6	-0.4	15	277.5
7. Other checkable deposits	7.7	-9.8	2.5	5.7	13.1	12	277.6
8. M2 minus M1[2]	5.5	3.5	9.2	9.4	8.1	7	2374.6
9. Overnight RPs and Eurodollars, NSA	-5.7	-23.7	1.1	-40.3	-43.3	13	72.2
10. General purpose and broker/dealer money market mutual fund shares, NSA	7.4	21.0	36.6	47.6	39.1	27	294.8
11. Commercial banks	6.9	5.4	7.1	11.1	7.6	12	1033.7
12. Savings deposits, SA, plus MMDAs, NSA[3]	1.4	-14.9	3.7	14.0	10.2	9	523.2
13. Small time deposits	14.7	29.0	10.6	7.8	5.0	15	510.4
14. Thrift institutions	4.6	-1.1	3.7	3.0	-0.6	-5	971.8
15. Savings deposits, SA, plus MMDAs, NSA[3]	-4.3	-24.6	-6.1	1.4	4.1	4	350.1
16. Small time deposits	11.7	14.0	9.5	4.1	-3.3	-9	621.7
17. M3 minus M2[4]	10.2	9.1	-4.4	-15.6	-23.1	-7	857.3
18. Large time deposits	11.0	14.0	-1.8	-8.2	-12.4	-4	563.2
19. At commercial banks, net[5]	12.2	17.8	1.8	-2.1	-5.1	7	395.3
20. At thrift institutions	8.8	5.8	-9.5	-22.6	-29.3	-29	167.9
21. Institution-only money market mutual fund shares, NSA	-0.8	12.2	34.1	29.3	-17.9	-5	99.1
22. Term RPs, NSA	14.5	2.5	-27.0	-51.8	-32.1	-32	116.5
23. Term Eurodollars, NSA	11.2	-6.7	-14.7	-25.3	-59.0	-48	92.8
	-----Average monthly change in billions of dollars----						
MEMORANDA:[6]							
24. Managed liabilities at commercial banks (25+26)	5.0	9.1	3.4	0.3	5.9	10	696.3
25. Large time deposits, gross	3.3	4.0	-0.2	-1.1	-2.4	2	458.1
26. Nondeposit funds	1.7	5.0	3.6	1.4	8.3	8	238.2
27. Net due to related foreign institutions, SA	-0.4	0.0	0.5	-2.1	0.5	-1	9.8
28. Other[7]	2.1	5.1	3.1	3.4	8.0	9	228.5
29. U.S. government deposits at commercial banks[8]	0.0	2.4	-1.2	0.2	0.9	-4	23.8

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 September and October at rates of 7.9 percent and 4 percent, respectively. At thrift institutions, savings deposits excluding MMDAs grew during September and October at rates of 3.8 percent and 4 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.

pe - preliminary estimate

close to its brisker third-quarter rate, buoyed last month by an acceleration of M1.

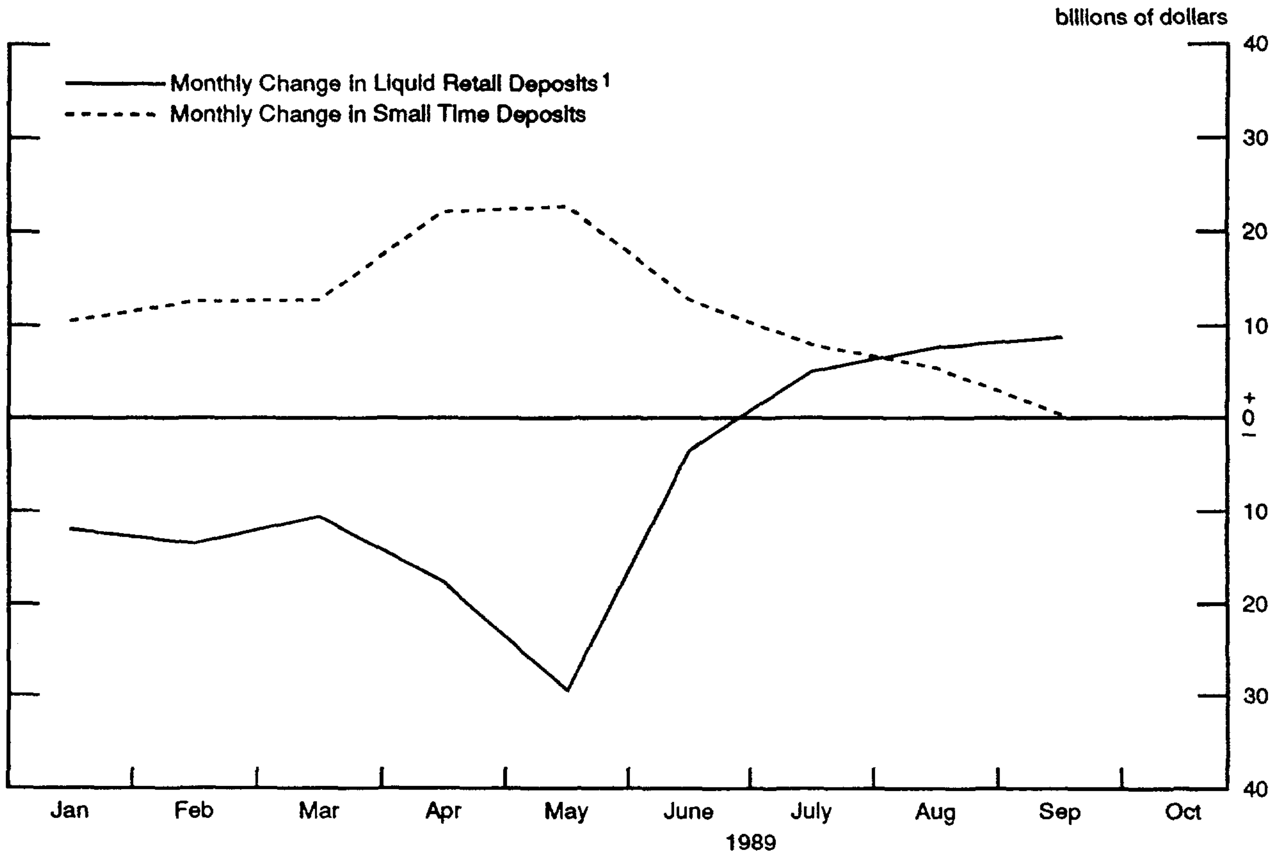
Overall credit demands of the nonfinancial sectors in October appear to have been broadly in line with the firmer pace of recent months. Business borrowing likely firmed; nonfinancial corporations increased their issuance of bonds, including junk bonds. Treasury borrowing rose sharply at the end of the month, reflecting accelerated issuance related to the debt ceiling. On a month-average basis, however, growth of federal government borrowing appears to have ebbed some from its advanced August-September pace. Borrowing by state and local governments moderated last month, while available evidence on household borrowing points to no major change in the growth of mortgages or consumer credit.

Monetary Aggregates and Bank Credit

M2 expanded at an 8 percent rate in October, in line with September's growth, and climbed further toward the midpoint of its annual target range. Growth in this aggregate was fueled by strength in its liquid components, including a sharp rise in M1 growth to a 10 percent rate. In recent months, the composition of M2 has shifted more toward the liquid components in response to a narrowing of the yield differential between small time and liquid retail deposits (chart).

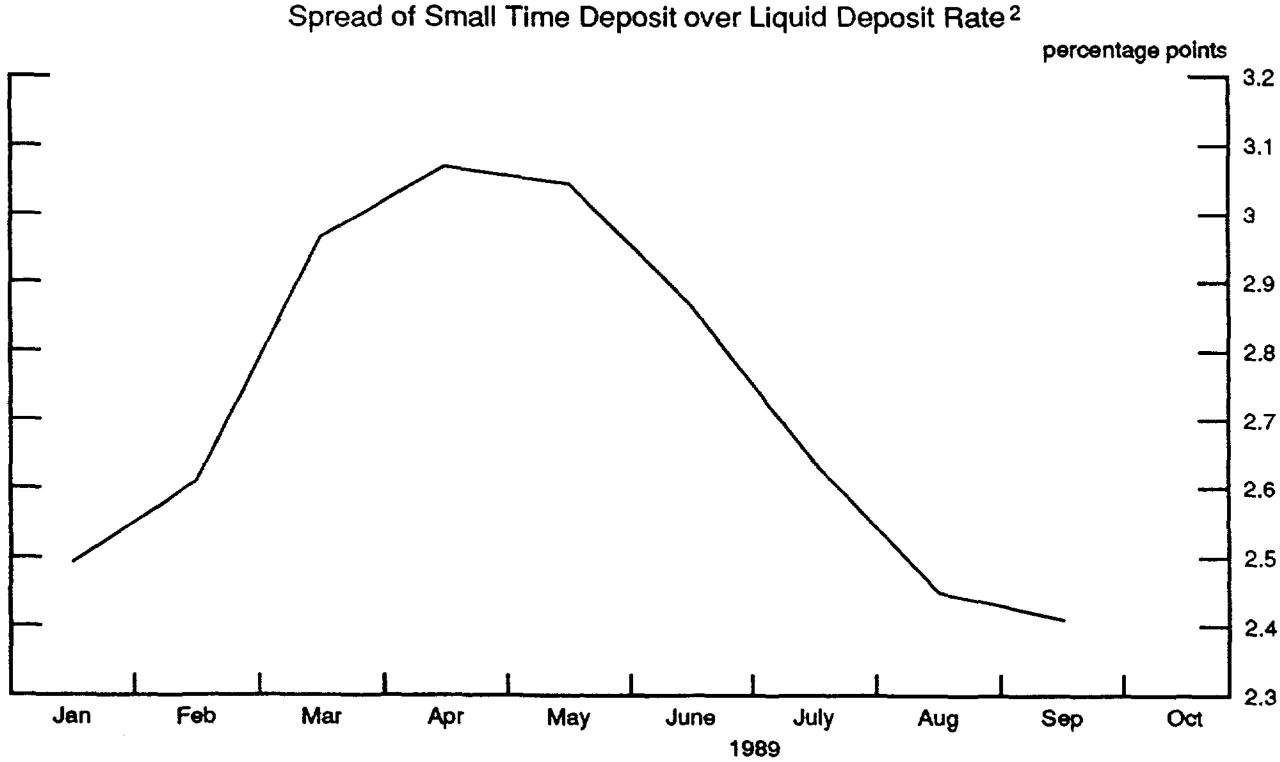
The surge in M1 in October was paced by large inflows to demand deposits at the beginning of the month, which may have reflected higher compensating balance requirements owing to the lower average level of market interest rates in recent months. A similar phenomenon was observed at the beginning of last quarter. The rapid growth of demand deposits last month does not appear to have been related to the October 13 fall in stock prices,

Relative Flows of Liquid and Small Time Deposits



1 Liquid Deposits = OCD + MMDA + Savings.

Spread of Small Time Deposit over Liquid Deposit Rate[2]



2 Six-month retail CD rate minus weighted average rate on liquid retail deposits.

as the data display only a relatively small and brief increase around that date. Inflows to general-purpose and broker-dealer money funds reacted more strongly to the turmoil in the stock and junk bond markets. A midmonth bulge buoyed growth of money funds; nevertheless, the 27 percent rate of expansion of this component represented a deceleration from the pace of previous months which had been boosted sharply by aggressive promotional efforts of a few funds.

Total small time deposits were again little changed in October, but this stability masked a 9 percent rate of decline in such deposits at thrifts, offset by strong inflows at commercial banks. Much of this divergence was caused by the closure of four large thrifts by the RTC in October, and the transfer of their roughly $5 billion in deposits to commercial banks. Thrift deposits also were pulled down by RTC advances, which replaced maturing high-cost brokered funds at intervened institutions. Savings deposits and MMDAs continued to grow at about a 7 percent rate; these flows, too, were skewed toward commercial banks, albeit less markedly than small time deposits.

M3 growth picked up to a 5 percent rate in October, keeping this aggregate just above the lower bound of its target range. The strengthening of M3 mainly reflected stronger issuance at commercial banks of large time deposits used to finance an acceleration of credit. Managed liabilities at thrifts, on the other hand, continued to run off at about the pace of the previous few months as insolvent institutions were sold off by the RTC and thinly capitalized ones likely continued their efforts to pare balance sheets.

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

	1987:Q4 to 1988:Q4	1989 Q2	1989 Q3	1989 Aug.	1989 Sept.	1989 Oct.p	Levels bil.$ Oct.p
	Commercial Bank Credit						
1. Total loans and securities at banks	7.6	5.2	8.0	7.7	6.2	13.3	2571.4
2. Securities	4.8	.7	1.6	1.1	4.7	24.8	573.3
3. U.S. government securities	7.3	5.4	5.4	7.1	7.0	36.4	390.3
4. Other securities	.5	-8.2	-6.2	-11.7	.7	1.3	183.1
5. Total loans	8.5	6.5	9.9	9.6	6.6	10.0	1998.1
6. Business loans	6.8	4.6	8.3	9.9	.4	7.2	640.6
Security loans	-5.7	-21.1	-6.8	-17.8	21.1	17.7	41.2
8. Real estate loans	14.0	11.7	13.7	14.9	12.9	10.0	739.9
9. Consumer loans	8.5	6.1	6.1	7.5	9.1	7.4	374.4
10. Other loans	-.4	1.2	11.6	-1.2	-4.2	21.8	202.0
	Short- and Intermediate-Term Business Credit						
11. Business loans net of bankers acceptances	6.9	4.6	7.9	9.2	-.2	5.7	636.3
12. Loans at foreign branches[2]	30.3	32.8	-83.3	-76.7	-192.8	-74.6	19.6
13. Sum of lines 11 & 12	7.6	5.6	4.1	5.7	-7.5	3.1	655.9
14. Commercial paper issued by nonfinancial firms	15.5	38.2	10.3	-9.7	41.0	-4.7	126.7
15. Sum of lines 13 & 14	8.6	10.5	5.1	3.4	.0	2.0	782.7
16. Bankers acceptances: U.S. trade related[3,4]	-6.8	8.0	.0	3.4	-3.4	n.a.	35.6[5]
17. Line 15 plus bankers acceptances: U.S. trade related	7.8	10.4	4.9	3.2	-.1	n.a.	817.1[5]
18. Finance company loans to business[3]	12.3	14.7	14.1	11.0	18.1	n.a.	256.3[5]
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	8.9	11.4	7.1	5.1	4.3	n.a.	1073.4[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. September data.
p--preliminary.
n.a.--not available

Bank credit growth accelerated to a 13 percent rate in October, primarily stemming from a sharp increase in acquisitions of government securities--particularly federally related mortgage-backed securities--and a pickup in business loans. To a minor extent, the strength in securities may reflect the investment of cash provided by the RTC to the commercial banks that bought intervened thrifts. Bolstered by business lending, total loan growth increased to a 10 percent pace last month. However, merger-related financings, which had been the source of the growth in C&I loans this year, appear to have been curtailed, as banks reportedly have become more cautious about LBO-related lending, as evidenced by the failed UAL Corporation buyout. Consumer loans on banks' balance sheets increased more slowly than in the prior two months, but preliminary data suggest this slowdown may merely represent an increase in loan securitization. Real estate lending by banks edged down in October to a pace slightly below its average for this year, suggesting that, to the extent that banks have been replacing thrifts in the mortgage arena, many did so primarily through the indirect means of mortgage securities last month.

Business Finance

The stronger business loan growth at domestic banking offices in October was partially offset by loan runoffs at foreign offices. Combining these loan totals with weak issuance of commercial paper by nonfinancial firms implies another month of little or no growth in this measure of short- and intermediate-term business credit. Borrowing in long-term credit markets, however, evidently rose significantly, responding to the decline in interest rates. Bond offerings by nonfinancial firms totaled $8 billion,

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

	1987 Year	1988 Year	1989 Q1	Q2	Q3[p]	Aug.[p]	Sept.[p]	Oct.[p]
Corporate securities - total[1]	24.08	22.23	18.87	19.97	15.18	14.70	15.49	23.60
Public offerings in U.S.	21.89	20.21	16.31	17.68	13.75	13.84	13.07	21.80
Stocks--total[2]	4.45	3.53	1.47	1.80	2.55	2.04	2.27	3.80
Nonfinancial	2.32	1.14	.60	.95	1.06	1.02	1.08	1.50
Utility	.57	.24	.16	.29	.35	.28	.73	.35
Industrial	1.75	.90	.44	.66	.71	.74	.35	1.15
Financial	2.12	2.39	.87	.85	1.49	1.02	1.19	2.30
Bonds--total[1]	17.44	16.68	14.84	15.88	11.20	11.80	10.80	18.00
Nonfinancial	6.61	6.08	4.57	7.32	4.91	5.05	4.40	8.00
Utility	2.02	1.77	.62	2.01	1.38	1.45	1.22	2.65
Industrial	4.59	4.31	3.95	5.31	3.53	3.60	3.18	5.35
Financial	10.83	10.60	10.27	8.56	6.29	6.75	6.40	10.00
By quality[3]								
Aaa and Aa	3.25	2.68	3.45	3.14	2.93	3.40	2.85	3.40
A and Baa	5.20	5.57	4.94	6.41	3.98	4.14	3.60	5.95
Less than Baa	2.77	2.51	1.91	3.81	1.90	1.77	1.50	3.10
No rating (or unknown)	.07	.07	.02	.02	.01	.01	.00	.05
Memo items:								
Equity-based bonds[4]	.87	.28	.12	.59	.60	.76	.93	1.20
Mortgage-backed bonds	5.19	4.69	2.94	1.01	1.26	1.50	1.10	.80
Other asset-backed	.96	1.26	1.58	1.49	1.12	.98	1.75	4.70
Variable-rate notes	1.88	1.19	.96	1.82	.25	.27	.20	.85
Bonds sold abroad - total	2.03	1.93	2.55	2.25	1.41	.82	2.00	1.50
Nonfinancial	.94	.69	.89	.48	.38	.01	.85	.30
Financial	1.09	1.24	1.66	1.77	1.03	.81	1.15	1.20
Stocks sold abroad - total	.16	.09	.01	.04	.02	.04	.42	.30
Nonfinancial	.12	.08	.01	.04	.02	.04	.42	.04
Financial	.04	.01	.00	.00	.00	.00	.00	.26

1. Securities issued in the private placement market are not included. Total reflects gross proceeds rather than par value of original discount bonds.
2. Excludes equity issues associated with equity for equity swaps that have occured in restructurings. Such swaps totaled $2.2 billion in 1989 Q1 and $4.2 billion in 1989 Q2.
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.

the largest monthly volume since May when the total was inflated by the RJR financing.

Most major stock price indexes rose to all-time highs on October 9, then, on Friday the 13th, the Dow Jones Industrial Average dropped 190 points, initially reacting to financing problems with the buyout of UAL Corporation. Except for the transportation indexes, most broad market indexes regained about one-third of their Friday losses early the next week, but have since declined in the wake of generally weak third-quarter earnings reports. Stocks perceived to be takeover candidates have suffered significantly larger price declines than the broad market averages since October 12. The market has continued to be plagued by high volatility, much of it related to weak earnings reports and changing market perceptions about the prospects for merger transactions. Nevertheless, gross nonfinancial equity issuance for October was a robust $1.5 billion--the highest level in more than a year--and was well-maintained after the stock market dropped. With the UAL Corporation buyout unlikely to occur this year, net equity retirements are expected to fall in the fourth quarter to around an annual rate of $85 billion, the lowest quarter since 1987.

The prices of shares in property and casualty insurance companies were little affected on balance by recent natural disasters, as insured losses did not seem likely to threaten solvency or liquidity, and market participants anticipated improved prospects for obtaining premium increases. Similarly, the share prices of large California thrift institutions and banks with substantial real estate loan exposure in the Bay area showed little reaction to the October 17 earthquake.

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

	1989					
	Q2	Q3[e]	Q4[p]	Oct.[e]	Nov.[p]	Dec.[p]
Treasury financing						
Total surplus/deficit (-)	22.9	-46.5	-79.2	-28.3	-34.5	-16.4
Means of financing deficit:						
Net cash borrowing from the public	10.1	38.6	58.6	32.1	20.1	6.4
Marketable borrowings/ repayments (-)	5.4	33.4	54.3	28.8	19.0	6.5
Bills	-20.0	9.5	25.8	21.4	6.2	-1.8
Coupons	25.3	23.9	28.5	7.4	12.8	8.3
Nonmarketable	3.3	5.6	4.3	3.3	1.1	-.1
Other borrowing[2]	1.4	-.4	.0	.0	.0	.0
Decrease in the cash balance	-29.1	2.8	24.8	-2.5	25.6	1.7
Memo: Cash balance at end of period	43.7	41.0	16.2	43.5	17.9	16.2
Other[3]	-3.9	5.2	-4.2	-1.3	-11.2	8.3
Federally sponsored credit agencies, net cash borrowing[4]	9.4	1.6	--	--	--	--
FHLBs	3.9	-10.3	--	--	--	--
FHLMC	1.9	1.5	--	--	--	--
FNMA	1.6	5.2	--	--	--	--
Farm Credit Banks	0.3	1.7	--	--	--	--
FAC	0.2	.0	--	--	--	--
SLMA	0.5	2.9	--	--	--	--
FICO	1.1	0.7	--	--	--	--
REFCORP	--	--	4.5	4.5	.0	.0

1. Data reported on a not seasonally adjusted, payment basis.
2. Securities issued by federal agencies under special financing authorities (primarily FSLIC).
3. Includes checks issued less checks paid, accrued items and other transactions.
4. Excludes mortgage pass-through securities issued by FNMA and FHLMC.
p--projected.
e--staff estimate.
Note: Details may not add to totals due to rounding.

The mid-October selloff in the stock market triggered some of the circuit breakers put in place after the October 1987 crash: Standard and Poor's index futures hit two price limits, and the NYSE invoked a procedure that separates program trades in the order flow. Few problems were encountered in the clearing and settlement areas, although two small option-trading firms required regulatory intervention. Subsequently, attention has focused on continuing volatility and proposals to curtail program trading.

Deterioration in the high-yield bond market has continued, as the spread between junk bonds and 10-year Treasury securities has widened about 65 basis points further since late September. Higher-grade junk bonds have continued to outperform the rest of the junk bond market. Reportedly, the acceleration of the already heavy redemptions from junk bond mutual funds since October 13 has been accommodated to date by liquid asset cushions and without significant liquidation of junk bonds by the funds. High-yield bond issuance by nonfinancial companies since the stock market selloff has remained heavy, mostly in better quality issues, bringing the total for October to $3.1 billion--the highest since May.

Treasury and Sponsored Agency Financing

Treasury financing was disrupted by a drop in the debt ceiling on November 1. In anticipation of the decline in the ceiling, the Treasury accelerated the settlement of weekly bill auctions that otherwise would have been issued in the first week of November, and it auctioned a small cash management bill. The Treasury announced a $30 billion midquarter refunding and a $10 billion cash management bill to settle on November 15, contingent on debt ceiling legislation. On November 6, the Treasury postponed its weekly bill auctions, but when the debt ceiling was increased to $3.12

trillion on November 8--one day before the government would have run out of cash--the Treasury announced its intentions to complete the auctions on a compressed schedule.

The staff anticipates a fourth-quarter federal deficit of more than $79 billion, which will be financed by $59 billion of borrowing from the public and by drawing down the Treasury's cash balance. The increase in borrowing relative to last quarter is again expected to take place primarily in the bill sector. Since the beginning of the third quarter, the gross size of weekly bill auctions has been increased in steps from $13.2 billion to the current level of $16.0 billion. These increases were prompted by the thrift bailout, as well as by the usual seasonal swing in financing needs, which typically is accommodated largely by a stepup in bill issuance. Still another factor behind the increases in gross auction sizes is the sharp drop in add-ons so far this year. Add-ons--representing additional issuance outside of the auction process, primarily to foreign central banks, have dwindled. The gross size of Treasury coupon auctions also is expected to be boosted--likely by $250 million to $500 million--during the fourth quarter.

The total debt of the government sponsored enterprises (GSEs) increased relatively little in the third quarter, though changes in the distribution reflected turmoil in the thrift sector. The dramatic falloff in Federal Home Loan Bank (FHLB) advances to thrifts led to a corresponding paydown of more than $10 billion in FHLB debt during the period. By contrast, Fannie Mae raised more than $5 billion of new cash in the debt market, which was primarily used to finance a $4 billion increase in its portfolio of mortgage assets.

In the fourth quarter, the most notable event in the GSE market has been the initial issue by the Resolution Funding Corporation. REFCORP, which was created by FIRREA to help finance the liquidation of insolvent thrifts, auctioned $4.5 billion of 30-year bonds on October 25. The auction average rate was 8.15 percent, 28 basis points above the yield on the comparable Treasury issue and, roughly in line with expectations. The yield spread was roughly half that on FICO bonds sold in September, largely reflecting the stronger federal protection attached to REFCORP bonds. REFCORP is expected to come to market with similar issues on a quarterly basis until it exhausts its $30 billion borrowing authority.

In a related market, the Tennessee Valley Authority priced $4 billion of so-called Power Bonds on October 17. This public offering marks a significant departure of the funding of wholly owned federal agencies from the pattern followed since the establishment of the Federal Financing Bank (FFB) in 1973. Prior to the formation of the FFB, all agencies borrowed on their own in the market, resulting in a crowded calendar and some confusion as to whose debt carried the full faith and credit backing of the U.S. government and whose did not. The FFB provided attractive financing for the wholly owned agencies by charging them a spread of only 12.5 basis points over similar Treasury securities. These new TVA bonds do not carry the full faith and credit of the Treasury, but the short-term maturities were priced at spreads similar to those on FHLB issues, about 45 basis points over Treasuries. TVA undertook this borrowing to pay off debt to the FFB incurred at the much higher interest rates prevailing in the early 1980s.

Municipal Securities

Gross issuance of long-term municipal securities slowed to $8 billion in October. Both new capital and refunding volume fell, as interest rates on tax-exempt obligations remained above those at the end of the summer. Since May, the overall decline in rates on municipal bonds has fallen short of that on high-grade corporate and Treasury bonds. As a result, the ratio of the municipal bond yield to the 30-year Treasury yield has risen from a low of 0.84 in May to its current level of 0.95. In part, the increase may reflect reduced demands for tax-exempt securities by money center banks, whose appetite for tax-exempt income probably has diminished as another round of sizable LDC-related loss provisions has greatly reduced expected future tax liabilities.

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

	1988 Year	1988 Q4	1989 Q1	1989 Q2	1989 Q3	1989 Aug.	1989 Sept.	1989 Oct.[p]
Total offerings[1]	11.74	12.35	9.20	13.14	12.78	14.19	12.26	9.48
Total tax-exempt	11.41	11.94	8.92	12.95	12.58	13.92	12.18	9.31
Long-term	9.54	10.68	7.77	9.56	9.80	8.71	10.82	8.23
Refundings[2]	2.90	3.14	2.49	2.20	2.83	3.05	3.35	1.71
New capital	6.64	7.54	5.28	7.36	6.97	5.66	7.47	6.52
Short-term[3]	1.87	1.26	1.15	3.39	2.78	5.21	1.36	1.08
Total taxable	.33	.41	.28	.19	.20	.27	.08	.17
Memo item:								
Bank-qualified[4]	.58	.40	.42	.54	.35	.41	.30	.43

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.
4. Bank-qualified bonds are the only tax-exempt bonds that banks can purchase and still deduct 80 percent of the carrying costs. Bonds are bank-qualified if issued by local governments that do not expect to issue more than $10 million of municipal bonds during the year.

Prices of northern California issues fell slightly after the earthquake, but recovered after rating agencies indicated that they do not anticipate significant credit deterioration on these issues. Yields on New York City bonds, however, recently have risen about 65 basis points amid concerns over the city's revenue shortfall.

Mortgage Markets

Since the last FOMC meeting, yields on conventional fixed-rate mortgages (FRMs) have declined 30 to 40 basis points, roughly in line with comparable Treasury securities. Initial rates on adjustable-rate mortgages (ARMs) indexed to the one-year constant maturity Treasury yield, meanwhile, have declined just 15 basis points, further narrowing the initial rate advantage of ARMs. This narrow spread and the general decline in fixed-rate mortgages have been reflected in a large FRM share of conventional home mortgage closings, as many homebuyers have opted for FRMs and a sizable volume of ARMs have been refinanced into FRMs. According to the OTS monthly survey of major institutional lenders, which does not include refinancing, roughly 75 percent of all conventional home loans closed in recent months have carried fixed rates, the largest share since the spring of 1987.

Data on loan pricing suggest that lenders have continued to offer ARMs at discounted initial rates; nonetheless, the overall prevalence of discounted loans has declined from levels seen earlier in the year. In the most recent OTS survey, 55 percent of ARMs closed in early September carried teaser rates, with an average discount in excess of 200 basis points (table). However, in some cases, the initial advantage is offset by higher margins after the discount expires. Unless ARM lenders become more

ARM DISCOUNTS
(September 1989)

Size of discount (basis points)	Average initial rate (percent)	Average base rate (percent)[1]	Percent of total
0	9.87	9.85	45
100 or fewer	10.01	10.67	5
101 - 200	9.41	11.07	15
201 - 300	8.73	11.17	32
301 or more	8.09	11.42	4
All discounted loans	8.97	11.12	55

1. The base rate represents the rate to which the loan will adjust following the discount period. If an index-plus-margin formula determines the adjusted rate, the base rate uses the current value of the index.

Source: OTS survey of conventional home mortgages closed during the first five working days of the month.

AVERAGE ARM INDEX VALUES AND INITIAL RATE SPREADS
(Percent)

Period (1)	Initial ARM rate[1] (2)	One-year Treasury (3)	FHLB 11th District cost of funds (4)	ARM spreads: Treasury (2)-(3)	ARM spreads: 11th District (2)-(4)
1985	10.04	8.43	9.52	1.62	.52
1986	8.42	6.46	8.24	1.96	.19
1987	7.82	6.76	7.38	1.06	.45
1988	7.91	7.65	7.69	.26	.22
1988-Q1	7.66	6.78	7.59	.88	.07
Q2	7.71	7.30	7.55	.41	.17
Q3	8.00	8.00	7.70	0	.30
Q4	8.22	8.53	7.92	-.31	.30
1989-Q1	8.76	9.29	8.30	-.53	.46
Q2	9.24	8.93	8.79	.31	.45
Q3 p	8.70	8.10	8.80	.60	-.11
1989-Jan.	8.55	9.05	8.13	-.50	.42
Feb.	8.65	9.25	8.35	-.61	.30
Mar.	9.09	9.57	8.42	-.48	.67
Apr.	9.40	9.36	8.65	.03	.75
May	9.30	8.98	8.80	.32	.50
June	9.03	8.44	8.92	.59	.11
July	8.74	7.89	8.84	.84	-.11
Aug. r	8.65	8.18	8.76	.47	-.11
Sept. p	8.71	8.22	8.81	.49	-.10

1. Initial rate on ARMs indexed to the one-year constant-maturity Treasury yield.

r--revised p--preliminary

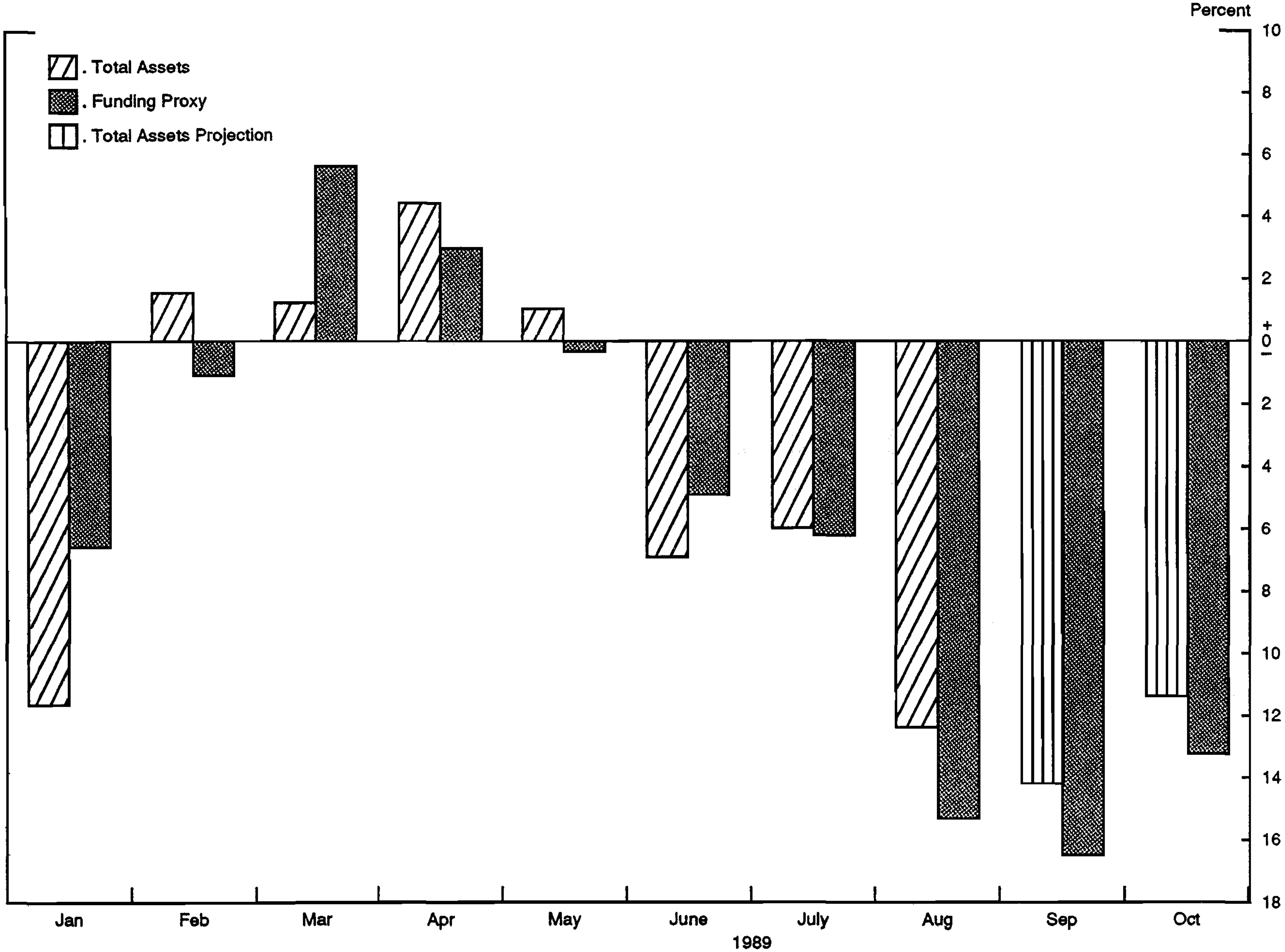
aggressive in pricing loans or unless interest rates rise, borrower preferences for FRMs are likely to be sustained over the near-term.

With the ARM share of gross loan originations low and thrifts attempting to trim asset growth to meet capital requirements, thrift mortgage lending activity has been subdued. This summer marked the first time in the 19-year history of HUD's quarterly survey that thrifts failed to account for the largest share of new mortgage loan originations, being surpassed by commercial banks. Data for August point to a modest pickup in thrift mortgage origination activity; mortgage originations at SAIF-insured institutions increased for the first time since early spring, while new commitments to originate loans increased for a second month.

Thrifts, however, have continued to pace their holding of mortgage assets as part of their efforts to shrink their balance sheets to satisfy impending capital requirements. Thrift mortgage asset holdings declined $12.2 billion in August, including a record $9.8 billion drop in holdings of mortgage pass-through securities, and assets likely continued to run off in September and October. Thrift asset flows in recent months have tracked a funding proxy, comprising the combined flow of total deposits, FHLB advances, and repurchase agreements (chart). In September, this funding proxy declined at a 16.5 percent annual rate, consistent with perhaps a $15 billion reduction in total thrift assets, and preliminary data for October suggest a continued, just slightly smaller, contraction in assets.

With FRMs accounting for three-quarters of all conventional mortgage originations in recent months, issuance of federally related pass-through securities has accelerated and is now running well ahead of the pace earlier in the year. There was heavy packaging of these assets into CMOs

SAIF-Insured Institutions
Total Assets and Funding Proxy
(percentage changes, annual rate)



Note: Funding Proxy is defined as total deposits, advances, and repurchase agreements (RPs). The value for the growth of the funding proxy in September and October is based on weekly data from a sample of SAIF-insured institutions. The value for the growth of total a[illegible]s in September and October is a projection based on correlation between the two series since January [illegible] Values for prior months are based on data for all SAIF-insured institutions.

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

	Mortgage transactions			Net change in mortgage assets[1]		
	Origina-tions	Commit-ments	Sales	Total	Mortgage loans	Mortgage-backed securities
1987 r	21.1	20.0	10.5	6.0	2.4	3.6
1988	19.9	19.4	8.8	4.8	3.8	1.0
1988-Q3 r	21.4	20.9	8.5	6.4	5.8	.6
Q4 r	19.8	19.9	9.5	3.7	2.6	1.1
1989-Q1 r	20.5	19.3	8.1	4.3	2.6	1.7
Q2	14.7	13.0	7.2	-1.1	1.5	-2.6
1989-Jan. r	21.5	19.6	7.0	.8	2.6	-1.8
Feb. r	19.7	19.7	8.6	5.8	2.1	3.7
Mar. r	20.5	18.6	8.7	6.4	3.0	3.4
Apr. r	16.1	13.9	7.0	3.1	4.3	-1.3
May r	15.1	12.7	7.1	-.4	.5	-.8
June r	12.9	12.3	7.4	-6.2	-.3	-5.8
July r	12.4	12.6	8.0	-6.6	-.8	-5.8
Aug. p	15.2	16.1	10.9	-12.2	-2.4	-9.8

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

MORTGAGE-BACKED SECURITY ISSUANCE
(Monthly averages, billions of dollars, NSA unless noted)

	Federally related pass-through securities			Multiclass securities				
	Total (SA)	Total	ARM-backed	Total	Private issues[1]	FNMA REMICs[2]	FHLMC REMICs	Agency strips
1987	20.1	19.6	1.2	5.9	5.0	.1	.0	.8
1988	12.4	12.6	2.4	7.1	4.2	.9	1.2	.6
1988-Q3 r	13.2	14.9	3.0	6.1	3.7	.7	1.1	.6
Q4	14.8	14.5	2.6	8.0	4.3	1.2	1.8	.7
1989-Q1 r	15.8	13.7	3.1	6.9	2.5	1.2	2.8	.4
Q2 r	13.5	13.8	2.8	5.2	.6	2.4	2.1	.1
Q3 p	15.9	17.8	2.5	9.5	1.0	3.6	4.4	.5
1989-Jan. r	14.6	12.1	.9	6.6	2.2	.9	3.5	.0
Feb. r	16.0	13.7	3.5	4.7	1.7	1.3	1.5	.2
Mar. r	16.8	15.4	4.8	9.4	3.6	1.5	3.4	.9
Apr. r	14.5	13.9	3.0	4.5	.4	2.4	1.5	.2
May	13.0	12.4	2.2	4.1	.2	1.4	2.4	.0
June r	13.0	15.0	3.2	7.1	1.1	3.5	2.5	.0
July r	13.5	15.5	2.9	10.3	1.0	4.9	3.3	1.1
Aug. r	16.0	17.2	2.3	9.6	1.4	3.3	4.6	.3
Sept.p	18.3	20.7	2.2	8.7	.6	2.7	5.2	.2

1. Excludes pass-through securities with senior/subordinated structures.
2. FNMA's first REMIC, a $500 million strip security issued in January 1987, is included in the FNMA REMIC category rather than in the strip category.
r--revised p--preliminary

CONSUMER CREDIT
(Seasonally adjusted)

	Percent change (at annual rate)						Net change (billions of dollars)		Memo: Outstandings (billions of dollars)
			1989		1989		1989		1989
	1987	1988	H1[1]	Q3[p]	Aug.[r]	Sept.[p]	Aug.[r]	Sept.[p]	Sept.[p]
Total installment[2]	6.2	8.5	7.2	1.6	4.6	1.0	2.66	.61	703.6
Installment, excluding auto	5.2	10.7	9.2	5.1	7.7	4.2	2.65	1.45	415.9
Selected types									
Auto	7.5	5.7	4.5	-3.5	0	-3.5	.01	-.84	287.7
Revolving	12.3	13.6	15.8	11.7	21.2	4.7	3.37	.76	195.2
All other	.1	8.3	3.8	-.5	-3.9	3.8	-.72	.69	220.8
Selected holders									
Commercial banks	7.6	12.7	5.9	3.7	9.3	4.7	2.51	1.26	327.4
Finance companies	4.7	3.5	9.3	-5.1	-9.1	-1.6	-1.10	-.20	144.2
Credit unions	5.1	7.5	9.2	-.2	2.2	.3	.16	.02	90.0
Savings institutions[3]	6.6	3.8	-7.0	-6.8	-17.2	-6.7	-.86	-.33	58.9
Asset pools (NSA)	n.a.	n.a.	40.2	26.3	-57.8	-9.5	1.71	-.30	37.0
Memorandum:									
Total[4]	4.9	7.3	6.7	2.0	4.6	2.9	2.90	1.85	768.5

1. Growth rates are adjusted for discontinuity in data between December 1988 and January 1989.
2. Includes items not shown separately.
3. Savings and loans, mutual savings banks, and federal savings banks.
4. Installment plus noninstallment.
r--revised. p--preliminary.
Note: Details may not add to totals due to rounding.

CONSUMER INTEREST RATES
(Annual percentage rate)

			1988		1989			
	1987	1988	Aug.	Nov.	May	July	Aug.	Sept.
At commercial banks[1]								
New cars (48 mo.)	10.46	10.86	10.93	11.22	12.44	...	12.13	...
Personal (24 mo.)	14.23	14.68	14.81	15.06	15.65	...	15.45	...
Credit cards	17.92	17.79	17.79	17.77	18.11	...	18.07	...
At auto finance cos.[2]								
New cars	10.73	12.60	12.64	13.20	11.80	11.94	12.22	12.42
Used cars	14.61	15.11	15.16	15.75	16.45	16.37	16.31	16.22

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.

and other REMIC securities in the third quarter, and trade reports indicate that large issuance of CMOs continued through October, as FNMA and FHLMC repackaged more than $8 billion of their own guaranteed pass-throughs into derivative securities last month. Notable among recent offerings is a $201 million FNMA REMIC security underwritten by Nomura Securities and marketed directly to Japanese investors, which reportedly went well. Spreads on mortgage-backed securities, measured by the GNMA current coupon yield, relative to 10-year Treasuries, have narrowed by about 10 basis points since the October FOMC meeting, despite reports of continued heavy mortgage asset liquidations by thrifts.

Consumer Credit

Consumer installment credit outstanding edged up at a 1 percent annual rate in September after expanding at a 5 percent rate in August. Consumer credit growth, which has been volatile from month to month, has been slowing, on balance, for much of this year. In the first half, credit growth generally tracked movements in consumer spending. In the third quarter, however, credit expansion fell short of growth in spending--particularly for automobiles. Auto credit outstanding declined 3-1/2 percent (annual rate) during the quarter. In part, the apparent weakness in auto credit may be the result of problems with seasonal adjustment arising from the 1985 and 1986 interest rate incentive programs which sharply boosted sales and credit in August and September in those years, causing seasonal adjustment factors to anticipate a similar advance this year. Also, some buyers may be paying for new autos by drawing on home equity lines (classified as mortgage credit) as was evidenced in two surveys of consumers taken last year, while trade reports suggest that some others may

PUBLIC ASSET-BACKED CONSUMER LOAN SECURITIZATIONS:
ORIGINAL ISSUES
(Number and $ millions)

		Total		Auto		Credit card		Other	
		#	$	#	$	#	$	#	$
1986:	Q1	1	424	1	424	0	0	0	0
	Q2	2	945	2	945	0	0	0	0
	Q3	7	1,794	7	1,794	0	0	0	0
	Q4	10	5,604	10	5,604	0	0	0	0
	Year	20	8,767	20	8,767	0	0	0	0
1987:	Q1	2	564	1	164	1	400	0	0
	Q2	10	2,670	8	2,270	2	400	0	0
	Q3	8	1,867	7	1,757	1	110	0	0
	Q4	15	4,102	9	2,186	2	1,300	4	616
	Year	35	9,203	25	6,377	6	2,210	4	616
1988:	Q1	2	257	0	0	1	150	1	107
	Q2	13	3,674	6	793	5	2,375	2	506
	Q3	13	4,137	6	1,299	4	2,245	3	593
	Q4	25	4,233	11	1,852	6	1,750	8	631
	Year	53	12,301	23	3,944	16	6,520	14	1,837
1989:	Q1	10	4,784	3	531	4	3,225	3	1,028
	Q2	10	2,971	2	175	6	2,595	2	201
	Q3	13	3,059	5	740	5	1,997	3	322
	9 months	33	10,814	10	1,446	15	7,817	8	1,551
Grand totals		141	41,085	78	20,534	37	16,547	26	4,004

be leasing instead of buying autos. Leasing results in a sale by the dealer with no corresponding increase in consumer credit. Both alternatives to the standard auto loan have become more attractive in recent years because of the gradual elimination of tax deductibility for personal interest expenses.

Activity in the consumer asset-backed securities market continued strong in the third quarter, with public placement of 13 issues totalling $3.1 billion; another seven private placements were announced totalling $2.3 billion. Volume was dominated in the third quarter, as it has been all year, by sales of credit card receivables. For the first three quarters, credit cards have accounted for a total of $7.8 billion in securitizations, with Citicorp and Sears responsible for the bulk of the activity. The third quarter also saw a slight pickup in securities backed by auto loans as several issues by banks totaled about $750 million. The captive auto finance companies were absent from the public market during the first three quarters of this year; however, Ford Motor Credit offered $3.05 billion of auto-backed securities in October, its first such issue. In total, through the first three quarters of 1989, there were 33 public issues amounting to $10.8 billion--compared with 28 issues amounting to $8.1 billion over the same period in 1988.

Securitization activity is usually quite heavy in the fourth quarter of the year as lenders attempt to clean up their books. This year the usual year-end incentives will be augmented by the move to tougher capital standards for banks and savings institutions. Consumer loans will be in the 100 percent category for risk-based capital purposes, compared with mortgage loans in the 50 percent category; thus, there is more incentive to remove consumer loans from the books. Based on recent experience, S&Ls may find it more profitable to sell off whole credit card portfolios than to securitize them; there were very sizable sales by such institutions in both June and September.

U.S. Merchandise Trade

The deficit on U.S. merchandise trade worsened in August to $10.8 billion (on a seasonally adjusted, Census basis, customs valuation), from an upwardly revised $8.2 billion deficit in July. The August trade balance was the largest monthly deficit recorded so far this year. A surge in the value of non-oil imports was largely responsible for the deterioration in August, as total exports and oil imports were about unchanged from July. Declines in the average price of non-oil imports following the appreciation of the dollar over much of this year appear to have stimulated the demand for these imports.

U.S. MERCHANDISE TRADE: MONTHLY DATA
(Billions of dollars, seasonally adjusted, Census customs basis)

	Exports			Imports			
	Total	Ag.	Nonag.	Total	Oil (nsa)	Non-oil	Balance
1988-May	27.4	3.2	24.3	36.1	3.6	32.5	-8.7
Jun	26.7	2.8	23.9	37.3	3.3	34.0	-10.6
Jul	26.6	3.1	23.5	35.1	3.1	31.9	-8.5
Aug	27.5	3.3	24.2	37.6	3.4	34.2	-10.1
Sep	27.6	3.4	24.2	36.8	3.0	33.7	-9.2
Oct	27.9	3.1	24.8	37.1	2.9	34.2	-9.2
Nov	27.6	3.2	24.3	38.1	2.9	35.2	-10.5
Dec	28.9	3.3	25.6	39.7	3.3	36.4	-10.8
1989-Jan	29.0	3.2	25.7	37.9	3.5	34.4	-8.9
Feb	28.8	3.4	25.4	38.2	3.2	35.0	-9.4
Mar	30.1	3.9	26.2	39.5	3.7	35.9	-9.5
Apr	30.8	3.7	27.1	39.0	4.0	35.0	-8.3
May	30.5	3.5	27.0	40.5	4.7	35.8	-10.1
Jun	31.3	3.3	28.0	39.3	4.2	35.1	-8.0
Jul[r]	30.5	3.4	27.1	38.7	4.3	34.4	-8.2
Aug[p]	30.4	3.2	27.2	41.2	4.3	36.9	-10.8

r--revised p--preliminary

U.S. MERCHANDISE TRADE: QUARTERLY DATA
(Billions of dollars, seasonally adjusted annual rates)

	Exports			Imports			
	Total	Ag.	Nonag.	Total	Oil	Non-oil	Balance
	- - - - - - - BOP basis (current dollars) - - - - - - -						
1988	319	38	281	447	39	407	-127
1988-1	306	36	270	440	40	399	-134
-2	314	38	276	440	41	399	-126
-3	322	40	283	444	39	405	-121
-4	335	39	296	463	37	426	-128
1989-1	352	43	309	465	43	422	-114
2	364	43	321	474	54	421	-111
Jul-Aug	361	39	322	485	54	431	-124
	- - - - - BOP basis (constant 1982 dollars)[1] - - - -						
1988-1	337	39	297	461	83	377	-124
-2	338	39	300	457	85	372	-119
-3	339	36	303	463	86	377	-124
-4	352	36	316	477	90	388	-125
1989-1	365	40	325	473	88	385	-108
2	378	40	338	482	92	390	-104
Jul-Aug	386	38	346	507	100	408	-121
Percent Change:							
J-A/88-Q3	13.9	5.6	14.2	9.5	16.3	8.2	
J-A/89-Q2 (not AR)	2.1	-5.0	2.4	5.2	9.9	4.6	
	- - - - - - GNP basis (constant 1982 dollars) - - - - -						
1988-1	336	40	296	460	83	377	-124
-2	339	39	300	457	85	372	-118
-3	344	36	308	468	86	382	-124
-4	359	36	322	483	90	393	-125
1989-1	373	40	332	477	88	390	-105
-2	387	41	346	488	92	396	-101
-3	391	37	354	510	99	410	-119
Percent Change:							
89-Q3/88-Q3	13.7	3.3	14.9	8.8	14.9	7.4	
89-Q3/88-Q2 (not AR)	1.0	-8.1	2.2	4.5	8.4	3.6	

1. Constant dollar estimates are derived using deflators from the GNP accounts.

On a seasonally adjusted balance-of-payments basis, the value of exports declined only slightly between the second quarter and the July-August average. This decline can be traced largely to a drop-off in agricultural shipments, particularly wheat and corn to the Soviet Union, from the high levels registered during the first half of this year.

Nonagricultural exports rose slightly in July-August as a decline in shipments of automotive products to Canada was more than offset by increased deliveries of civilian aircraft. Exports of aircraft during the fourth quarter are expected to be substantially lower than shipments in July-August, owing to the strike at Boeing. Declines in the price of exports (discussed below) and continued strong growth abroad stimulated the quantity of nonagricultural exports, which rose by over 2 percent between the second quarter and July-August.

The value of imports increased more than 2 percent in July-August from their level in the second quarter, due to a surge in imports of non-oil products. The July-August increase was primarily in consumer goods and machinery, with smaller increases in other categories. Demand for consumer goods was relatively robust in the third quarter. All of the growth of non-oil imports was in quantity terms, as prices declined on average over this period.

The quantity of imported oil rose substantially further in August, marking the highest monthly rate since February of 1980. The bulk of these imports was crude petroleum, rather than petroleum products. Most of the increase in imports went into domestic stocks, as consumption remained about unchanged. Weekly data suggest that the quantity of oil imports declined only slightly in September and October despite higher prices in both spot and posted markets.

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

	1988			1989			
	Year	Q3	Q4	Q1	Q2	July	August
Value (Bil. $)	39.31	39.10	36.87	43.40	53.71	53.47	53.56
Price ($/BBL)	14.39	14.24	12.85	15.54	18.46	17.43	16.46
Quantity (mbd.)	7.49	7.51	7.84	7.65	7.97	8.41	8.91

Import and Export Prices

As reported by the BLS, the average price of U.S. imports declined more than 5 percent at an annual rate in the third quarter, reflecting declines in the prices of both oil and non-oil products. Oil prices dropped almost 30 percent at an annual rate, reversing some of the increase recorded in the first half of this year. The average price of non-oil imports declined for the second consecutive quarter, owing partly to the effects of the appreciation of the dollar this year. Large declines were registered for the prices of imported foods and industrial materials in the third quarter, while prices of other categories of imports were essentially unchanged.

Export prices also declined on average in the third quarter, by almost 3 percent at an annual rate. The decline was largely attributable to falling agricultural prices. Prices of nonagricultural exports declined only slightly on average, as a drop in the prices of industrial materials outweighed modest increases in other categories. Export prices of most industrial materials have fallen steadily since early this year. The declines have been in excess of declines in

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

	4-Quarters 1989-Q3 / 1988-Q3	Quarters 1989 Q1	Q2	Q3	Months 1989 Aug.	Sept.
		(annual rates)			(monthly rates)	
	- - - - - - - - - BLS Prices - - - - - - - - -					
Imports, Total	2.5	7.3	0.3	-5.2	-0.5	0.2
Foods, Feeds, Bev.	-5.0	-1.4	-7.2	-15.5	-2.1	-1.2
Industrial Supplies	5.3	25.8	8.9	-14.4	-1.9	0.1
Ind Supp Ex Oil	0.4	5.0	-5.4	-7.5	-0.8*	-0.6*
Capital Goods	1.4	0.3	-4.2	-0.6	0.9	-0.6
Automotive Products	1.7	-0.3	-2.8	0.0	-0.5	1.2
Consumer Goods	3.5	4.1	1.2	0.9	0.5	0.1
Memo:						
Oil	18.6	104.4	47.8	-28.2	-4.2	0.0
Non-oil	1.4	2.2	-3.1	-2.8	-0.1	0.2
Exports, Total	0.4	6.2	-0.4	-2.8	-0.8	0.4
Foods, Feeds, Bev.	-11.4	12.1	-11.4	-21.6	-4.5	-0.4
Industrial Supplies	0.7	7.3	0.7	-4.6	-1.0	1.1
Capital Goods	3.1	3.8	2.7	3.0	0.2	0.2
Automotive Products	2.7	1.5	1.9	3.0	0.1	0.6
Consumer Goods	4.6	8.8	1.0	2.8	0.5	0.0
Memo:						
Agricultural	-7.8	13.6	-5.3	-15.8	-3.8	-0.7
Nonagricultural	2.0	4.7	0.7	-0.4	-0.3	0.6
	- - - - - - - Prices in the GNP Accounts - - - -					
Fixed-Weighted						
Imports, Total	3.2	11.3	8.0	-8.2	--	--
Oil	19.2	114.9	99.4	-28.9	--	--
Non-oil	1.2	2.6	-1.3	-4.5	--	--
Exports, Total	-0.7	-0.8	2.7	-4.8	--	--
Ag.	-5.5	-2.9	-3.1	-10.4	--	--
Nonag.	0.4	-0.3	3.9	-3.6	--	--
Deflators						
Imports, Total	-0.3	6.0	0.2	-11.4	--	--
Oil	19.0	113.1	100.2	-29.2	--	--
Non-oil	-1.6	-1.5	-6.4	-7.5	--	--
Exports, Total	-1.2	5.2	-0.5	-8.3	--	--
Ag.	-5.5	-2.9	-3.1	-10.4	--	--
Nonag.	-0.4	5.6	-0.0	-7.6	--	--

*Not for publication.

comparable domestic prices, possibly in response to the appreciation of the dollar. On the other hand, prices of capital goods appear to have been less sensitive to movements in dollar exchange rates. Since the beginning of the year, prices of exports of capital goods have risen fairly steadily and have moved in tandem with their counterparts in the Producer Price Index, suggesting that producers of capital goods allow the foreign-currency prices of their products to vary along with the dollar.

Beginning with the second quarter, the BEA uses primarily the price information provided by BLS in formulating estimates for export and import prices in the GNP accounts. Unit value indexes, previously used to measure the prices of industrial materials and foods, are no longer available.

U.S. International Financial Transactions

In August U.S. net capital inflows for which data are available totaled over $31 billion (lines 1 through 5 of the Summary of U.S. International Transactions table) -- roughly three times the U.S. trade deficit in that month. These monthly data, and the implied statistical discrepancy, tend to be volatile. Combining the August figure with the recorded $1 billion inflow in July yields a figure much more in line with the likely magnitude of the current account deficit plus net direct investment inflows.

Recorded private foreign net purchases of U.S. Treasury securities totaled $11-3/4 billion in August (line 3). This was more than accounted for by net purchases of bonds and notes. These large net purchases coincided with the Treasury's mid-quarter refunding and

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

	1987 Year	1988 Year	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2	1989 June	1989 July	1989 Aug.
Private Capital										
Banks										
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	47.5	21.3	15.3	-0.4	9.6	-1.4	0.3	-0.9	-1.5	9.1
Securities										
2. Private securities transactions, net[1]	36.4	15.5	10.9	5.8	3.4	5.8	3.7	1.3	2.3	2.0
a) foreign net purchases (+) of U.S. corporate bonds[2]	26.4	26.9	8.9	6.4	9.0	8.8	6.2	2.2	2.7	1.6
b) foreign net purchases (+) of U.S. corporate stocks	16.8	0.4	1.1	1.3	-2.0	0.1	3.7	2.7	1.7	0.9
c) U.S. net purchases (-) of foreign securities	-6.9	-11.8	1.0	-1.9	-3.5	-3.0	-6.2	-3.6	-2.2	-0.5
3. Foreign net purchases (+) of U.S. Treasury obligations	-7.3	20.6	5.6	3.5	5.5	8.7	2.4	-4.9	-4.2	11.7
Official Capital										
4. Changes in foreign official reserves assets in U.S. (+ = increase)	47.7	40.2	6.4	-2.0	10.7	8.0	-5.6	-4.4	5.4	9.9
a) By area										
G-10 countries (incl. Switz.)	38.8	15.5	-0.8	-6.8	5.3	0.3	-9.5	-8.0	0.8	5.5
OPEC	-8.9	-3.4	-1.7	-0.8	0.7	6.8	0.3	1.3	0.7	3.3
All other countries	17.8	28.0	9.0	5.7	4.6	0.9	3.6	2.4	3.9	1.1
b) By type										
U.S. Treasury securities	43.2	41.7	5.9	-3.8	11.9	4.6	-9.7	-4.2	3.4	10.6
Other[3]	4.5	-1.6	0.6	1.8	-1.3	3.4	4.1	-0.2	2.0	-0.6
5. Changes in U.S. official reserve assets (+ = decrease)	9.1	-3.6	*	-7.4	2.3	-4.0	-12.1	-5.3	-0.8	-1.2
Other transactions (Quarterly data)[4]										
6. U.S. direct investment (-) abroad	-44.2	-17.5	2.4	-4.9	-8.9	-5.5	-2.7	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	46.9	58.4	13.9	11.9	23.0	19.2	12.3	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow)[5]	5.7	2.2	-5.3	1.6	2.5	2.1	6.1	n.a.	n.a.	n.a.
9. U.S. current account balance	-143.7	-126.5	-33.5	-32.3	-28.7	-30.4	-31.0	n.a.	n.a.	n.a.
10. Statistical discrepancy	1.9	-10.6	-15.7	24.0	-19.4	1.7	26.6	n.a.	n.a.	n.a.
MEMO:										
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-159.5	-127.2	-31.4	-30.3	-32.0	-28.4	-27.7	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 all U.S. bonds other than Treasury obligations.
3. Includes deposits in banks, commercial paper, acceptances, borrowing under repurchase agreements, and other securities.
4. Seasonally adjusted.
5. 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 to the data in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.
*--Less than $50 million.
NOTE: Details may not add to total because of rounding.

reflect the increasing tendency of foreigners to purchase Treasury securities at or around the auction dates. Over the past eighteen months changes in the monthly pattern of the Treasury's net borrowing from the public has "explained" more than half of the monthly variation in foreign net purchases of Treasuries. As foreign investors have become larger participants in the market for Treasuries, and the size of their transactions has increased, their bids have had a larger effect on the market price. Because of their market impact, foreigners have tended to bid at the auction directly or to purchase in the relatively active markets immediately following the auction when large orders are less apt to move the market.

Foreign official reserve assets in the United States rose by almost $10 billion in August (line 4) with large net inflows attributed to G-10 countries and OPEC. Most of the inflow probably reflected a shifting out of Eurodollar deposits into Treasury securities as the spread between Eurodeposit and Treasury rates declined.

Foreign net purchases of U.S. corporate stocks and bonds declined modestly in August (lines 2a and 2b of the Summary table) as did private U.S. purchases of foreign securities (line 2c). New Eurobond issues by U.S. corporations, which were depressed in August, picked up again in September.

The Summary table shows large net inflows through banking in August (line 1). However, as shown on the International Banking Table on the following page, net claims of U.S. banking offices on their own foreign offices declined by about $1 billion in August and $2 billion in September. The data in the International Banking Table, which are monthly averages and treat IBF's as outside the U.S. domestic banking system, tend to be much less erratic than the month-end data used for banking in the Summary table.

Foreign Exchange Markets

Since the October 3 FOMC meeting, the trade-weighted, foreign exchange value of the dollar against the other G-10 currencies declined on balance about 1-1/4 percent. Early in the period, the dollar rose about 1-3/4 percent, despite a round of interest rate increases in Europe, the release of weaker-than-expected U.S. employment data, a surprise discount-rate increase in Japan, and continued,

. A factor temporarily contributing to the dollar's rise was the market's misinterpretation of statements by Chairman Greenspan in the Soviet Union, which were viewed as criticism of U.S. intervention operations at that time. After

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1987	1988				1989					
	Dec.	Mar.	June	Sept.	Dec.	Mar.	June	July	Aug.	Sept.	Oct.[2]
1. Net Claims of U.S. Banking Offices (excluding IBFS) on Own Foreign Offices and IBFS	-10.9	8.7	-4.8	-4.9	-4.9	-2.9	-3.9	-3.9	-4.8	-6.6	-4.6
(a) U.S.-chartered banks	15.2	27.8	17.0	16.6	21.6	20.4	19.2	17.3	16.2	14.8	16.2
(b) Foreign-chartered banks	-26.1	19.0	-21.8	21.5	-26.5	23.3	-23.1	-21.2	-21.0	-21.4	-20.8
2. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	15.8	19.1	19.7	21.4	21.2	24.0	26.0	26.2	25.4	21.6	20.5
3. Eurodollar Holdings of U.S. Nonbank Residents[1]	132.6	128.9	138.1	141.1	145.3	144.2	137.8	141.6	140.9	138.8	133.7

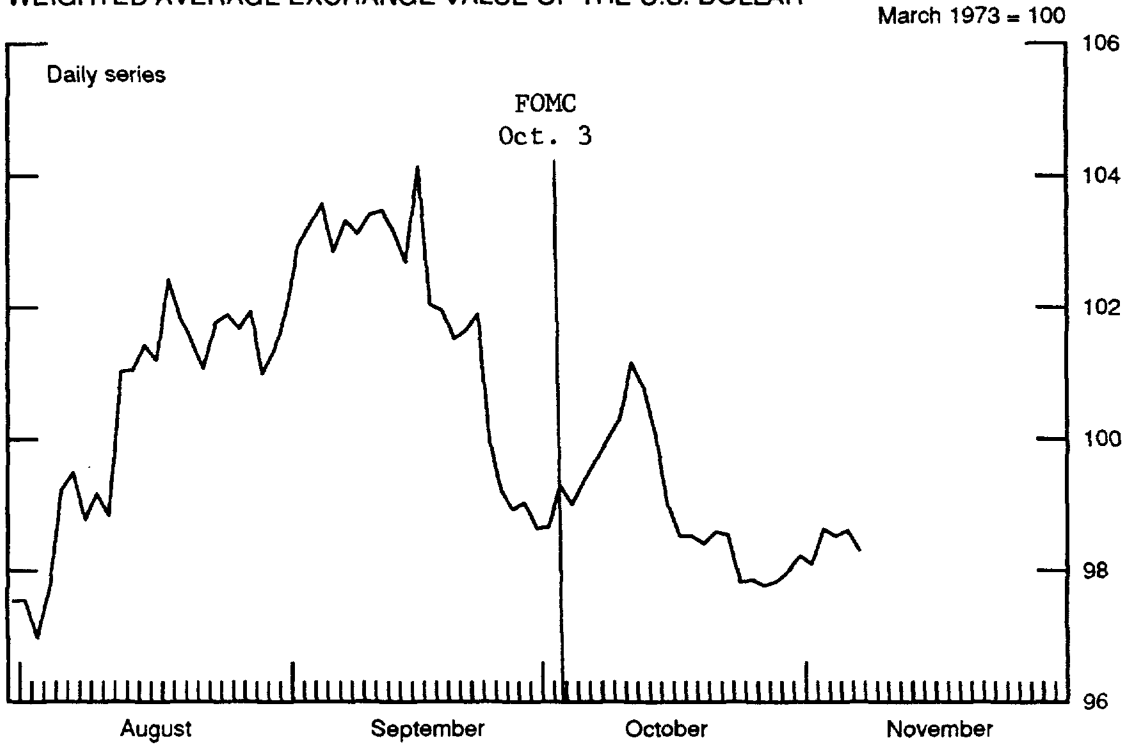
1. Includes term and overnight Eurodollars held by money market mutual funds. Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactions accounts. Line 1 is an average of daily data reported to the Federal Reserve by U.S. banking offices. Line 2 is an average of daily data. Line 3 is an average of daily data for the overnight component and an average of Wednesday data for the term component.
2. Through October 23, 1989.

reaching highs of DM1.9225 and ¥145.10 on October 11, the dollar reversed course amid increases in market interest rates in Germany and Japan in anticipation of further tightening and perceptions that the Federal Reserve was adopting an easier monetary policy stance, particularly after the selloff in U.S. stocks two days later. Subsequently, the dollar continued to decline, prodded by narrowing interest-rate differentials and by the release of data showing a larger-than-expected U.S. trade deficit in August.

The dollar's performance over the intermeeting period was not uniform against individual currencies. The dollar strengthened about 1-3/8 percent against the yen but weakened about 2-3/8 percent against the mark and the other EMS currencies. The differential movement of the dollar against the yen and the mark appears to have been caused by a perception that the Bundesbank is prepared to move aggressively against inflation and to strengthen the mark while the Japanese authorities are perceived as more reluctant to use monetary policy for these purposes.

Against sterling the dollar firmed about 1 percent over the intermeeting period. Sterling suffered two bouts of downward pressure during the period. The first occurred just prior to the announcement of official interest rate increases in Germany. The increases in German rates were widely anticipated, but it was felt that the United Kingdom would not move in step with Germany because U.K. interest rates were already so high and its economy was nearing recession. Sterling recovered briefly after the U.K. authorities announced a full percentage-point increase, matching Germany's increases, but then weakened again as market attention shifted to prospects for recession in

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



the United Kingdom. The second bout of downward pressure occurred after the surprise resignation of Nigel Lawson as Chancellor of the Exchequer.

. Since that time, sterling has recovered somewhat to DM2.92.

The accompanying table details the increases in interest rates in Germany and other countries since October 3. The Bundesbank raised its discount and Lombard rates 1 percentage point each on October 6, prompting similar increases elsewhere in Europe. There was little immediate reaction to the increases in Germany because they were largely anticipated, but short-term interest rates there have since moved up another 35 basis points in anticipation of further tightening. One week after the European increases, the Bank of Japan surprised the market with a 1/2 percentage-point increase in its discount rate on October 11; market interest rates moved up sharply immediately following the announcement and have risen further since then.

Stock prices worldwide declined following the selloff in the United States on October 13. The table shows changes in stock indices since the date of the previous FOMC. Japan's stock prices are above their levels just before the stock decline, having returned close to their levels at the beginning of the period, while prices in the United Kingdom have recovered only slightly and prices in Germany and France have declined even further. During this period of turbulence in financial markets, the price of gold rose 5 percent to $384 per ounce.

Selected Financial Indicators

	Oct. 3	Oct. 6	Oct. 12	Oct. 16	Nov. 7
Germany					
Lombard	7.00	8.00	8.00	8.00	8.00
Discount	5.00	6.00	6.00	6.00	6.00
3-month interbank	8.00	7.95	8.05	8.15	8.30
long bond	7.20	7.18	7.30	7.24	7.50
stock index*	--	1.82	0.79	-7.31	-9.51
France					
Money-market intervention	8.75	9.50	9.50	9.50	9.50
3-month interbank	9.50	9.75	9.94	9.94	10.38
long bond	8.82	8.74	8.88	8.80	9.12
stock index*	--	2.23	0.92	-3.02	-7.79
United Kingdom					
Money-market dealing	13.88	14.88	14.88	14.88	14.88
3-month interbank	14.63	15.00	15.19	14.88	15.06
long bond	9.46	9.46	9.59	9.36	9.69
stock index*	--	-2.19	-4.30	-8.88	-7.66
Japan					
Discount	3.25	3.25	3.75	3.75	3.75
3-month CD	5.69	5.72	6.25	6.20	6.70
long bond	5.27	5.36	5.48	5.28	5.61
stock index*	--	-1.09	-2.42	-1.72	-0.95
United States					
Federal funds	9.08	8.92	8.82	8.63	8.64
3-month CD	8.94	8.78	8.63	8.24	8.58
10-year Treasury	8.23	8.03	8.04	7.98	7.90
stock index*	--	1.07	0.07	-3.59	-5.64

* Percent change from October 3.

. The Desk sold $770 million against yen and $390 million against marks. The Desk's activity was concentrated during the first two weeks of the period when the dollar was rising; since October 12, before the stock slide, the Desk has conducted no operations for the accounts of the System or the Treasury.

U.S. Bank Lending to Foreigners

U.S.-chartered banks' cross-border claims on foreign borrowers increased by $1.3 billion in the second quarter of 1989. Increases in claims on G-10 countries, smaller developed countries, and offshore banking centers were almost completely offset by a decline in claims on non-OPEC developing countries, OPEC, and Eastern European countries.

The decline in U.S. bank claims on non-OPEC developing countries was largely accounted for by a decline in claims on Argentina and Mexico. Reported claims on Argentina declined because U.S. banks wrote off some of their long-term public sector claims on Argentina in response to a regulatory decision to require reserves against Argentine exposure. The decline in Mexican claims held by U.S. banks is more closely accounted for by secondary market sales of such claims to other investors.

U.S. bank claims on G-10 countries increased by $3.1 billion in the second quarter of 1989, largely reflecting an increase in claims on borrowers in France, Germany, Italy, and Switzerland, possibly reflecting decisions by U.S. banks to participate in financing corporate restructurings in Europe. Claims on East European countries declined $0.3 billions, largely because of a decline in claims on the Soviet

CROSS BORDER CLAIMS OF U.S.-CHARTERED BANKS
(billions of dollars)

	Changes (no sign = increase)								Out-
	1985	1986	1987	1988	1988		1989		standing
	Year	Year	Year	Year	Q3	Q4	Q1	Q2	6/30/89
Total, all countries	-28.9	-18.9	-8.3	-32.0	-9.8	-8.9	-3.6	1.3	233.0
Non-OPEC developing countries	-7.6	-7.7	-5.7	-12.8	-3.4	-2.6	-1.4	-2.5	68.1
of which:									
(Latin America)	-4.0	-2.5	-3.2	-9.3	-2.4	-2.2	-1.5	-2.9	50.9
(Asia and Africa)	-3.6	-5.2	-2.5	-3.5	-1.1	-0.3	0.1	0.3	17.2
OPEC countries	-3.2	-2.7	-2.7	-1.6	-0.5	-0.5	0.0	-0.6	13.2
Eastern Europe	-0.5	-0.8	-0.3	0.1	-0.1	0.3	0.0	-0.3	3.1
Smaller developed countries	-5.1	-4.5	-3.4	-4.6	-1.1	-1.7	-0.8	0.5	17.6
G-10 countries	-7.9	-1.5	3.8	-10.0	-4.4	-4.4	-0.7	3.1	100.2
Offshore banking centers	-4.6	-1.8	0.0	-3.3	-0.2	-0.2	-0.3	1.0	29.7
Miscellaneous	0.1	0.1	0.1	0.2	-0.1	0.1	-0.4	0.2	1.2

Source: Country Exposure Lending Survey.

Union and Yugoslavia, and U.S. banks continue to account for less than 5 percent of total bank claims on East Europe.

As indicated in the following table and chart, secondary market prices of bank loans to the heavily indebted countries on average changed relatively little over the second and third quarters of 1989 with a large decline in the price of Brazilian debt offset by increases in the prices of other countries' debts. In October, secondary market prices have fallen for Brazilian, Mexican and other developing-country debt. The recent weakness in the secondary market prices of developing-country debt in part reflects concerns by participants that the choices by lenders under the Mexican restructuring agreement will result in a selection for debt and debt-service reductions in excess of the funds available to enhance those two options. Failure to implement a debt restructuring for Mexico would make it difficult to achieve progress for other countries under the Brady initiative.

Developments in Foreign Industrial Countries

The slower pace of economic activity reflected in second-quarter GDP growth in the major foreign industrial countries appears to have continued in the third quarter. Monthly indicators of economic activity, such as industrial production, remained relatively flat during the third quarter. Germany appears to be an exception to this trend, with several indicators showing a rebound.

Recent trends in inflation have not been uniform across countries. Consumer price inflation in Japan, Germany, and the United Kingdom edged up slightly in September and October, reflecting, to some extent,

INDICATIVE PRICES FOR BANK LOANS TO BAKER-15 COUNTRIES
(Average of bid and offer price, expressed as a percentage of face value)

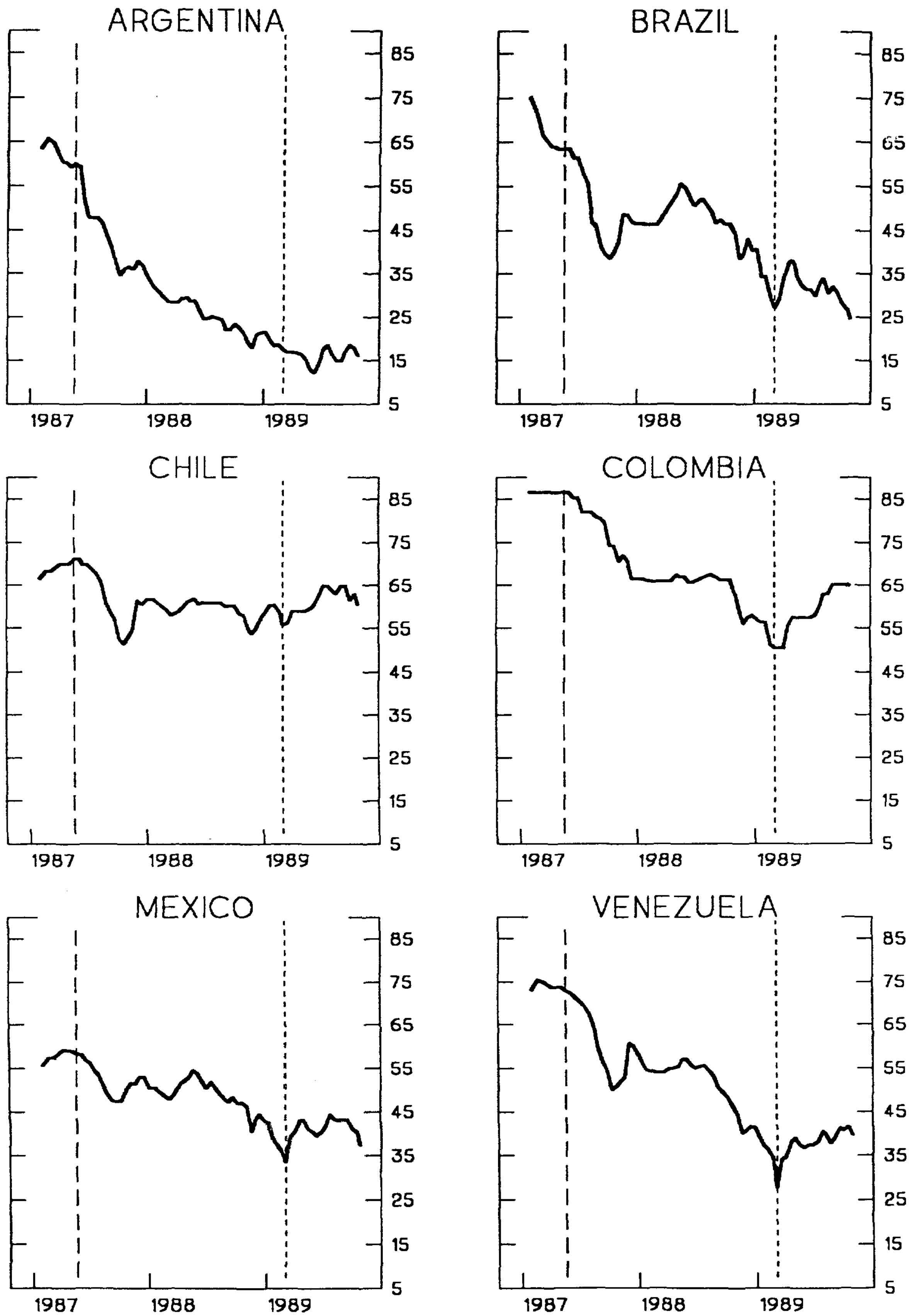
Countries[1/]	86Q4[2/]	5/18/87[3/]	87Q4[2/]	88Q3[2/]	88Q4[2/]	89Q1[2/]	89Q2[2/]	89Q3[2/]	10/26/89
Brazil	75.5	63.5	46.5	46.4	40.4	33.9	31.4	28.1	24.6
Mexico	56.5	58.6	50.5	46.9	43.1	40.5	40.4	41.1	37.4
Argentina	66.0	60.0	34.5	23.4	21.5	16.9	14.6	18.6	16.1
Venezuela	74.5	73.0	58.0	48.5	41.3	34.5	37.4	40.8	39.6
Chile	68.0	71.3	61.8	60.1	57.5	58.9	62.5	61.5	60.4
Philippines	73.5	71.3	50.4	52.5	49.5	41.5	49.0	49.8	49.1
Yugoslavia	79.0	78.0	49.8	47.8	45.5	44.0	51.0	55.0	56.5
Nigeria	39.0	31.5	30.5	24.0	24.0	21.5	23.5	28.8	28.5
Colombia	86.5	86.5	66.5	66.3	58.0	50.5	57.5	65.3	65.0
Ecuador	65.5	53.5	37.3	19.0	13.0	10.5	12.5	16.5	17.3
Peru	19.0	16.0	8.0	5.8	5.5	3.5	4.0	5.0	6.1
Morocco	69.5	70.0	53.5	50.5	48.5	42.5	43.4	45.5	43.5
Cote d'Ivoire	77.0	76.5	42.5	28.0	5.0	15.0	15.0	7.0	7.0
Uruguay	66.5	74.3	60.0	60.5	60.0	57.0	55.5	55.5	55.0
Bolivia	7.5	10.0	12.0	10.5	10.5	11.5	11.5	11.5	11.5
Baker-15 countries[4/]	66.0	62.5	47.4	43.4	39.2	34.7	35.0	35.6	33.2

1. Ranked by December 1986 BIS quarterly claims.
2. Prices last reported within quarter.
3. Citibank announced $3 billion reserve action on May 19, 1987.
4. Index of weighted-average secondary market value of LDC debt. The weight of each of the 15 countries is the December 1986 BIS quarterly claims on that country divided by the total BIS quarterly claims on the 15 countries combined.

Source: Salomon Brothers.

Indicative Secondary Market Prices of Bank Loans
for Six of the Baker Initiative Countries

(as a percent of face value)



— — — Citibank announcement of $3 billion reserve action, May 18, 1987.

- - - - - - - Announcement of the Brady Initiative, March 10, 1989.

earlier weakness in their respective currencies. In Italy and Canada, inflation rates declined from recent summer peaks which were associated with the introduction of indirect taxes.

Progress in external adjustment has been mixed. In Japan, and to a lesser extent Germany, trade and current account surpluses have narrowed from levels registered earlier in the year. In contrast, external imbalances in France, Canada, and the United Kingdom worsened. Italy was the only deficit country that showed some improvement, registering a third-quarter trade deficit significantly below the record first-quarter level.

Individual Country Notes. In Japan, preliminary third quarter data suggest relatively weak economic activity. As shown in the table below, industrial production declined 2 percent (s.a.) in September, and for the third quarter as a whole was only 0.2 percent above its second-quarter level. Retail sales declined by 1.8 percent (s.a.) in August, following increases of over 2 percent in the previous two months. The rate of capacity utilization fell by 3.8 percent in July, though it remains at an historically very high level. The unemployment rate edged back down to 2.2 percent (s.a.) in September.

JAPANESE ECONOMIC INDICATORS
(percent change from previous period except were noted, s.a.)

	1989						
	Q1	Q2	Q3	Jun.	Jul.	Aug.	Sept.
Real GNP	2.3	-0.8	--	--	--	--	--
Industrial Production	3.1	0.0	0.2	2.0	-2.6	2.9	-2.0
Retail Sales	6.4	-5.4	--	2.1	2.7	-1.8	--
Capacity Utilization	0.0	0.2	--	2.6	-3.8	--	--
Unemployment Rate (%)	2.3	2.3	--	2.2	2.2	2.3	2.2

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

	Q4/Q4 1987	Q4/Q4 1988	1988 Q4	1989 Q1	1989 Q2	1989 Q3	1989 May	1989 June	1989 July	1989 Aug.	1989 Sept.	Latest 3 months from year ago 2
Canada												
GDP	6.5	4.0	.7	.8	.2	n.a.	*	*	*	*	*	2.5
IP	9.6	2.7	-.7	.2	.9	n.a.	.4	-.2	-.2	n.a.	n.a.	1.2
France												
GDP	2.6	3.0	.6	1.1	.6	n.a.	*	*	*	*	*	3.4
IP	3.2	4.3	-.2	1.0	1.8	n.a.	-1.8	1.7	1.0	.0	n.a.	4.6
Germany												
GNP	2.3	3.0	.5	2.9	.3	n.a.	*	*	*	*	*	4.9
IP	1.5	4.0	.6	2.4	-.8	2.1	-4.6	4.2	1.0	.2	-.6	4.4
Italy												
GDP	3.8	3.3	.9	.8	.4	n.a.	*	*	*	*	*	3.1
IP	5.7	6.7	4.4	.1	-1.0	n.a.	-1.4	2.9	1.4	-1.4	n.a.	5.5
Japan												
GNP	5.7	4.8	.8	2.3	-.8	n.a.	*	*	*	*	*	4.7
IP	8.1	7.6	1.8	3.1	.0	.2	.5	2.0	-2.6	3.0	-2.0	5.2
United Kingdom												
GDP	5.1	3.5	.7	.5	-.3	n.a.	*	*	*	*	*	2.2
IP	4.4	2.1	-.3	-.5	-1.1	n.a.	-1.3	.1	1.5	1.5	n.a.	-.5
United States												
GNP	5.4	3.4	.7	.9	.6	.6	*	*	*	*	*	2.9
IP	5.8	5.0	1.1	.5	.8	.3	-.0	.3	-.0	.3	-.1	2.8

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 1987	Q4/Q4 1988	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2	1989 Q3	1989 July	1989 Aug.	1989 Sept.	1989 Oct.	Latest 3 months from year ago
Canada													
CPI	4.2	4.1	1.3	1.1	.8	1.2	1.7	1.6	.7	.1	.5	-.3	5.2
WPI	4.3	3.7	.8	1.1	.6	1.0	.3	-.2	-.2	.1	-.2	n.a.	1.7
France													
CPI	3.2	3.0	1.0	.9	.6	.8	1.2	.7	.3	.2	.3	n.a.	3.4
WPI	3.4	7.2	1.2	2.4	2.5	2.4	.6	n.a.	*	*	*	*	8.1
Germany													
CPI	1.0	1.5	.5	.1	.4	1.6	1.0	.1	-.2	-.1	.2	.2	3.1
WPI	-.7	2.7	1.1	.4	1.2	2.7	1.7	-.7	-.9	-.3	1.1	n.a.	5.0
Italy													
CPI	5.2	5.2	1.0	1.0	1.9	2.0	1.7	1.0	.2	.2	.5	1.0	6.7
WPI	4.6	5.4	1.3	1.2	1.7	2.3	1.4	n.a.	-.2	.4	n.a.	n.a.	6.4
Japan													
CPI	1.1	1.5	.6	.1	1.0	-.1	2.1	.1	-.2	-.3	1.0	1.0	3.1
WPI	-.6	-1.4	-.3	.9	-.8	.5	2.7	.8	.0	.0	.4	n.a.	3.1
United Kingdom													
CPI	4.1	6.5	2.4	1.4	2.1	1.6	2.9	.9	.1	.3	.7	n.a.	7.7
WPI	4.1	4.9	1.4	1.2	1.1	1.4	1.2	1.1	.3	.4	.4	n.a.	4.9
United States													
CPI (SA)	4.4	4.3	1.1	1.2	1.1	1.3	1.6	.6	.2	.0	.2	n.a.	4.6
WPI (SA)	2.5	3.4	.8	1.1	.9	2.2	1.6	-.1	-.4	-.4	.9	n.a.	4.6

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)

	1987	1988	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2	1989 Q3	1989 June	1989 July	1989 Aug.	1989 Sept.
Canada												
Trade	8.6	8.0	2.5	2.3	1.6	2.0	1.0	n.a.	.2	.4	.2	n.a.
Current account	-8.0	-8.4	-1.7	-2.0	-3.2	-3.1	-4.8	n.a.	*	*	*	*
France												
Trade	-5.2	-5.4	-.6	-1.9	-2.0	-.6	-2.1	n.a.	-.5	-1.2	n.a.	n.a.
Current account	-4.1	-3.9	-.6	-1.1	-3.6	1.6	-1.2	n.a.	*	*	*	*
Germany												
Trade (NSA)	65.9	72.9	19.9	17.0	21.0	19.4	17.7	17.8	7.0	5.6	5.8	6.4
Current account (NSA)	45.6	48.7	14.4	8.7	15.9	15.8	13.7	10.4	5.1	2.6	3.6	4.2
Italy												
Trade	-8.7	-9.9	-1.4	-2.6	-2.6	-5.2	-3.1	-2.2	-1.1	-.6	-1.0	-.6
Current account (NSA)	-1.6	-5.4	1.0	.2	-1.5	-6.6	n.a.	n.a.	*	*	*	*
Japan												
Trade	79.4	77.4	17.0	18.4	21.9	21.9	15.4	15.0	5.1	5.0	4.4	5.5
Current account 2	87.0	79.6	17.1	18.4	20.8	21.5	12.5	13.2	2.9	4.1	5.1	4.1
United Kingdom												
Trade	-16.9	-36.6	-8.4	-9.8	-11.2	-10.2	-9.4	-10.8	-3.0	-4.0	-3.7	-3.0
Current account	-5.1	-26.0	-5.1	-5.8	-9.8	-8.5	-7.5	-9.3	-2.4	-3.6	-3.2	-2.6
United States												
Trade 2	-159.5	-127.2	-31.4	-30.3	-32.0	-28.4	-27.7	n.a.	*	*	*	*
Current account	-143.7	-126.5	-33.5	-32.3	-28.7	-30.4	-31.0	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.

Recent monthly data show further increases in inflation rates. The consumer price index for Tokyo increased by 1 percent (n.s.a.) in October, to a level 3.3 percent above that of a year earlier. Wholesale prices in September registered a 3.3 percent increase from their level a year earlier. Over this period, prices of domestic goods were up 2.7 percent while import prices jumped by 8.3 percent. These inflation developments, and weakness in the yen, were factors in the Bank of Japan's October 11 decision to raise the discount rate by 1/2 percentage point to 3-3/4 percent.

The trade surplus increased in September. However, the cumulative trade surplus over the first three quarters was $70 billion (s.a.a.r.), below the $74 billion surplus over the same period last year. The current account surplus has shown a greater decline this year, due mainly to a sharp increase in Japanese tourist expenditures.

On October 1, the ruling Liberal Democrat Party won a legislative by-election, breaking a string of election defeats. The government has said that it intends to pass the budget for the coming fiscal year (beginning next April) before calling for an election of the lower house of the Diet.

In Germany, monthly data suggest that economic activity rebounded in the third quarter from its slowdown in the second quarter. Industrial production fell 0.6 percent (s.a.) in September, but increased in the third quarter as a whole by 2.1 percent from its second-quarter level. The volume of manufacturers' new orders increased 0.4 percent (s.a.) in both August and September after a 0.3 percent decline in July; the level for September was 6.3 percent above that of a year earlier. External demand continues to be the most important source of stimulus. During August and September, foreign orders increased 3 percent while domestic orders fell by 1 percent. In the labor market, the unemployment rate remained at 7.8 percent in both September and October.

GERMAN ECONOMIC INDICATORS
(percent change from previous period except where noted, s.a.)

	1988			1989				
	Q1	Q2	Q3	June	July	Aug.	Sep.	Oct
Industrial Prod.	2.4	-0.8	2.1	4.2	1.0	0.2	-0.6	--
Vol. of Manufacturing Orders	2.3	3.3	0.7	2.6	-0.3	0.4	0.4	--
Capacity Utilization	-0.9	1.1	--	--	--	--	--	--
Unemployment Rate (percent)	7.9	7.9	7.8	7.9	7.9	7.8	7.8	7.8

Inflation appears to have increased somewhat in September and October after moderating during the summer. Consumer prices in October were 3.3 percent (n.s.a.) above their level a year earlier, compared with 3.1 percent in September and 2.9 percent in August. Wholesale prices were 5.5 percent above their year-earlier level in September, up from 4.5 percent in August. The recent rise in inflation is primarily due to the mark's decline against most major currencies between mid-July and mid-September, and to this summer's rise in energy prices.

GERMAN INFLATION INDICATORS
(percent change from year earlier)

	Q1/89	Q2/89	Q3/89	May	June	July	Aug.	Sep.	Oct.
Consumer Prices (nsa)	2.6	3.1	3.0	3.1	3.1	3.0	2.9	3.1	3.3
CPI Less Energy	2.2	2.5	2.5	2.5	2.6	2.6	2.5	2.5	---
Producer Prices (nsa)	3.1	3.3	3.0	3.4	3.0	3.0	3.0	3.0	---
Wholesale Prices (nsa)	5.4	6.1	5.0	6.5	5.5	5.0	4.5	5.5	---
Import Prices	6.1	6.5	3.2	7.1	5.3	3.1	2.7	3.7	---
Hourly Wages & Salaries	5.0	5.3	---	5.7	4.6	1.5	---	---	---

Germany's external surpluses, after setting new records in the first quarter, have narrowed somewhat. However, on a cumulative basis through September, the current account surplus was $53 billion (n.s.a.a.r.), significantly larger than the $44 billion surplus over the same period in 1988. Meanwhile, the cumulative trade surplus over this period was $73 billion (n.s.a.a.r.), slightly above its year-earlier level of $69 billion.

The Bundesbank raised the discount and Lombard rates in the first week of October by a full percentage point to 6 and 8 percent respectively, citing as factors strong growth and the potentially inflationary impact of wage negotiations scheduled for early 1990. This was the fifth increase in official rates since last December. Growth in M3 fell back from 5.1 percent in August to 4.6 percent in September (s.a.a.r., from Q4-1988), and is now below the Bundesbank's target of "about 5 percent" for 1989.

In France, the average level of industrial production in July and August increased 0.5 percent (s.a.) from its level in June. The cumulative trade deficit for the first seven months of 1989 widened to $6.6 billion (s.a.a.r), from $3.9 billion over the same period last year.

In September, the government announced its 1990 budget; the deficit is projected to decline to 1.4 percent of GDP next year from 1.7 percent of GDP in 1989, primarily due to strong revenue growth. The Bank of France raised official interest rates by 75 basis points on October 5, in conjunction with actions by other European central banks, primarily to prevent the emergence of downward pressures on the franc within the EMS.

Economic activity in the United Kingdom slackened in the third quarter. Real consumer spending rose a preliminary 0.1 percent (s.a.) in the third quarter after a 1.6 percent rise in the second quarter. Industrial production grew 1.5 percent (s.a.) in August, due, in part, to a rebound in oil production, but only to a level 0.9 percent above that of a year earlier. The volume of retail sales rose 0.6 percent (s.a.) in September and brought the third-quarter average to a level 0.6 percent below the previous quarter. The unemployment rate fell to a nine-year low of 6 percent in August.

The consumer price index rose to 7.6 percent (n.s.a.) in September from its level a year earlier, up from the 7.3 percent increase in August. Excluding mortgage interest payments, the rise in September was 5.8 percent, down only slightly from the peak of 6 percent in May. Wage pressures have persisted; the annual rate of increase in average earnings was 8-3/4 percent in August. The U.K. trade balance improved somewhat in September, after registering near-record deficits in July and August. The cumulative deficit was $41 billion (s.a.a.r.) in the nine months through September compared with a deficit of about $33 billion over the same period last year.

Nigel Lawson, the Chancellor of the Exchequer for the past 6-1/2 years, resigned on October 26. In his resignation letter, Lawson cited differences with Thatcher and her economic advisor, Sir Alan Walters (who also subsequently resigned), over economic policy. Lawson was replaced by John Major, the Foreign Secretary, who stated that eradicating inflation would remain the primary policy objective, and that the United Kingdom would enter the EMS when inflation had fallen to the EC average and capital controls had been removed in the other EMS countries.

In Canada, continued weakness in the pace of economic activity is suggested by 0.2 percent (s.a.) declines in industrial production in both June and July. Canada's current account registered a record deficit in the second quarter of \$4.8 billion (s.a.), reflecting the strong Canadian dollar and continued rapid imports of capital goods. The cumulative trade surplus (s.a.) through August of this year is about forty percent below its total during the same period in 1988.

In Italy, the July-August average level of industrial production (s.a.) did not increase, but still was 2.2 percent above the second quarter level.

The 1990 budget and accompanying budget legislation were presented to parliament on September 30. It includes legislative changes designed to reduce the projected 1990 deficit to 10.4 percent of GDP from 11 percent in 1989. On the expenditure side, it includes cuts and in the subsidy to employees' social security contributions and to public corporations. The increase in revenues, which accounts for roughly 2/3 of the \$14 billion deficit reduction, comes from increases in the gasoline tax, fees for government services, and a reduction in the depreciation allowance. However the recent failure of a tax amnesty to yield the expected revenue, and the rapid growth of health expenditures, has resulted in reports suggesting that these measures may not be sufficient to attain the 1990 deficit target.

Economic Situation in Major Developing Countries

Mexico's external accounts and fiscal balance have weakened, while its economy has shown stronger-than-expected growth. Commitments on the Mexican financing package are being collected. With somewhat less than half of the base debt accounted for, only $500 million in new money had been pledged by creditor banks by November 7, representing about 9 percent of the base debt committed so far. In Brazil, pre-election uncertainty has increased inflationary expectations and caused turmoil in financial markets. Argentina has reached agreement with the IMF on a proposed 17-month, SDR 1.1 billion stand-by arrangement; the structural reforms launched by President Menem continue, although at a reduced pace. Venezuela cleared $920 million in interest arrears to the banks in early October and has resumed talks with its bank creditors on a financing package of new money and debt- and debt-service reduction to support its economic program. The Philippines expects to meet its 1989-90 financing needs through a proposed package of new money from banks of about $1.0 billion and the buyback of about $1.3 billion of its $7.2 billion in medium- and long-term bank debt at a 50 percent discount. Costa Rica and its bank advisory committee reached agreement in principle on a debt reduction proposal covering both the stock of old debt and substantial accumulated interest arrears.

Individual country notes. Mexico's external accounts appear to have deteriorated since late August, amid mounting indications that the end-year fiscal performance criteria of the IMF program may not be met. Rising private investment and a recovery of production are likely to result in 3 percent real GDP growth in 1989, twice the (optimistic) official forecast made last January. The stronger economy, however, is stimulating imports and diverting potential exports to the home market.

On the fiscal side, in spite of larger-than-expected revenue gains, the overall deficit is being swollen by supplemental appropriations and by stubbornly high interest payments on the domestic public debt. While domestic interest rates fell dramatically in July and August, following announcement of the agreement reached with Mexico's bank advisory committee, rates have increased steadily since late August, reflecting high private and public sector demand for credit. The interest rate on 28-day Treasury bills stood at 38.2 percent on October 31, up from 33 percent on August 29. To counter the fiscal deterioration, selected public sector prices, notably for rail transport, fertilizer, and residential electricity, have been raised in recent weeks. But other public sector prices, such as for gasoline, have not been raised since the end of 1987. The increases in public sector prices have caused business to clamor for permission to raise prices that are subject to control and labor to demand emergency wage increases. Higher gasoline prices and changes in the policy of devaluing the peso against the dollar by 1 peso per day are unlikely until a new wage-price pact with business and labor is concluded; the current pact expires next March.

By November 7, 187 banks, representing $23 billion of the estimated $52.7 billion base debt to be restructured under Mexico's debt agreement, had indicated their choice among the three options. Only eight banks, with $2.1 billion in base debt among them, had opted for new money, for a total new money commitment of just over $500 million.

In Brazil, the government has had only limited success preventing inflation from rising further before the November 15 presidential election. Consumer prices rose 38 percent in October, compared with 36 percent in September. In mid-October, the government signed agreements with representatives of several industries to limit price rises to no more than 90 percent of the previous month's inflation rate. Recently, however, producers have been pressing for larger increases. In early November, financial markets forecast November inflation at 45 percent.

Financial markets have been volatile in recent weeks. The spread between the official and parallel market exchange rates widened from 83 percent September 22 to 105 percent on October 11. After reaching 152 percent October 26, it fell to 102 percent November 6. The fall in the spread has been accompanied by a rise in domestic interest rates.

Political uncertainty appears to be the main factor behind the rise in inflation expectations. Twenty-two candidates are running in the November 15 election. If no candidate wins 50 percent or more of the vote--as is virtually certain--a runoff between the top two finishers will be held December 17. The winner will take office in March 1990. The October 31 entry into the race of Silvio Santos, a popular television host, adds further uncertainty to an already-clouded political picture.

Brazil's trade surplus was $1.2 billion in September, bringing the cumulative surplus for the first nine months of 1989 to $13.2 billion, compared with $14.7 billion for the comparable period of 1988.

Argentina and the IMF reached agreement in late September on a 17-month, SDR 1.1 billion stand-by arrangement; the program is scheduled for discussion by the Fund's Executive Directors on November 10. The program requires Argentina to implement further its plans for structural reform, which include privatization of public enterprises, elimination of government subsidies, tax reform, and other measures to restore fiscal balance. The arrangement also envisages Argentina's normalizing relations with the commercial banks; the two sides met inconclusively in early November.

Argentina's program of economic reform has continued to move ahead, although at a somewhat slower pace in recent weeks. Plans for the privatization of additional public enterprises have been announced, and various subsidy programs have been suspended. However, the bill to overhaul the tax system underwent frequent modifications before its submission to Congress in late October and may encounter further resistance during Congressional deliberations. Moreover, the proposed new charter for the Central Bank, which would enhance its independence from the government, is stalled as well.

After declining from 197 percent in July to 38 percent in August 9.4 percent in September, monthly inflation fell to 5.6 percent in October. Partially in response to September's inflation rate, which was somewhat higher than expected, the parallel market exchange rate, which had stabilized at or below the official rate of 650 australs per dollar in September, rose to about 730 australs per dollar at the end of October, or about 10 percent above the official rate.

In early October, Venezuela cleared its $920 million in interest arrears on public sector debt to commercial banks, using $320 million of its own reserves and $600 million from a club loan from a limited group of banks. The clearing of the arrears has led to a resumption of talks on a restructuring of Venezuela's public sector debt to the banks and on a possible package of new money and debt- and debt-service reduction. Significant disagreements remain, however, both among the banks themselves and between the banks and the Venezuelan authorities as to Venezuela's actual financing needs.

A sharp fall in imports and firmer oil prices have greatly improved Venezuela's balance of payments this year. A current account surplus of several hundred million dollars is expected in 1989, compared with a $4.5 billion deficit in 1988. The public sector budget deficit has also fallen sharply, from 8 percent of GDP last year to near zero in 1989.

The Philippines announced in late October that it expected to be able to raise enough money from its commercial bank creditors to cover its estimated financing gap of $1.4 billion in 1989-90. Creditor banks are to indicate by November 10 how much new money they will provide, as well as how much, if any, existing debt they would be willing to sell back at a 50 percent discount. The debt buyback is to take place on January 3, 1990, and is expected to retire about $1.3 billion of the country's $7.2 billion in medium- and long-term bank debt.

Costa Rica and its commercial bank creditors have agreed in principle to a debt reduction plan, despite $325 million in interest arrears. Under the agreement, announced October 26, Costa Rica would buy back a projected 60 percent of its $1.8 billion commercial bank debt, which includes the arrears, at about 16 cents on the dollar. The remaining principal would be converted to par bonds carrying a 6.25 percent annual coupon. Banks tendering at least 60 percent of their exposure under the buy-back would receive interest guarantees and a shorter maturity for the bonds. The agreement also calls for Costa Rica to repay immediately $26 million of the unrepurchased $130 million in interest arrears (40 percent of $325 million), with the balance to be repaid over 15 years at LIBOR plus 13/16, with no grace period.