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## **Part 2**

December 16, 1998

# **CURRENT ECONOMIC AND FINANCIAL CONDITIONS**

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## **Recent Developments**

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

December 16, 1998

## **RECENT DEVELOPMENTS**

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## **DOMESTIC NONFINANCIAL DEVELOPMENTS**

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## Domestic Nonfinancial Developments

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### Overview

Overall economic activity appears to have maintained a good deal of momentum in the fourth quarter. Domestic final demand has been robust, driving continued solid gains in overall production and employment, even as a weak trade sector has held down manufacturing. Labor markets are still tight, but inflation has remained subdued.

### Labor Market Developments

Employment strengthened in November, with private nonfarm payrolls rising 249,000--more than in other recent months.<sup>1</sup> In the household survey, employment rose even faster, and the unemployment rate dropped back to 4.4 percent.

Job gains were widespread in November with the notable exception of manufacturing, where employment shrank another 47,000.<sup>2</sup> Construction payrolls have surged in the past two months, boosted by strong housing demand. Retail employment rebounded 65,000 in November after a subpar October, and employment growth in FIRE remained robust. Gains in the services industries totaled 150,000; business services--including help supply--and engineering and management services accounted for much of the rise.

Aggregate hours of production or nonsupervisory workers on private nonagricultural payrolls rose 0.1 percent last month, and the average workweek remained essentially unchanged. After correcting for difficulties with the seasonal adjustment of the workweek in September, we estimate that production worker hours in November stood about 1-1/4 percent (annual rate) above the third-quarter average.<sup>3</sup>

The household survey continues to indicate tight labor markets. The unemployment rate fell to 4.4 percent in November from 4.6 percent in October.

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1. In addition, private payroll employment growth for September and October was revised up 35,000 per month, on average, which lessened the dropoff in payroll growth for those months reported earlier.

2. Since peaking in March, factories have cut their payrolls by a quarter million. In addition, anecdotal reports suggest that much of the weakness in the help supply industry in the spring and summer was the result of declines in placements in the light industrial area.

3. The BLS has indicated that the dip in the September workweek in the published data is linked to difficulties seasonally adjusting for both the Labor Day holiday and monthly variation in the length of the pay period. Since 1988, when a change in survey methodology made the workweek sensitive to variations in the length of pay periods, Labor Day occurred only twice in the survey reference week--1992 and 1998--and, in these instances, the length of the semimonthly pay period increased from ten to eleven days between August and September. Both the timing of the holiday and the lengthening of the pay period tend to depress the workweek, but with so few observations, the standard seasonal adjustment procedures have difficulty capturing the effects. Had there been no dip in the September workweek, the level of aggregate hours in the third quarter would have been about 0.2 percent higher.

CHANGES IN EMPLOYMENT

(Thousands of employees; based on seasonally adjusted data)

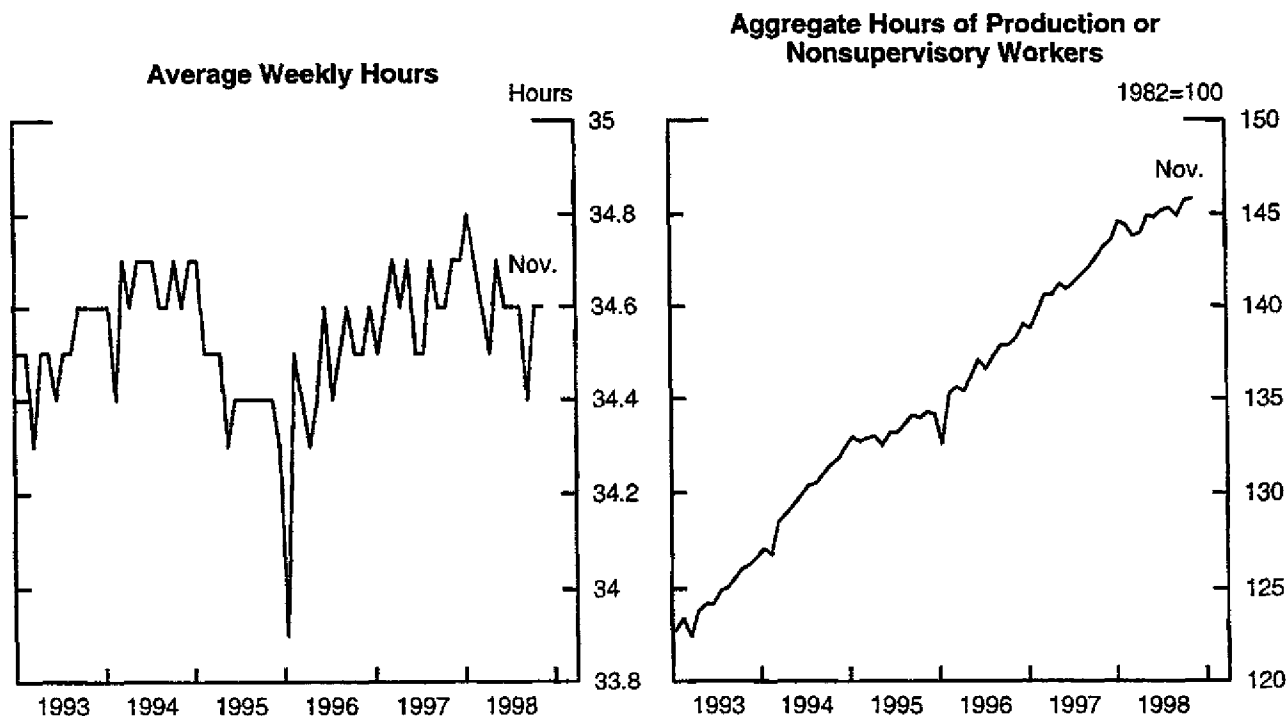
	1996	1997	1998				
			H1	Q3	Sept.	Oct.	Nov.
	-Average monthly changes-						
Nonfarm payroll employment <sup>1</sup>	233	282	244	204	172	145	267
Private	224	263	222	166	166	132	249
(Previous)				(156)	(137)	(92)	
Manufacturing	3	21	-2	-29	-1	-61	-47
Nonmanufacturing	222	241	223	195	167	193	296
Construction	28	20	23	12	-8	32	47
Transportation and utilities	8	14	15	14	9	14	7
Retail Trade	42	34	34	48	47	6	65
Finance, insurance, real estate	14	17	23	20	21	22	23
Services	117	142	117	91	77	124	150
Business services	45	61	44	16	-14	69	55
Help supply services	19	26	12	-12	-32	7	22
Total government	9	20	22	38	6	13	18
Private nonfarm production workers <sup>1</sup>	190	212	166	125	169	94	137
Manufacturing production workers	0	16	-10	-26	29	-48	-46
Total employment <sup>2</sup>	232	240	72	185	597	-88	477
Nonagricultural	226	243	79	127	607	-172	735
<b>Memo:</b>							
Aggregate hours of production workers (percent change) <sup>1,3</sup>	3.2	3.4	2.0	1.6	-0.3	0.6	0.1
Average workweek (hours) <sup>1</sup>	34.4	34.6	34.7	34.5	34.4	34.6	34.6
Manufacturing (hours)	41.6	42.0	41.8	41.7	41.6	41.7	41.6

Note. Average change from final month of preceding period to final month of period indicated.

1. Survey of establishments.

2. Survey of households.

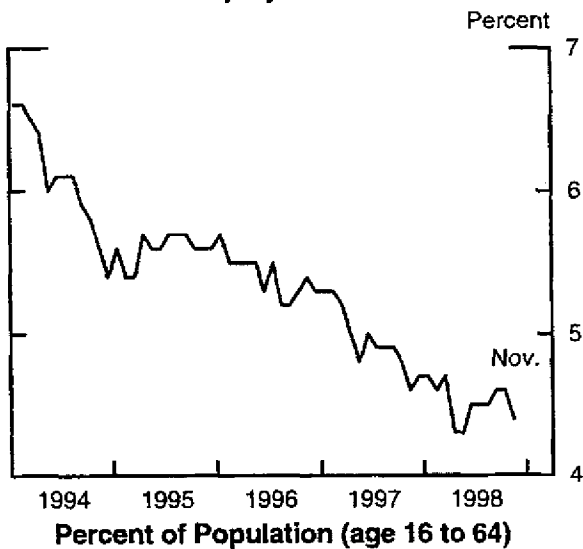
3. Annual data are percent change from Q4 to Q4. Data for H1 are Q2 over Q4 at an annual rate. Quarterly data are percent change from preceding period at an annual rate. Monthly data are percent change from preceding month.



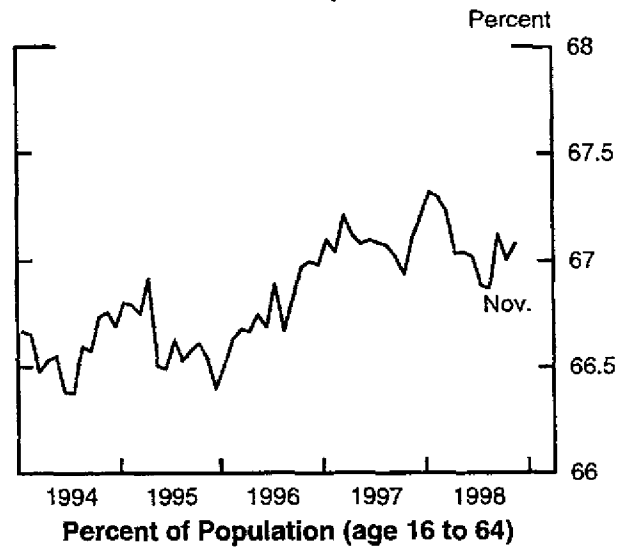
**SELECTED UNEMPLOYMENT AND LABOR FORCE PARTICIPATION RATES**  
 (Percent; based on seasonally adjusted data, as published)

	1996	1997	1998				
			H1	Q3	Sept.	Oct.	Nov.
Civilian unemployment rate (concurrent seasonal factors)	5.4	4.9	4.5	4.6	4.6	4.6	4.4
Teenagers	16.7	16.0	14.3	14.7	15.4	16.0	15.1
Men, 20 years and older	4.6	4.2	3.7	3.8	3.8	3.7	3.5
Women, 20 years and older	4.8	4.4	4.2	4.0	4.0	4.0	4.1
Labor force participation rate	66.8	67.1	67.2	67.0	67.1	67.0	67.1
Teenagers	52.3	51.6	52.8	52.7	53.8	52.9	52.4
Men, 20 years and older	76.8	76.9	76.9	76.7	76.7	76.6	76.8
Women, 20 years and older	59.9	60.5	60.5	60.3	60.4	60.4	60.4
Women maintaining families	65.3	67.4	67.7	68.7	69.4	68.2	68.9

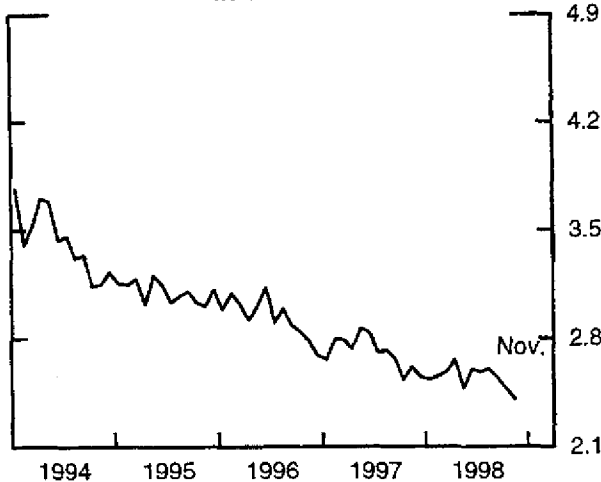
**Unemployment Rate**



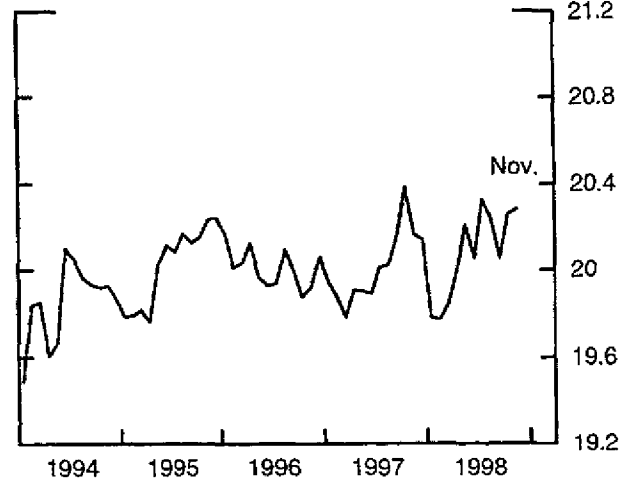
**Labor Force Participation Rate**



**That Wants a Job**



**That Does Not Want a Job**

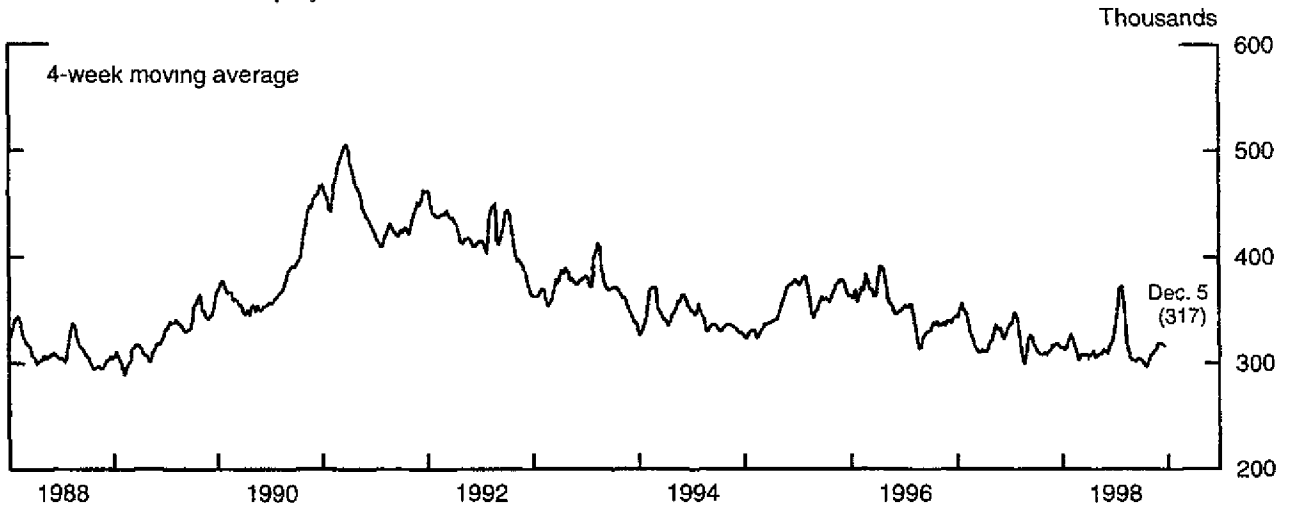


Note. Seasonally adjusted by FRB staff.

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# Labor Market Indicators

Initial Claims for Unemployment Insurance



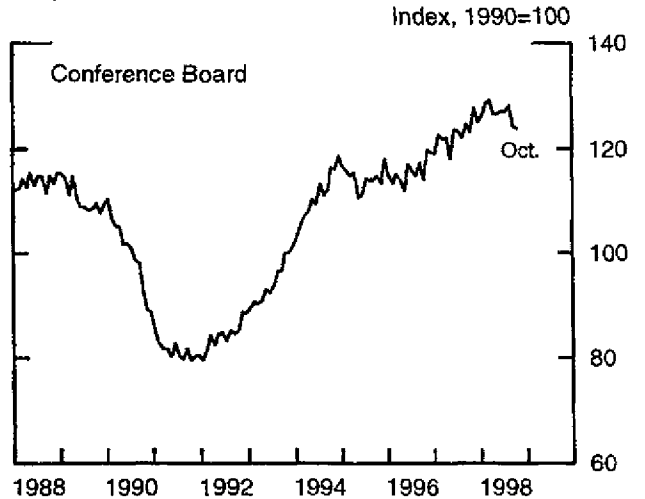
Note. State programs, includes EUC adjustment

Net Hiring Strength



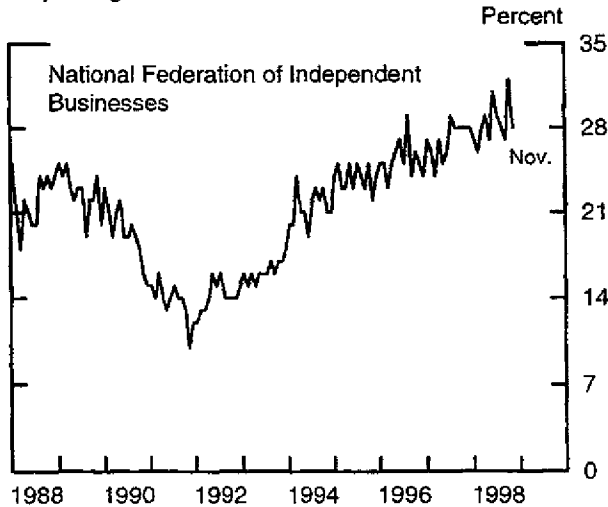
Note. Percent planning an increase in employment minus percent planning a reduction.

Help Wanted Index

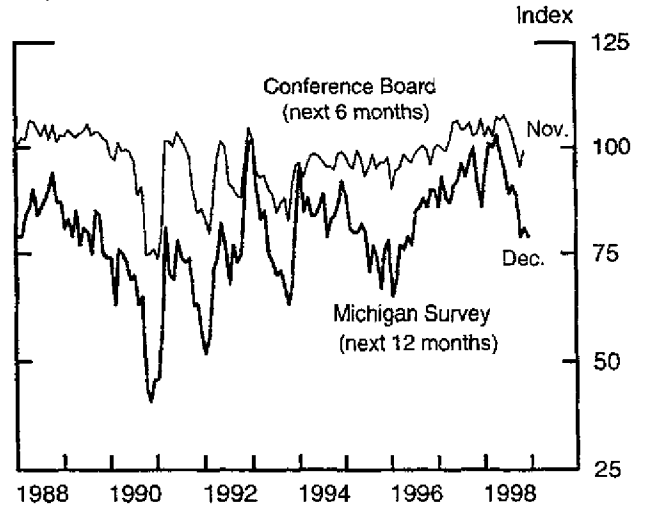


Note. Series has been adjusted to take account of structural and institutional changes, including consolidation of newspaper industry and tendency to increase hiring through personnel supply agencies.

Reporting Positions Hard to Fill



Expected Labor Market Conditions



Note. Michigan index: the proportion of households expecting unemployment to fall less the proportion expecting unemployment to rise plus 100. Conference Board index: the proportion of respondents expecting more jobs less the proportion expecting fewer jobs plus 100.



Using concurrent seasonals, the unemployment rate had held steady at 4.5 percent from June through October and then edged down 0.1 percentage point in November.<sup>4</sup> On a published basis, household employment rose 477,000, and the labor force participation rate ticked up to 67.1 percent--around where it has fluctuated during the past two years.

The four-week moving average of initial claims for unemployment insurance has remained very low, and other indicators--including the Manpower index of net hiring strength and the Conference Board's help-wanted index--point to sustained sizable gains in employment. According to the NFIB survey of small firms, hiring intentions remain high, but tight supplies of potential workers are making positions hard to fill. Consumers' expectations of changes in labor market conditions over the next six or twelve months, as measured by the Conference Board and the Michigan Survey Research Center (SRC), respectively, are less favorable than the levels seen earlier this year: News reports of international turmoil and corporate downsizings evidently have led households to be less sanguine about job prospects.

Productivity in the nonfarm business sector is now estimated to have risen at a 3 percent annual rate in the third quarter and almost 2 percent over the past year. In the nonfinancial corporate sector, output per hour increased 4-1/2 percent last quarter and was up 2-3/4 percent over the past four quarters. The difference in productivity growth rates between these sectors over the past year largely reflects differences in how output is measured: Output has grown more rapidly when measured on the income side of the accounts--as it is for the nonfinancial corporate sector--than when it is measured on the product side of the accounts--as it is for the nonfarm business sector.

Information on labor costs this quarter is limited to the BLS monthly data on average hourly earnings of production or nonsupervisory workers, which increased just 0.2 percent for a third month in November. Over the past twelve months, average hourly earnings increased 3.7 percent, down from a 4 percent rate of rise over the previous twelve-month period; for much of this year, the twelve-month changes were in excess of 4 percent. The deceleration in average hourly earnings has been fairly widespread across industries, but most pronounced in manufacturing. Wages have continued to accelerate in services and in finance, insurance, and real estate, where the annualized increase over the past three months exceeded 6 percent.

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4. When the BLS introduces revised seasonal adjustment factors for the household data next month, we expect the new seasonal pattern to be similar to that obtained with the concurrent seasonal factors available this month.

**LABOR PRODUCTIVITY**  
 (Percent change from preceding period at compound annual rate;  
 based on seasonally adjusted data)

	1996 <sup>1</sup>	1997 <sup>1</sup>	1997 Q4	1998 Q1	1998 Q2	1998 Q3	1997:Q3 to 1998:Q3
<u>Output per hour</u>							
Total business	2.4	1.9	0.9	4.1	0.1	3.1	2.0
Nonfarm business	2.1	1.7	0.9	3.5	0.3	3.0	1.9
Manufacturing	4.7	5.4	4.3	1.6	4.0	5.2	3.8
Nonfinancial corporations <sup>2</sup>	2.4	2.6	1.0	2.6	3.1	4.6	2.8
<u>Compensation per hour</u>							
Total business	3.9	4.0	5.3	4.9	4.1	3.8	4.5
Nonfarm business	3.7	3.9	4.9	4.6	4.0	4.1	4.4
Manufacturing	2.4	5.3	8.0	4.1	2.6	3.3	4.5
Nonfinancial corporations <sup>2</sup>	3.4	3.9	5.0	3.6	4.6	4.2	4.3
<u>Unit labor costs</u>							
Total business	1.5	2.0	4.4	0.8	4.0	0.7	2.5
Nonfarm business	1.6	2.1	4.0	1.1	3.7	1.1	2.5
Manufacturing	-2.2	-0.1	3.6	2.4	-1.3	-1.8	0.7
Nonfinancial corporations <sup>2</sup>	0.9	1.2	4.0	0.9	1.5	-0.4	1.5
Memo: ECI compensation per hour	3.1	3.4	4.3	2.7	3.6	4.4	3.8

1. Changes are from fourth quarter of preceding year to fourth quarter of year shown.

2. Nonfinancial corporate sector includes all corporations doing business in the United States except banks, stock and commodity brokers, and finance and insurance companies; the sector accounts for about two-thirds of business employment.

**AVERAGE HOURLY EARNINGS**  
(Percentage change; based on seasonally adjusted data)

	Twelve-month percent change			Percent change to Nov. 1998 since		1998	
	Nov. 1996	Nov. 1997	Nov. 1998	May 1998	Aug. 1998	Oct.	Nov.
	----- Annual rate -----					-Monthly rate-	
Total private nonfarm	3.7	4.0	3.7	3.2	2.5	0.2	0.2
Manufacturing	3.4	3.3	1.9	1.8	2.1	0.0	0.1
Construction	2.5	4.1	3.2	3.7	2.2	0.7	0.5
Finance, insurance, and real estate	4.0	4.9	5.3	4.9	6.1	0.6	0.8
Retail trade	4.5	4.6	4.2	3.0	0.9	-0.2	0.1
Wholesale trade	4.1	4.8	3.5	2.9	1.1	0.4	0.1
Services	4.0	4.1	4.6	3.9	3.4	0.3	0.2

**Average Hourly Earnings of Production or Nonsupervisory Workers**



\*Three-month moving average of twelve-month changes.

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

	Proportion 1997	1997 <sup>1</sup>	1998		1998		
			H1	Q3	Sept.	Oct.	Nov.
			-Annual rate-		--Monthly rate--		
Total index	100.0	6.6	2.2	.9	-.4	.2	-.3
Mining	6.1	2.1	-1.1	-5.8	-1.0	-.8	-1.2
Utilities	6.3	1.9	2.4	14.9	.2	-3.7	-3.4
Manufacturing	87.6	7.3	2.5	.4	-.4	.6	.0
Motor vehicles and parts	5.2	12.8	-15.8	5.7	-2.8	-.2	.2
Aircraft and parts	2.6	20.1	18.7	2.0	-1.0	1.2	-1.9
High-tech	8.3	38.5	23.1	29.1	3.2	2.3	2.1
Other manufacturing	71.4	3.2	1.0	-3.0	-.6	.4	-.2
Consumer goods	23.3	1.6	1.6	-5.9	-.9	.4	.4
Business equipment	8.9	5.7	1.2	2.2	.2	1.1	-.9
Construction supplies	5.4	2.1	4.2	6.0	-.9	1.2	.7
Business supplies	7.5	3.6	.9	-.4	-.3	.9	-.5
Materials	24.6	4.3	-.6	-4.9	-.5	-.1	-.6
Durables	16.1	4.5	.3	-4.8	-.4	.0	-.7
Nondurables	8.3	4.6	-2.1	-3.7	-1.0	-.5	-.4
Memo: High-tech industries							
Computer equipment	2.1	43.6	65.2	38.9	3.9	3.2	3.0
Communication equipment	2.0	15.2	11.4	7.3	1.1	-.7	-1.2
Semiconductors <sup>2</sup>	4.2	48.6	9.3	37.6	4.0	3.4	3.4

1. From the final quarter of the previous period to the final quarter of the period indicated.

2. Includes related electronic components.

CAPACITY UTILIZATION  
(Percent of capacity; seasonally adjusted)

	1988-89	1959-97	1998			1998		
	High	Avg.	Q1	Q2	Q3	Sept.	Oct.	Nov.
Manufacturing	85.7	81.7	81.8	81.2	80.2	80.1	80.2	79.8
Primary processing	88.9	82.8	84.8	84.1	82.8	82.0	82.1	81.7
Advanced processing	84.2	81.2	80.8	80.2	79.3	79.5	79.6	79.3

## Industrial Production

Activity in the industrial sector remained soft in November.<sup>5</sup> Total industrial production declined 0.3 percent, held down by a steep weather-related drop in utilities output and continued weakness in mining output. Manufacturing production was unchanged, and the factory operating rate fell to 79.8 percent--matching the lowest level in more than five years.

Output in the high-technology sector continued to increase rapidly in November. Production of semiconductors, which has been recovering steadily since midyear, rose 3-1/2 percent, and the apparent pickup in demand for semiconductor manufacturing equipment in recent months provides further evidence that the slump in semiconductors has ended. Gains in computer output have also been sizable of late--though somewhat below the spectacular first-half pace. Output of communications equipment fell in November for a second month after having posted sizable increases over the first three quarters of the year.

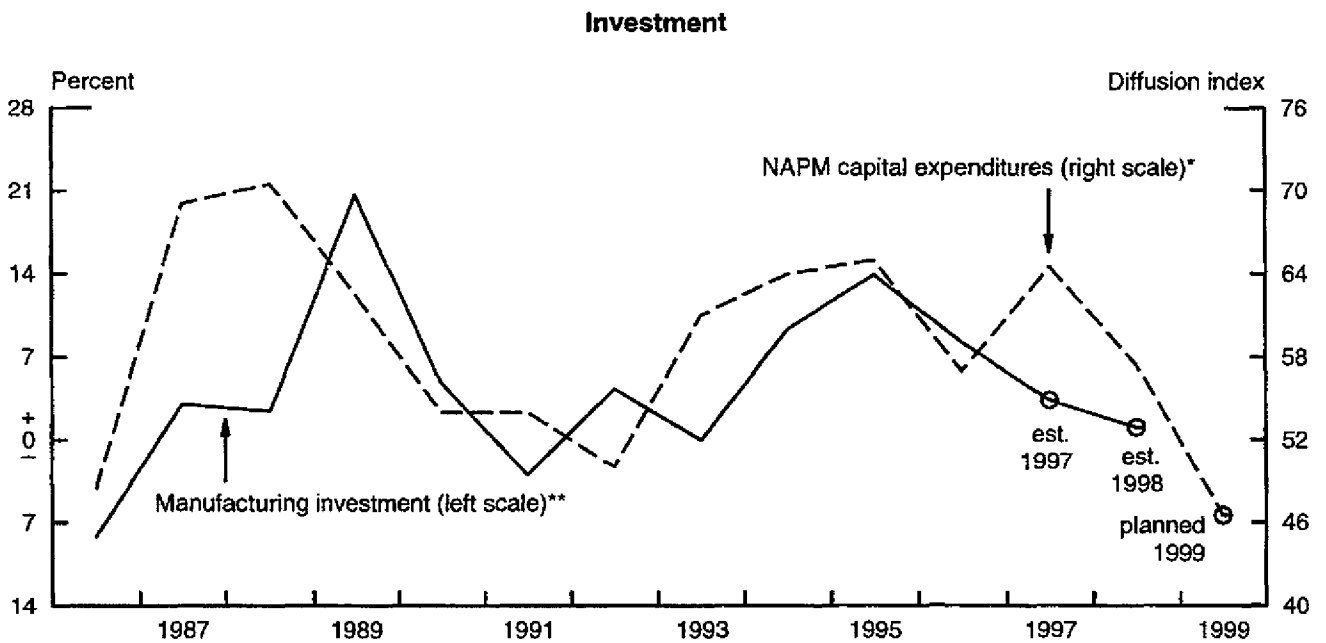
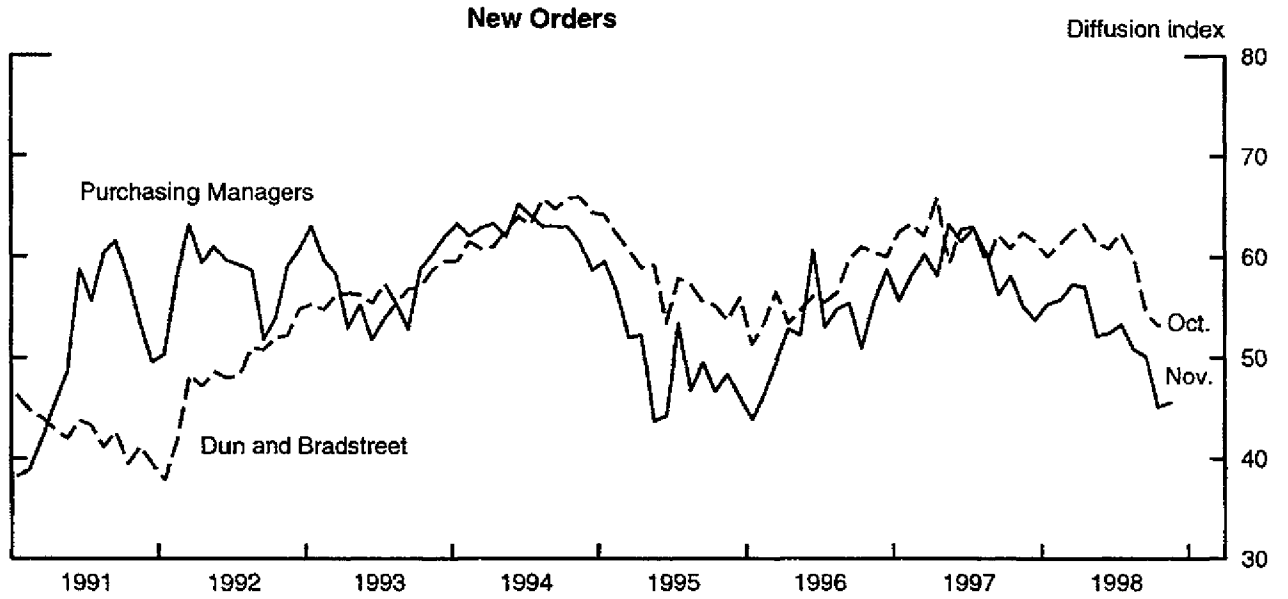
Motor vehicle assemblies totaled 12.9 million units at an annual rate in November, essentially the same as in October and more than 1 million units above the average pace over the first three quarters of the year. The high assembly rates in the past couple of months reflect both the continuing recovery from the strikes at General Motors last summer and the strong pace of sales. With inventories remaining lean, manufacturers have scheduled assemblies in December at 12-3/4 million units and plan to keep production at this rate in the first quarter.

Production of aircraft and parts declined in November but remained at a very high level. Boeing is aiming to deliver a record number of planes in December, and, like last year, will keep some assembly lines operating during their usual Christmas break to help meet this goal. Looking ahead, however, Boeing has announced sizable reductions in production rates for late 1999 and for 2000. These reductions will come on top of the previously planned slowdown in the production of 747s slated to begin in the spring of 1999. A Boeing official has indicated that upstream suppliers have already been affected by the planned slowdown in the production of 747s in 1999.

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5. On November 24, the Federal Reserve published a revision of the index of industrial production and the related measures of capacity and utilization for the period 1992 to date. The recent paths of industrial production and capacity were revised up because of more rapid growth in the output and capacity of high-technology industries. The rate of industrial capacity utilization in the third quarter of 1998 was estimated to be 0.4 percentage point above its previous published figure. With the exception of stronger growth of manufacturing production in the second and third quarters of 1998--mostly due to higher assemblies of commercial aircraft--the quarterly pattern of output growth was roughly unchanged.

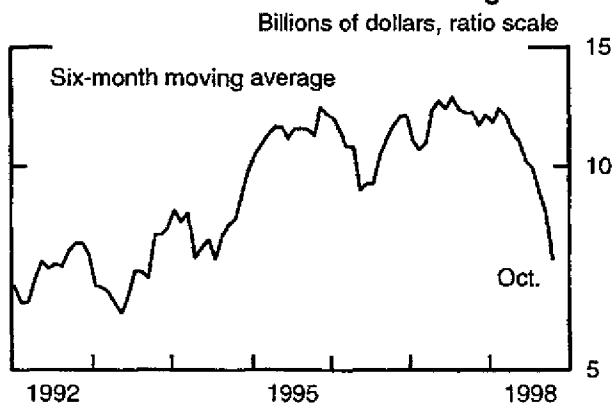
## Indicators for the Manufacturing Sector



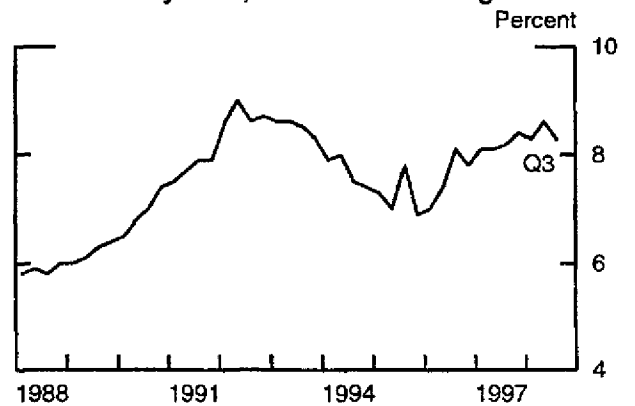
\*One half of the percentage of respondents reporting higher capital expenditures minus one half of the percentage reporting lower capital expenditures plus 50.

\*\*Percent change in nominal manufacturing investment. Source: Annual Survey of Manufacturers. The figures for 1997 and 1998 are staff estimates.

### Contracts for Industrial Buildings



### Vacancy Rate, Industrial Buildings



Elsewhere, manufacturing production remained weak in November, with widespread declines in the production of business equipment and business supplies. Furthermore, materials output continued to trend down; in particular, production of iron and steel plummeted. In contrast, consumer goods production rose, mostly owing to increases in the production of appliances, food, and chemicals. The output of construction supplies advanced briskly for a second month.

**Production of Domestic Autos and Trucks**  
(Millions of units at an annual rate; FRB seasonal basis)

Item	1998					1999
	Oct.	Nov.	Dec. <sup>1</sup>	Q3	Q4 <sup>1</sup>	Q1 <sup>1</sup>
U.S. production	13.0	12.9	12.7	11.4	12.8	12.7
Autos	6.1	5.8	5.8	5.6	5.9	5.7
Trucks	6.9	7.1	6.9	5.8	7.0	7.0

NOTE. Components may not sum to totals because of rounding.

1. Production rates are manufacturers' schedules.

Looking beyond November, most indicators point to continued softness in the manufacturing sector. The October and November readings in the National Association of Purchasing Management (NAPM) index of new orders were the lowest since early 1996, and the Dun and Bradstreet index edged down in October, after having fallen sharply in September. In addition, the staff's series of real adjusted durable goods orders turned down in October, following a sizable gain in the third quarter--and that prior increase was concentrated in categories with long production cycles and thus is expected to provide only a small boost to industrial production over the near term. On the other hand, anecdotal evidence from the Beige Book and the Board staff's contacts with industrial firms sent more mixed signals: Producers of computers, lumber, building materials, aerospace equipment, trucks, and office supplies reported strong orders in recent months, while manufacturers of steel, chemicals, and paper indicated that business is quite weak.

**New Orders for Durable Goods**  
(Percent change from preceding period; seasonally adjusted)

Component	Share, 1998:H1	1998				
		Q2	Q3	Aug.	Sept.	Oct.
Total durable goods	100.0	-8	2.7	2.0	1.3	-2.2
Adjusted durable goods <sup>1</sup>	70.0	-6	3.3	-1.7	2.9	-2.9
Computers	6.0	4.3	2.7	-1.3	-2.2	1.9
Nondefense capital goods excluding aircraft and computers	18.0	-2.5	5.4	3.8	9.3	-11.7
Other	46.0	-5	2.6	-3.7	1.1	.3
MEMO						
Real adjusted orders <sup>2</sup>	...	.7	4.9	-1.1	3.3	-2.7
Real adjusted orders excluding engines and turbines	...	.7	3.6	-1.8	2.0	-.8

1. Orders excluding defense capital goods, nondefense aircraft, and motor vehicle parts.

2. Nominal adjusted durable goods orders were split into three components: computers, electronic components, and all other. The components were deflated and then aggregated in a chain-weighted fashion.

... Not applicable.

This year's slowing in manufacturing production--and the expectation of only a limited recovery in 1999--apparently is leaving a mark on plans for capital spending in 1999. According to the semiannual NAPM survey, which provides the first reading on 1999 investment plans, more manufacturing firms are planning to reduce nominal investment spending next year than are planning to increase it. In the past, the diffusion index that summarizes these numbers has been a useful predictor of the change in manufacturers' investment, and, all else equal, the latest reading points to some slowdown in capacity growth in 1999. In addition, contracts for industrial buildings have been falling steadily this year, while the vacancy rate has remained high.



### Personal Consumption Expenditures and Income

Consumer spending has remained strong so far this quarter.<sup>6</sup> Total nominal retail sales rose 0.6 percent in November, and the retail control category--which excludes sales at automotive dealers and building and material supply stores--rose 0.4 percent. In addition, sales at the retail control group are now estimated to have risen 0.8 percent in October, 0.3 percentage point more than reported in the advance data. Most major categories within the retail control recorded sizable gains last month, but the rise in sales at GAF stores (general merchandise, apparel, and furniture and appliance stores) was especially large. Over past twelve months, sales in the GAF category have risen 6-3/4 percent.

Taken together, the November retail sales report and the available information on consumer prices suggest that real expenditures for goods other than motor vehicles rose a solid 1/2 percent in November, to stand about 1-1/4 percent above the third-quarter average. We estimate that total real goods outlays in November were 1-1/2 percent above their third-quarter average.

Real expenditures for services were little changed in October (the last month for which data are available), as a steep weather-related drop in energy spending offset gains elsewhere.<sup>7</sup> Spending on services likely remained weak in November, as temperatures averaged above normal and stock market volume declined.

Fundamentals remain strong in the household sector. Real disposable income rose 3-1/4 percent over the year ending in October, about in line with the average of the past few years. Production worker hours and wages both rose in November, which points to another increase in income last month. In addition, the rebound in the stock market thus far this quarter has reversed much of the third-quarter drop in the wealth-to-income ratio. Consumer sentiment, as measured by the Michigan SRC, remained at

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6. Purchases made over the Internet have soared over the past couple of years and, according to a study by The Boston Consulting Group, exceeded \$13 billion in 1998, about 0.2 percent of total PCE. So far, they do not appear to be creating great difficulties for the NIPA. One reason is that a sizable share of Internet spending is for brokerage and travel services; in the NIPA, expenditures in these categories are estimated from sources such as stock market volume and passenger air miles rather than from point-of-purchase data. As for goods, the Census Bureau includes--and regularly adds--web sites to the annual and monthly samples used for the retail sales survey and thus should be capturing purchases made on line. Payments made by consumers for actual Internet use or on-line access are included in the services category of PCE.

7. The October decline in energy services was in electricity and reflected the return to more seasonal temperatures after much warmer-than-average weather boosted air conditioning use in August and September. In November, energy outlays likely fell again, as the warm weather reduced the need for heating.

**RETAIL SALES**  
(Percent change from preceding period)

	1998		1998		
	Q2	Q3	Sept.	Oct.	Nov.
Total sales	1.9	.0	.4	1.2	.6
Previous estimate		-.1	.3	1.0	
Building materials and supplies	2.3	.4	.8	.6	.9
Automotive dealers	3.6	-3.0	1.2	2.6	1.3
Retail control <sup>1</sup>	1.3	1.0	.0	.8	.4
Previous estimate		1.0	.0	.5	
GAF <sup>2</sup>	1.1	.6	-.2	.6	1.2
Durable goods	.0	1.9	-.1	1.1	.4
Furniture and appliances	-.6	2.6	-.2	.1	.8
Other durable goods	.6	1.3	-.1	1.9	-.0
Nondurable goods	1.6	.8	.1	.7	.4
Apparel	1.1	-.6	-3.2	2.2	.8
Food	1.7	1.1	.0	.4	.6
General merchandise	1.8	.1	.9	.3	1.4
Gasoline stations	-.4	.4	-.2	.1	.0
Other nondurable goods	2.1	1.6	.4	1.2	-.5

1. Total retail sales less sales at building material and supply stores and automotive dealers, except auto and home supply stores.
2. General merchandise, apparel, furniture, and appliance stores.

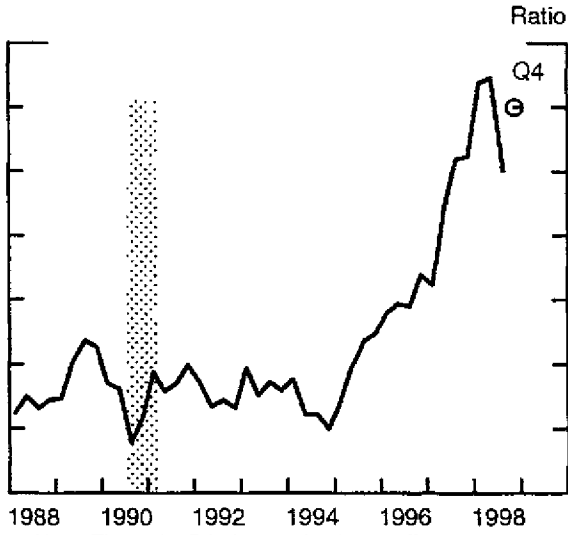
**PERSONAL INCOME**  
(Average monthly percent change)

	1996	1997	1998			1998		
			Q1	Q2	Q3	Aug.	Sept.	Oct.
		-- Q4/Q4 --	-- Annual rate --			--- Monthly rate ---		
Total personal income	5.9	5.4	5.9	4.5	4.3	.4	.2	.4
Wages and salaries	6.5	7.2	7.4	5.6	5.8	.7	.2	.5
Private	7.3	7.9	7.9	6.0	6.2	.8	.2	.5
Other labor income	-2.4	2.8	5.9	2.9	2.7	.2	.2	.2
Less: Personal tax and nontax payments	12.4	11.5	17.1	10.1	5.6	.8	.0	.3
Equals: Disposable personal income	4.9	4.4	4.0	3.5	4.1	.3	.3	.5
Memo:								
Real disposable income <sup>1</sup>	2.7	2.9	4.0	2.6	3.1	.2	.3	.3
Saving rate (percent)	2.9	2.1	1.2	.4	.2	.3	-.1	-.2

1. Derived from billions of chained (1992) dollars.

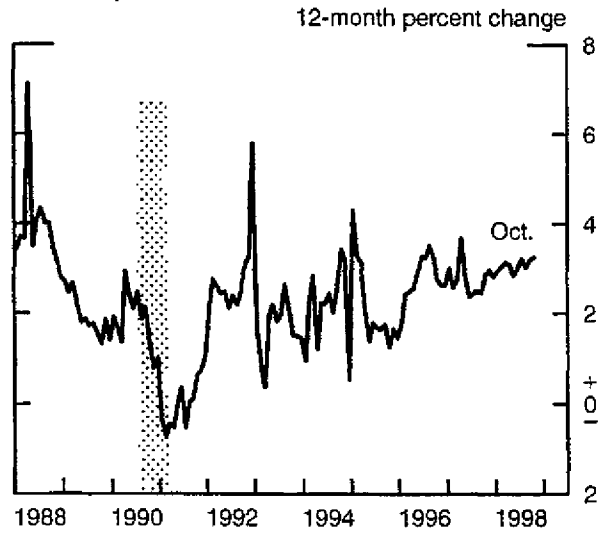
## Household Indicators

Ratio of Net Worth to DPI

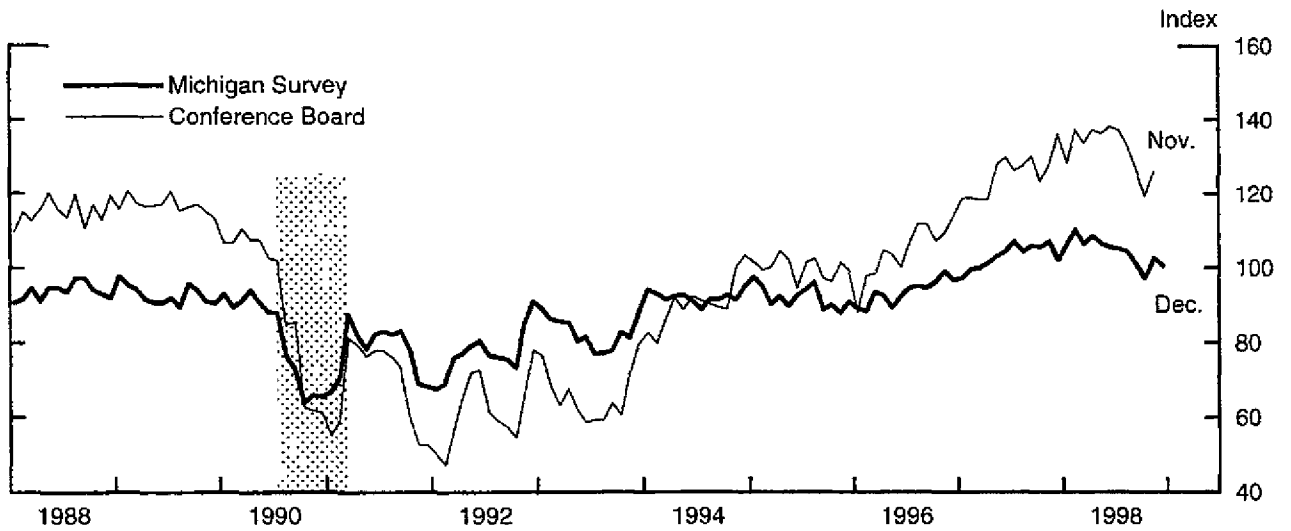


Note. The 1998:Q4 observation is a staff estimate.

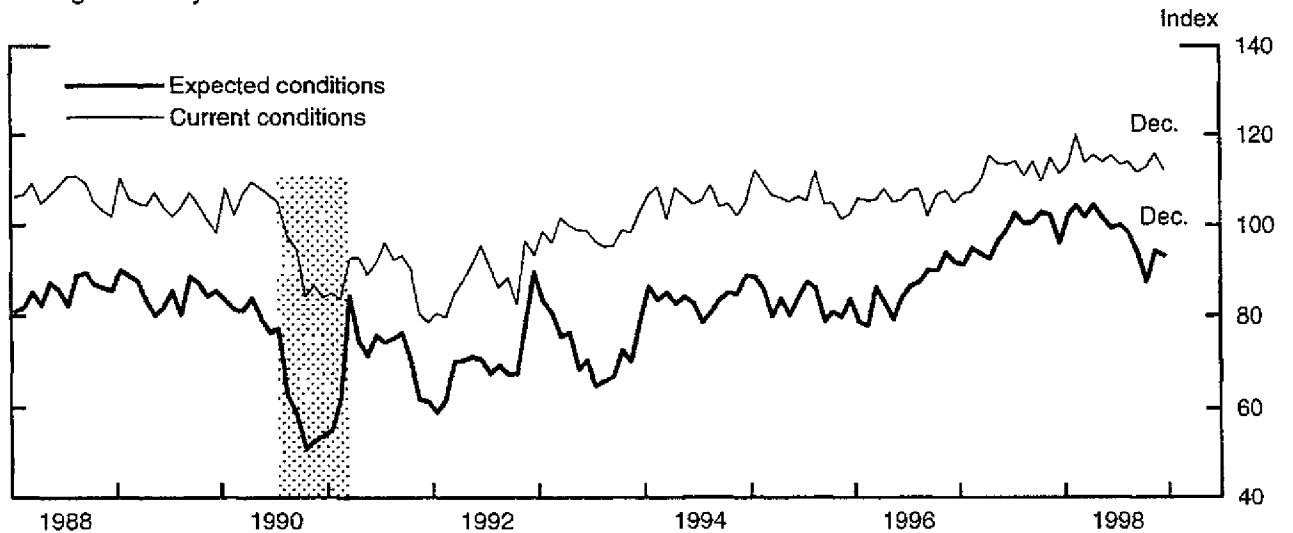
Real Disposable Personal Income



Consumer Confidence



Michigan Survey



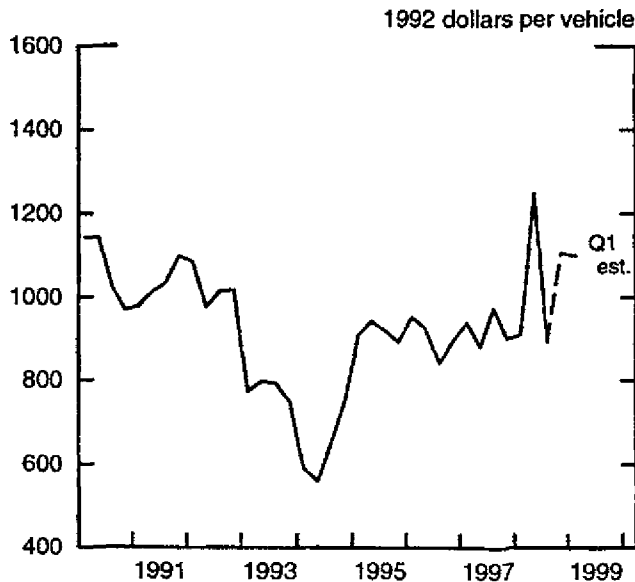
SALES OF AUTOMOBILES AND LIGHT TRUCKS  
(Millions of units at an annual rate, FRB seasonals)

	1996	1997	1998			1998		
			Q1	Q2	Q3	Sept.	Oct.	Nov.
Total	15.0	15.1	15.1	16.1	14.6	15.5	16.4	15.3
Adjusted <sup>1</sup>	15.1	15.0	15.3	16.0	14.6	15.5	16.3	15.4
Autos	8.5	8.3	8.0	8.4	7.7	8.2	8.7	7.9
Light trucks	6.5	6.8	7.0	7.6	6.8	7.3	7.7	7.4
North American <sup>2</sup>	13.3	13.1	13.1	14.1	12.5	13.5	14.3	13.2
Autos	7.3	6.9	6.6	7.1	6.4	6.9	7.3	6.5
Big Three	5.3	4.9	4.7	5.0	4.2	4.9	5.0	4.5
Transplants	2.0	2.0	1.9	2.0	2.3	2.0	2.2	2.0
Light trucks	6.1	6.2	6.5	7.0	6.2	6.6	7.0	6.7
Foreign Produced	1.7	1.9	1.9	2.0	2.0	1.9	2.1	2.1
Autos	1.3	1.4	1.4	1.4	1.3	1.2	1.4	1.4
Light trucks	.4	.6	.6	.6	.7	.7	.7	.7

Note. Components may not add to totals because of rounding. Data on sales of trucks and imported autos for the most recent month are preliminary and subject to revision.

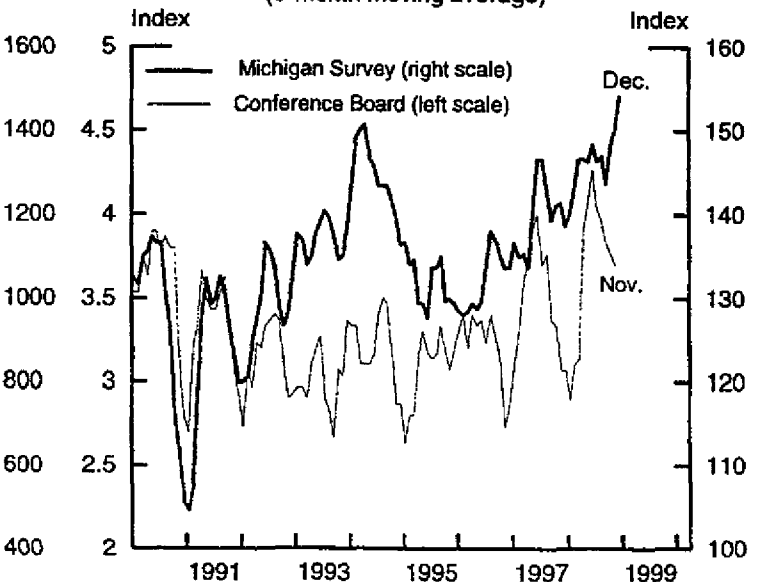
1. Excludes the estimated effect of automakers' changes in reporting periods.
2. Excludes some vehicles produced in Canada that are classified as imports by the industry.

**New Car and Light Truck Incentives**



Note. Incentive data from J.D. Power, deflated by CPI for all items.

**Buying Attitudes for New Vehicles**  
(3-month moving average)



a relatively favorable level in early December, although it has retraced only a little of the decline it has posted since peaking earlier this year.

### **Motor Vehicles**

Sales of new light vehicles remained strong in November at 15.4 million units at an annual rate (adjusted for shifts in reporting periods), although they were one million units below the spectacular pace of October. Among the major companies, Chrysler, Toyota, and Honda reported high levels of sales in both months. But sales at General Motors and Ford, which were boosted in October by heavy incentives on 1998 models, dropped sharply in November as supplies of these cars dwindled. The disappointing November results at GM--despite the generous incentives on 1999 vehicles--are likely a factor behind its decision to extend its incentives into the first quarter.

According to the Michigan SRC, consumers' attitudes toward car-buying conditions remained upbeat in early December, reflecting favorable assessments of prices. Increases in sticker prices on the 1999 models were modest and incentive programs have been generous. The Conference Board index of buying intentions was about unchanged in November at a fairly high level. In addition, auto company sources have indicated informally that sales in early December remained robust.

### **Housing Markets**

Housing has continued to boom. Single-family starts were at a 1.35 million unit annual rate in November, up 60,000 units from the strong October pace. Sales of new homes were at an 851,000 unit annual rate in October; for 1998 as a whole, new home sales are on track to break the high recorded in 1977. The October level of existing homes sales (which is a lagging indicator) was about the same as the average from January to September.

Near-term leading indicators point to continued strength in single-family housing for at least the next few months. The thirty-year fixed mortgage rate averaged about 6.7 percent during the first half of December, down a bit from November. After having spiked to a record in October, mortgage applications for home purchase have slipped a bit, on net, during the past six weeks, but are still at a very high level. The jump in October applications coincided with a short-lived dip in the fixed mortgage rate to below 6.5 percent. In December, builders' assessments of homebuying conditions broke the record set in November; similarly, consumers' assessments of homebuying conditions, as measured by the Michigan SRC, hit a record last month.

The typical seasonal pattern looks for single-family starts to decline about

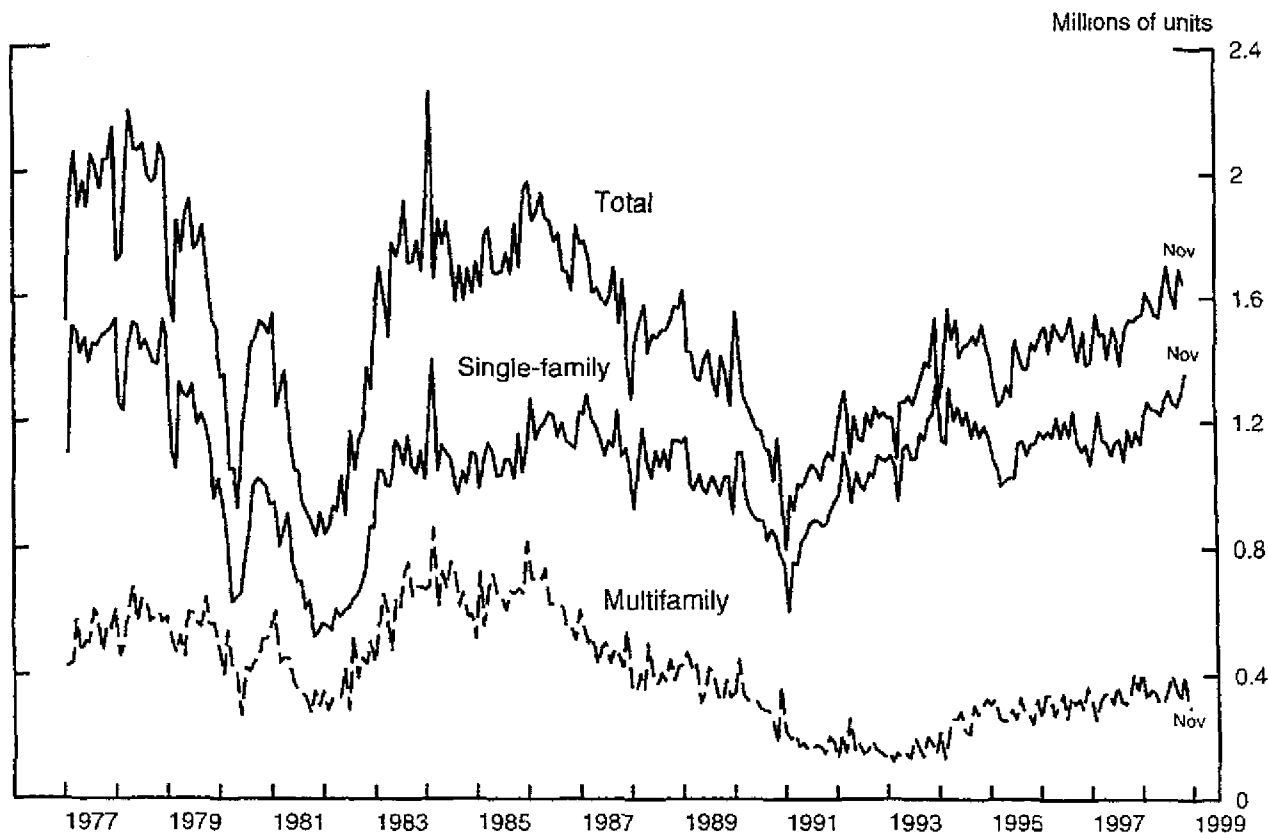
**Private Housing Activity**  
(Millions of units; seasonally adjusted annual rate)

	1997	1998					
		Q1	Q2	Q3 <sup>r</sup>	Sept. <sup>r</sup>	Oct. <sup>r</sup>	Nov. <sup>p</sup>
<i>All units</i>							
Starts	1.47	1.58	1.57	1.63	1.57	1.69	1.65
Permits	1.44	1.59	1.53	1.58	1.54	1.69	1.65
<i>Single-family units</i>							
Starts	1.13	1.24	1.24	1.27	1.25	1.29	1.35
Permits	1.06	1.15	1.14	1.17	1.16	1.20	1.23
Adjusted permits <sup>1</sup>	1.14	1.24	1.23	1.26	1.26	1.28	1.32
New home sales	.80	.86	.90	.85	.84	.85	n.a.
Existing home sales	4.22	4.68	4.78	4.78	4.69	4.79	n.a.
<i>Multifamily units</i>							
Starts	.34	.34	.33	.36	.32	.41	.30
Permits	.39	.44	.38	.41	.38	.49	.42
<i>Mobile homes</i>							
Shipments	.35	.37	.37	.37	.37	.38	n.a.

Note. p Preliminary. r Revised. n.a. Not available.

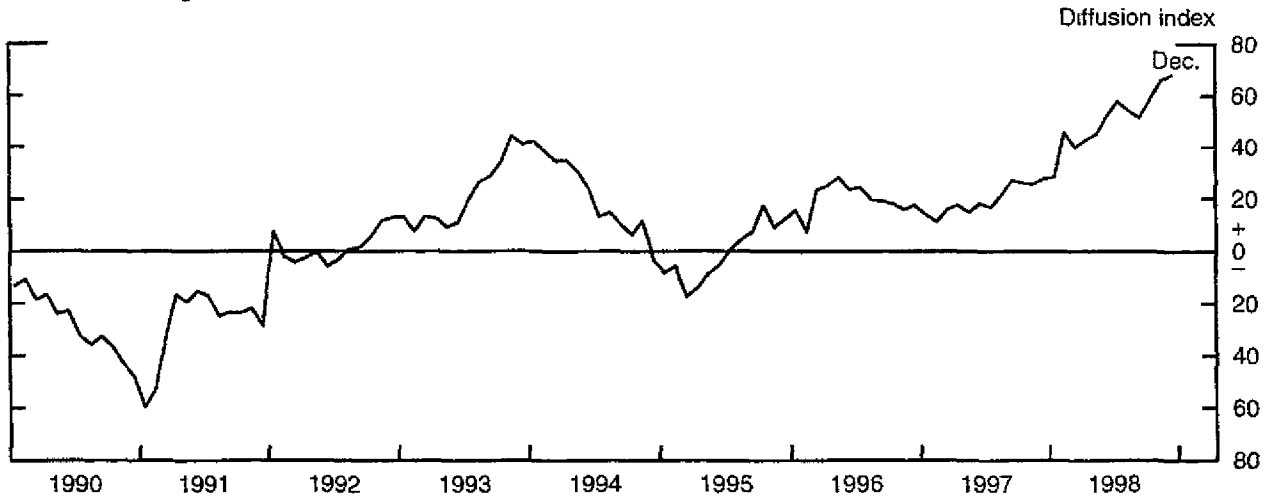
1. Adjusted-permits equals permit issuance plus total starts outside of permit-issuing areas, minus a correction for those starts in permit-issuing places that lack a permit.

**Private Housing Starts**  
(Seasonally adjusted annual rate)



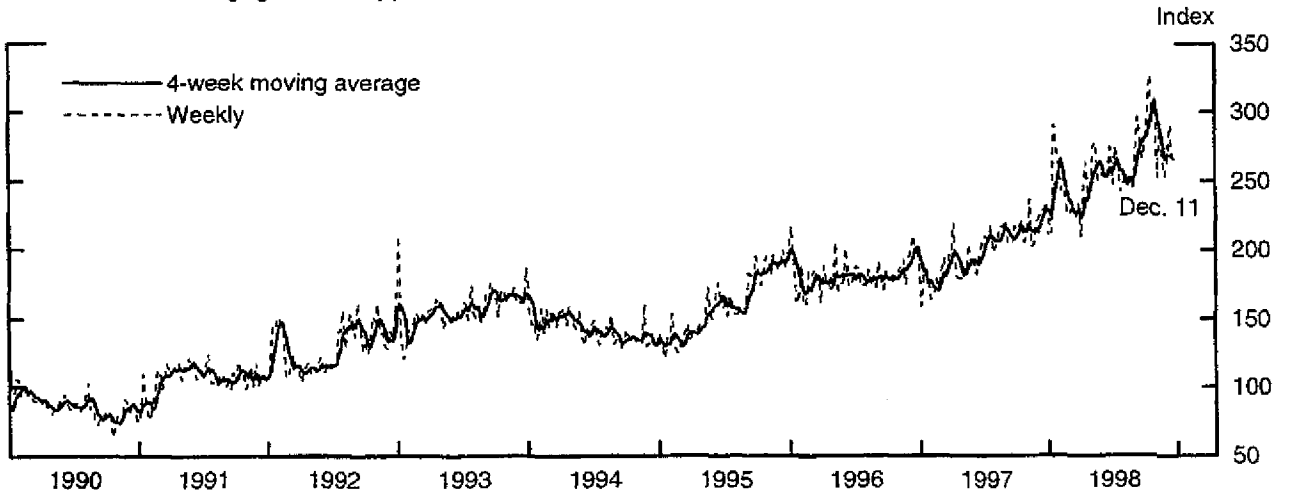
## Indicators of Housing Demand

Builders' Rating of New Home Sales, SA

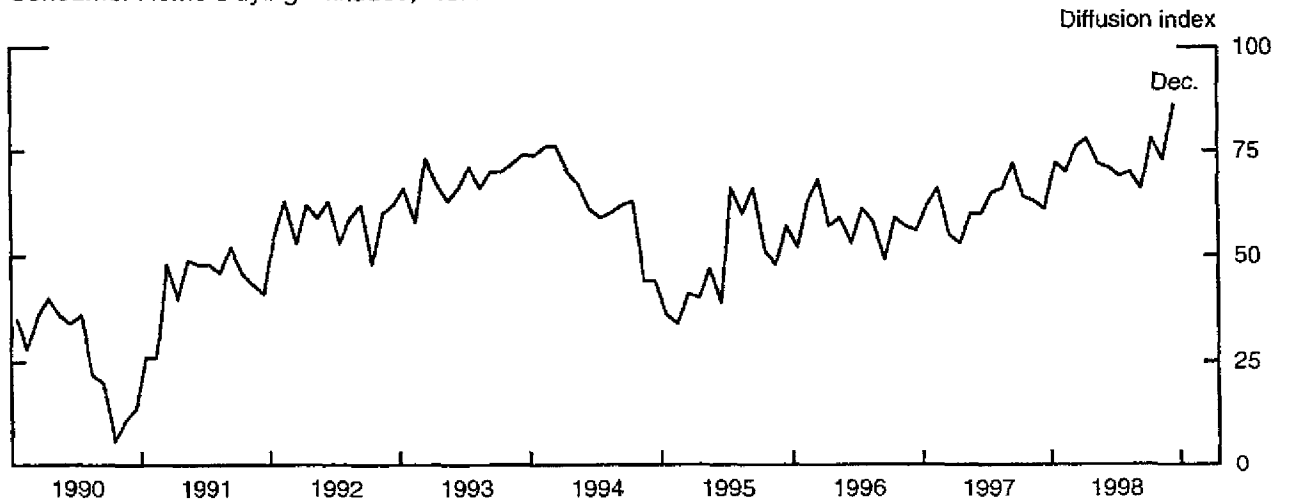


Note. The index is calculated from National Association of Homebuilders data as the proportion of respondents rating current sales as good minus the proportion rating them as poor.

MBA Index of Mortgage Loan Applications for Home Purchase, SA



Consumer Home-Buying Attitudes, NSA



Note. The homebuying attitudes index is based on the Michigan Survey and is calculated as the proportion of respondents rating current conditions as good minus the proportion rating conditions as bad.

**BUSINESS CAPITAL SPENDING INDICATORS**  
 (Percent change from preceding comparable period;  
 based on seasonally adjusted data, in current dollars)

	1998		1998		
	Q2	Q3	Aug.	Sept.	Oct.
<u>Producers' durable equipment</u>					
Shipments of nondefense capital goods	1.4	1.6	-.2	4.3	.6
Excluding aircraft and parts	1.6	1.4	-.9	3.0	-.1
Office and computing	4.7	2.0	-2.4	-1.0	3.9
Communications equipment	.8	2.1	3.7	9.5	-4.0
All other categories	.6	1.0	-1.5	3.0	-.6
Shipments of complete aircraft	-12.6	5.3	-20.0	-3.3	62.8
Sales of heavy trucks	4.7	9.9	5.7	3.6	4.2
Orders for nondefense capital goods	-.1	4.3	9.1	-3.3	-6.7
Excluding aircraft and parts	-.9	4.7	2.5	6.4	-8.6
Office and computing	4.3	2.7	-1.3	-2.2	1.9
Communications equipment	-4.9	-3.0	6.2	17.8	-4.1
All other categories	-1.8	7.7	3.2	7.2	-13.8
<u>Nonresidential structures</u>					
Construction put in place, buildings	1.1	.5	1.8	-3.0	.9
Office	5.7	.4	-.4	1.1	5.5
Other commercial	.6	-2.8	-3.9	-6.3	2.1
Institutional	-2.3	-.8	3.6	-.2	-.3
Industrial	-2.5	-.5	13.3	-8.3	-4.6
Lodging and miscellaneous	4.3	11.3	1.1	.8	-.1
Rotary drilling rigs in use <sup>1</sup>	-11.9	-13.4	-5.7	-4.7	-5.9
Memo (1992 Chained dollars):					
Business fixed investment	12.8	-1.2	n.a.	n.a.	n.a.
Producers' durable equipment	18.8	-1.1	n.a.	n.a.	n.a.
Office and computing	59.7	49.5	n.a.	n.a.	n.a.
Communications equipment	10.2	11.8	n.a.	n.a.	n.a.
Other equipment <sup>2</sup>	8.8	2.5	n.a.	n.a.	n.a.
Nonresidential structures	-2.3	-1.5	n.a.	n.a.	n.a.

1. Percent change of number of rigs in use, seasonally adjusted.  
 2. Producers' durable equipment excluding office and computing, communications, motor vehicles, and aircraft and parts.  
 n.a. Not available.



50 percent from October to January. However, many builders are apparently carrying a large backlog of orders, which provides an incentive for them to curtail starts less than usual this year. Of course, builders' ability to do this will depend, in part, on the weather and on the willingness of workers to stay on construction sites beyond the normal season. Indeed, this phenomenon may help explain some of the strength in starts in November. To the extent that builders are able to continue to defy the normal seasonal downshift, seasonally adjusted starts could be boosted considerably over the next few months; after seasonal adjustment, each unit actually begun in January is equivalent to about 1-3/4 units started in June.

Multifamily housing starts averaged about 350,000 units at an annual rate in October and November, just above the average for the first nine months of the year. Financing for most of the units started in the past couple of months was probably put together before the recent turmoil in the market for commercial mortgage backed securities (CMBS).

Permit issuance for multifamily units has been running at a fairly high level, on balance, this fall, suggesting that starts of such units will be well-maintained for at least the next couple of months. In addition, financing conditions have eased. In particular, spreads for CMBS--though substantially above the very low levels seen last spring--have narrowed in the past few weeks. Moreover, the multifamily sector has a fairly broad base of credit suppliers, and industry contacts report that pension funds, insurance companies, and government sponsored enterprises, including Freddie Mac and Fannie Mae, have continued to be active players, helping to blunt the impact of the difficulties in the CMBS and REIT markets.

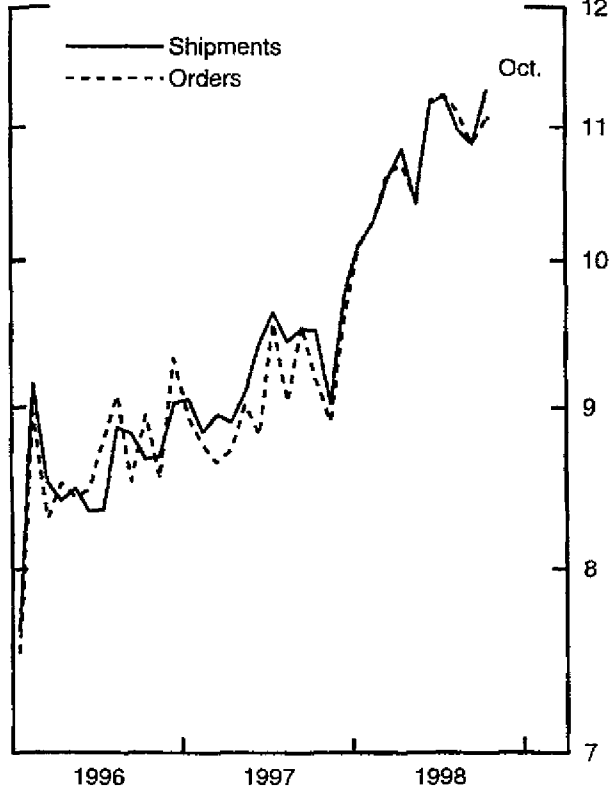
### **Business Fixed Investment**

Real business fixed investment appears to have picked up markedly of late, after having been depressed in the third quarter by a strike-related drop in business purchases of motor vehicles and ongoing weakness in nonresidential construction.

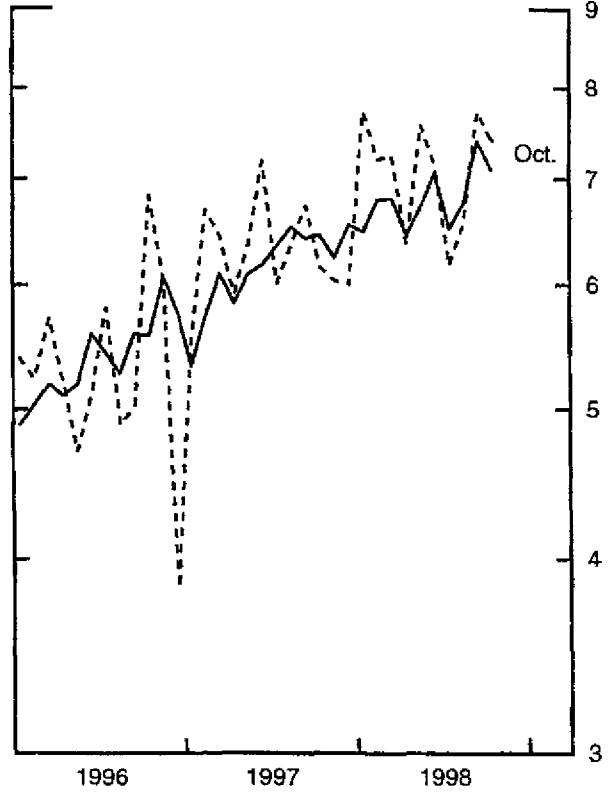
**Producers' durable equipment.** Real expenditures on producers' durable equipment have posted sizable gains of late after having hit a lull in the third quarter. Nominal shipments of office and computing equipment climbed almost 4 percent in October, after two months of decline, and, with computer prices falling rapidly, real expenditures on office and computing equipment look poised to post another large gain in the fourth quarter. Outlays for communications equipment are also likely to register a hefty gain: Shipments--although down in October--were 3 percent above

## Orders and Shipments of Nondefense Capital Goods

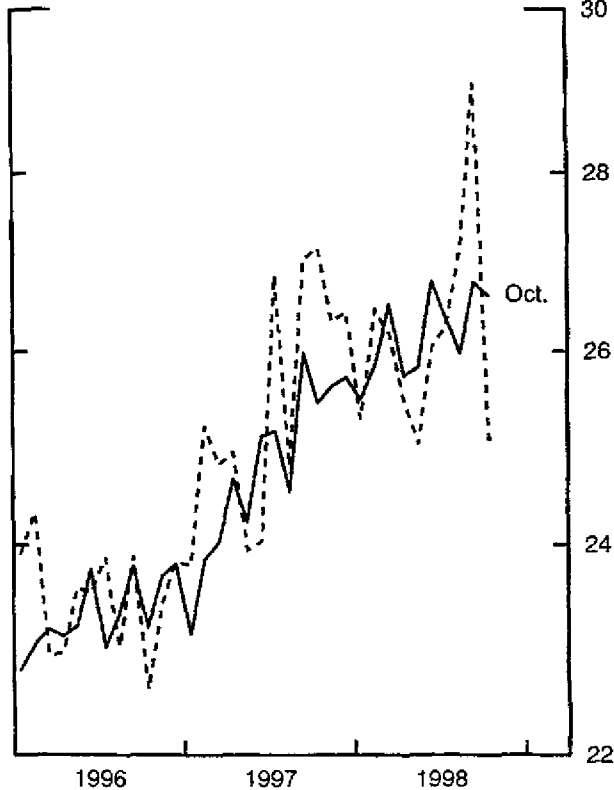
Office and Computing Equipment  
Billions of dollars, ratio scale



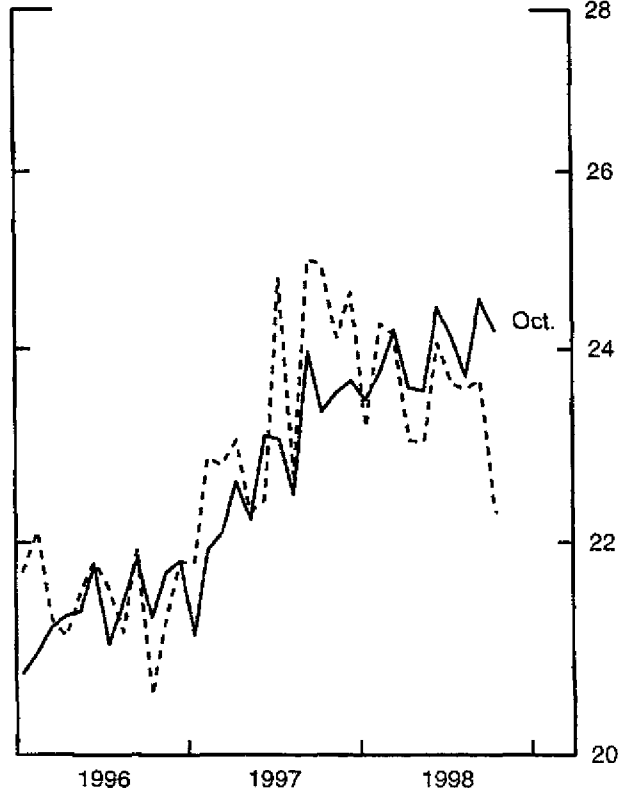
Communications Equipment  
Billions of dollars, ratio scale



Other Equipment  
Billions of dollars, ratio scale



Other Equipment Less Engines and Turbines  
Billions of dollars, ratio scale



their third-quarter level, and with new orders running well ahead of shipments, a sizable backlog of orders remains to be filled.

Outlays for transportation equipment are also rising briskly this quarter. Fleet sales of light vehicles to businesses rebounded smartly in October and November, after having been held down in the third quarter when General Motors routed vehicles to the consumer market. Sales of heavy trucks surged to record levels this fall, and business expenditures on aircraft appear to have been well maintained.

Outside of the high-tech and transportation sectors, nominal shipments in October were 1 percent above the third-quarter average. However, new orders plunged 13-3/4 percent--a drop that was steepened by the unwinding of the third-quarter jump in orders for engines and turbines. Excluding this sector, orders fell about 6 percent in October; declines were evident in all major categories.

**Nonresidential structures.** Nonresidential construction has remained soft: The level of spending in the third quarter was about 2 percent below the recent high reached in the fourth quarter of 1997, and the construction-put-in-place data for October point to further slippage in the current quarter. The office sector has been the one bright spot, as rising prices and falling vacancy rates have provided a considerable lift to activity. However, the recent contracts data suggest that office construction is likely to decelerate in coming quarters. Expenditures for many other types of construction have been sluggish for some time, and contracts have weakened considerably.

As in the multifamily housing sector, financing conditions for nonresidential construction have improved somewhat in recent weeks. Spreads on CMBS have narrowed, and originations in this market appear to be resuming. Furthermore, anecdotal reports indicate that other suppliers of credit, such as insurance companies and pension funds, have continued to be active in commercial real estate markets. However, credit standards for loans by banks and thrifts for nonresidential structures remain firm, and the large declines in the stock prices of equity REITs have limited their ability to acquire new properties.

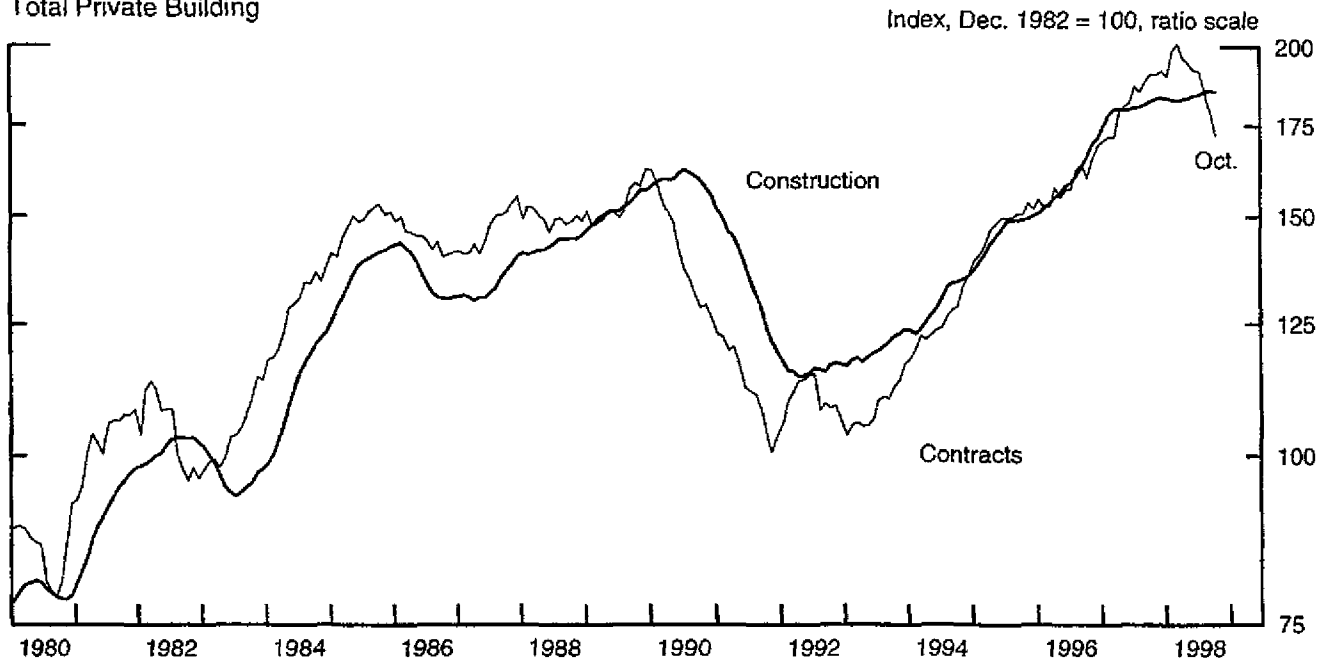
### **Business Inventories**

The incoming data suggest that a deceleration in the rate of inventory accumulation may be under way. The book value of manufacturing and trade inventories (excluding motor vehicles) slowed to a \$17-1/2 billion annual rate in October, about half the pace recorded in the third quarter. With a few exceptions--notably, chemicals, paper,

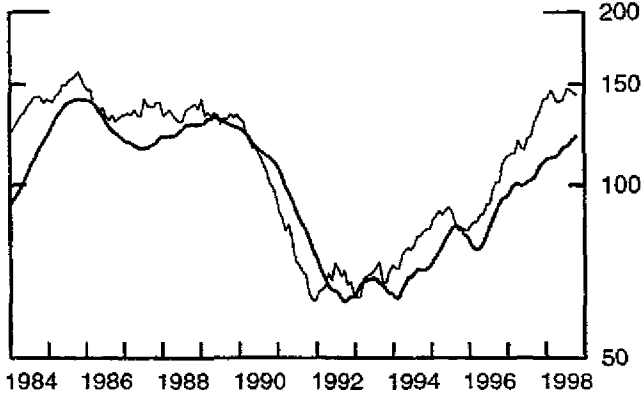
## Nonresidential Construction and Contracts

(Six-month moving average)

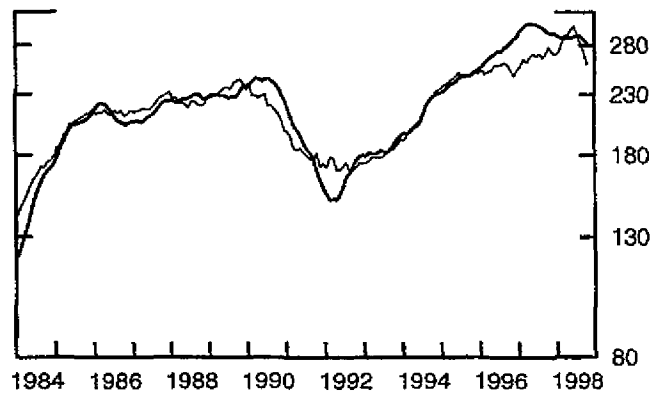
Total Private Building



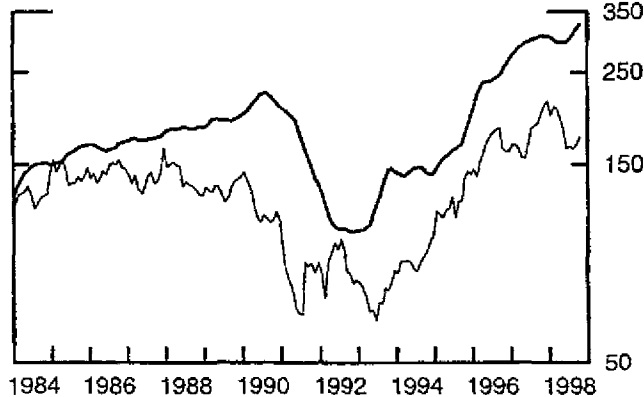
Office



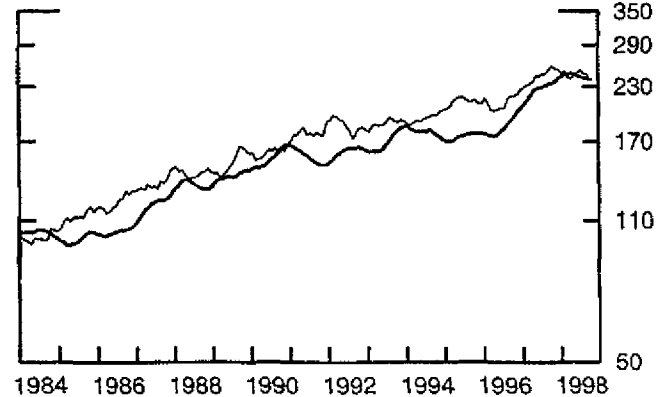
Other Commercial



Lodging and Miscellaneous



Institutional



Note. Individual sectors include both public and private building.

machinery, and metals and minerals--inventories generally seem to be in line with sales.

In manufacturing, inventories increased at a \$35 billion annual rate in October, up substantially from the \$7-1/2 billion pace in the third quarter. Stockbuilding at manufacturers of aircraft and parts accounted for about half of the inventory investment in October. Indeed, Boeing has experienced a considerable run-up in inventories over the past several months, in part because financing difficulties have prevented some foreign customers from taking ownership of finished planes. With some of the financing difficulties apparently being resolved, Boeing reportedly delivered twelve planes out of inventory in November. We expect this drop in aircraft inventories to be reflected in Census's book value data for November. Outside of aircraft, manufacturing inventories expanded at a \$17-1/2 billion pace in October. Inventories held by food producers rose nearly \$5 billion; this buildup may have been due, in part, to this year's early harvest.

The book value of wholesale inventories excluding motor vehicles fell at a \$10 billion annual rate in October after a large buildup in the third quarter. As expected, distributors of farm products liquidated some of the stocks they had accumulated in September as a result of the early harvest, and there were scattered reductions elsewhere. The overall ratio of inventories to sales (excluding motor vehicles) remained at the high end of the range of recent years, with quite notable overhangs at distributors of machinery and metals and minerals.

Retailers, excluding automotive dealers, shed inventories at a \$7-1/2 billion annual rate in October, following only a small accumulation in the third quarter. The drawdown was concentrated in the "other nondurable goods" grouping, which includes gas stations, restaurants, and drug stores. Inventories were also liquidated at apparel outlets, more than reversing September's buildup. On balance, retail inventories appear fairly well aligned with sales.

### **Federal Sector**

The October Monthly Treasury Statement reported a \$32 billion unified budget deficit, \$4 billion lower than a year earlier. Receipts have been bounced around lately by timing shifts and, on balance, were 4-1/2 percent higher in October than a year earlier. The year-over-year increase in withheld income taxes and social insurance contributions slowed to only 2 percent because this October had one less work day than did October 1997. Daily Treasury data indicate that receipts in these categories rebounded in November, in part reflecting an extra work day this year. Combining

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

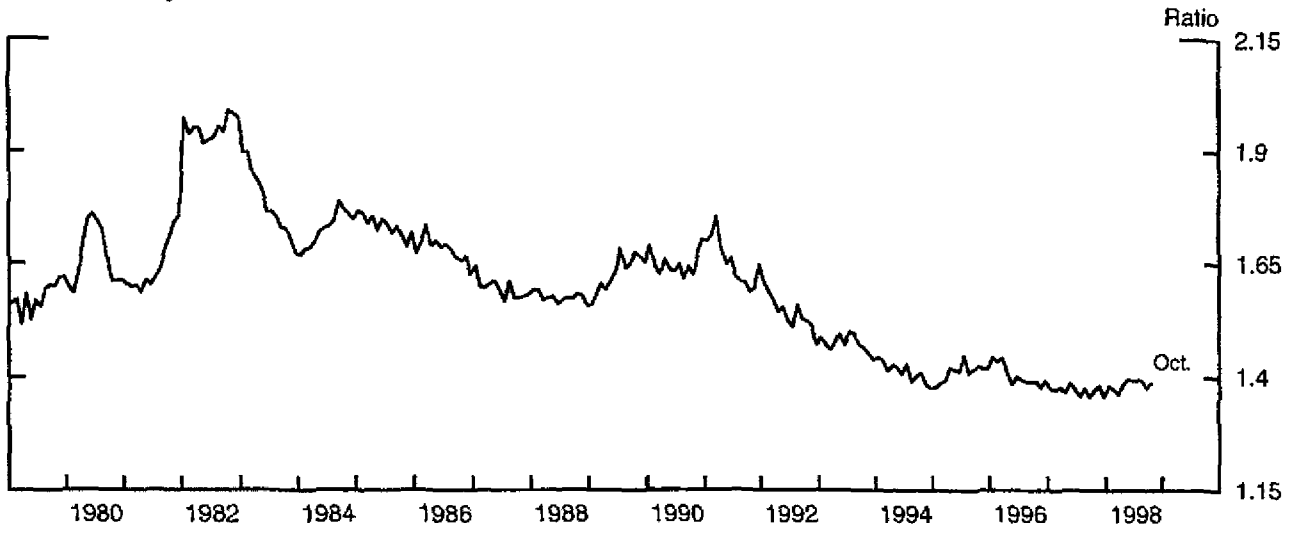
	1998		1998			Memo: Oct. level
	Q2	Q3	Aug.	Sept.	Oct.	
<u>Book value basis</u>						
Total	7.0	41.4	47.9	72.0	34.8	1083.8
Excluding wholesale and retail motor vehicles	35.0	33.8	41.7	39.2	17.4	964.9
Manufacturing	19.0	7.4	9.7	1.3	35.0	471.5
Excluding aircraft	6.9	1.3	-2.8	2.9	17.7	416.6
Wholesale	-.4	26.4	37.5	42.4	-8.4	283.4
Excluding motor vehicles	10.9	24.5	30.2	38.5	-10.2	255.0
Retail	-11.5	7.6	.7	28.2	8.1	328.9
Auto dealers	-16.6	5.7	-1.1	28.8	15.6	90.5
Excluding auto dealers	5.0	1.8	1.8	-.6	-7.5	238.4

SELECTED INVENTORY-SALES RATIOS  
(Months' supply, based on Census book-value data, seasonally adjusted)

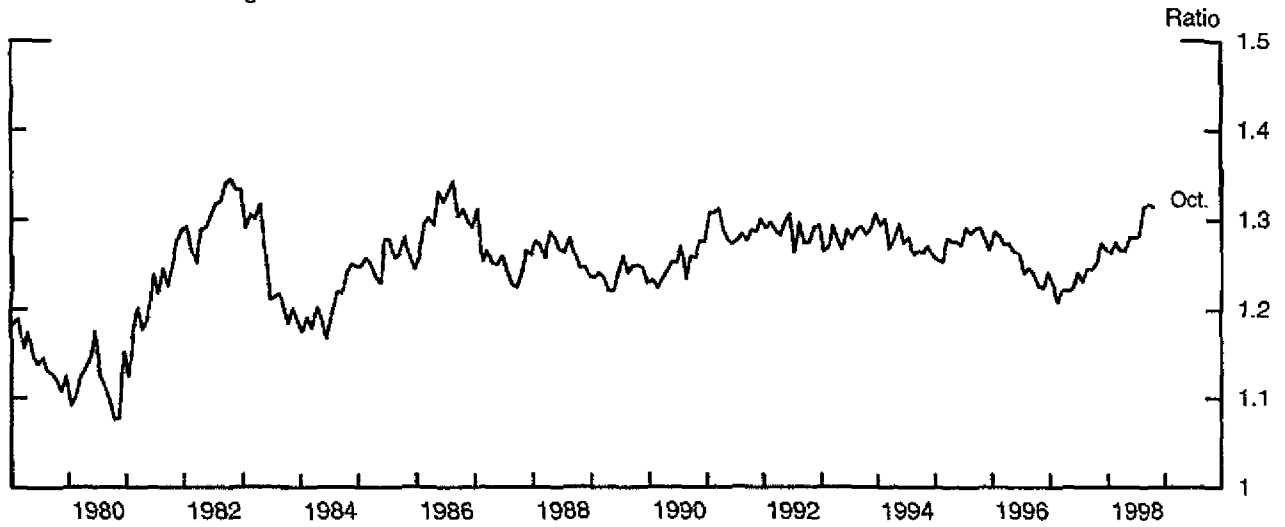
	<u>Cyclical reference points</u>		<u>Range over preceding 12 months</u>		Oct. 1998
	1990-91 high	1995-96 low	High	Low	
Manufacturing and trade	1.58	1.38	1.39	1.38	1.39
Less wholesale and retail motor vehicles	1.55	1.35	1.37	1.35	1.37
Manufacturing	1.75	1.38	1.40	1.36	1.39
Primary metals	2.08	1.49	1.67	1.54	1.70
Steel	2.56	1.69	2.10	1.80	2.15
Nonelectrical machinery	2.48	1.77	1.75	1.61	1.65
Electrical machinery	2.08	1.41	1.39	1.24	1.26
Transportation equipment	2.93	1.51	1.85	1.57	1.62
Motor vehicles	.97	.56	.64	.54	.53
Aircraft	5.84	4.44	5.12	4.34	4.34
Nondefense capital goods	3.09	2.27	2.33	2.12	2.12
Textiles	1.71	1.42	1.59	1.40	1.56
Paper	1.32	1.06	1.22	1.13	1.24
Chemicals	1.44	1.25	1.45	1.34	1.45
Petroleum	.94	.80	.91	.86	.92
Home goods & apparel	1.96	1.63	1.72	1.59	1.74
Merchant wholesalers	1.36	1.26	1.33	1.28	1.33
Less motor vehicles	1.31	1.22	1.32	1.25	1.31
Durable goods	1.83	1.55	1.64	1.58	1.66
Nondurable goods	.95	.91	.99	.94	.97
Retail trade	1.61	1.50	1.50	1.45	1.44
Less automotive dealers	1.48	1.43	1.42	1.40	1.39
Automotive dealers	2.22	1.69	1.77	1.56	1.62
General merchandise	2.42	2.20	2.10	2.00	2.03
Apparel	2.53	2.27	2.54	2.35	2.44
GAF	2.42	2.23	2.12	2.06	2.07

### Inventory-Sales Ratios, by Major Sector (Book value)

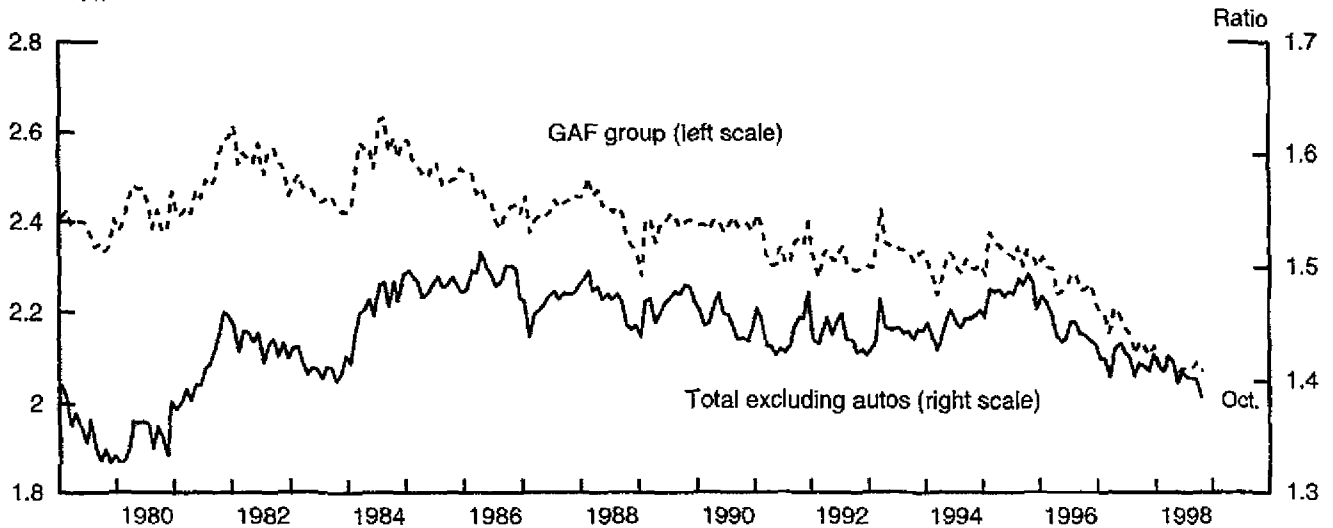
Manufacturing



Wholesale Excluding Motor Vehicles



Retail



FEDERAL GOVERNMENT OUTLAYS AND RECEIPTS  
(Unified basis; billions of dollars)

	October			12 months ending in Oct.		
	1997	1998	Percent change	1997	1998	Percent change
<b>Outlays</b>	150.9	152.4	1.0	1612.3	1653.0	2.5
Deposit insurance	-0.4	-0.4	n.a.	-14.6	-4.4	n.a.
Spectrum auction	0.0	0.0	n.a.	-11.0	-2.6	n.a.
Sale of major assets	0.0	0.0	n.a.	0.0	-3.2	n.a.
Other	151.3	152.8	1.0	1637.9	1663.1	1.5
<b>Receipts</b>	114.9	120.0	4.4	1594.2	1726.5	8.3
<b>Surplus</b>	-36.0	-32.5	n.a.	-18.1	73.5	n.a.
Adjusted for payment timing shifts <sup>1</sup> and excluding deposit insurance and spectrum auction						
<b>Outlays</b>	143.5	144.8	0.9	1630.2	1662.9	2.0
National defense	24.5	23.6	-3.9	274.6	269.5	-1.9
Net interest	21.8	19.4	-10.8	244.3	241.0	-1.4
Social security	30.6	31.7	3.8	366.5	380.4	3.8
Medicare	17.1	16.9	-1.2	191.0	192.6	0.8
Medicaid	9.4	10.0	5.5	96.8	101.8	5.1
Other health	2.5	2.6	6.1	28.2	29.9	6.3
Income security	18.1	17.9	-1.1	230.5	232.7	1.0
Other	19.5	22.8	16.6	198.2	215.0	8.5
<b>Receipts</b>	114.9	120.0	4.4	1594.2	1726.5	8.3
Individual income and payroll taxes	97.2	99.6	2.4	1249.3	1366.3	9.4
Withheld + FICA	91.6	93.4	2.0	1063.4	1150.9	8.2
Nonwithheld + SECA	6.5	7.3	12.3	279.4	315.0	12.7
Refunds (-)	0.9	1.1	26.0	93.5	99.7	6.6
Corporate	3.3	1.8	-46.0	184.7	187.2	1.4
Other	14.4	18.6	29.2	160.2	173.0	8.0
<b>Surplus</b>	-28.6	-24.9	n.a.	-36.0	63.6	n.a.

Note. Components may not sum to totals because of rounding.

1. A shift in payment timing occurs when the first of the month falls on a weekend or holiday. Outlays for defense, Medicare, income security, and "other" have been adjusted to account for this shift.

n.a.--Not applicable



October and November, collections for withheld income taxes and social insurance contributions were a solid 7 percent above the year-earlier average. Because of a provision in the 1997 Taxpayer Relief Act that allowed firms to defer the payment of August and September excise taxes until October, "other" revenues were nearly 30 percent higher than in October 1997.

Outlays in October were only 1 percent higher than a year earlier, held down by declining net interest payments and defense outlays and by continued restraint in Medicare expenditures. The Commodity Credit Corporation and Supplemental Security Income are the only entitlement programs showing substantial increases in outlays in recent months, and the increases in these areas reflect recent policy changes that raised payments to farmers and relaxed SSI eligibility restrictions.

### **State and Local Governments**

Real purchases of goods and services by state and local governments appear to have decelerated again of late after having risen about 3-1/2 percent at an annual rate in the third quarter. Real construction outlays in October were slightly below the third-quarter average--and about 4-1/2 percent below the high reached in the first quarter of 1997. In addition, payroll employment rose only a little, on net, in October and November.

In November, forty-six states, the District of Columbia, and five U.S. territories together settled lawsuits with the tobacco industry. The agreement requires payments totaling \$206 billion (over the next twenty-five years) to compensate states for their smoking-related health costs, and it contains initiatives aimed at curbing smoking among young persons. In earlier agreements with Florida, Minnesota, Mississippi, and Texas, the tobacco industry had agreed to pay an additional \$38 billion. Combining all agreements, payments will be small through 1999, but are scheduled to rise to the range of \$7 billion to \$9 billion per year by 2000. The states are concerned that the federal government may seek a portion of these payments on the grounds that it provided much of the funding for the smoking-related Medicaid outlays.

CPI AND PPI INFLATION RATES  
(Percent change)

	From twelve months earlier		1998		1998	
	Nov. 1997	Nov. 1998	Q2	Q3	Oct.	Nov.
			-Annual rate-		-Monthly rate-	
<u>CPI</u>						
All items (100.0) <sup>1</sup>	1.8	1.5	2.0	1.7	.2	.2
Food (15.3)	1.7	2.3	1.9	2.8	.6	.1
Energy (7.0)	-.4	-9.2	-6.7	-5.6	.9	.0
CPI less food and energy (77.7)	2.2	2.3	2.6	2.3	.2	.2
Commodities (24.1)	.4	.7	1.0	1.2	.0	-.1
New vehicles (5.1)	-.6	-.3	-1.1	1.3	-.3	.0
Used cars and trucks (1.9)	-5.7	4.3	4.9	4.7	.7	.7
Apparel (4.9)	1.0	.2	.8	1.7	.1	.0
Tobacco (0.9)	6.1	12.2	16.5	16.9	.3	-1.1
Other Commodities (11.3)	.5	.0	.3	-.8	.0	-.2
Services (53.6)	2.9	3.1	3.4	2.7	.2	.3
Shelter (29.4)	3.1	3.5	3.8	3.2	.2	.3
Medical care (4.4)	2.7	3.4	4.1	3.6	.2	.2
Other Services (19.8)	2.9	2.2	2.8	1.7	.3	.2
<u>PPI</u>						
Finished goods (100.0) <sup>2</sup>	-.7	-.7	.3	-.3	.2	-.2
Finished consumer foods (23.2)	-1.1	.1	.7	.9	.4	-.5
Finished energy (13.6)	-3.5	-11.0	-7.4	-8.8	1.2	-1.2
Finished goods less food and energy (63.2)	.2	1.3	1.9	1.0	.1	.1
Consumer goods (38.0)	.6	2.2	3.6	1.9	.0	.1
Capital equipment (25.2)	-.3	-.1	-.6	-.2	.0	.1
Intermediate materials (100.0) <sup>3</sup>	-.2	-2.9	-1.8	-2.2	-.2	-.2
Intermediate materials less food and energy (81.8)	.5	-1.5	-.8	-1.2	-.3	-.2
Crude materials (100.0) <sup>4</sup>	-.1	-19.0	-4.9	-17.5	1.7	-1.4
Crude food materials (42.1)	-6.2	-7.2	-1.1	-17.3	4.0	-1.9
Crude energy (36.4)	5.7	-32.6	-7.0	-20.6	1.9	.0
Crude materials less food and energy (21.5)	1.7	-15.7	-8.6	-13.6	-2.7	-2.5

1. Relative importance weight for CPI, December 1997.

2. Relative importance weight for PPI, December 1997.

3. Relative importance weight for intermediate materials, December 1997.

4. Relative importance weight for crude materials, December 1997.

## Prices

Inflation has remained reasonably steady. Both the overall consumer price index and the index excluding food and energy were up 0.2 percent last month.<sup>8</sup> November to November, the total CPI rose 1.5 percent and the core measure moved up 2.3 percent--the gap being mainly attributable to the sharp decline in energy prices.

Consumer energy prices were unchanged in November. Prices of natural gas and electricity both increased on a seasonally adjusted basis. But motor fuel and heating fuel prices declined around 1 percent, and survey evidence from early December points to further declines in those categories--not surprising, given that crude oil prices have dropped to stunningly low levels, with the WTI spot price now running near \$11 per barrel.

The CPI for food edged up 0.1 percent in November after having posted an unusually large increase in October. Prices for fruits and vegetables declined, as did those in the meat, poultry, fish, and eggs category. And, although dairy prices continued to rise, the increase was smaller than those of the preceding three months. Overall food prices are up 2.3 percent over the past twelve months--the same as the rise in the CPI excluding food and energy.

Among commodities other than food and energy, consumer prices of new motor vehicles were unchanged in November, reflecting both the ongoing heavy incentives, especially on 1998-model-year vehicles, and the relatively small increases in sticker prices on the 1999 models.<sup>9</sup> Motor vehicle prices have been quite soft for some time, and now stand slightly below the levels of two years ago. The rising dollar was a major factor in holding down prices over much of this period, although more recently, industry contacts have suggested that the intense struggle to maintain market share has been important as well.

Non-energy service prices rose 0.3 percent in November, and were up 3.1 percent over the past twelve months--just a bit higher than the increase over the preceding twelve months. Prices of shelter and medical services have accelerated some over the past year while prices of many other service items have decelerated.

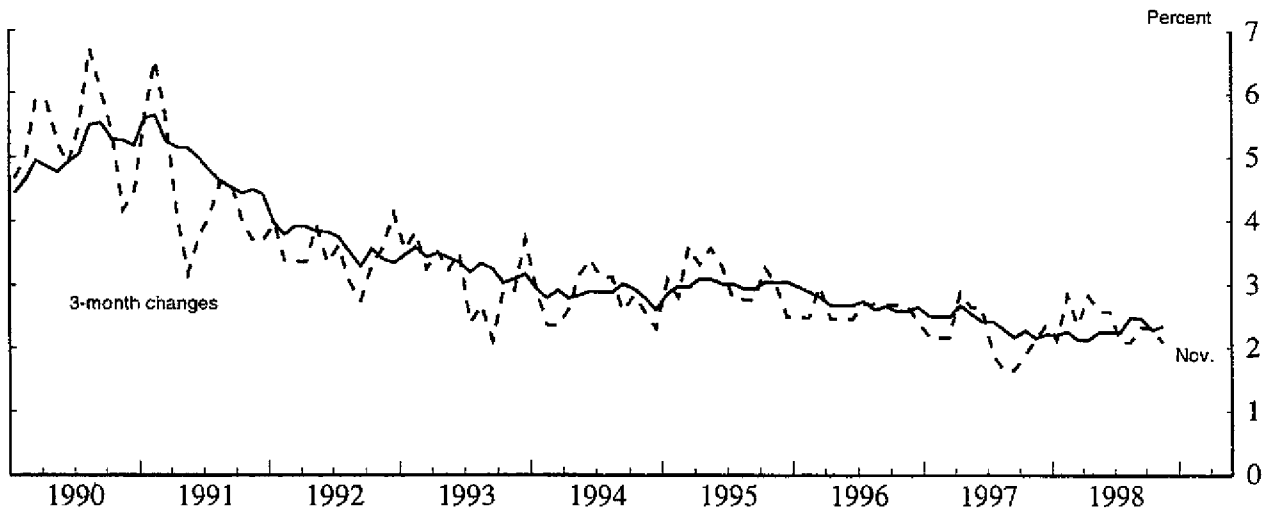
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8. The cigarette makers' increase of \$0.45 per pack went into effect too late in the month to be captured in the November surveys for either the PPI or the CPI. If the wholesale price increase is passed through fully to the retail level, it would add 0.2 percent to the overall CPI and 1/4 percent to the index excluding food and energy items; the increase in the CPI should be seen mostly in December.

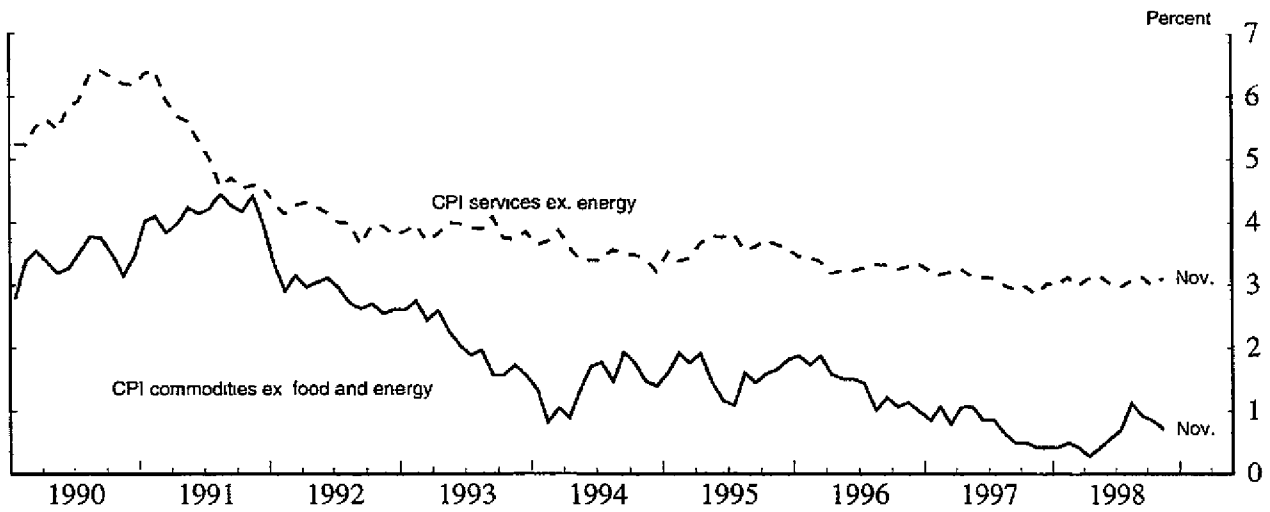
9. For any given model of vehicle, the CPI begins pricing the new-model-year version in the month when dealers report that sales exceed those for the old-model-year vehicles. Thus, the share of new-model-year vehicles in the CPI gradually increases over the autumn. A little more than half of the vehicles priced in the November CPI were from the new model year.

## Measures of Core Consumer Price Inflation (Twelve-month changes except as noted)

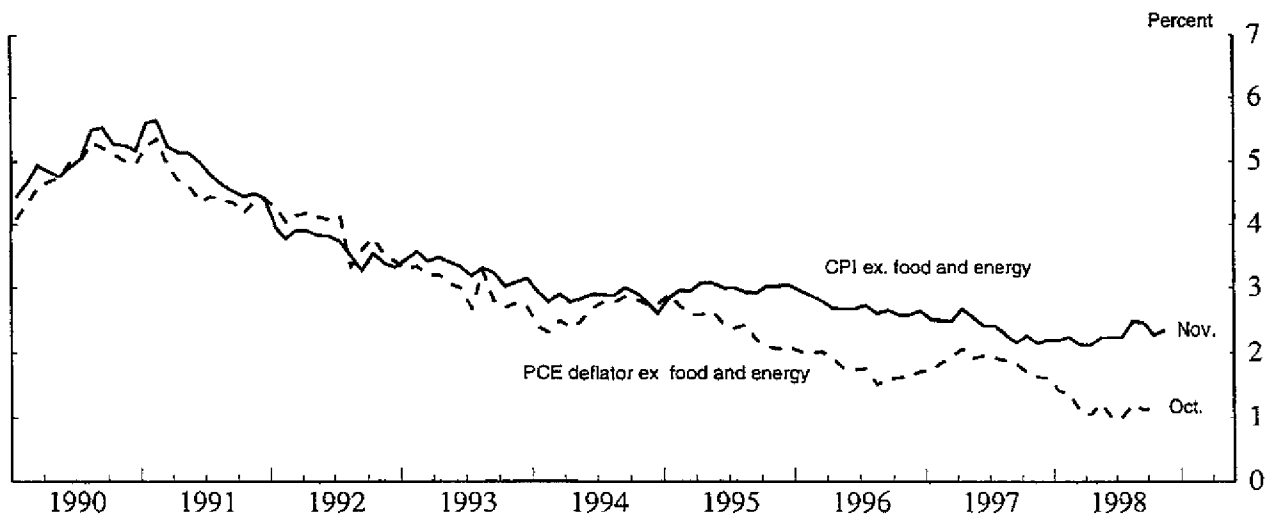
CPI Excluding Food and Energy



CPI Services and Commodities



CPI and PCE



Most other broad price measures have continued to rise less rapidly than the CPI. The GDP chain price index rose only 0.9 percent over the year ended in the third quarter of 1998, nearly 1 percentage point lower than the increase over the preceding year. Very soft prices for capital equipment have been important in holding down overall GDP prices: The PPI for capital equipment was about unchanged over the past twelve months, after having posted a small decline over the preceding period.

The deceleration in GDP prices also owes to a continued deceleration in the chain price index for personal consumption expenditures, whose rate of increase has diverged from that of the CPI to an unusual extent. Over the year ended in the third quarter of 1998, the PCE chain price index increased 0.7 percent, nearly 1 percentage point less than the rise in the CPI over this period. The gap is even larger when we exclude food and energy items, with the PCE measure increasing 1-1/4 percentage points less than the CPI. Part of the divergence between these measures reflects the fact that PCE prices already incorporate the geometric-mean CPIs that BLS has been producing on an experimental basis and that will not be incorporated into the official CPI until January; this factor accounts for about 0.2 percentage point per year of the divergence between PCE prices and the CPI as currently measured. But most of the divergence reflects a grab-bag of other differences between the two measures--different weights, different price estimates for some items, and the inclusion in PCE of expenditures by nonprofit institutions and some other expenditures that are not included in the CPI.<sup>10</sup>

There are few signs of inflationary pressures at earlier stages of processing. The PPI for intermediate materials other than food and energy edged lower again in November and is down 1-1/2 percent over the past twelve months. The PPI for core crude materials has dropped nearly 16 percent over the past year. Since the middle of November, most commodity prices have moved downward. The *Journal of Commerce* industrial price index has declined nearly 2 percent over the past month, and the CRB futures index--which is heavily influenced by food commodities--has fallen to its lowest level in decades.

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10. On Friday, December 18, the BLS is expected to announce that it will begin to update the weights in the CPI more frequently than the current procedure of decennial updates (although the change will not take effect for a couple of years). Earlier work in this area has suggested that more frequent updating would not have any appreciable effect on increases in the CPI. In any case, this change will have no effect on the PCE chain price index, which does not utilize the CPI weights.

BROAD MEASURES OF INFLATION  
(Four-quarter percent change)

	1995 Q3	1996 Q3	1997 Q3	1998 Q3
<u>Product prices</u>				
GDP chain price index	2.2	1.9	1.8	0.9
Nonfarm business chain-type price index <sup>1</sup>	1.8	1.3	2.0	0.5
<u>Expenditure prices</u>				
Gross domestic purchases chain-type price index	2.2	1.7	1.6	0.4
Less food and energy	2.3	1.4	1.6	0.7
PCE chain-type price index	2.1	1.9	1.9	0.7
Less food and energy	2.3	1.6	1.9	1.1
CPI	2.6	2.9	2.2	1.6
Less food and energy	3.0	2.7	2.3	2.4
Median CPI	3.2	3.1	2.9	2.8
Trimmed mean CPI	2.7	2.9	2.4	2.0

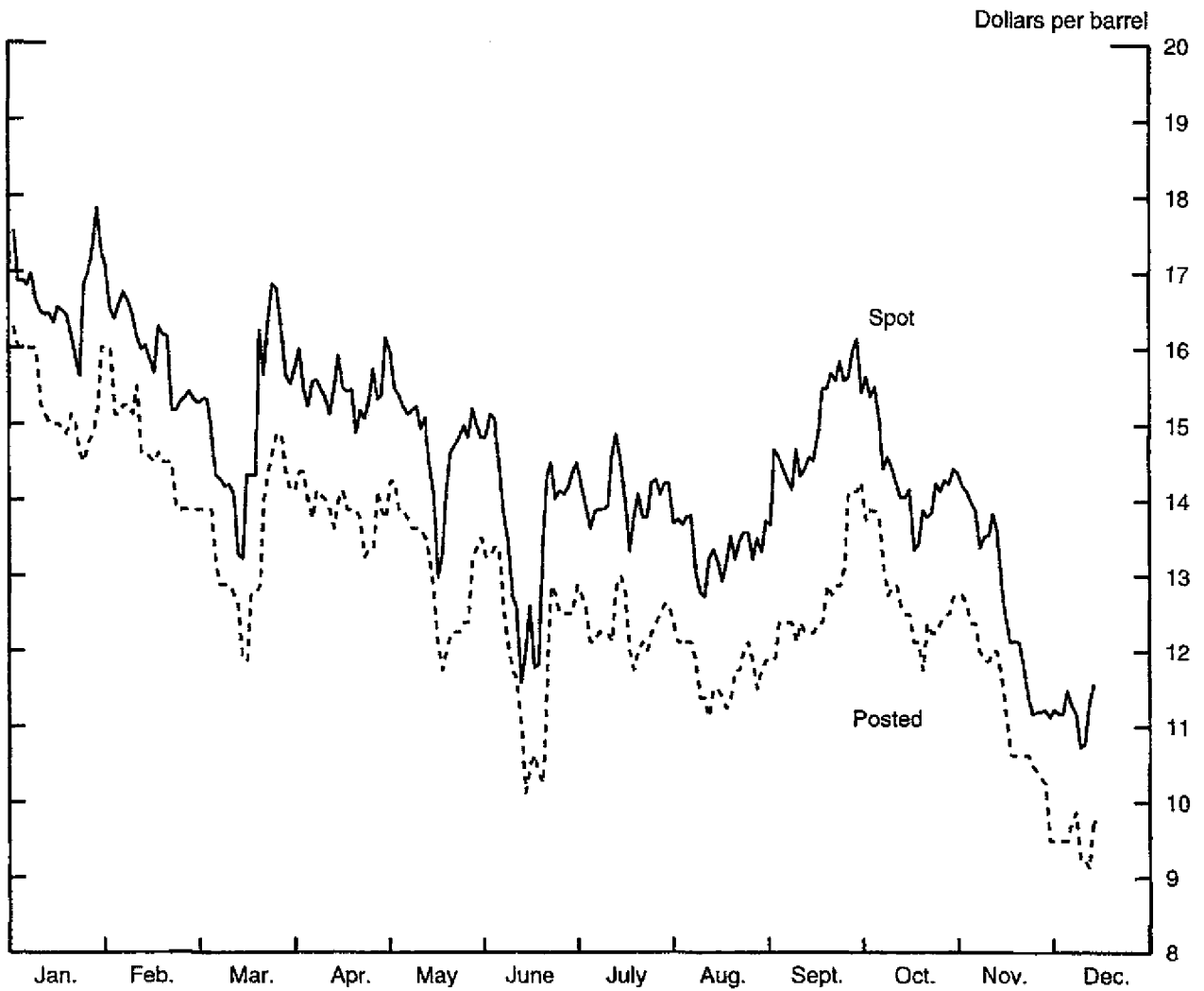
1. Excluding housing.

SURVEYS OF (CPI) INFLATION EXPECTATIONS  
(Percent)

	Actual inflation <sup>1</sup>	University of Michigan				Professional forecasters (10-year) <sup>6</sup>
		(1-year) Mean <sup>2</sup>	Median <sup>3</sup>	(5- to -10-year) Mean <sup>4</sup>	Median <sup>5</sup>	
1997-Q1	2.9	3.8	2.9	3.8	3.1	3.0
Q2	2.3	3.6	2.9	3.8	3.0	2.9
Q3	2.2	3.4	2.7	3.6	3.0	3.0
Q4	1.9	3.3	2.8	3.8	3.1	2.7
1998-Q1	1.5	2.8	2.4	3.3	2.9	2.6
Q2	1.6	3.0	2.6	3.3	2.8	2.5
Q3	1.6	2.8	2.4	3.2	2.8	2.5
Q4		2.7	2.5	3.1	2.8	2.5
July	1.7	3.1	2.6	3.1	2.7	
Aug.	1.6	2.7	2.4	3.0	2.7	
Sept.	1.5	2.7	2.3	3.4	2.9	2.5
Oct.	1.5	2.6	2.5	3.2	2.8	
Nov.	1.5	2.7	2.3	3.1	2.8	
Dec.		2.8	2.7	3.1	2.8	2.5

1. CPI; percent change from the same period in the preceding year.
2. Average increase for responses to the question: By about what percent do you expect prices (CPI) to go up, on the average, during the next 12 months?
3. Median increase for responses to the question above.
4. Average increase for responses to the question: By about what percent per year do you expect prices (CPI) to go up, on the average, during the next 5 to 10 years?
5. Median increase for responses to question above.
6. Compiled by the Federal Reserve Bank of Philadelphia.

### Daily Spot and Posted Prices of West Texas Intermediate



Note. Posted prices are evaluated as the mean of the range listed in the Wall Street Journal.

### Monthly Average Prices of West Texas Intermediate

Month	Posted	Spot
January	15.33	16.71
February	14.78	16.06
March	13.44	15.02
April	13.90	15.44
May	13.13	14.86
June	12.09	13.66
July	12.36	14.08
August	11.73	13.36
September	12.65	14.95
October	12.81	14.39
November	11.54	12.94
December <sup>1</sup>	9.50	11.18

1. Through December 15, 1998.

## SPOT PRICES OF SELECTED COMMODITIES

	Current price (\$)	-----Percent change <sup>1</sup> -----				Memo: Year earlier to date
		1996	1997	Dec. 30 to Nov. 10 <sup>2</sup>	Nov. 10 <sup>2</sup> to Dec. 15	
<b>Metals</b>						
Copper (lb.)	.690	-21.3	-24.3	-6.2	-9.2	-16.9
Steel scrap (ton)	72.667	-15.1	15.9	-45.8	-3.1	-47.5
Aluminum, London (lb.)	.551	-8.5	-.6	-13.8	-6.2	-19.1
<b>Precious metals</b>						
Gold (oz.)	292.550	-4.8	-21.4	.7	.1	2.5
Silver (oz.)	4.900	-6.1	28.3	-18.2	-2.2	-16.8
<b>Forest products</b>						
Lumber (m. bdf.)	290.000	59.2	-29.6	-6.8	6.6	1.8
Plywood (m. sqft.)	317.000	-3.2	-4.8	7.3	-1.6	9.3
<b>Petroleum</b>						
Crude oil (barrel)	9.740	29.3	-31.7	-30.9	-12.8	-42.2
Gasoline (gal.)	.322	27.2	-25.8	-22.0	-17.6	-37.6
Fuel oil (gal.)	.326	18.3	-29.7	-24.9	-12.1	-36.2
<b>Livestock</b>						
Steers (cwt.)	58.000	-1.1	3.0	-7.4	-7.9	-14.7
Hogs (cwt.)	11.000	14.9	-36.4	-42.1	-45.7	-72.2
Broilers (lb.)	.600	12.5	-21.2	24.7	-2.4	30.1
<b>U.S. farm crops</b>						
Corn (bu.)	2.110	-24.4	.2	-17.8	.5	-17.6
Wheat (bu.)	3.198	-12.8	-22.6	-3.4	-5.9	-12.6
Soybeans (bu.)	5.430	-3.7	-1.8	-16.9	-3.3	-19.8
Cotton (lb.)	.592	-8.7	-9.7	3.6	-10.5	-5.6
<b>Other foodstuffs</b>						
Coffee (lb.)	1.230	34.7	25.4	-27.0	-1.2	-29.3
<b>Memo:</b>						
JOC Industrials	89.400	-4.1	-8.6	-7.2	-1.8	-9.5
JOC Metals	73.400	-8.3	-5.0	-14.8	-3.0	-18.1
CRB Futures	191.670	-.1	-3.2	-11.2	-6.3	-17.7
CRB Spot	266.420	.9	-8.4	-12.1	-1.3	-13.4

1. Changes, if not specified, are from the last week of the preceding year to the last week of the period indicated.

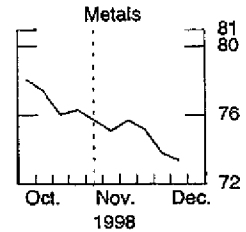
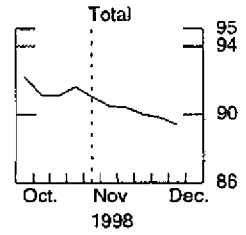
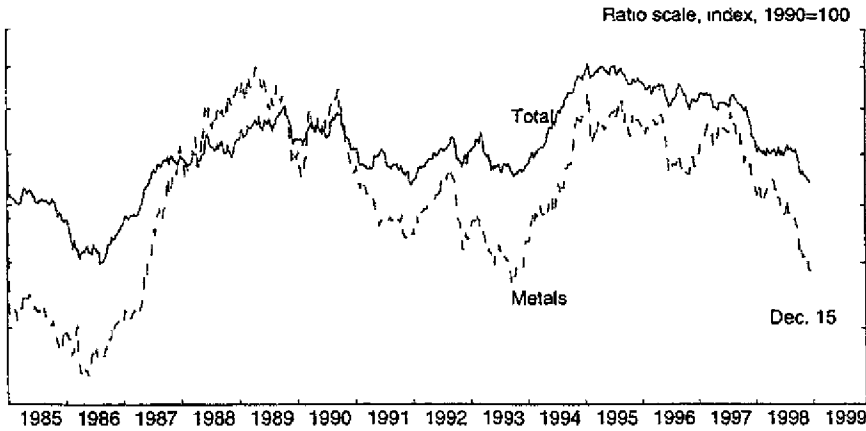
2. Week of the November Greenbook.



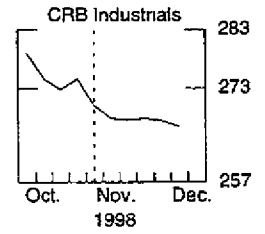
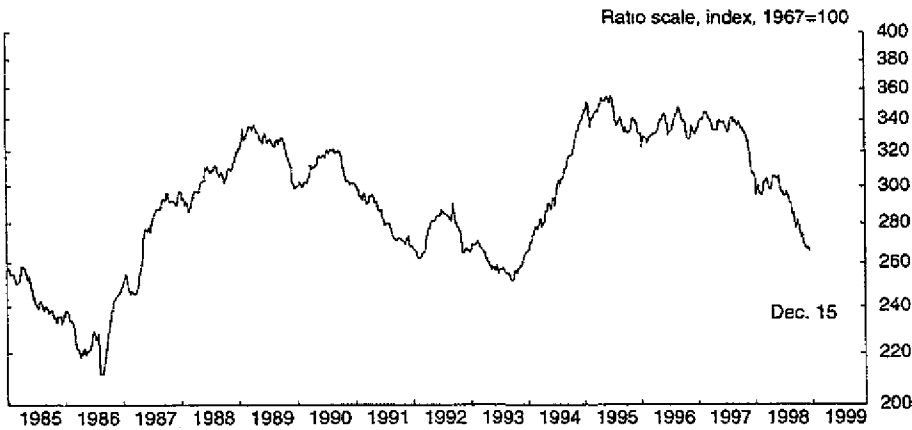
Signals about short-term inflation expectations have been mixed of late. According to the Michigan SRC, median one-year-ahead inflation expectations were 2.7 percent in early December, after several months of readings in the range of 2-1/4 percent to 2-1/2 percent. Longer-term inflation expectations have remained low, with both the Michigan survey's median five- to ten-year-ahead inflation expectations and the Philadelphia Fed's survey of professional forecasters' ten-year expectations continuing to show expected inflation below 3 percent.

## Commodity Price Measures

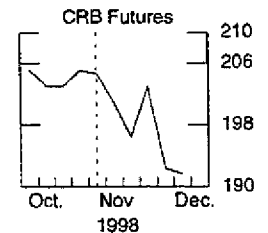
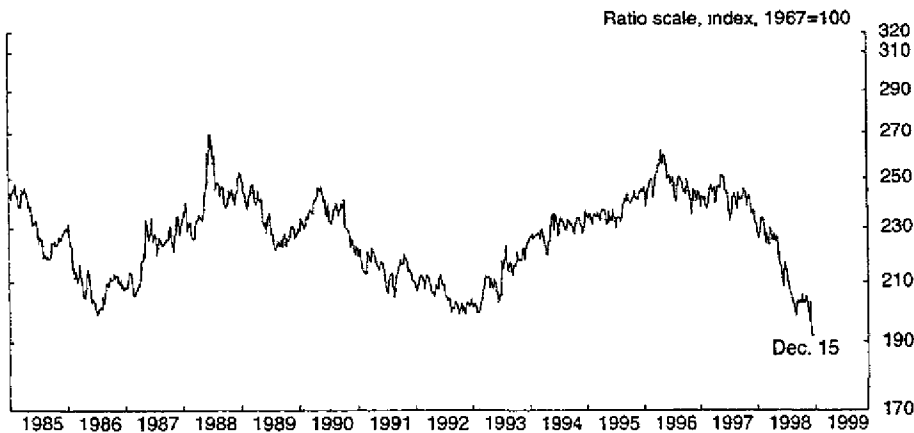
Journal of Commerce Index



CRB Spot Industrials



CRB Futures



Note: Weekly data, Tuesdays. Vertical lines on small panels indicate week of last Greenbook. The Journal of Commerce index is based almost entirely on industrial commodities, with a small weight given to energy commodities, and the CRB spot price index consists entirely of industrial commodities, excluding energy. The CRB futures index gives about a 60 percent weight to food commodities and splits the remaining weight roughly equally among energy commodities, industrial commodities, and precious metals. Copyright for Journal of Commerce data is held by CIBC, 1994.

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# **DOMESTIC FINANCIAL DEVELOPMENTS**

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III-T-1  
**Selected Financial Market Quotations**  
(One-day quotes in percent except as noted)

Instrument	1997	1998			Change to Dec. 15 from selected dates (percentage points)		
	Dec. 31	Oct. 14	FOMC* Nov. 17	Dec. 15	Dec. 31	Oct. 14	FOMC* Nov. 17
<i>Short-term</i>							
Federal funds							
FOMC intended rate	5.50	5.25	5.00	4.75	-.75	-.50	-.25
Realized rate <sup>1</sup>	5.44	5.40	5.08	4.79	-.65	-.61	-.29
Treasury bills <sup>2</sup>							
3-month	5.22	3.93	4.41	4.38	-.84	.45	-.03
6-month	5.23	4.06	4.42	4.40	-.83	.34	-.02
1-year	5.22	4.01	4.34	4.29	-.93	.28	-.05
Commercial paper							
1-month	5.65	5.26	5.13	5.24	-.41	-.02	.11
3-month	5.57	5.11	5.09	5.00	-.57	-.11	-.09
Large negotiable CDs <sup>2</sup>							
1-month	5.65	5.34	5.19	5.49	-.16	.15	.30
3-month	5.72	5.30	5.31	5.13	-.59	-.17	-.18
6-month	5.74	5.09	5.12	4.98	-.76	-.11	-.14
Eurodollar deposits <sup>3</sup>							
1-month	5.63	5.25	5.19	5.44	-.19	.19	.25
3-month	5.72	5.25	5.31	5.13	-.59	-.12	-.18
Bank prime rate	8.50	8.25	8.00	7.75	-.75	-.50	-.25
<i>Intermediate- and long-term</i>							
U.S. Treasury (constant maturity)							
2-year	5.66	4.08	4.56	4.47	-1.19	.39	-.09
10-year	5.75	4.58	4.85	4.62	-1.13	.04	-.23
30-year	5.93	5.00	5.28	5.03	-.90	.03	-.25
U.S. Treasury 10-year indexed note	3.70	3.72	3.80	3.80	.10	.08	.00
Municipal revenue (Bond Buyer) <sup>4</sup>	5.40	5.17	5.28	5.18	-.22	.01	-.10
Corporate bonds, Moody's seasoned Baa	7.28	7.23	7.37	7.22	-.06	-.01	-.15
High-yield corporate <sup>5</sup>	9.06	11.20	10.62	10.44	1.38	-.76	-.18
Home mortgages (FHLMC survey rate) <sup>6</sup>							
30-year fixed	6.99	6.49	6.93	6.69	-.30	.20	-.24
1-year adjustable	5.53	5.36	5.56	5.53	.00	.17	-.03

Stock exchange index	Record high		1998			Change to Dec. 15 from selected dates (percent)		
	Level	Date	Oct. 14	FOMC* Nov. 17	Dec. 15	Record high	Oct. 14	FOMC* Nov. 17
Dow-Jones Industrial	9,374.27	11-23-98	7,968.78	9,011.25	8,823.30	-5.88	10.72	-2.09
S&P 500 Composite	1,192.33	11-27-98	1,005.53	1,135.87	1,162.83	-2.47	15.64	2.37
NASDAQ (OTC)	2,050.42	12-9-98	1,540.97	1,861.68	2,012.60	-1.84	30.61	8.11
Russell 2000	491.41	4-21-98	324.98	390.42	389.57	-20.72	19.88	-.22
Wilshire 5000	11,106.10	7-17-98	9,060.47	10,383.89	10,591.28	-4.64	16.90	2.00

1. Average for two-week reserve maintenance period ending on or before date shown. Most recent observation is average for current maintenance period to date.

2. Secondary market.

3. Bid rates for Eurodollar deposits collected around 9:30 a.m. Eastern time.

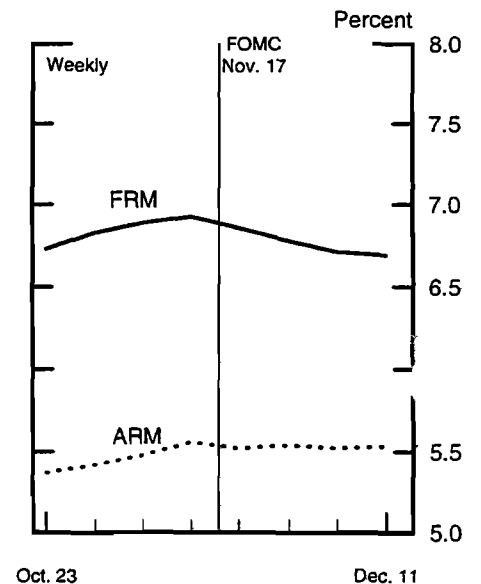
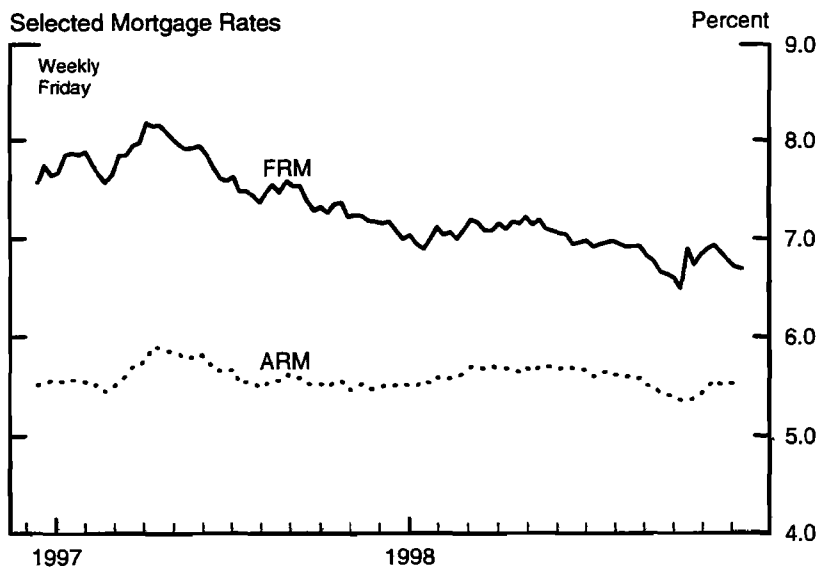
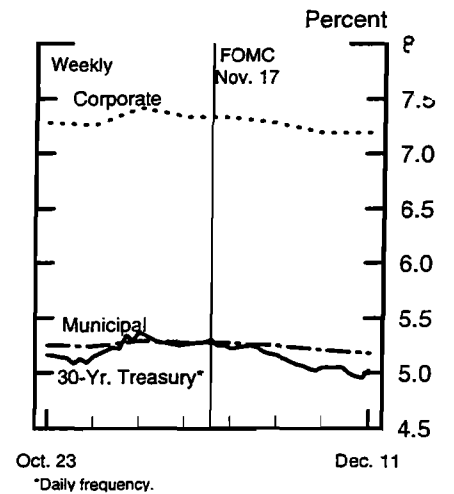
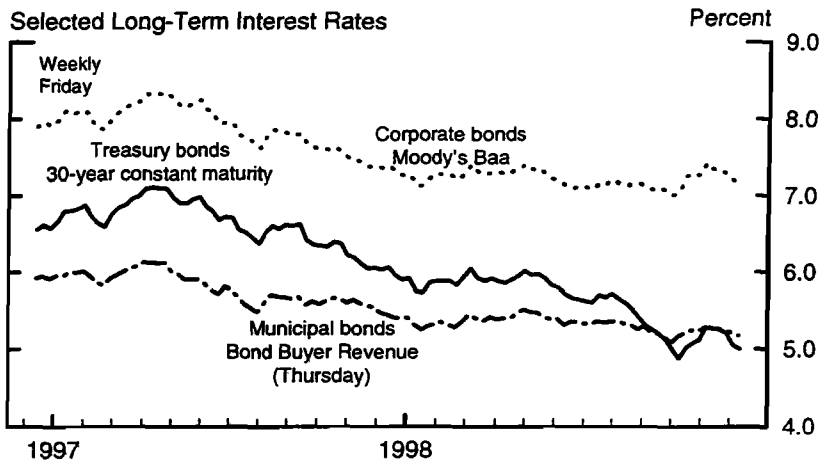
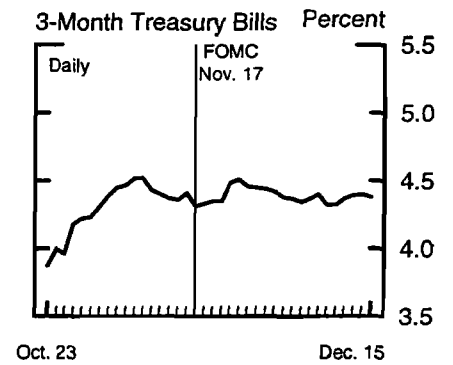
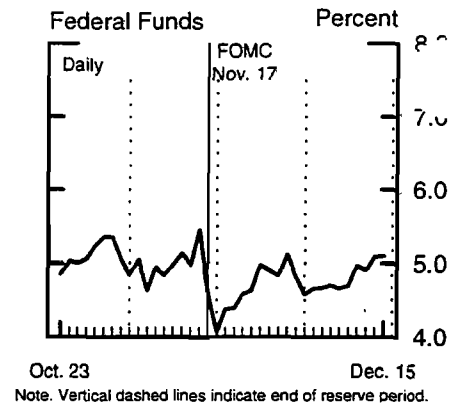
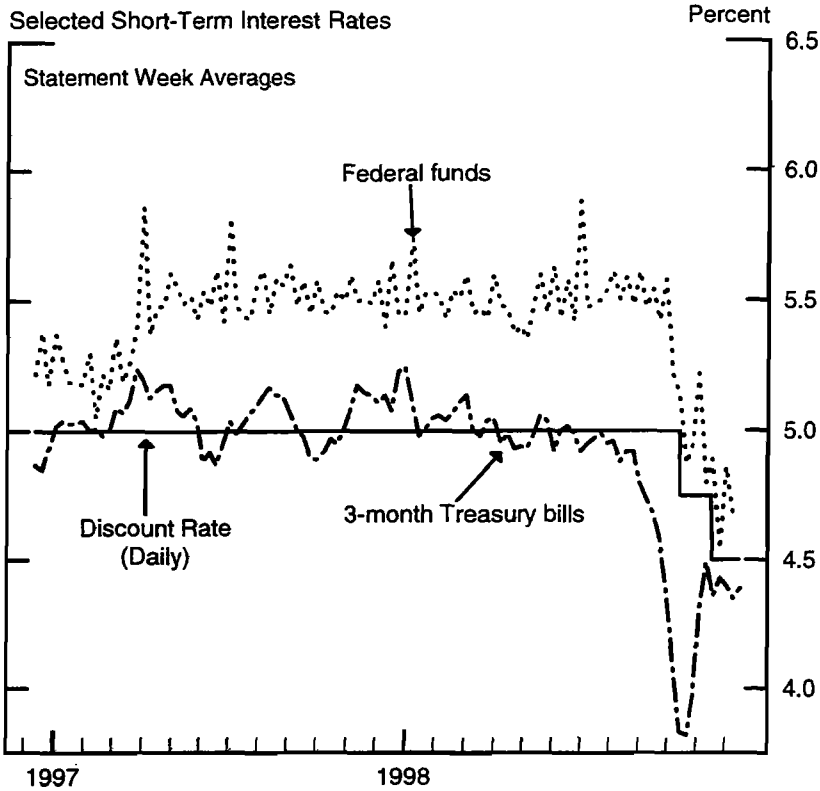
4. Most recent Thursday quote.

5. Merrill Lynch Master II high-yield bond index composite.

6. For week ending Friday previous to date shown.

\* Data are as of the close on November 16, 1998.

# Selected Interest Rates



## Domestic Financial Developments

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### Overview

Financial markets showed further signs of mending over the intermeeting period, although the process has been anything but smooth, and signs persist of an elevated aversion to risk and an increased preference for liquidity. Major share price indexes initially extended their strong recovery in the days following the November FOMC meeting. Many touched new highs. But, over the past two weeks, the generally negative tone to corporate earnings announcements and concerns about prospects for Latin America produced several downdrafts in equity prices, leaving major equity indexes showing mixed changes on net since mid-November.

Prices of Treasury securities benefited from positive news on inflation, particularly the continued decline in oil and other commodity prices. The quest for safe havens also contributed at times to the intermeeting decline in Treasury yields--particularly for the most liquid, on-the-run issues. Longer-term Treasury bonds shed as much as 1/4 percentage point, on balance, over the intermeeting period.

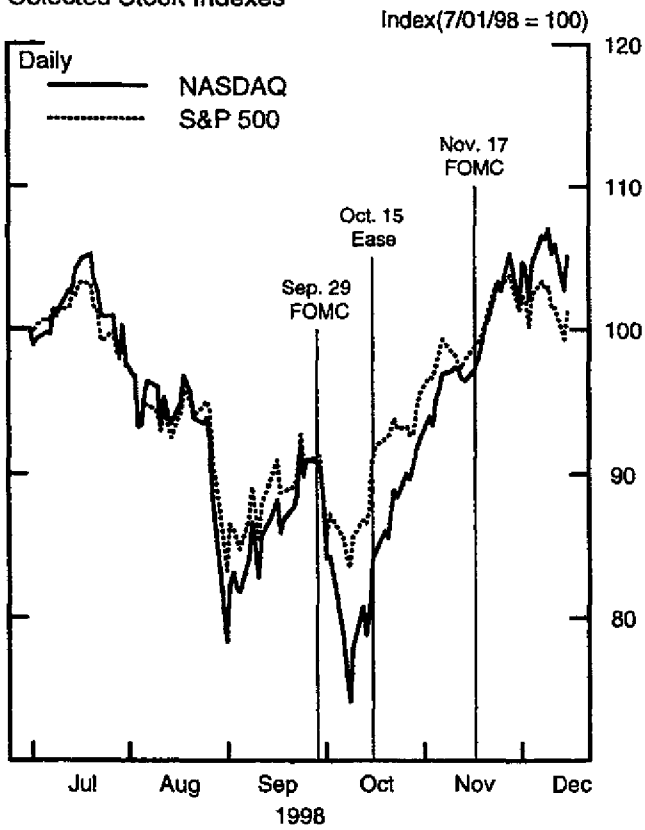
Spreads for both investment-grade and high-yield corporate bonds relative to Treasuries narrowed early in the intermeeting period, although a portion of the improvement in bond spreads was reversed more recently as investors' concerns about risk and liquidity reintensified. The liquidity of the corporate bond market reportedly has been limited by a reluctance of dealers to commit capital to market-making as they position their balance sheets for reporting at year-end. In the commercial paper market, significant year-end pressures remain as investors are demanding a large premium to hold lower-tier issues across the turn of the year; however, the premium has come down substantially of late and quality spreads on shorter-dated paper have narrowed, suggesting a generally improving tone in this market.

Borrowing by businesses has remained brisk this quarter. Offerings of investment-grade corporate bonds soared to a record in November as firms took advantage of low rates. Moreover, a growing number of below-investment-grade issuers have come to the market, although volume remains well below the strong pace of the first half of the year. The greater receptivity of the capital markets--evident also in a mild recovery in equity issuance--has permitted firms to rely less heavily on banks.

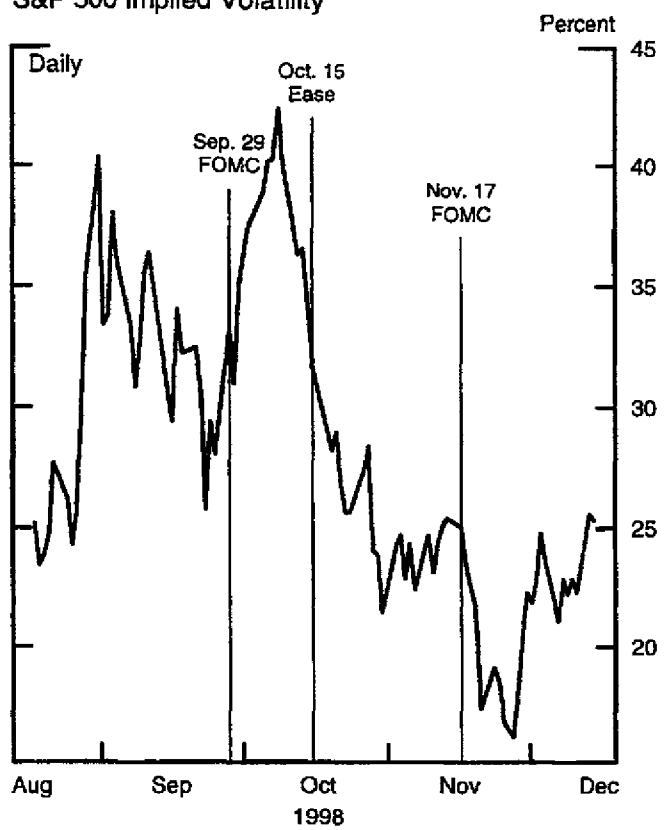
Borrowing by households appears to be staying high in the fourth quarter. There was a notable pickup in consumer credit growth in October, and November loan

### Equity and Treasury Markets

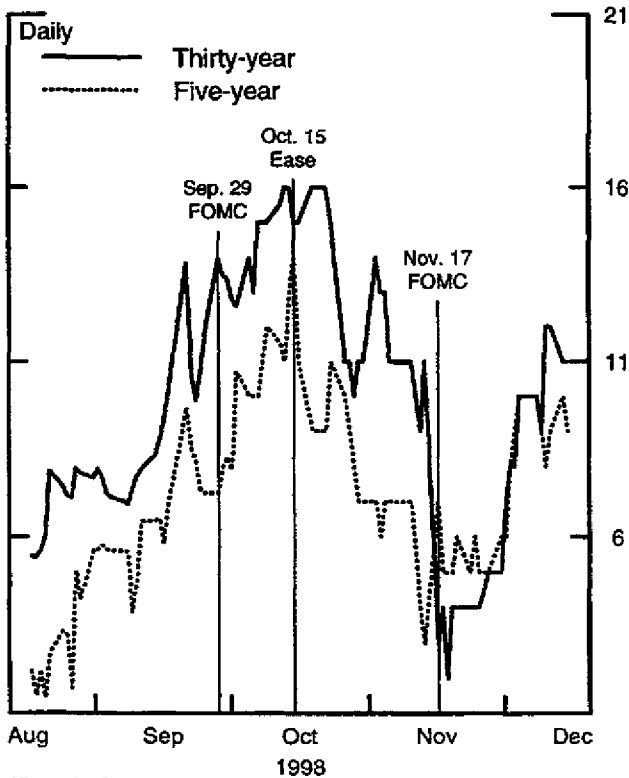
Selected Stock Indexes



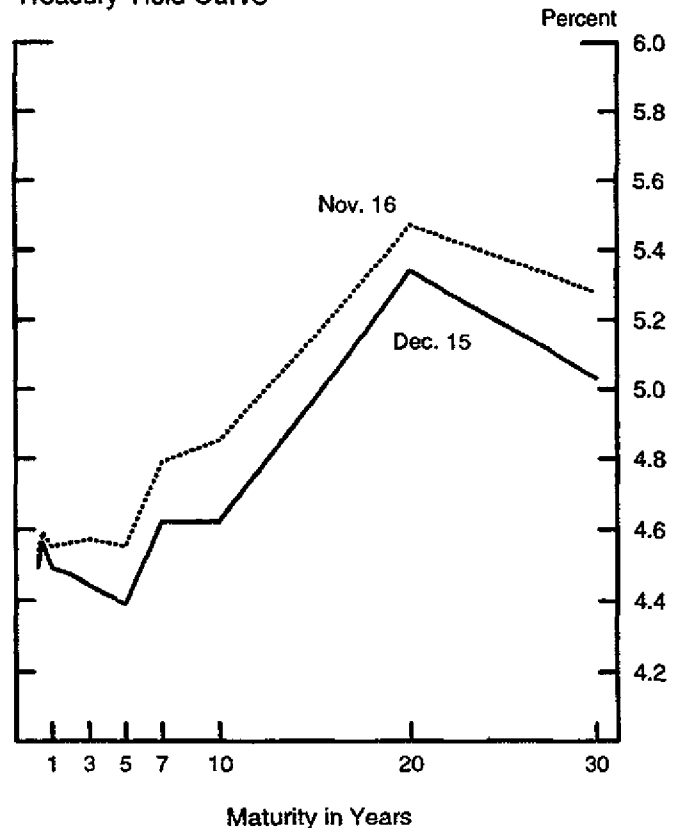
S&P 500 Implied Volatility



On-the-Run Premiums for Treasury Securities\*  
Basis Points



Treasury Yield Curve



\*Spreads of next-to-most-recently over most-recently issued security.  
 Note. New five- and thirty-year Treasury securities issued on Nov. 16.

figures for banks suggest a sizable further increase. Loan applications through early December and real estate loan growth at banks point to heavy borrowing in the home mortgage sector.

The Treasury increased its net borrowing in the bill sector in the fourth quarter, leading to a net paydown of an estimated \$30 billion of coupon securities as the overall need for funds remained modest. Meanwhile, state and local governments have continued to issue bonds in volume, primarily to finance capital outlays.

Rapid growth in bank credit continued through November, reflecting not only strong lending to households but an outsized buildup of securities. These asset acquisitions have been funded importantly by liquid deposits, as growth in the broad monetary aggregates has continued at a double-digit pace.

### **Business Finance**

Offerings of new corporate bonds have rebounded strongly since the end of the third quarter, and the market has come to embrace a wider variety of issuers. Investment-grade offerings soared to a record \$23-1/2 billion in November, with more than half of the proceeds earmarked to pay down short-term debt, much of it accumulated since August. Moreover, the improving tone of this market was evident in the maturities of bonds sold, which on average rose from twelve years in October to eighteen years in November. The relatively high spreads between investment-grade corporate debt and Treasury securities evidently have not discouraged issuers, no doubt because the level of corporate yields remains quite low by historical standards.

Recent indications of the condition of the commercial paper market have been mixed. Over the intermeeting period, the spread between medium-grade and prime paper fell sharply on short-dated issues that mature before the end of the year, but the same spread on thirty-day paper has widened, with a significant jump occurring on the day that the maturity crossed the year-end. Although investors have continued to demand a hefty premium to hold medium-grade paper over the four days at year-end, the premium has come down notably in recent days. Moreover, the placement of paper over year-end has proceeded somewhat ahead of last year's pace.

Issuance of junk bonds has picked up since mid-October, but the market still shows signs of stress. Offerings have been largely limited to well-known firms, particularly telecommunications and other noncyclical firms, and issuance has been running at only about half the extraordinary monthly pace that was recorded in the first half of the year. Spreads on high-yield debt relative to Treasury securities remain nearly double the level observed in the spring.



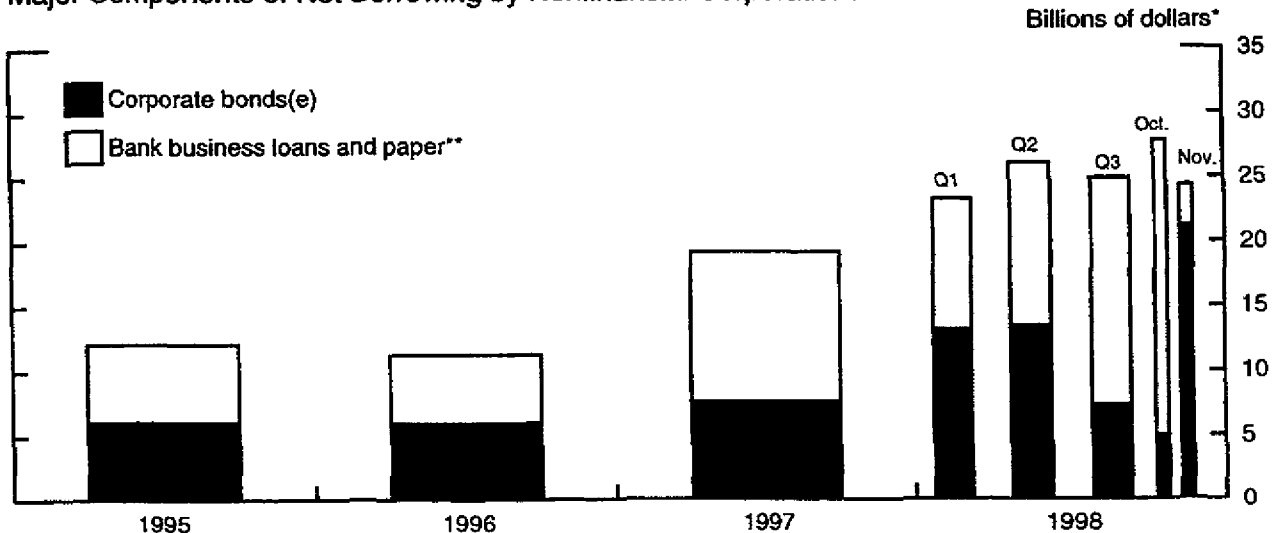
**GROSS ISSUANCE OF SECURITIES BY U.S. CORPORATIONS**  
(Billions of dollars; monthly rates, not seasonally adjusted)

Type of security	1997	1998					
		Q1	Q2	Q3	Sept.	Oct.	Nov.
<b>All U.S. corporations</b>	69.7	94.3	97.0	70.1	79.9	69.2	98.2
Stocks <sup>1</sup>	9.8	12.7	14.8	6.1	4.8	8.2	9.4
Bonds	59.9	81.6	82.2	64.0	75.1	61.0	88.8
<b>Nonfinancial corporations</b>							
Stocks <sup>1</sup>	5.0	6.1	8.4	3.7	2.3	5.1	5.9
Initial public offerings	1.8	1.2	2.8	1.0	.1	4.4	3.2
Seasoned offerings	3.2	4.8	5.6	2.8	2.2	.7	2.7
Bonds	17.0	27.2	26.8	15.6	10.3	12.3	31.5
By rating, sold in U.S. <sup>2</sup>							
Investment grade	7.4	13.1	10.7	10.1	6.8	8.7	23.4
Speculative grade	8.0	12.6	14.3	4.2	2.7	3.3	8.1
Public	1.5	2.1	3.0	1.4	1.4	.0	.9
Rule 144A	6.5	10.5	11.3	2.8	1.3	3.3	7.2
<b>Financial corporations</b>							
Stocks <sup>1</sup>	4.8	6.6	6.4	2.3	2.4	2.6	3.0
Bonds	42.6	54.3	55.3	48.3	64.8	46.5	57.1
<b>Memo:</b>							
Net issuance of commercial paper, nonfinancial corporations <sup>3</sup>	1.1	4.5	.5	7.4	7.2	-5.2	.4
Change in C&I loans at commercial banks <sup>3</sup>	6.1	3.5	11.5	7.4	6.3	27.9	.1

Note. Components may not sum to totals because of rounding. These data include speculative-grade bonds issued privately under Rule 144A. All other private placements are excluded. Total reflects gross proceeds rather than par value of original discount bonds.

1. Excludes equity issues associated with equity-for-equity swaps that have occurred in restructurings.
2. Bonds categorized according to Moody's bond ratings, or to Standard & Poor's if unrated by Moody's. Excludes mortgage-backed and asset-backed bonds.
3. End-of-period basis. Seasonally adjusted.

Major Components of Net Borrowing by Nonfinancial Corporations



\*Monthly rate.  
 \*\*Bank loans to business including CLOs plus domestic nonfinancial commercial paper; calculated on a period-end basis.  
 e—Staff estimate.

Gross public issuance of equity shares by nonfinancial firms picked up in November; however, as has been the case for the past couple of months, activity was dominated by several large issues. The few IPOs brought to market since the last FOMC meeting, which were mostly Internet-related, have been remarkably well received, with some stocks appreciating so sharply that questions have been raised about mispricing by the underwriters. Encouraged by the performance of recent IPOs, a number of firms, including many that have delayed public offerings in recent months, have filed registration statements, suggesting that a surge of new issues may occur after the usual year-end lull in underwriting activity.

While the earlier financial turmoil has had a lingering effect on securities markets, small businesses appear to have encountered little difficulty in accessing credit throughout this period, even though banks report that they have slightly firmed lending standards and terms for small, as well as large, customers. According to the November survey of the National Federation of Independent Business, the net proportion of small businesses that found credit harder to obtain remained near the bottom of the range seen during the current expansion, and hardly any of the responding firms anticipated a deterioration in their access to credit looking one quarter ahead. Indeed, reductions in the prime rate that accompanied recent policy easings have helped lower the cost of much of their borrowing.

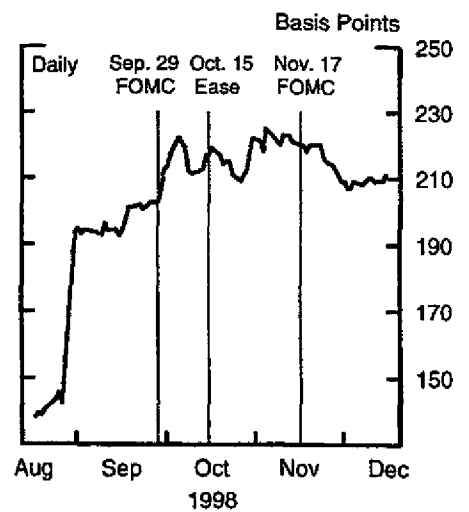
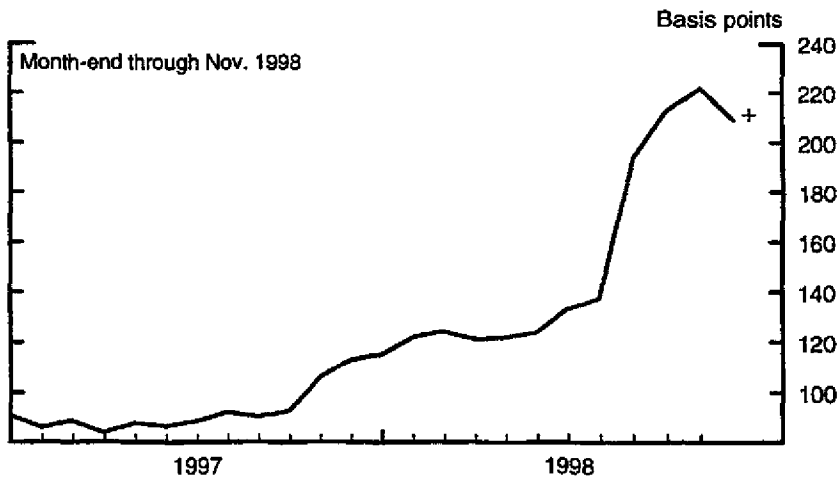
There is not much evidence of any deterioration in the credit quality of nonfinancial firms generally. In November, the amount of debt downgraded by Moody's slightly exceeded the amount upgraded, but the amounts put on watch for potential upgrade were higher than potential downgrades. Although the rate of nonfinancial business failures edged up in recent months, it remained near the low end of its range over the 1990s. (There was, however, some downgrading of financial firms, mostly reflecting difficulties with large trading losses or soured loans arising from foreign operations.)

Profits of nonfinancial corporations, measured by four-quarter growth of NIPA economic profits after tax, slipped in the third quarter. The weakness largely owed to the continued decline in receipts generated abroad; however, domestic profit growth also slowed, reflecting in part softer prices for manufactured goods, notably metals and electronic components.

Equity prices continued to climb after the November FOMC meeting, with most major indexes reaching record highs. Some of those gains have been lost in recent sessions, as earnings warnings by some large firms and developments in Latin

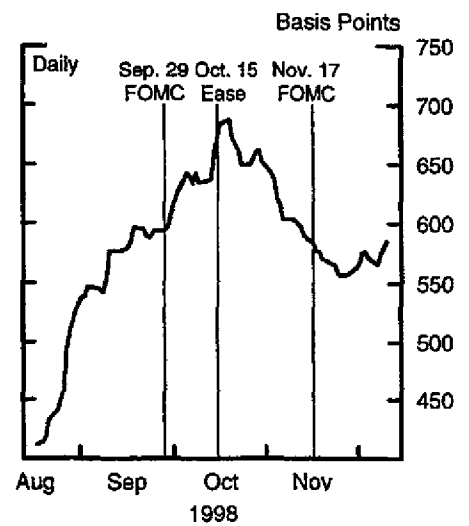
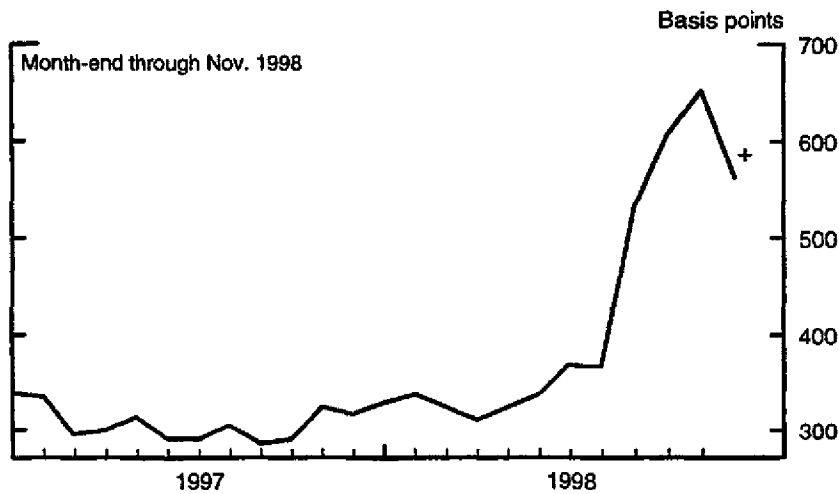
## Spreads on Corporate Securities

BBB Corporate Bond Yield\* less Ten-year Treasury



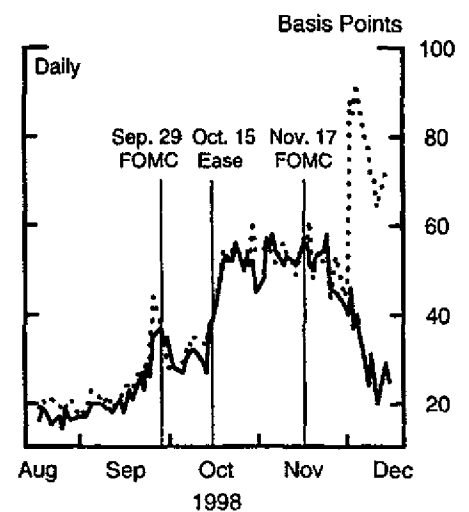
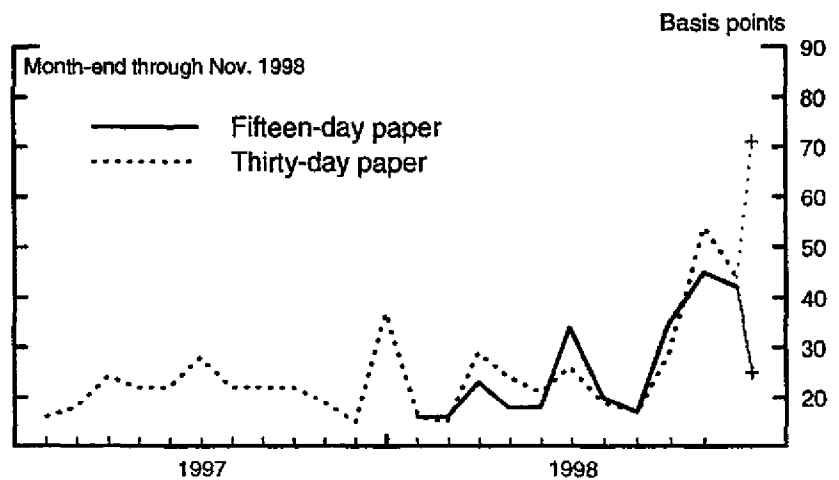
\*Source: Merrill Lynch  
 Note: + indicates the latest observation (Dec. 15).

High-Yield Bond Yield\* less Seven-year Treasury



\*Merrill Lynch Master II High Yield Bond Index  
 Note: + indicates the latest observation (Dec. 15).

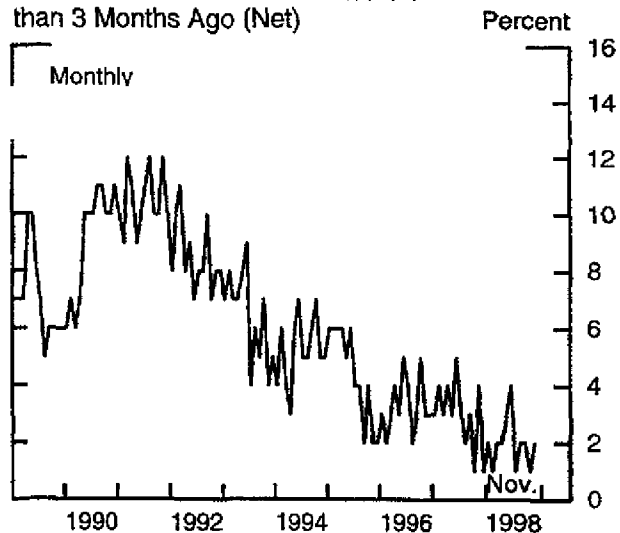
Medium Grade less Prime Commercial Paper Yield



Note: Data for the fifteen-day issue are only available since January 1998.  
 Note: + indicates the latest daily observation (Dec. 15).

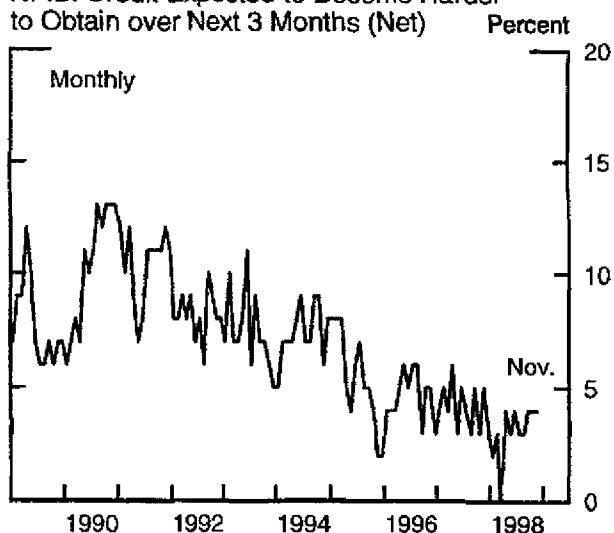
## Business Finance

NFIB: Credit Harder to Obtain Now than 3 Months Ago (Net)



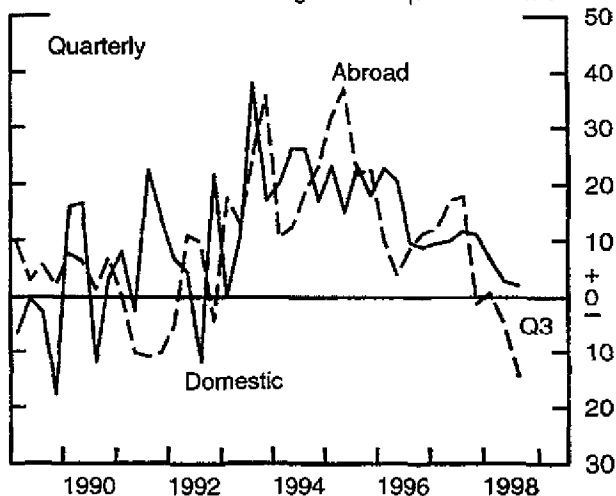
Note. Respondents consist of firms that sought credit in the past three months.

NFIB: Credit Expected to Become Harder to Obtain over Next 3 Months (Net)



Note. Respondents consist of firms that sought credit in the past three months.

NIPA Economic Profits After-tax  
Percent change from 4 quarters earlier

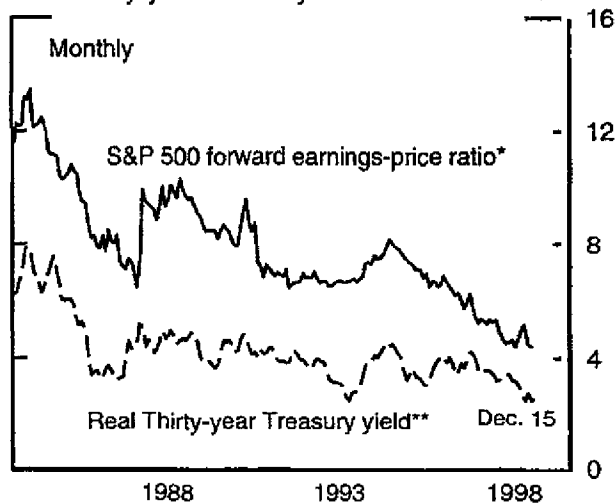


Selected Stock Indexes

	Last FOMC*	Year-end 1997
1. DJIA	-2	12
2. S&P 500	2	20
3. Nasdaq	8	28
4. Russell 2000	0	-11
5. Money Center Banks	0	-9

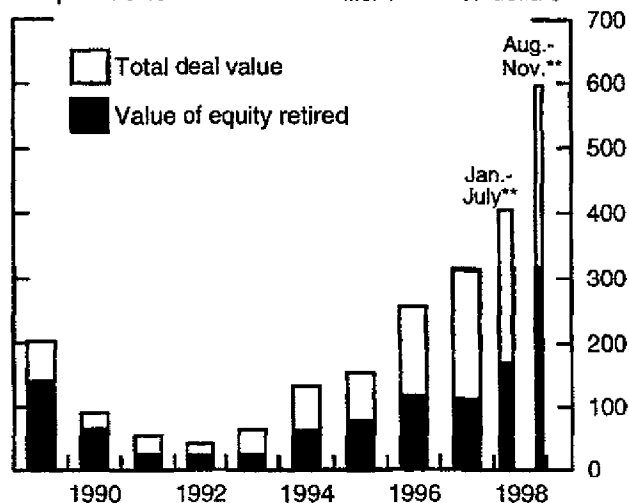
\*Nov. 16, 1998.

Forward Earnings-Price Ratio and Real Thirty-year Treasury Yield



\*Based on I/B/E/S operating earnings over coming 12 months.  
\*\*Nominal yield less Philadelphia Fed ten-year inflation expectations.

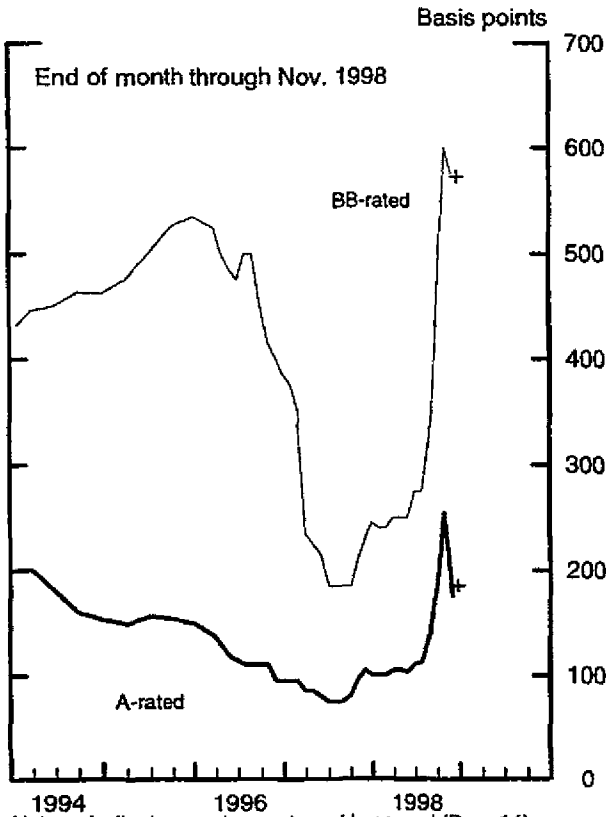
Completed Mergers of U.S. Nonfinancial Corporations  
Billions of 1997 dollars\*



\*Deflated to 1997 dollars using GDP deflator.  
\*\*At an annual rate.

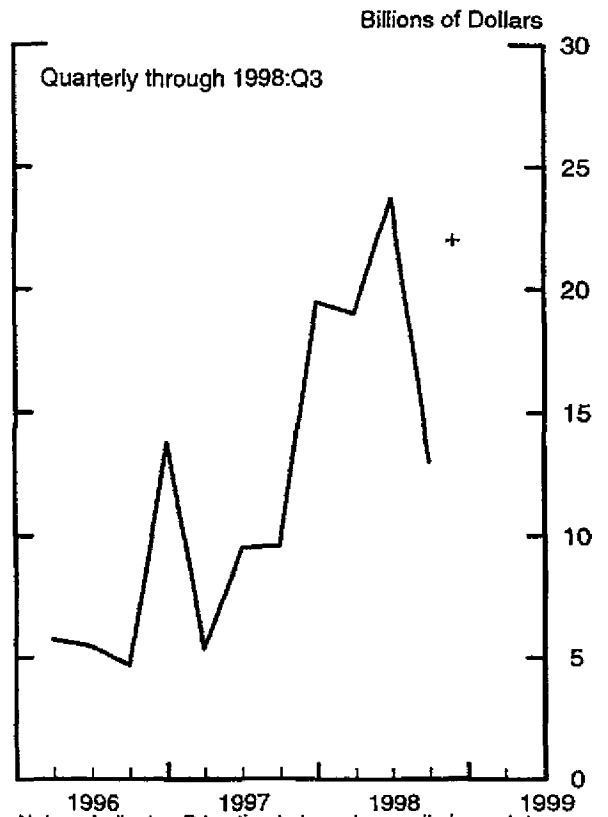
### Commercial Real Estate

CMBS Yield less Ten-Year Treasury



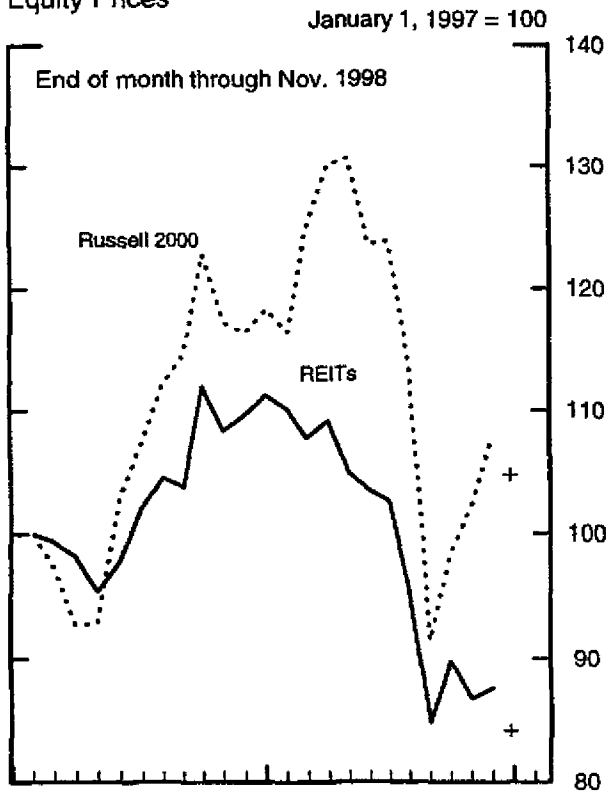
Note. + indicates most recent weekly spread (Dec. 14).  
Source. Morgan Stanley.

CMBS Gross Issuance



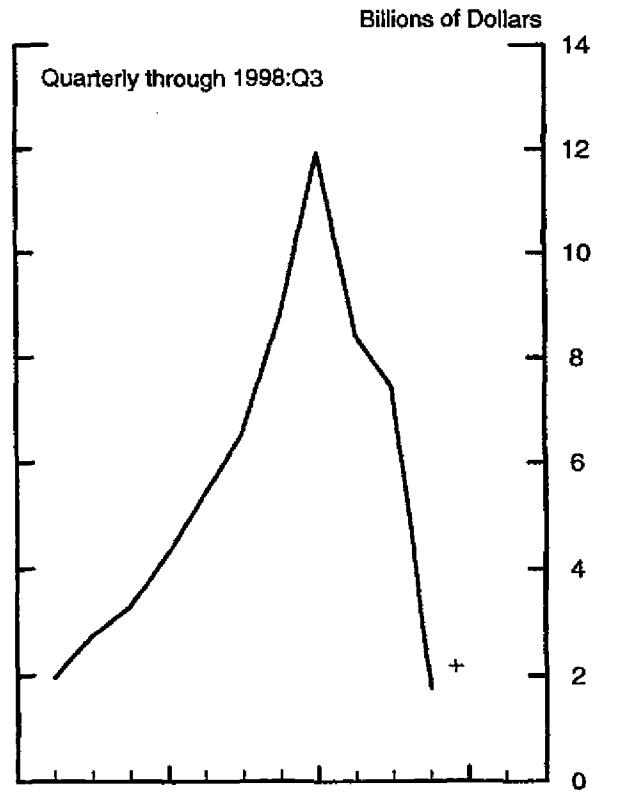
Note. + indicates Q4 estimate based on preliminary data.  
Source. Commercial Mortgage Alert.

Equity Prices



Note. + indicates most recent daily value (Dec. 14).  
Source. National Association of Real Estate Investment Trusts.

REIT Gross Equity Issuance



Note. + indicates Oct. and Nov. average at quarterly rate.  
Source. National Association of Real Estate Investment Trusts.

America have weighed on the markets. Stock prices of the basic materials sector-- among the hardest hit by the turmoil in Asia and emerging markets--continued to drop, while technology shares, which had also suffered more than the broader indexes during the earlier swoon, instead appreciated sharply over the intermeeting period. The recovery in equity prices since mid-October has reduced the forward earnings-price ratio from its recent peak. Although it has opened up a bit from the extremes reached earlier this year, the still narrow gap between this equity yield and the inflation-adjusted Treasury yield suggests that equity valuations are quite lofty. This seems rather at odds with the wide spreads still found on bonds, suggesting that those spreads may reflect more the lower liquidity of the bond market than risk aversion on the part of investors.

Mergers have continued to be completed at a strong pace in recent months, despite the turmoil in financial markets. The equity retirements from completed deals are expected to set a record in the fourth quarter, boosted by a couple of blockbuster foreign acquisitions of domestic companies. Moreover, more than \$110 billion of new megamergers, led by the \$81 billion combination of Exxon and Mobil, have been announced in recent weeks and will close sometime next year. Continuing the trends of this merger wave, the recent announcements are largely intra-industry and represent friendly combinations of firms looking to cut costs in industries with excess capacity.

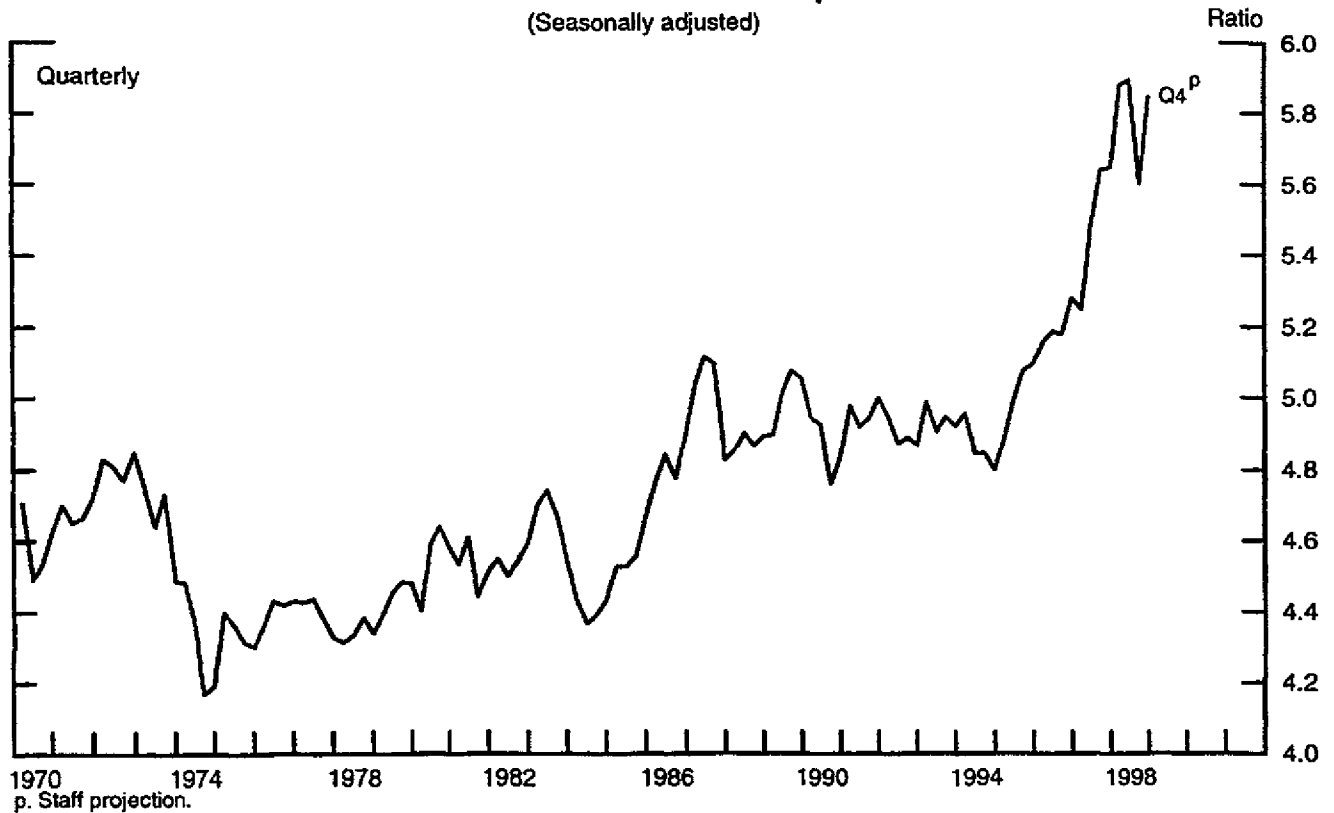
### **Commercial Real Estate**

The commercial real estate financing market, which had been under severe strain since mid-August, has staged a notable recovery. Commercial mortgage-backed securities issues brought to market in November were generally well-received, which has helped to build confidence among issuers and investors. The market improvement has perhaps been most evident in pricing: The yield on A-rated CMBS fell 27 basis points since the November Greenbook, adding to a decline that began in mid-October. More speculative BB-rated issues have shed 50 basis points since early November, reversing a trend toward higher yields that began in September; new buyers have entered into the market for the subordinated pieces of these securitizations. Nevertheless, spreads relative to Treasury securities remain quite wide compared with those earlier in the year. CMBS issuance has rebounded sharply in the current quarter and is expected to remain strong in the first quarter of 1999.

In contrast to the improvement in the CMBS market, REIT share prices and the level of REIT gross equity issuance remained subdued in November, likely owing to

### Household Net Worth Relative to Disposable Income

(Seasonally adjusted)



### Net Flows of Mutual Funds Excluding Reinvested Distributions (Billions of dollars; monthly rates; not seasonally adjusted)

	1996	1997	1998				Memo: End of October	
			H1	Q3	Oct.	Nov. <sup>e</sup>	Assets	Liquidity Ratio
<b>Total Long-Term Funds</b>	<b>19.3</b>	<b>22.7</b>	<b>29.3</b>	<b>10.5</b>	<b>6.7</b>	<b>28.7</b>	<b>3,805</b>	<b>5.5</b>
<b>Equity Funds</b>	<b>18.0</b>	<b>19.0</b>	<b>21.1</b>	<b>4.7</b>	<b>2.4</b>	<b>17.7</b>	<b>2,651</b>	<b>6.0</b>
Domestic	14.1	15.8	18.6	5.9	3.1	16.9	2,287	5.6
International	4.0	3.1	2.5	-1.2	-0.7	0.8	365	8.3
<b>Hybrid Funds</b>	<b>1.0</b>	<b>1.4</b>	<b>1.7</b>	<b>-0.1</b>	<b>-0.3</b>	<b>1.6</b>	<b>344</b>	<b>8.1</b>
<b>Bond Funds</b>	<b>0.2</b>	<b>2.4</b>	<b>6.5</b>	<b>6.0</b>	<b>4.6</b>	<b>9.5</b>	<b>809</b>	<b>3.1</b>
International	-0.2	-0.1	0.0	-0.3	-0.3	0.0	24	7.2
High-yield	1.0	1.4	1.8	-0.4	0.4	4.8	108	6.2
Other Taxable	-0.1	1.0	3.5	5.3	3.9	2.1	382	2.9
Municipal	-0.5	0.1	1.2	1.4	0.6	2.5	295	2.5

Source. Investment Company Institute (ICI).

<sup>e</sup> Staff estimates based on ICI weekly data.

continued concerns that over-building could restrain the growth of rental income from commercial properties.

### **Household Finance**

Household balance sheets have benefited from the rise in equity prices over the past two months, and the ratio of net worth to income probably has returned to near the record heights reached in the second quarter of 1998. Households have exhibited a renewed appetite for risky financial assets, with flows into equity and high-yield bond mutual funds continuing the rebound that began in mid-October. Flows into high-yield bond funds during November--at \$4-1/2 billion--were the strongest of any month on record. However, according to weekly data provided by ICI on a confidential basis, high-yield bond and equity inflows diminished during the first weeks of December, as stock prices faltered and market volatility turned up.

Based on fragmentary data through November, household borrowing appears to have grown briskly this quarter. Growth in mortgage debt has continued to be spurred by strong home purchases and heavy refinancing activity. Despite the paydown of installment loans that typically accompanies mortgage refinancing, consumer credit growth picked up to a 9 percent annual rate in October.<sup>1</sup>

Indicators of household credit quality remain favorable on balance. Call Report data show that the delinquency rate on consumer loans at commercial banks was about unchanged in the third quarter, while the ABA delinquency rate on all closed-end consumer loans declined. Moody's reported that the delinquency rate on credit card accounts in securitized pools in October continued the downtrend observed over the past year. Delinquency rates on loans at the auto finance companies declined in October and remain well below the peak reached in early 1997. The MBA reported that sixty-day and over delinquencies on home mortgage loans also edged down in the third quarter. One distinctly negative note is that personal bankruptcies rose at a 7 percent annual rate in the third quarter, a marked increase from the 2-1/2 percent average rate over the previous four quarters. However, the pickup may be linked to the progress of bankruptcy reform legislation in the third quarter: Some lawyers

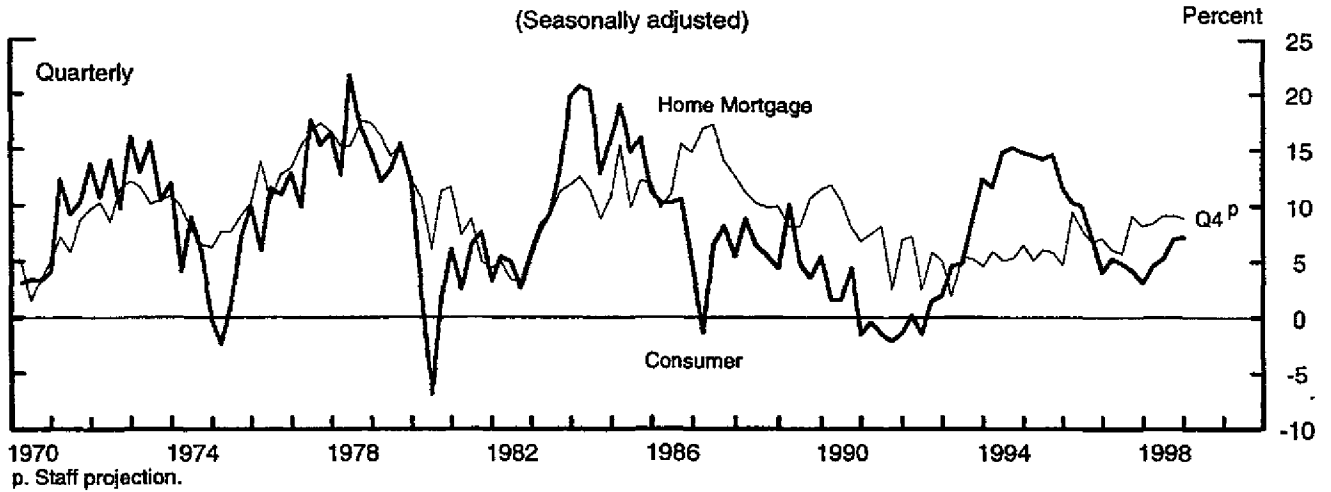
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1. A revision of the Call Report data involving members of a large bank holding company increased the growth rate of consumer credit in the third quarter to near 7 percent, up from the previous estimate of 4-1/2 percent.



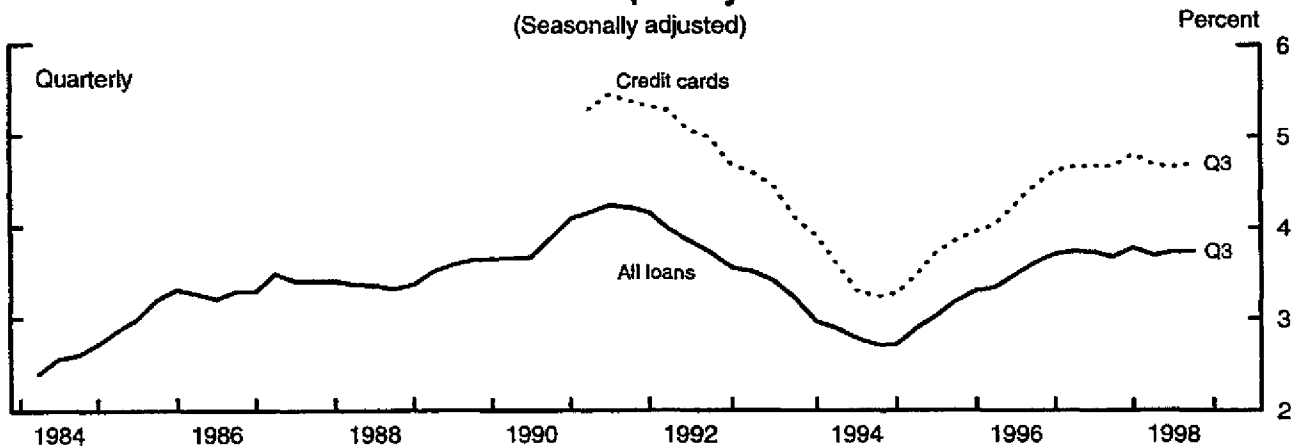
### Household Debt Growth

(Seasonally adjusted)



### Consumer Loan Delinquency Rates at Banks

(Seasonally adjusted)

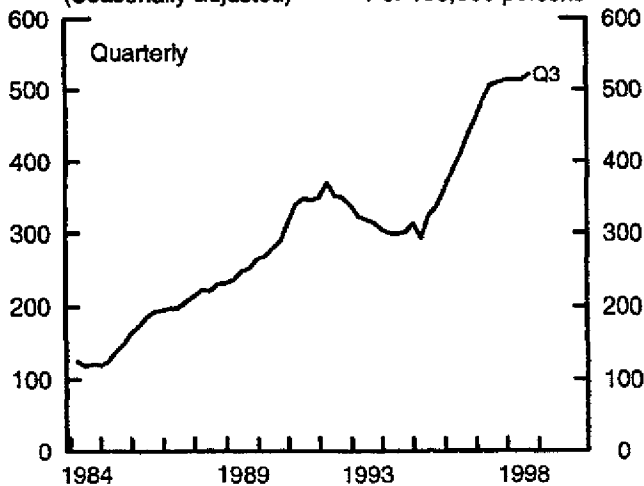


Source. Call Reports.

### Personal Bankruptcy Filings

(Seasonally adjusted)

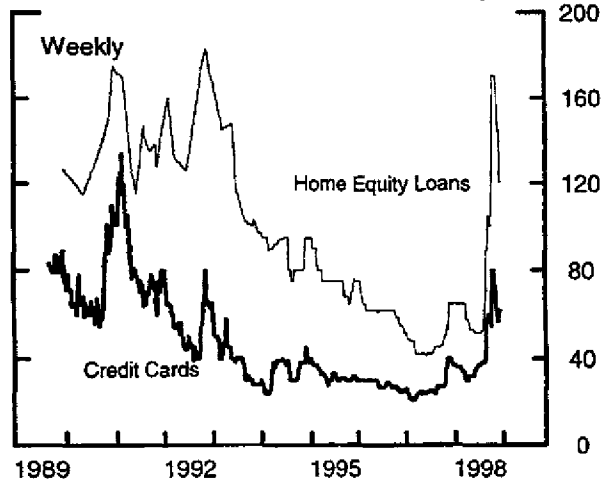
Per 100,000 persons



Source. Administrative Office of the U.S. Courts.

### ABS Yield less Two-Year Treasury

Basis points



Source. Salomon Smith Barney.  
Note. Latest observation is for Dec. 11.

reportedly encouraged clients to file for bankruptcy before a new federal law might take effect.<sup>2</sup>

Issuance of asset-backed securities picked up strongly in November, and home equity securitizers returned to the market after sitting out the month of October. Nonetheless, home equity spreads remain wide, and home equity lenders that rely on securitizations as their primary source of funding continue to encounter resistance from investors. Issuance of subprime home equity securities has picked up, but many of the deals required guarantees from private insurers, in contrast to most deals completed earlier in the year. The problems of these originators may have caused some reduction in lending to households with blemished credit histories, but other intermediaries with alternative sources of financing, such as diversified parent companies or well-capitalized partners, are likely finding that reduced competition is providing favorable lending opportunities in this market.

### **Government Finance**

The Treasury increased its net borrowing in the bill sector to an estimated \$55 billion in the fourth quarter, in part through larger weekly auctions implemented in late September. Given this increase, and the fact that overall borrowing needs remain modest, about \$30 billion of coupon securities should be paid down, on net, in the quarter.

The only coupon auction scheduled during the intermeeting period, that of the two-year note, met with modest demand--similar to the most recent mid-quarter refunding--perhaps evidencing dealers' reluctance to assume large positions in an uncertain market as the year-end approaches. Indeed, the four primary government securities dealers that close their books at the end of November pared some of their positions significantly last month. Also, on the demand side, foreign official holdings of U.S. Treasury securities at the Federal Reserve Bank of New York, which had declined sharply in September as pressures developed in international financial markets, continued to rebound and now stand just \$15 billion below their April peak.

Spurred in part by the growth of their mortgage portfolios, Fannie Mae and Freddie Mac have raised a sizable volume of funds both domestically and abroad. Fannie has issued about \$40 billion of benchmark notes since it started the program in January, of which international investors are reported to have bought around

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2. Both the House and the Senate approved bankruptcy reform legislation, but a compromise bill was not voted on in the Senate before it adjourned in October.

**Treasury Financing**  
(Billions of dollars)

Item	1998					
	Q1	Q2	Q3	Sep	Oct	Nov
<b>Total surplus, deficit (-)</b>	<b>-30.2</b>	<b>136.9</b>	<b>3.0</b>	<b>38.2</b>	<b>-32.5</b>	<b>n.a.</b>
Means of financing deficit						
Net borrowing	25.9	-81.8	-28.8	-46.4	15.3	21.4
Nonmarketable	17.3	15.9	10.1	7.3	3.6	.9
Marketable	8.6	-97.7	-38.9	-53.7	11.7	20.5
Bills	4.1	-78.8	-3.5	-38.8	13.6	34.2
Coupons	3.5	4.6	-18.9	-14.8	-1.9	-13.7
Decrease in cash balance	4.3	-44.6	33.4	-2.5	2.7	20.3
Other <sup>1</sup>	.0	-10.5	-7.6	10.7	14.5	n.a.
MEMO						
Cash balance, end of period	27.6	72.3	38.9	38.9	36.2	15.8

NOTE. Components may not sum to totals because of rounding.

1. Direct loan financing, accrued items, checks issued less checks paid, and other transactions.

**Net Cash Borrowing of Government-Sponsored Enterprises**  
(Billions of dollars)

Agency	1998					
	Q1	Q2	Q3	Aug	Sep	Oct
FHLBs	4.0	10.5	14.7	6.5	8.7	24.1
FHLMC	24.1	7.0	32.7	5.0	19.2	13.7
FNMA	11.3	25.1	24.4	8.0	7.4	0.7
Farm Credit Banks	-1.2	2.4	-0.4	-6.6	6.4	-3.6
SLMA	-1.4	-3.1	0.5	0.1	0.4	n.a.

NOTE. Excludes mortgage pass-through securities issued by FNMA and FHLMC.

## State and Local Finance

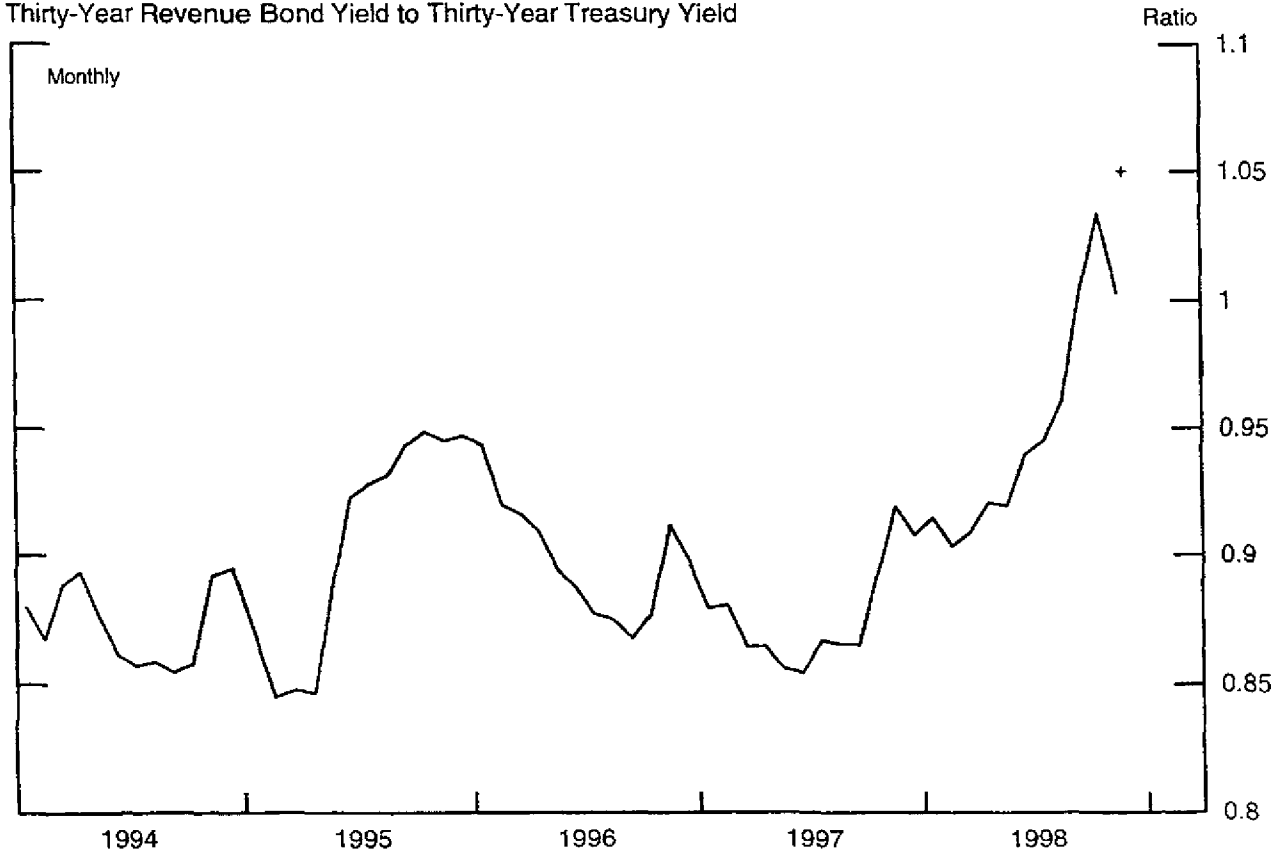
**GROSS OFFERINGS OF MUNICIPAL SECURITIES**  
(Billions of dollars; monthly rates, not seasonally adjusted)

	1998							
	1996	1997	Q1	Q2	Q3	Sept.	Oct.	Nov.
Total tax-exempt	17.9	21.5	23.3	27.5	23.1	20.6	21.7	21.0
Long-term	14.3	17.9	22.0	24.3	20.2	17.5	19.5	19.3
Refundings <sup>1</sup>	4.9	6.6	9.5	8.5	8.1	8.4	6.8	6.9
New capital	9.4	11.3	12.5	15.7	12.1	9.1	12.7	12.5
Short-term	3.6	3.6	1.3	3.2	2.9	3.1	2.2	1.7
Total taxable	0.8	1.1	1.3	0.8	1.3	1.0	0.5	0.7

Note. Includes issues for public and private purposes.  
1. All issues that include any refunding bonds.

## Tax-Exempt to Taxable Yield Ratio

Thirty-Year Revenue Bond Yield to Thirty-Year Treasury Yield



Note. Average of weekly data.  
Note. + indicates the latest observation (Dec. 10).

40 percent. The strong interest shown by international investors owes in part to a desire by foreign central banks to invest their dollar reserves in safe securities amid the international financial crisis, even though these securities are not explicitly guaranteed by the government. Although Freddie Mac has issued a much smaller quantity of its reference notes, the agency recently announced its intention to move to a monthly auction schedule for this series and anticipates total issuance of \$40 billion over the next twelve months.

Spreads between non-callable non-benchmark agency-issued securities and Treasuries widened 6 to 7 basis points over the intermeeting period, perhaps reflecting investors' renewed concern about liquidity. Indeed, more liquid benchmark securities fared slightly better, posting spread increases of 3 basis points or less. Spreads on benchmark securities are near 40 basis points for three-year notes and 60 basis points for ten-year notes.

### **Municipal Finance**

Total tax-exempt bond issuance was little changed from October. Advance refunding activity remains below the levels seen in the first nine months of the year, in part because the low yields on Treasury bonds relative to municipal bonds make refunding more expensive (issuers hold Treasuries in escrow accounts until the old muni can be called and redeemed). In addition, advance refunding likely is being constrained by the limited supply of bonds eligible to be refunded, which has been reduced by the strong refunding activity since the middle of 1997. Nevertheless, new capital issuance to date in the fourth quarter has been sizable, and 1998 overall is likely to post the largest gross issuance of tax-exempt bonds since the all-time high issuance in 1993.

Investor demand for tax-exempt bonds has strengthened since October. Tax-exempt mutual funds attracted an estimated \$2-1/4 billion of inflows in November, up from \$1/2 billion in October. Market sources indicate that retail demand has strengthened as some investors have sought to avoid volatility in equity markets. The recent firming of demand helped pull down the thirty-year revenue yield index about 10 basis points since the November FOMC. Even so, ongoing supply pressures and continued preference for Treasuries left muni yields relative to Treasuries at very high levels.

### **Money and Bank Credit**

The monetary aggregates posted another strong month in November. Substantial net flows into liquid deposits contributed to a 10-1/2 percent rate of increase in M2 last

MONETARY AGGREGATES  
(Based on seasonally adjusted data)

Aggregate or component	1997	1998		1998			1997:Q4	Level
		Q2	Q3	Sept	Oct.	Nov.	to Nov. 98	(bil. \$) Nov. 98
						(p)	(p)	(p)
Aggregate	Percentage change (annual rate) <sup>1</sup>							
1. M1	-1.2	.2	-2.4	3.5	7.2	10.2	1.7	1087.7
2. M2 <sup>2</sup>	5.7	7.4	6.6	14.8	12.7	10.4	8.8	4376.0
3. M3	8.8	10.2	7.1	14.5	12.9	14.7	11.0	5909.6
<b>Selected Components</b>								
4. Currency	7.5	5.1	8.4	15.4	10.1	9.0	8.2	456.7
5. Demand deposits	-2.0	-5.6	-11.6	-1.9	1.6	7.7	-4.4	376.5
6. Other checkable deposits	-12.2	1.1	-7.0	-9.9	9.0	17.8	.6	246.6
7. M2 minus M1 <sup>3</sup>	8.5	9.9	9.8	18.6	14.6	10.4	11.3	3288.3
8. Savings deposits	9.9	13.6	11.9	15.8	14.9	14.7	13.7	1576.0
9. Small time deposits	2.3	-2.6	-1.3	1.5	1.6	-1.5	-.7	961.6
10. Retail money market funds	16.3	20.9	21.3	48.3	31.3	17.0	25.1	750.8
11. M3 minus M2 <sup>4</sup>	19.6	18.8	8.4	13.8	13.3	27.0	17.7	1533.5
12. Large time deposits, net <sup>5</sup>	17.1	15.2	-2.7	-3.5	-8.8	8.1	7.9	611.9
13. Institution-only money market mutual funds	21.0	36.5	21.6	38.4	60.9	44.4	35.3	498.5
14. RPs	17.4	14.6	10.5	29.8	-20.3	46.2	20.9	277.8
15. Eurodollars	31.2	-7.7	14.3	-18.4	20.4	12.5	5.6	145.3
<b>Memo</b>								
16. Liquid Deposits <sup>6</sup>	4.3	8.5	5.4	9.7	12.0	13.8	8.6	2199.0
17. Sweep-adjusted M1 <sup>7</sup>	6.0	4.6	3.7	7.6	8.3	10.3	5.9	1393.1
18. Monetary base	5.9	4.1	6.9	11.5	9.3	9.1	7.1	509.9
19. Household M2 <sup>8</sup>	6.6	8.7	8.9	14.7	13.3	10.9	10.2	3998.0
Average monthly change (billions of dollars) <sup>9</sup>								
<b>Memo</b>								
Selected managed liabilities at commercial banks:								
20. Large time deposits, gross	11.2	5.0	-2.1	3.8	5.4	12.8	. . .	732.2
21. Net due to related foreign institutions	-3.9	-15.8	7.0	-1.1	23.4	-3.6	. . .	220.1
22. U.S. government deposits at commercial banks	.1	4.3	-2.4	2.0	7.0	2.7	. . .	28.8

1. For the years shown, fourth quarter-to-fourth quarter percent change. For the quarters shown, based on quarterly averages.

2. Sum of seasonally adjusted M1, retail money market funds, savings deposits, and small time deposits.

3. Sum of retail money funds, savings deposits, and small time deposits, each seasonally adjusted separately.

4. Sum of large time deposits, institutional money funds, RP liabilities of depository institutions, and Eurodollars held by U.S. addressees, each seasonally adjusted separately.

5. Net of holdings of depository institutions, money market mutual funds, U.S. government, and foreign banks and official institutions.

6. Sum of seasonally adjusted demand deposits, other checkable deposits, and savings deposits.

7. Sweep figures used to adjust these series are the estimated national total of transaction account balances initially swept into MMDAs owing to the introduction of new sweep programs, on the basis of monthly averages of daily data.

8. M2 less demand deposits.

9. For the years shown, "average monthly change" is the fourth quarter-to-fourth quarter dollar change, divided by 12. For the quarters shown, it is the quarter-to-quarter dollar change, divided by 3.

p--Preliminary.

**Commercial Bank Credit**  
(Percent change; seasonally adjusted annual rate)

Type of credit	1997	1998					Level, Nov 1998 (billions of \$)
		Q2	Q3	Sep	Oct	Nov	
1. Bank credit: Reported	9.0	5.4	9.1	15.5	25.3	9.3	4,527.0
2.           Adjusted <sup>1</sup>	8.6	6.0	8.0	10.2	18.1	15.1	4,397.4
3. Securities: Reported	10.3	0.5	12.3	20.6	42.1	9.2	1,225.6
4.           Adjusted <sup>1</sup>	8.5	2.3	8.2	-0.1	15.3	32.6	1,095.9
5.   U.S. government	6.2	-3.4	0.6	-6.5	11.3	22.3	787.9
6.   Other <sup>2</sup>	20.8	9.2	37.6	75.2	99.5	-13.8	437.7
7. Loans <sup>3</sup>	8.6	7.2	8.0	13.5	19.2	9.3	3,301.4
8.   Business	8.8	7.0	12.6	15.2	27.9	10.8	950.5
9.   Real estate	9.2	6.3	1.8	1.1	5.4	19.3	1,307.0
10.   Home equity	15.5	-0.8	-2.5	3.7	-7.4	17.3	98.3
11.   Other	8.7	6.9	2.1	0.9	6.4	19.6	1,208.7
12. Consumer: Reported	-1.5	1.7	-5.4	7.7	-1.4	4.8	501.3
13.           Adjusted <sup>4</sup>	4.1	9.1	3.8	6.8	-0.3	5.7	745.4
14.   Other <sup>5</sup>	20.9	16.0	30.6	47.9	57.1	-12.5	542.6

Note. Adjusted for breaks caused by reclassifications. Monthly levels are pro rata averages of weekly (Wednesday) levels. Quarterly levels (not shown) are simple averages of monthly levels. Annual levels (not shown) are levels for the fourth quarter. Growth rates shown are percentage changes in consecutive levels, annualized but not compounded.

1. Adjusted to remove effects of mark-to-market accounting rules (FIN 39 and FASB 115).
2. Includes securities of corporations, state and local governments, and foreign governments and any trading account assets that are not U.S. government securities.
3. Excludes interbank loans.
4. Includes an estimate of outstanding loans securitized by commercial banks.
5. Includes security loans, loans to farmers, state and local governments, and all others not elsewhere classified. Also includes lease financing receivables.

month, only a modest slowing from October. Continuing declines in M2's opportunity cost following the policy moves this fall have helped fuel growth in this aggregate, but the advance was limited by a marked slowing in retail MMMF growth. Nevertheless, M2 growth for the year is well above the upper bound of its annual range, and the strength in M2 in October and November points to another decline in velocity in the current quarter. M3 grew at a 14-3/4 percent pace in November, somewhat faster than in October, as still-strong flows into institution-only MMMFs were accompanied by a resumption of issuance of large time deposits.<sup>3</sup>

Despite sizable net flows into core deposits, banks have relied heavily on wholesale liabilities for funding, as commercial bank credit, adjusted for mark-to-market rules, expanded at a 15 percent rate in November. Indeed, over the past four months, bank credit has surged, on average, at a nearly 16 percent annual rate, the most rapid four-month pace in twenty-five years. The strength in bank credit has been evident both in its securities and loans components, suggesting that banks generally are comfortable with their capital positions. In particular, bank holdings of securities increased at about a 33 percent annual rate in November, even as bank loans grew at a robust 9-1/4 percent pace.

The strength in bank lending last month spanned most loan categories. Real estate loans surged, with home mortgages accounting for the bulk of this increase. The growth in home mortgages was lifted by a strong housing market as well as heavy refinancing activity, which often involves temporarily warehousing new loans on banks' books until they are securitized. Consumer loans originated by banks rebounded last month amid vigorous household spending on durables.

Business loan growth dropped back to a 10-3/4 percent rate in November on a month-average basis, and weekly data indicate an even sharper slowing since the middle of October. This pull-back is consistent with the notion that the earlier surge in business loans was driven importantly by stresses in capital markets, which have partly unwound. Banks apparently responded to the reduction in competition for loans and to concerns about the economic outlook by raising spreads on new loans. According to the latest Survey of Terms of Business Lending conducted during the first week of November, the average spread between rates on newly originated bank C&I loans and the intended federal funds rate has increased 9 basis points since the last survey in August. This average, however, masks a more substantial rise on loans

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3. The appendix to this section reviews the behavior of debt and monetary aggregates over 1998 as a whole.



that were not made under commitment, as spreads on such loans widened nearly 50 basis points at domestic banks and nearly 40 basis points at U.S. branches and agencies of foreign banks.

While the combination of strong loan demand and high spreads on C&I loans brightens the outlook for bank earnings going forward, profits last quarter were hurt by sharp declines in trading revenues and increased provisioning for hedge-fund and foreign loan losses, especially at the ten largest banks. In contrast, the return on equity of other banks, which tend to rely on more traditional banking activities, remained high. For the banking system as a whole, net interest income and noninterest, nontrading income were robust, and provisioning for losses on most domestic loans stayed low. Quality indicators of banks' balance sheets remained favorable, on net, and virtually all bank assets were at well-capitalized banks.

## Appendix

### A Review of Debt and Money in 1998

The monetary and debt aggregates accelerated considerably in 1998. The growth of M2, M3, and domestic nonfinancial sector debt exceeded staff projections made in both February and July, and the two broad monetary aggregates substantially overshot their annual ranges. Debt, by contrast, finished the year within its annual range, albeit in the upper half.

The pickup in total debt growth reflected an acceleration in nonfederal borrowing, as federal debt began to contract. With overall demands for credit strong and banks apparently willing to expand their balance sheets significantly, bank credit grew relatively rapidly over the year. Bank loans expanded especially quickly in late summer and early fall, when securities markets were disrupted and borrowers turned to banks for credit. The strong expansion in M3 partly reflected banks' need to finance credit growth, but it also owed to institution-only money market mutual funds, which accelerated sharply from an already-brisk pace. M2 displayed surprising strength. Its rapid growth owed in part to reductions in market interest rates in the second half of the year and the consequent declines in the opportunity costs of holding M2 assets, neither of which was anticipated in staff projections earlier in the year, and perhaps in part to lagged adjustments to earlier gains in household wealth. In addition, M2 was boosted in the autumn by heightened demands for safety and liquidity as a result of turbulent market conditions. Nonetheless, the factors driving M2 this year remain incompletely understood.

#### **Domestic Nonfinancial Debt**

The growth of domestic nonfinancial sector debt is estimated at 6-1/4 percent for 1998 on a fourth-quarter to fourth-quarter basis, up noticeably from 5 percent in 1997 and substantially above the 4-1/2 percent advance in nominal GDP estimated by the staff.<sup>1</sup> Although debt growth increased, the aggregate remained within the FOMC's 3 to 7 percent range. Federal debt outstanding actually contracted over the year, reflecting the first budget surplus on a fiscal-year basis since 1969. The debt of other nonfinancial sectors accelerated to an 8-3/4 percent pace, a substantial pickup from last year's 6-1/2 percent pace and the fastest annual growth in a decade.

**Household finance.** Reflecting brisk growth in consumption, especially spending on durables, growth in consumer credit picked up this year. Moreover, very favorable home mortgage financing conditions and a sharp increase in housing activity and refinancings contributed to an acceleration of home mortgage debt. The disruption to financial markets in late summer and early fall evidently resulted in some restraint on

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1. The growth rates for money and debt for 1998 presented in this appendix are preliminary estimates. For debt measures, they are based on data through October and, for monetary and bank credit aggregates, on data through November.

credit to the most marginal borrowers, but elsewhere appears to have left little imprint on household borrowing. For the year, household debt once again has outpaced household income. Nonetheless, indicators of credit quality in the household sector remained fairly stable, and lenders maintained a generally accommodative posture.

**Business finance.** Growth in nonfinancial business debt picked up to nearly a double-digit rate in 1998 as capital outlays outstripped internal funds and share retirements moved sharply higher. The disruptions in credit markets in late summer and early fall shifted financing from the capital markets to banks, but as conditions in securities markets improved after mid-October, a growing number of firms returned to the bond market. As of November, issuance of both investment-grade and junk bonds already exceeded the totals for all of 1997. Measures of financial condition of the business sector registered mixed changes.

Borrowing in the market for commercial mortgages strengthened over the first three quarters of the year, with funding concentrated in the commercial mortgage-backed securities market. However, the disruptions to financial markets in late summer led to a sharp cutback in this source of funds, although the accompanying wider spreads drew some banks and other institutional lenders back into the market.

**State and local finance.** The debt of state and local governments is estimated to have expanded 6-1/2 percent this year, up from last year's pace. State and local governments stepped up their borrowing to finance new projects and to advance-refund eligible bonds outstanding. With tax revenues boosted by healthy income growth, measures of the financial condition of states and localities improved.

### **Depository Credit**

Growth in credit extended by depository institutions picked up in 1998. The bulk of this acceleration was accounted for by bank credit, though thrift credit also expanded at a faster rate than in the previous year. Bank credit (adjusted for mark-to-market accounting rules) expanded 10-1/4 percent, up from 8-1/2 percent in 1997 and the fastest rate since 1984. The share of bank credit in domestic nonfinancial debt rose to its highest level since 1988. The pickup in bank credit growth reflected accelerations both in adjusted security holdings and in loans held on banks' books. The increase in loans originated by banks was even greater than that of loans held on banks' books, as the pace of bank loan securitization also picked up. Loan growth was spurred by C&I and security loans, which expanded rapidly over the year, especially late in the summer and early in the fall. Largely owing to securitizations, consumer loans on banks' books were about flat while real estate loans rose moderately.

### **Monetary Aggregates**

M2 expanded rapidly in 1998, growing an estimated 8-3/4 percent on a fourth-quarter to fourth-quarter basis. It exceeded its annual range of 1 to 5 percent by a wide margin. In part, the rapid growth in M2 was a continuation of a development that appeared in the second half of 1997, when M2 growth began to exceed that of nominal GDP despite little change in the opportunity cost of holding M2 assets. Since

then, M2 velocity has fallen in each quarter, representing a distinct break from a previous trend of stable or rising velocity. To some degree, the rapid growth in M2 since mid-1997 may reflect portfolio adjustments by households in response to substantial increases in their wealth resulting from stock market gains. More recently, heightened demands for liquidity and safety since late summer and reductions in the opportunity cost of holding M2 assets have boosted M2 growth. The expansion of liquid accounts (retail money fund shares and liquid deposits), at 12-1/4 percent over the year, was particularly strong.<sup>2</sup> Growth of M2 in 1998 has far outpaced that predicted by standard models.

M3 rose 10-3/4 percent from the fourth quarter of 1997 through the fourth quarter of 1998, accelerating 2 percentage points from last year and far exceeding its 2 to 6 percent range for 1998. The strong growth in core deposits included at the M2 level funded part of the expansion in bank credit, but banks also relied importantly on managed liabilities in M3 to obtain funds. The non-M2 component of M3 was given a sharp boost by institution-only money funds, as well. Rapid growth in these instruments partly reflected a long-term trend of substituting money funds for in-house management of corporate liquid assets. In the fall, growth of money funds was lifted further by the policy easings, as their yields lagged declines in market rates.

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2. MZM grew about 14 percent over the year. For the first time in four years, M1 did not contract, as new retail sweep activity slowed. Still, depository institutions implemented an additional \$60 billion of retail sweep arrangements this year, lowering required reserve balances by another \$5-1/4 billion or so.

**THE GROWTH AND FLOW OF MONETARY AND CREDIT AGGREGATES**  
**(Q4 to Q4 averages, seasonally adjusted unless otherwise noted)**

Growth rates or flows	1994	1995	1996	1997	1998 <sup>1</sup>	Memo: 1998 Q4 levels (billions of dollars) <sup>1</sup>	
<b>Growth rates (percent)</b>							
Domestic nonfinancial debt - total	4.9	5.4	5.3	5.0	6.3	16,040.6	
Federal	5.7	4.4	3.8	0.7	-1.2	3,748.4	
Nonfederal	4.6	5.7	5.9	6.6	8.8	12,292.2	
Depository credit	4.9	5.8	4.2	6.6	8.3	5,644.1	
Bank credit <sup>2</sup>	5.7	7.2	4.4	8.6	10.2	4,383.7	
Thrift credit	2.6	1.6	3.6	0.7	2.2	1,260.4	
M1	2.5	-1.6	-4.5	-1.2	1.6	1,085.6	
Sweep-adjusted M1 <sup>3</sup>	3.4	1.6	5.2	6.0	5.7	1,390.5	
M2	0.6	3.9	4.6	5.7	8.7	4,373.3	
M3	1.7	6.1	6.8	8.8	10.8	5,902.0	
Memo: Nominal gross domestic product	5.8	4.2	5.8	5.6	4.5	8,624.6	
<b>Flows (\$ billions, December to December)</b>							
	Currency	32.1	18.1	22.5	30.6	34.3	456.6
M1	Transactions deposits	-11.8	-40.5	-67.9	-37.2	-19.6	621.0
	Sweep-adjusted transactions deposits <sup>3</sup>	-2.0	4.1	44.3	46.3	37.0	n.a.
	Nontransactions M2	-5.3	170.3	220.6	227.2	344.6	3,287.8
M2	Savings, MMDAs, and small time deposits	-34.7	100.4	152.8	146.6	187.0	2,537.1
	Retail MMMFs	29.4	69.9	67.9	80.4	157.8	750.7
	Non-M2 component	59.2	113.8	160.6	225.4	222.2	1,528.6
	Institution-only MMMFs	-9.5	50.8	56.4	65.9	137.8	497.7
M3	Large time deposits	29.8	56.2	71.7	81.6	44.7	612.4
	Total RPs and Eurodollars, net (NSA)	37.2	6.0	31.7	77.2	38.7	415.8

1. Preliminary estimates. For debt aggregates, based on data through October 1998. For credit and monetary aggregates, based on data through November 1998. Figure for nominal GDP is staff projection.

2. Adjusted for the estimated effects of mark-to-market accounting rules.

3. Sweep figures used to adjust this series are the estimated national total of transaction account balances initially swept into MMDAs by new sweep programs, on the basis of monthly averages of daily data.

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# **INTERNATIONAL DEVELOPMENTS**

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## International Developments

### U.S. International Trade in Goods and Services

In September, the U.S. nominal trade deficit in goods and services was \$14.0 billion, significantly smaller than in August. The trade deficit in the third quarter was modestly larger than in the second quarter. Trade data for October will be released on December 17 and will be discussed in the Greenbook supplement.

**Net Trade in Goods & Services**  
(Billions of dollars, seasonally adjusted)

	1997	Annual rates			Monthly rates		
		1998			1998		
		Q1	Q2	Q3	Jul	Aug	Sep
<b>Real NIPA<sup>1</sup></b>							
Net exports of G&S	-136.1	-198.5	-245.2	-253.9	...	...	...
<b>Nominal BOP</b>							
Net exports of G&S	-110.2	-140.0	-175.5	-183.0	-14.5	-15.9	-14.0
Goods, net	-198.0	-222.8	-257.8	-257.4	-21.0	-22.7	-20.6
Services, net	87.7	82.8	82.3	74.4	6.5	6.8	6.6

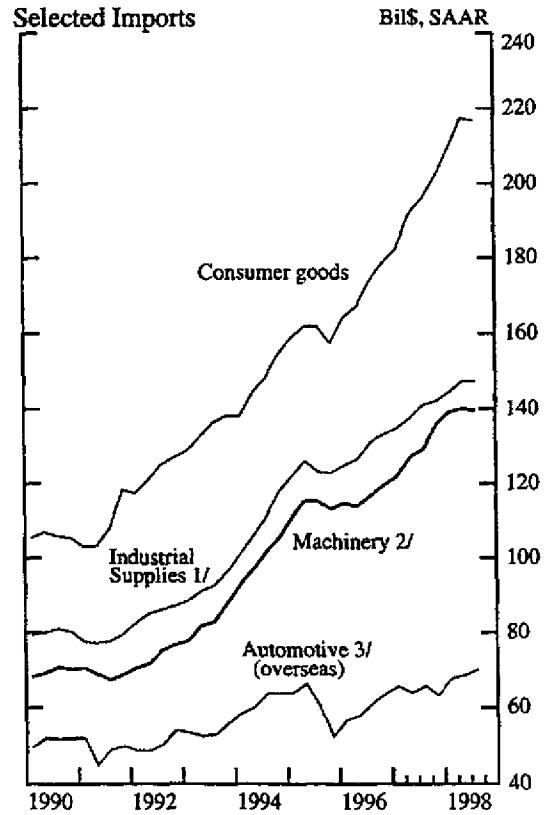
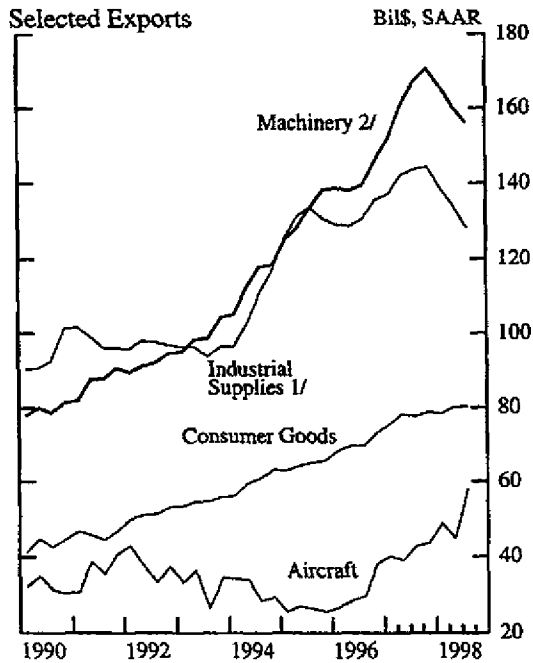
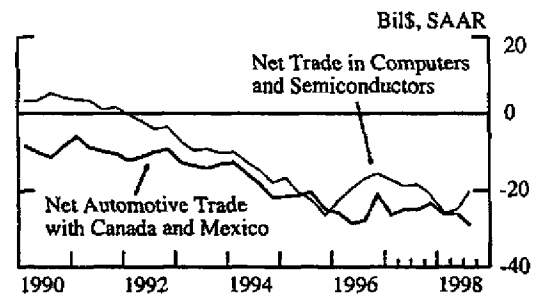
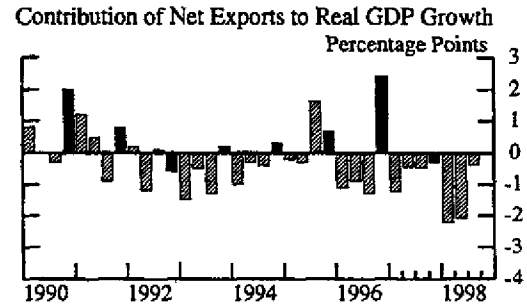
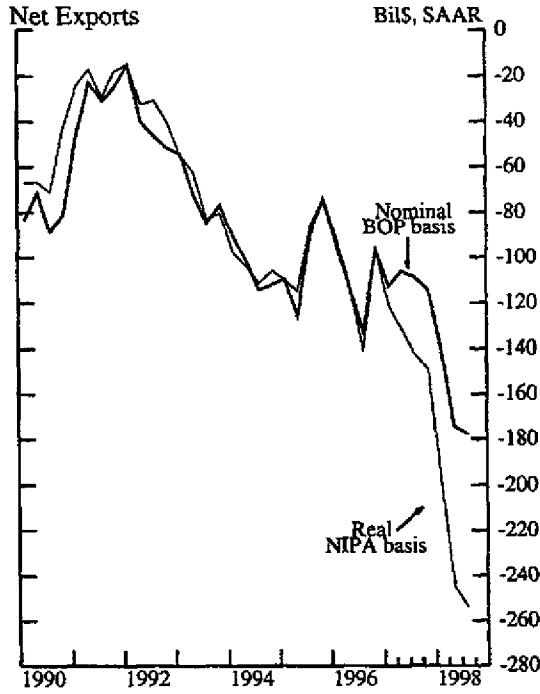
1. In billions of chained (1992) dollars.

Source. U.S. Dept. of Commerce, Bureaus of Economic Analysis and Census.

The value of exports increased 2¼ percent in September. The rise was mostly due to a jump in deliveries of aircraft, although exports of automotive products also increased (a rebound from the GM strike). For the third quarter as a whole, however, exports declined 4 percent at an annual rate. A sharp increase in aircraft exports was more than offset by decreases in exports of most other export categories, especially automotive products (reflecting the effects of the GM strike early in the quarter), industrial supplies, machinery, services, and agricultural products. Exports of computers and semiconductors increased slightly, while exports of consumer goods were about flat. By area, the decline in exports reflected decreases in exports to Canada and Eastern Europe. There were small increases to other areas, suggesting that recent declines in exports to developing countries in Asia are subsiding.

The value of imports decreased slightly in September, as increases in automotive products from Canada (a rebound from the GM strike) were about offset by decreases in the value of imported oil (a decrease in volume). For the third quarter as a whole, imports declined 2½ percent at an annual rate. There were declines in imports of oil

### U.S. International Trade in Goods and Services



1/Excludes agriculture and gold.  
2/Excludes computers and semiconductors.

1/Excludes oil and gold.  
2/Excludes computers and semiconductors.  
3/Excludes Canada and Mexico.



**U.S. Exports and Imports of Goods and Services**  
(Billions of dollars, SAAR, BOP basis)

	Levels				Amount Change <sup>1</sup>			
	1998		1998		1998		1998	
	Q2	Q3	Aug	Sep	Q2	Q3	Aug	Sep
<b>Exports of G&amp;S</b>	921.2	910.6	905.1	925.5	-25.0	-10.5	3.9	20.4
Goods exports	659.3	654.2	646.3	670.5	-26.6	-5.0	0.4	24.1
Agricultural	52.0	49.0	49.5	45.4	-4.4	-3.0	-2.8	-4.1
Gold	4.2	5.2	6.6	6.4	-1.1	1.0	3.9	-0.2
Other goods	603.0	600.0	590.3	618.8	-21.2	-3.0	-0.6	28.4
Aircraft & pts	44.8	58.0	46.3	72.7	-4.1	13.3	-8.8	26.4
Computers	44.8	45.1	45.3	45.3	-0.7	0.3	0.7	-0.1
Semiconductors	35.5	37.4	37.9	38.5	-2.3	1.9	2.2	0.5
Other cap gds	162.8	158.8	156.8	156.9	-5.6	-4.1	-5.8	0.2
Automotive	72.2	65.4	67.2	72.3	-5.5	-6.8	10.4	5.1
to Canada	39.0	33.8	36.0	37.6	-1.8	-5.2	8.1	1.7
to Mexico	12.3	10.5	10.1	13.1	-0.9	-1.9	2.0	3.0
to ROW	20.8	21.1	21.1	21.5	-2.9	0.3	0.4	0.4
Ind supplies	134.1	128.3	128.1	127.4	-4.7	-5.9	-1.2	-0.8
Consumer goods	80.1	80.2	80.3	80.3	1.7	0.1	0.4	0.0
All other	28.8	26.8	28.3	25.4	0.0	-2.0	-0.2	-2.9
Services exports	261.9	256.4	258.8	255.0	1.6	-5.5	3.5	-3.7
<b>Imports of G&amp;S</b>	1095.4	1088.5	1095.9	1093.9	9.2	-6.9	20.1	-2.0
Goods imports	917.1	911.7	919.2	917.6	8.4	-5.4	20.9	-1.5
Petroleum	53.9	48.7	49.5	46.5	-1.0	-5.2	-0.6	-3.0
Gold	5.5	7.3	9.2	7.7	-1.2	1.9	4.0	-1.5
Other goods	857.7	855.7	860.5	863.4	10.6	-2.0	17.5	2.9
Aircraft & pts	22.4	21.8	19.6	21.5	4.6	-0.7	-4.6	1.9
Computers	71.7	71.1	70.3	72.1	-0.7	-0.5	-0.7	1.8
Semiconductors	33.5	31.6	32.3	31.2	-3.3	-2.0	1.2	-1.1
Other cap gds	142.9	142.2	144.4	141.3	1.1	-0.6	3.4	-3.1
Automotive	146.0	143.3	146.8	154.9	-2.0	-2.7	18.7	8.1
from Canada	49.0	47.4	47.1	55.4	-4.0	-1.6	7.3	8.4
from Mexico	28.5	25.8	28.5	28.7	1.3	-2.7	8.2	0.2
from ROW	68.5	70.0	71.3	70.8	0.8	1.5	3.2	-0.5
Ind supplies	147.3	147.4	149.2	146.1	2.9	0.1	2.2	-3.1
Consumer goods	217.4	216.8	215.8	215.3	8.2	-0.6	-3.4	-0.5
Foods	41.8	40.6	40.2	40.3	0.0	-1.2	-1.0	0.1
All other	34.7	40.9	41.8	40.8	-0.1	6.2	1.7	-1.0
Services imports	178.4	176.8	176.7	176.2	0.8	-1.5	-0.8	-0.5
<i>Memo:</i>								
Oil qty (mb/d)	11.80	11.50	11.94	10.83	0.98	-0.30	0.23	-1.11
Oil price (\$/bbl)	12.51	11.60	11.34	11.76	-1.39	-0.91	-0.36	0.42

1. Change from previous quarter or month.

Source: U.S. Dept. of Commerce, Bureaus of Economic Analysis and Census.

(mostly due to price declines), automotive products (because of the GM strike early in the quarter), and semiconductors.

**Oil imports and prices.** The quantity of imported oil fell sharply in September, with weaker consumption, delivery delays due to storms in the Gulf of Mexico, and unusually high inventories contributing to the fall. For the third quarter, as a whole, the quantity of imported oil was about 1 percent (at an annual rate) below the second-quarter level. Preliminary Department of Energy statistics indicate relatively flat imports in October and November, reflecting continuing high stocks and a slow start to the winter heating season.

The price of imported oil declined 26 percent (at an annual rate) in the third quarter, despite a strong price increase in September. The price of imported oil rose sharply in October, as well, largely reflecting weather-driven delivery delays, civil unrest in Nigeria and Colombia, and decreased production due to maintenance in the North Sea. In November, the spot price of West Texas Intermediate (WTI) fell back to \$12.94 per barrel after trading above the \$14 level in September and October. This decline was driven by higher than expected production from OPEC, weaker than expected consumption (especially in OECD Asia), and surprisingly high inventories. OPEC's unwillingness to extend production cuts and the peaceful resolution of the Iraqi situation also contributed to falling prices. WTI traded briefly below \$11 in mid-December, the lowest level since 1986. Spot WTI is currently trading between \$11 and \$12 per barrel.

**Prices of non-oil imports and exports.** Price data for November and revised data for October were released on December 16. Prices for non-oil imports edged up in October and November, marking the first time since 1995 that these prices advanced two months in a row. Prices for exports also edged up in November for the first time since May, as increase in agricultural prices (led by a sharp rise in grain and oilseed prices) offset a dip in the prices of other export categories. Additional details and revised tables will be included in the Greenbook supplement.

#### **U.S. Current Account**

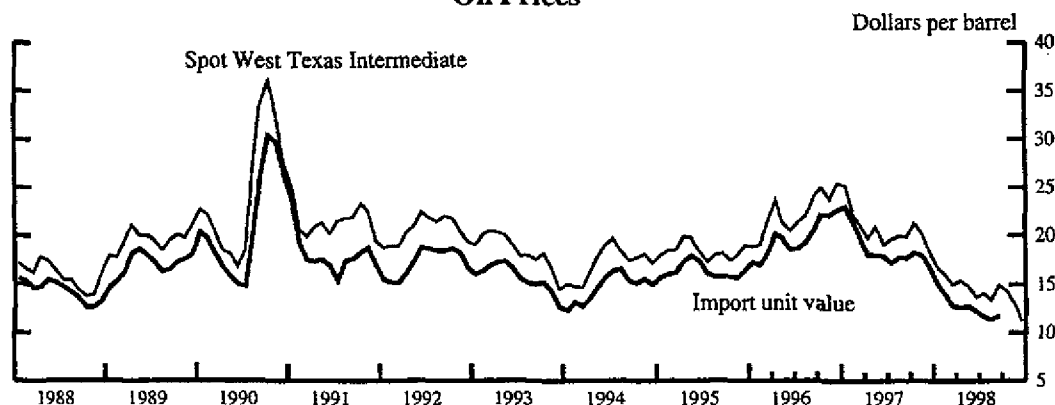
The U.S. current account deficit widened \$18 billion (SAAR) in the third quarter to \$245 billion (SAAR). The increase resulted from a widening in the deficit on investment income (importantly from a reduction in direct investment receipts from abroad), a small increase in unilateral transfers (mostly an increase in U.S. government

**Prices of U.S. Imports and Exports**  
(Percentage change from previous period)

	Annual rates			Monthly rates		
	1998			1998		
	Q1	Q2	Q3	Aug	Sep	Oct
	-----BLS prices (1995=100)-----					
<b>Merchandise imports</b>	-11.6	-5.8	-6.2	-0.4	0.1	0.2
Oil	-61.5	-31.6	-25.9	-0.4	3.6	5.0
Non-oil	-5.3	-3.7	-4.5	-0.4	-0.2	0.0
Core goods*	-3.8	-2.7	-3.5	-0.4	-0.1	0.1
Foods, feeds, beverages.	-5.1	-0.1	-7.0	-2.4	1.5	1.2
Industrial supplies ex oil	-11.1	-4.0	-8.1	-0.6	-0.4	-1.0
Computers	-17.3	-19.1	-10.4	-0.9	-0.9	-2.5
Semiconductors	-17.2	-4.9	-14.2	-0.8	0.0	0.6
Cap. goods ex comp & semi	-3.2	-2.4	-3.9	-0.1	-0.4	0.7
Automotive products	-0.1	-0.8	-1.6	-0.2	-0.1	0.2
Consumer goods	-1.1	-2.7	-1.5	-0.3	0.0	0.3
<b>Merchandise exports</b>	-5.0	-3.3	-4.5	-0.5	-0.5	-0.1
Agricultural	-15.6	-7.0	-11.7	-4.1	-3.0	0.2
Nonagricultural	-3.7	-2.8	-3.7	-0.1	-0.2	-0.1
Core goods*	-3.5	-2.1	-2.4	0.0	-0.2	-0.1
Industrial supplies ex ag	-9.0	-5.2	-9.1	-0.2	-1.0	-0.6
Computers	-10.5	-11.8	-14.0	-1.0	-0.7	-0.4
Semiconductors	-6.8	-8.6	-10.3	0.0	0.0	0.0
Cap. goods ex comp & semi	0.0	-0.1	-0.3	-0.1	-0.1	0.0
Automotive products	-0.1	0.3	0.3	0.0	-0.1	0.5
Consumer goods	-0.5	-1.4	-0.8	0.0	0.1	0.0
	-----Prices in the NIPA accounts (1992=100)-----					
<b>Chain-weight</b>						
Imports of goods & services	-10.4	-4.5	-4.8	...	...	...
Non-oil merchandise	-5.6	-3.7	-4.4	...	...	...
Core goods*	-3.3	-1.8	-3.3	...	...	...
Exports of goods & services	-3.4	-1.8	-2.9	...	...	...
Nonag merchandise	-3.5	-2.8	-3.5	...	...	...
Core goods*	-2.4	-1.7	-2.3	...	...	...

\*/ Excludes computers and semiconductors.

**Oil Prices**



grants), and a modest increase in the goods and services deficit. The increase in the goods and services deficit was due to a reduction in net service transactions, primarily from a drop in receipts from foreign travelers and passenger fares. The deficit in goods trade in the third quarter was virtually unchanged from the second quarter.

<b>U.S. Current Account</b>				
( Billions of dollars, seasonally adjusted annual rates)				
	Goods & services balance	Investment income, net	Transfers, net	Current acct balance
<b>Years</b>				
1996	-108.6	14.2	-40.6	-134.9
1997	-110.2	-5.3	-39.7	-155.2
<b>Quarters</b>				
1997 - 1	-112.5	0.1	-35.5	-148.0
2	-106.1	1.8	-36.1	-140.4
3	-108.4	-6.2	-37.8	-152.4
4	-113.8	-17.0	-49.3	-180.2
1998 - 1	-140.0	-9.0	-37.9	-186.9
2	-175.5	-13.5	-37.8	-226.8
3	-183.0	-21.8	-40.3	-245.2
<b>Memo:</b>				
<b>\$ Change</b>				
Q4-Q3	-5.4	-10.8	-11.6	-27.8
Q1-Q4	-26.2	8.0	11.4	-6.8
Q2-Q1	-35.5	-4.5	0.2	-39.8
Q3-Q2	-7.5	-8.3	-2.6	-18.4

Source. U.S. Department of Commerce, Bureau of Economic Analysis.

### U.S. International Financial Transactions

Foreign official assets held in the United States increased in October after a sharp decline in September (line 1 of the U.S. International Transactions table). A rise in the holdings of European countries accounted for nearly all of the October inflow and about half of the swing from September to October. The remainder of the shift was primarily the result of a cessation of September's large outflows by Brazil and Argentina. Partial data for November from the Federal Reserve Bank of New York indicate that foreign official inflows continued on the order of \$15 billion, about two-thirds of which was from industrialized countries. The same data suggest that Brazilian and Argentinian official

holdings in the United States have remained stable in November (for a second straight month), suggesting that news of the IMF package may have eased, at least temporarily, pressure on their currencies. The increase in Korean official holdings, noted last month, continued in October and partial data suggest a further increase in November.

Net purchases of U.S. securities by private foreigners were modest in both September and October (line 4); however, the composition of the inflow changed from September to October. Foreign net purchases of U.S. Treasuries accounted for an inflow in September and a small outflow in October (line 4a). The shift was mostly accounted for by the large and volatile transactions of financial institutions in the United Kingdom. Net sales were concentrated in the Treasury bond and note markets, while purchases of Treasury bills remained strong.

After heavy selling in September, foreign net purchases of U.S. stocks recovered, leading to an inflow in October (line 4c). The swing was more than accounted for by transactions in financial centers in the Caribbean.

As in September, foreign purchases of corporate and other bonds were largely responsible for the securities inflow in October (line 4b). Bond purchases were sizeable in October, owing to a large number of new Eurobond issues by U.S. corporations. Most of the action was through financial centers in Europe and the Caribbean. There were net sales of Agency securities in October. U.S. investors sold foreign securities on net in October (line 5). Bond sales accounted for about 65 percent of the October sell-off. Significant sales of European and Japanese securities, noted in the last Greenbook, continued in October. Selling in Japan was concentrated among one or two respondents in the bond market. In addition, marked sales of foreign stocks were observed in financial centers in the Caribbean.

Large net capital inflows recorded through private banking transactions continued in October on a month-end basis (line 3). About one-third of the inflow was concentrated in one bank's position vis-a-vis its own foreign offices in Switzerland. The recent large inflows have been associated with a record increase in domestic bank credit. Although the credit surge continued in November, preliminary data suggest that bank flows reversed. This may be the result of a boom in (non-large time) deposit growth in November, implying that there was less of a need for bank inflows from abroad to finance credit.

**Summary of U.S. International Transactions**  
(Billions of dollars, not seasonally adjusted except as noted)

	1996	1997	1998					
			Q4	Q1	Q2	Q3	Sept	Oct
<b>Official capital</b>								
<b>1. Change in foreign official assets in U.S. (increase, +)</b>	<b>127.7</b>	<b>19.9</b>	<b>-26.3</b>	<b>12.4</b>	<b>-9.9</b>	<b>-46.0</b>	<b>-25.7</b>	<b>12.6</b>
a. G-10 countries	36.6	1.8	-12.6	4.0	-10.0	*	-1.7	3.0
b. OPEC countries	15.4	13.0	-.9	-.5	.1	-11.6	-4.8	-.1
c. All other countries	76.3	5.1	-12.7	8.9	*	-34.4	-19.2	9.7
<b>2. Change in U.S. official reserve assets (decrease, +)</b>	<b>6.7</b>	<b>-1.0</b>	<b>-4.5</b>	<b>-.4</b>	<b>-1.9</b>	<b>-2.0</b>	<b>-.1</b>	<b>-.1</b>
<b>Private capital</b>								
<b>Banks</b>								
<b>3. Change in net foreign positions of banking offices in the U.S.<sup>1</sup></b>	<b>-50.1</b>	<b>34.6</b>	<b>46.2</b>	<b>-5.7</b>	<b>5.6</b>	<b>52.9</b>	<b>29.1</b>	<b>30.8</b>
<b>Securities<sup>2</sup></b>								
<b>4. Foreign net purchases of U.S. securities (+)</b>	<b>287.2</b>	<b>346.6</b>	<b>71.2</b>	<b>77.3</b>	<b>99.4</b>	<b>22.1</b>	<b>3.3</b>	<b>4.7</b>
a. Treasury securities <sup>3</sup>	155.6	147.2	35.5	-1.5	27.1	-.3	5.6	-3.6
b. Corporate and other bonds <sup>4</sup>	118.9	128.1	25.8	47.7	57.0	26.6	7.8	6.1
c. Corporate stocks	12.7	71.3	9.8	31.1	15.2	-4.2	-10.1	2.3
<b>5. U.S. net purchases (-) of foreign securities</b>	<b>-110.6</b>	<b>-89.1</b>	<b>-8.8</b>	<b>-12.5</b>	<b>-27.4</b>	<b>15.5</b>	<b>9.4</b>	<b>23.3</b>
a. Bonds	-51.4	-48.2	-9.1	-9.7	-26.4	7.4	3.3	15.2
b. Stocks	-59.3	-40.9	.3	-2.8	-1.0	8.1	6.1	8.0
<b>Other flows (quarterly data, s.a.)</b>								
6. U.S. direct investment (-) abroad	-81.1	-121.8	-35.5	-34.3	-40.5	-21.2	n.a	n.a
7. Foreign direct investment in U.S.	77.6	93.4	28.5	25.9	19.1	27.1	n.a	n.a
8. Foreign holdings of U.S. currency	17.4	24.8	9.9	.7	2.3	7.3	n.a	n.a
9. Other (inflow, +) <sup>5</sup>	-80.3	-50.9	14.9	-13.6	8.4	9.1	n.a	n.a
<b>U.S. current account balance (s.a.)</b>	<b>-134.9</b>	<b>-155.2</b>	<b>-45.0</b>	<b>-46.7</b>	<b>-56.7</b>	<b>-61.3</b>	<b>n.a</b>	<b>n.a</b>
<b>Statistical discrepancy (s.a.)</b>	<b>-59.6</b>	<b>-99.7</b>	<b>-52.0</b>	<b>-3.1</b>	<b>1.6</b>	<b>-3.5</b>	<b>n.a</b>	<b>n.a</b>

NOTE: The sum of official capital, private capital, the current account balance, and the statistical discrepancy is zero. Details may not sum to totals because of rounding.

1. Changes in dollar-denominated positions of all depository institutions and bank holding companies plus certain transactions between broker-dealers and unaffiliated foreigners (particularly borrowing and lending under repurchase agreements). Includes changes in custody liabilities other than U.S. Treasury bills.

2. Includes commissions on securities transactions and therefore does not match exactly the data on U.S. international transactions published by the Department of Commerce.

3. Includes Treasury bills.

4. Includes U.S. government agency bonds.

5. Transactions by nonbanking concerns and other banking and official transactions not shown elsewhere plus amounts resulting from adjustments made by the Department of Commerce and revisions in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.

Recently released U.S. balance of payments data for the third quarter show a marked drop in U.S. foreign direct investment abroad from the record levels in recent quarters (line 6). Foreign direct investment in the United States strengthened in the third quarter and remains near last year's record pace (line 7). As a result of continued merger activity (including the completion of the Daimler-Benz-Chrysler merger), we expect inflows to reach record highs in the fourth quarter.

There was a notable rise in foreign holdings of U.S. currency in the third quarter (line 8), largely a result of shipments to Russia.

The statistical discrepancy in the U.S. international accounts narrowed significantly in the first three quarters of 1998 (last line), as compared with 1997. The magnitude of the discrepancy in the second quarter was revised down from negative \$9.4 billion (reported last month) to \$1.6 billion. In the third quarter, the statistical discrepancy was negative \$3.5 billion, indicating some combination of over-recorded net capital inflows or under-recorded net exports.

**Foreign Exchange Markets**

Since the November FOMC meeting, the foreign exchange value of the dollar on a weighted average basis against other major currencies declined about 1¼ percent on balance, led by a 3 percent depreciation against the yen. Factors weighing on the dollar during the period included perceptions that U.S. economic activity remains vulnerable to financial turbulence in Latin America, especially Brazil, as well as the impeachment proceedings. The dollar was buoyed during the period by interest rate cuts abroad and continued signs of strength in the U.S. economy, which led market participants to discount the probability of further monetary easing in the near future.

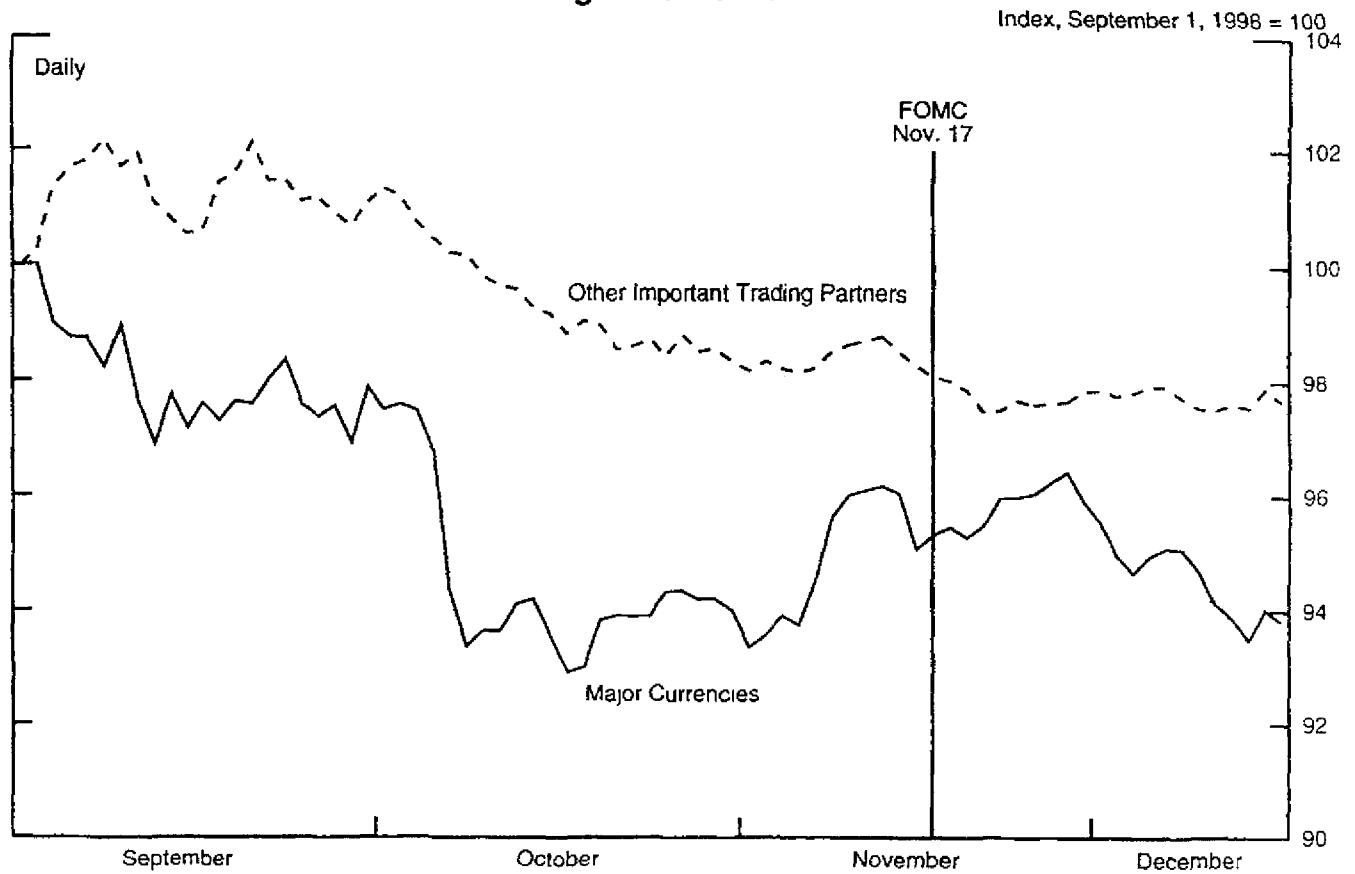
Commodity prices continued to fall in the intermeeting period, with the Commodity Research Bureau index declining to a 21-year low and oil prices reaching a 12-year low. The dollar appreciated about 2½ percent against the Australian dollar during the period, as weakness in commodity prices weighed on the latter currency. The decline in oil prices tended to weaken currencies of oil exporters such as Norway; the dollar gained about 3½ percent against the Norwegian krone

. Weak commodity prices was one of several factors behind the 15 percent depreciation of the Russian ruble during the period. More importantly, the moratorium on foreign debt repayment ended, Russian households were allowed to withdraw savings, which some used to buy foreign currency, and there has been substantial growth in the monetary base.

The dollar's movements against other major currencies were more moderate during the period. The dollar depreciated ¼ percent against the mark, on balance. The surprise coordinated interest rate cut by the Bundesbank and other euro-area central banks on December 3 contributed to the dollar's stability against the mark. The Bundesbank lowered its repo rate 30 basis points to 3 percent as did the Bank of France, the National Bank of Belgium, and the Netherlands Bank. Most other euro-area central banks lowered official interest rates to 3 percent during the period, largely completing the convergence process ahead of the launch of the monetary union in January. This amounted to a cut of 40 basis points by the Finnish central bank, a decrease of 50 basis points by the Bank of Spain, a reduction of 69 basis points by the Central Bank of Ireland, and a 75-point cut in Portugal. The Bank of Italy was the only euro-area central bank that did not lower its official interest rates to 3 percent, instead cutting its discount rate 50 basis points to 3½ percent. However, the Bank of Italy did conduct repurchase operations at an interest rate near 3 percent during the period.



### Exchange Rates Indexes



### Financial Indicators in Major Industrial Countries

	Three-month rates		Ten-year yields		Equity prices
	Dec. 16	Change	Dec. 16	Change	Change
Canada	5.24	-0.24	4.86	-0.30	-1.90 <sup>P</sup>
Japan	0.53	0.02	1.35	0.47	-2.30
Germany	3.26	-0.34	3.88	-0.29	-0.07
United Kingdom	6.19	-0.69	4.49	-0.45	1.92
France	3.24	-0.26	3.89	-0.37	1.19
Italy	3.20	-0.64	4.02	-0.47	3.35 <sup>P</sup>
Switzerland	1.40	-0.04	2.31	-0.24	1.93
Australia	4.82	-0.10	4.81	-0.35	0.85
Weighted-average foreign	3.35	-0.24	3.57	-0.12	
United States	5.13 <sup>P</sup>	-0.18	4.62 <sup>P</sup>	-0.23	0.56 <sup>P</sup>

The dollar eased about ¼ percent against sterling, as the Bank of England lowered its official repo rate 50 basis points during the period in response to further indications of weakening economic activity in the United Kingdom. The U.S. dollar depreciated about 1 percent against the Canadian dollar, in part as the results of Quebec's election made a secession referendum less likely. The Bank of Canada reduced its bank rate 25 basis points following the November FOMC policy action by the Federal Reserve.

The trend towards monetary easing continued elsewhere as well. Monetary authorities in Australia, New Zealand, Denmark, Sweden, Greece, Poland, the Czech Republic, Hungary, Taiwan, and China lowered official rates during the intermeeting period.

The widespread declines in short-term interest rates have generally been accompanied by a reduction in longer term interest rates. Yields on 10-year government bonds fell 30 to 50 basis points in most of the euro-area countries and the United Kingdom during the period, compared with a 23-basis-point decline in the United States. The one exception to the downward trend is Japan, where the yield on the 10-year benchmark bond rose 47 basis points as expected future bond issuance rose along with the expected size of the latest fiscal stimulus package and the announcement that Nippon Credit Bank would be nationalized. Equity price performance was mixed in the major industrial countries.

In the initial period following the November FOMC meeting, emerging market assets continued to benefit from a calmer global atmosphere. In late November, however, a resurgence of flight-to-quality flows affected a number of these markets, although not in as uniform a manner as seen in September and October. In part these developments were sparked by the rejection of a key pension reform measure by Brazil's lower house of Congress. The yield spread on Brazilian Brady bonds over U.S. Treasuries widened almost 240 basis points on balance, while similar spreads in Argentina and Mexico narrowed slightly. The spread on Venezuelan Brady bonds declined nearly 120 basis points, in part a reaction to the absence of radical policy U-turns or a repudiation of debt that some market participants seemed to have feared would follow the election of Hugo Chavez. Meanwhile, the spreads on dollar-denominated bonds in Asian emerging market economies declined, or in the cases of China and Indonesia, firmed only slightly. Equity

### Financial Indicators in Latin America, Asia, and Russia

	Currency/US dollar		Short-term interest rates		Dollar-denominated bond spread		Equities
	Dec. 16	Change	Dec 15/16	Change	Dec. 15/16	Change	Change
Mexico	9.903	-0.65	33.40	0.90	9.50 <sup>b</sup>	-0.37	-5.1
Brazil	1.2045	1.18	27.80	-5.70	13.54 <sup>b</sup>	2.37	-12.7
Argentina	.9998	0.00	8.00	0.00	8.34 <sup>b</sup>	-0.09	-11.1
Chile	472.80	2.78					-4.1
Venezuela	561.60	-1.30			17.98 <sup>b</sup>	-1.19	25.1
China	8.2778	0.00			2.46 <sup>g</sup>	0.13	-8.6
Korea	1207.50	-8.31	7.00	-0.25	4.88 <sup>g</sup>	-0.88	29.3
Taiwan	32.20	-1.23	4.70	-0.40			-3.4
Singapore	1.6495	1.13	1.38	-0.87			7.9
Hong Kong	7.7478	0.05	5.45	-0.26			-3.5
Malaysia	3.80	-0.01	6.19	-0.31	5.91 <sup>e</sup>	-1.03	17.5
Thailand	36.30	-0.77	6.00	-2.25	3.25 <sup>y</sup>	-1.04	-0.2
Indonesia	7600	0.66	42.35	-14.75	10.29 <sup>y</sup>	0.85	15.9
Philippines	39.33	-1.67			3.82 <sup>e</sup>	-0.45	7.0
Russia	21.35	14.17		-45.38	51.23 <sup>b</sup>	-12.83	1.2

Note. Change is in percentage points from November 16 to December 15/16. <sup>b</sup> Stripped Brady bond yield spread over U S Treasuries. <sup>g</sup> Global bond yield spread. <sup>e</sup> Eurobond yield spread. <sup>y</sup> Yankee bond yield spread

prices rose substantially in several Asian emerging market nations, with the major exceptions of China, Hong Kong, and Taiwan, where share prices fell. Korean share prices rose 29 percent, on balance, and the won appreciated 8 percent against the dollar as the government's plan to reorganize five major industrial groups (the chaebols) was well-received by the market. Equity prices on most Latin American exchanges fell between 4 and 13 percent, while Venezuelan share prices soared 25 percent, on balance, largely following the presidential election.

. The Desk did not intervene during the period for the accounts of the System or the Treasury.

### **Developments in Foreign Industrial Countries**

Recent data suggest that the pace of growth in most of the major industrial countries has been slowing during the past several months. Japan remains mired in recession with real GDP still falling and aggregate investment contracting at double-digit rates. In Germany, industrial production fell sharply in August and September and, despite a rebound in October, production is below its third-quarter average. Elsewhere in Europe, a similar picture emerges: industrial production trends have been flat or falling since late summer in France and the United Kingdom. In Italy, production has recently picked up but, with deteriorating business sentiment, the rebound could prove to be fleeting. In Canada, the underlying production trend has been distorted by strikes in the manufacturing and construction industries over the summer. Although a rough estimate of strike-adjusted growth suggests some slowing since the beginning of the year, a substantial pickup in November employment may herald a sizable rebound in fourth-quarter activity.

Consumer price inflation is very subdued, reflecting low and falling import prices, especially for commodities, and output that is below potential in the major foreign industrial countries. (The exception is the United Kingdom where output is projected to fall below potential by the end of the year.) On a twelve-month basis, inflation is slightly negative in Japan (abstracting from the jump in produce prices that followed recent typhoons), is at or below 1 percent in Germany, France, and Canada, and is 1-1/2 percent in Italy. In the United Kingdom, retail price inflation appears to have stabilized at a rate of 2-1/2 percent.

Since the November Greenbook, short-term interest rates have been cut by 50 basis points in the United Kingdom and 25 basis points in Canada. Official rates were cut on December 3 in a coordinated policy move of the EURO-11 countries with cuts of 30 basis points in France, Germany, and several other countries, and larger cuts in four of the countries.

**Individual country notes.** Japan is experiencing its most protracted recession of the postwar era, with economic activity contracting for four consecutive quarters and the level of GDP now almost 5 percent below its 1997Q1 peak. During the third quarter, GDP declined 2.6 percent (SAAR), with business and residential investment plunging 17.3 percent and 22.5 percent, respectively. Private consumption also contributed to the poor performance, falling 1.1 percent. In one piece of good news, the effects of the April

stimulus package were finally visible, as public investment surged 15.4 percent and government consumption rose 3.5 percent. Net exports contributed 1 percentage point to growth, with exports gaining almost 7 percent and imports falling for the sixth consecutive quarter.

**JAPANESE REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997	1998		
			Q4	Q1	Q2	Q3
GDP	5.1	-0.8	-3.7	-4.8	-2.9	-2.6
Total Domestic Demand	4.5	-2.2	-5.3	-3.9	-4.5	-3.8
Consumption	2.4	-1.1	-3.8	1.4	-0.6	-1.1
Investment	8.2	-4.8	-6.4	-14.3	-12.9	-10.0
Government Consumption	3.1	-1.0	-8.4	2.8	0.6	3.5
Inventories (contribution)	0.3	0.0	-0.3	-0.3	-0.3	-0.4
Exports	12.0	7.6	6.3	-10.6	-7.6	6.7
Imports	7.3	-3.3	-6.1	-4.4	-21.4	-1.4
Net Exports (contribution)	0.6	1.4	1.6	-1.0	1.6	1.0

1. Annual changes are Q4/Q4.

Recent data provide little evidence of a rebound. The performance of consumption indicators is mixed, with household expenditure in October well above the third-quarter average but with retail sales and auto registrations continuing to decline. The unemployment rate in October remained at 4.3 percent for the third consecutive month, while the offers-to-applicants ratio edged down to a new record low of 0.48. Industrial production and housing starts appear to have stabilized in recent months but remain at historically weak levels. Public demand remained strong in October, with public works contracts up about 10 percent (not annualized) from third-quarter levels. Twelve-month consumer price inflation turned positive in October and November, reflecting a temporary surge in fresh produce prices after several typhoons, but "core" inflation remains slightly negative.

The Bank of Japan's December "Tankan" survey showed a further decline in business confidence, with particular weakness in the manufacturing sector. The diffusion index for large manufacturers declined from -51 in September to -56 in December (not shown), marking the sixth consecutive decline. The diffusion index for small manufacturers fell from -57 to -60, the lowest score since these firms were included in the survey in 1967.

**JAPANESE ECONOMIC INDICATORS**  
(Percent change from previous period except where noted, SA)

	1998						
	Q1	Q2	Q3	Aug	Sep	Oct	Nov
Industrial Production	-1.2	-5.1	0.0	-1.3	3.3	-1.1	NA
Housing Starts	1.1	-6.2	-7.6	7.2	-3.2	1.7	NA
Machinery Orders	-4.2	-6.5	-4.6	-8.1	15.1	-10.2	NA
New Car Registrations	-7.5	-3.4	2.2	-3.5	6.7	-11.8	-7.4
Unemployment Rate (%)	3.6	4.2	4.3	4.3	4.3	4.3	NA
Job Offers Ratio <sup>1</sup>	0.61	0.53	0.50	0.50	0.49	0.48	NA
Business Sentiment <sup>2</sup>	-31	-38	-51	...	...	...	...
CPI (Tokyo area) <sup>3</sup>	2.1	0.6	-0.1	-0.1	-0.1	0.4	1.0
Wholesale Prices <sup>3</sup>	-0.4	-1.6	-0.7	-0.2	-1.5	-2.8	-3.5

1. Level of indicator.

2. Percent of large manufacturing firms having a favorable view of business conditions less those with an unfavorable view (Tankan survey).

3. Percent change from previous year, NSA.

Japan's dollar-denominated monthly trade surplus rose to an all-time high of \$12.1 billion in October, up almost 30 percent from September. Of this rise, about half reflects an increase in the yen-denominated surplus (mainly due to a decline in imports), and the remainder reflects the fact that a given quantity of yen now translates into a larger quantity of dollars. Through the first ten months of 1998, Japan's trade surplus was \$110 billion at an annual rate, up sharply from the \$83 billion surplus registered during all of 1997.

In mid-November, the government announced a fiscal stimulus package with headline value of ¥24 trillion (4.8 percent of GDP). The package contains about ¥6 trillion of personal

and corporate tax income cuts and about ¥18 trillion of expenditures, including new public works projects, increased funding for government financial institutions (an attempt to ease the credit crunch), and a small quantity of consumption vouchers. As is typically the case with Japanese stimulus packages, however, the headline value significantly overstates the likely economic impact (“real water” content). In addition to the ¥6 trillion of tax cuts, only ¥6 trillion of the other measures would qualify as real water.

In mid-November, the BOJ announced three measures designed to facilitate firms’ financing efforts and provide a modest degree of economic stimulus. First, the BOJ expanded the maximum maturity of commercial paper eligible for use in its repo operations from three months to one year. Second, effective December 21, the BOJ will establish a temporary facility to refinance (at the official discount rate) half of the loans made by financial institutions during the fourth quarter. Third, the BOJ will consider establishing a new lending mechanism that would involve the use of private debt as collateral.

On December 13, the Japanese authorities nationalized Nippon Credit Bank (NCB) after an examination by the Financial Supervisory Agency found NCB to be insolvent. The nationalization of NCB will proceed in a manner similar to that of Long-Term Credit Bank. In particular, shareholders effectively will be wiped out, senior management will be replaced, and all NCB obligations (with the possible exception of subordinated debt) will be fully protected.

Significant variation in growth rates and sentiment exists across the EURO-11 countries. Weighted by GDP shares, however, recent data point to falling business confidence and slowing industrial production, as well as consumer confidence that has been stuck at low levels for some time now. The good news for the EURO-11 countries has been the steady decline in inflation rates.



**EURO-11 ECONOMIC INDICATORS**  
(Percent change from previous period except where noted, SA)

	1998						
	Q1	Q2	Q3	Aug	Sep	Oct	Nov
GDP <sup>1</sup>	0.8	0.5	NA	...	...	...	...
Industrial Production <sup>2</sup>	1.0	0.5	0.7	-0.9	-0.9	NA	NA
Unemployment Rate <sup>3</sup>	11.9	11.6	11.4	11.4	11.3	10.0 <sup>4</sup>	NA
Business Confidence	2.0	2.0	-0.7	-1.0	-2.0	-5.0	-8.0
Consumer Confidence	-7.7	-5.3	-4.7	-5.0	-5.0	-3.0	-2.0
Consumer Prices <sup>5</sup>	1.2	1.5	1.2	1.2	1.1	1.1	NA

NOTE: Series are the weighted averages of the eleven countries in EMU where weights depend on GDP, except as otherwise noted.

1. Q3 data have been reported for 3 countries only. Luxembourg is not included in the estimates.
2. The estimates exclude Luxembourg (for which there are no data), and Austria, Ireland, and Portugal (where data have not been released for recent months). Data for Spain have been seasonally adjusted using X-11 ARIMA; the official data are not seasonally adjusted. Because only 3 countries have yet reported October data, no estimate is given.
3. Weighted average of national unemployment rate statistics. Excludes Luxembourg. Q3 rate for Portugal is a forecast. Monthly data for Spain, Italy and Portugal do not exist and are constructed using a cubic spline on the quarterly data.
4. The drop in the October rate relative to September is a reflection of the omission of October employment rate data for Spain, Italy, and Portugal: October data for these countries cannot be constructed without the quarterly data. The September unemployment rate, calculated excluding these same countries, would be 10.1. Because only 3 countries have reported November data, no estimate is given.
5. Harmonized CPI; percent change from previous year, weighted by shares in private final domestic consumption of households converted to a common currency using estimated PPP exchange rates.

GDP growth in **Germany** resumed in the third quarter as private consumption and investment bounced back strongly from their second-quarter pace, pushing overall growth up to 3.5 percent (SAAR). The rebound in the third quarter exaggerates the trend in real activity because of special factors that distorted the pattern of growth over the preceding two quarters--warmer than usual weather in the first quarter and an April increase in the VAT that accelerated both construction and consumption expenditures into the first quarter. Export growth fell sharply in the third quarter as did inventory stockbuilding. Survey data suggests that the retrenchment of inventory stocks was intentional as manufacturers have noted for some time now that inventory stocks are too high.

**GERMAN REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997	1998		
			Q4	Q1	Q2	Q3
GDP	2.1	2.3	1.3	5.9	0.2	3.5
Total Domestic Demand	1.2	1.5	3.1	7.4	-1.4	2.4
Consumption	1.3	1.0	3.2	3.4	-1.6	3.8
Investment	2.3	-0.8	0.5	11.1	-16.9	8.7
Government Consumption	0.8	-2.9	-11.5	16.2	-1.8	-0.5
Inventories (contribution)	-0.2	1.7	3.5	0.1	3.8	-1.4
Exports	8.5	11.1	-1.0	0.8	10.9	1.5
Imports	5.1	8.2	4.8	5.6	5.7	-2.3
Net Exports (contribution)	0.9	0.8	-1.7	-1.4	1.5	1.2

1. Annual changes are Q4/Q4.

Monthly data suggest that the pace of growth has been slowing since August notwithstanding the healthy estimate of third quarter GDP. Industrial production fell in August and September and, despite a pickup in October, production is currently below its third-quarter level. The volume of manufacturing orders has been trending down since the start of the year, with weakness in both domestic and foreign orders. The German industry association reported abysmal September and October figures for incoming orders for plant and machinery, with foreign orders especially weak. September and October surveys of business confidence (the IFO survey) indicated that more firms believe that business conditions have deteriorated than improved. The slowdown in economic activity is reflected in the unemployment rate which, having declined by over a percentage point during the course of the past year, appears to have stabilized at 10.6 percent in November.

Price data continue to show the absence of any inflationary pressure. In November, consumer prices rose 0.7 percent on a 12-month basis. October producer prices, wholesale prices, and import prices were down 1.2, 4.7, and 5.7 percent, respectively, from their year-earlier levels.

**GERMAN ECONOMIC INDICATORS**  
(Percent change from previous period except where noted, SA)

	1998						
	Q1	Q2	Q3	Aug	Sep	Oct	Nov
Industrial Production	1.9	-0.5	1.7	-0.9	-2.5	1.0	NA
Orders	2.1	0.2	-0.5	-1.5	0.2	-2.5	NA
Unemployment Rate (%)	11.5	11.2	10.8	10.8	10.7	10.6	10.6
Western Germany	9.6	9.4	9.2	9.2	9.2	9.1	9.1
Eastern Germany	19.2	18.5	17.5	17.6	17.2	16.9	16.9
Capacity Utilization <sup>1</sup>	87.3	87.2	87.0	...	...	...	...
Business Climate <sup>1,2</sup>	18.3	16.0	6.0	7.0	-1.0	-6.0	NA
Consumer Prices <sup>3</sup>							
All-Germany	1.2	1.3	0.8	0.8	0.8	0.7	0.7
Western Germany	1.1	1.3	0.8	0.7	0.7	0.7	0.6

1. Western Germany.
2. Percent of firms citing an improvement in business conditions (current and expected over the next six months) less those citing a deterioration.
3. Percent change from previous year.

In **France**, third-quarter GDP growth was 2.1 percent (SAAR), substantially lower than second-quarter growth, which was revised up to 3.3 percent (from 2.8 percent). In contrast to the recent trend of strong domestic demand propelling GDP growth, third-quarter growth reflected a surge in net exports with domestic demand restrained by an inventory swing from a pace of moderate stockbuilding in the second quarter to one of decumulation in the third quarter. Consumption and investment also slowed from their second-quarter pace.

Fourth-quarter indicators are limited, but they point to the possibility of additional slowing. In October, consumption of manufactured goods declined from its September level, and an index of business confidence plummeted, holding at the lower level through November. The unemployment rate, however, edged down slightly in October.

Consumer price inflation is at a 40-year low. In November, the consumer price index rose 0.2 percent on a 12-month basis, down from 0.4 percent in October.

**FRENCH REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997	1998		
			Q4	Q1	Q2	Q3
GDP	2.4	3.1	3.2	2.8	3.3	2.1
Total Domestic Demand	1.4	1.8	3.2	4.9	4.1	0.6
Consumption	1.8	2.6	4.6	2.6	4.4	3.0
Investment	-0.1	1.0	1.7	6.1	3.9	3.3
Government Consumption	2.6	0.9	1.5	1.6	1.8	1.0
Inventories (contribution)	-0.2	-0.2	-0.2	1.7	0.3	-2.0
Exports	10.0	13.2	4.0	4.3	1.4	12.2
Imports	6.5	9.3	4.2	10.9	3.6	8.0
Net Exports (contribution)	1.0	1.3	0.0	-1.9	-0.7	1.4

1. Annual changes are Q4/Q4.

**FRENCH ECONOMIC INDICATORS**  
(Percent change from previous period except where noted, SA)

	1998						
	Q1	Q2	Q3	Aug	Sep	Oct	Nov
Consumption of Manufactured Products	1.4	0.8	2.6	-1.4	2.1	-0.7	NA
Industrial Production	0.8	1.1	0.1	0.0	-0.9	NA	NA
Capacity Utilization	86.5	86.5	85.5	...	...	...	...
Unemployment Rate (%)	12.2	11.9	11.8	11.8	11.7	11.6	NA
Business Confidence <sup>1</sup>	18.0	19.3	19.0	20.0	17.0	4.0	5.0
Consumer Prices <sup>2</sup>	0.7	1.0	0.7	0.7	0.5	0.4	0.2

1. Percent balance of manufacturing firms citing an improvement in the outlook versus those citing a worsening.
2. Percent change from previous year.

In Italy, industrial production rose in September and again in October after having declined (on a quarterly basis) through most of the year, and consumer confidence posted a sizable rebound in November. But a drop in capacity utilization in the third quarter and business sentiment that has been deteriorating since August make the outlook for fourth quarter growth difficult to read as yet.

**ITALIAN ECONOMIC INDICATORS**  
(Percent change from previous period except where noted, SA)

	1998						
	Q1	Q2	Q3	Aug	Sep	Oct	Nov
Industrial Production	-0.1	-0.2	-0.3	-1.6	1.7	1.1	NA
Capacity Utilization <sup>1</sup> (%)	78.2	79.5	76.6	...	...	...	...
Unemployment Rate (%)	12.1	12.3	12.4	...	...	...	...
Consumer Confidence <sup>2</sup>	118.6	122.7	117.0	117.0	115.2	116.6	119.7
Business Sentiment <sup>3</sup> (%)	32.0	11.7	9.0	14.0	5.0	-3.0	NA
Consumer Prices <sup>4</sup>	1.7	1.8	1.8	1.9	1.8	1.7	1.5

1. NSA.

2. Level of index, NSA.

3. Percent of manufacturing firms having a favorable view of business conditions minus those with an unfavorable outlook.

4. Percent change from previous year.

Inflationary pressures remain subdued. After having held relatively steady at around 1.8 percent throughout much of the year, consumer price inflation dipped to 1.5 percent on a 12-month basis in November. This latest drop likely reflects the passthrough of falling oil and commodity prices.

The pace of economic activity in the **United Kingdom** slowed in the third quarter, as real GDP expanded 1.5 percent (SAAR). Consumer expenditure increased 1.6 percent, somewhat faster than in the second quarter but well below the average rate of growth last year. Investment expenditure grew 9.7 percent, following a decline in the second quarter. Net exports subtracted 2.3 percentage points from growth, and inventories made a small positive contribution following a sizeable positive contribution in the second quarter.

Available data for the fourth quarter point to continuing deceleration. Industrial production was unchanged in October, with manufacturing output declining for the third

consecutive month. The volume of retail sales declined further in October, and business and consumer confidence remain at low levels. Business surveys continue to suggest further contraction of the manufacturing sector, while surveys of service sector activity indicate only modest growth in October and a slight contraction in November. The official claims-based unemployment rate remained 4.6 percent in November.

**UNITED KINGDOM REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997	1998		
			Q4	Q1	Q2	Q3
GDP	2.6	3.9	2.9	3.1	1.9	1.5
Total Domestic Demand	2.8	5.2	6.2	4.4	1.6	3.3
Consumption	3.9	4.7	6.0	2.3	1.3	1.6
Investment	5.1	8.8	11.5	12.5	-4.6	9.7
Government Consumption	1.4	0.0	1.1	4.5	3.4	2.2
<i>Inventories (contribution)</i>	-0.8	0.7	0.2	0.0	1.0	0.2
Exports	8.5	6.7	2.0	-2.0	8.3	-1.9
Imports	9.1	10.6	12.2	3.2	6.4	5.0
Net Exports (contribution)	-0.2	-1.2	-3.2	-1.7	0.4	-2.3

1. Annual changes are Q4/Q4.

*Producer input prices fell further in November. The twelve-month rate of retail price inflation (excluding mortgage interest payments) remained 2.5 percent in November, meeting the inflation target for the fourth consecutive month. On an EU-harmonized basis, consumer price inflation is somewhat lower and declined to 1.3 percent in October.*

At its December meeting, the Monetary Policy Committee (MPC) of the Bank of England reduced the official repo rate 50 basis points to 6.25 percent, following reductions of 50 basis points in November and 25 basis points in October. The MPC noted that the outlook

**UNITED KINGDOM ECONOMIC INDICATORS**  
(Percent change from previous period except where noted, SA)

	1998						
	Q1	Q2	Q3	Aug	Sep	Oct	Nov
Industrial Production	-0.3	1.2	0.1	-0.4	-0.7	0.0	NA
Retail Sales	0.9	0.2	0.5	0.3	-0.4	-0.4	NA
Unemployment Rate (%)	4.9	4.8	4.6	4.6	4.6	4.6	4.6
Business Confidence <sup>1</sup>	10.7	-0.7	-11.7	-15.0	-12.0	-29.0	-27.0
Consumer Confidence <sup>2</sup>	0.0	3.3	-13.3	-17.0	-15.0	-22.0	-14.0
Retail Prices <sup>3</sup>	2.5	3.0	2.6	2.5	2.5	2.5	2.5
Producer Input Prices <sup>4</sup>	-9.7	-7.9	-9.1	-9.4	-9.5	-10.1	-8.9

1. Percent of firms expecting output to increase in the next four months minus those expecting output to decrease.
2. Level of index, expectations of general economic situation over the next 12 months.
3. Excluding mortgage interest payments. Percent change from previous year.
4. Percent change from previous year.

for global economic activity appears to have weakened and surveys of domestic activity continue to indicate "a deterioration across the economy."

In **Canada** GDP grew 1.8 percent (SAAR) in the third quarter, with an increase in net exports more than accounting for the overall increase. Exports have managed to post solid gains in 1998, despite the impact of the Asian crisis on commodity exports. Growth was restrained by a swing in inventory investment, from a modest level of stockbuilding in the second quarter to a small decumulation of stocks in the third quarter. To a large extent, the inventory situation reflects the effect of strikes in manufacturing and construction that occurred in June and July. Solid gains in employment were registered in September and October, and the November employment report showed the second largest monthly gain over the 1990s. The gains in employment are no doubt boosted by a recovery in the manufacturing and construction industries hurt by the summer strikes. At the same time, the pickup in employment and a surge in manufacturing orders in October could indicate that, despite survey evidence of falling business and consumer confidence, near-term growth could be surprisingly strong.

**CANADIAN REAL GDP**  
(Percent change from previous period, SAAR) <sup>1</sup>

	1996	1997	1997	1998		
			Q4	Q1	Q2	Q3
GDP	1.7	4.4	2.8	3.1	1.4	1.8
Total Domestic Demand	3.7	4.7	2.8	0.1	4.2	-3.0
Consumption	2.9	4.1	2.6	0.3	5.6	2.2
Investment	13.6	7.3	1.1	2.7	10.7	-0.4
Government Consumption	-2.0	0.4	-0.9	-0.3	2.6	1.1
Inventories (contribution)	0.1	0.7	1.2	-0.5	-1.6	-4.5
Exports	3.0	11.0	7.1	9.1	1.9	5.7
Imports	8.3	13.5	8.5	0.0	8.9	-8.1
Net Exports (contribution)	-1.6	-0.7	-0.4	3.3	-2.4	5.2

1. Annual changes are Q4/Q4.

In November, the Bank of Canada reduced its Bank Rate 25 basis points to 5.25 percent. In its semi-annual Monetary Policy Report published on November 16, the Bank lowered its forecast for 1999 GDP growth to 2-1/2 percent "in light of adverse effects of international developments." The bank forecast remains above the consensus forecast of 2 percent, with the difference largely attributable to the outlook for net exports. The Bank forecasts that 1999 core CPI inflation will be above the rate of 1-1/2 percent projected for 1998 (year over year) but will likely remain in the lower half of its 1 to 3 percent target range.



**CANADIAN ECONOMIC INDICATORS**  
(Percent change from previous period except where noted, SA)

	1998						
	Q1	Q2	Q3	Aug	Sep	Oct	Nov
GDP at Factor Cost	0.7	0.3	0.3	0.7	0.1	NA	NA
Industrial Production	0.3	0.2	0.0	2.1	0.2	NA	NA
New Manufacturing Orders	-1.7	-0.6	1.5	8.5	-2.4	4.1	NA
Retail Sales	0.3	1.6	0.9	-0.2	1.1	NA	NA
Employment	0.7	0.7	0.3	0.3	0.5	0.4	0.7
Unemployment Rate (%)	8.7	8.4	8.3	8.3	8.3	8.1	8.0
Consumer Prices <sup>1</sup>	1.0	1.0	0.9	0.8	0.7	1.0	NA
Consumer Attitudes <sup>2</sup>	118.4	115.0	103.3	...	...	...	...
Business Confidence <sup>3</sup>	155.0	148.9	128.6	...	...	...	...

1. Percent change from year earlier.

2. Level of index, 1991 = 100.

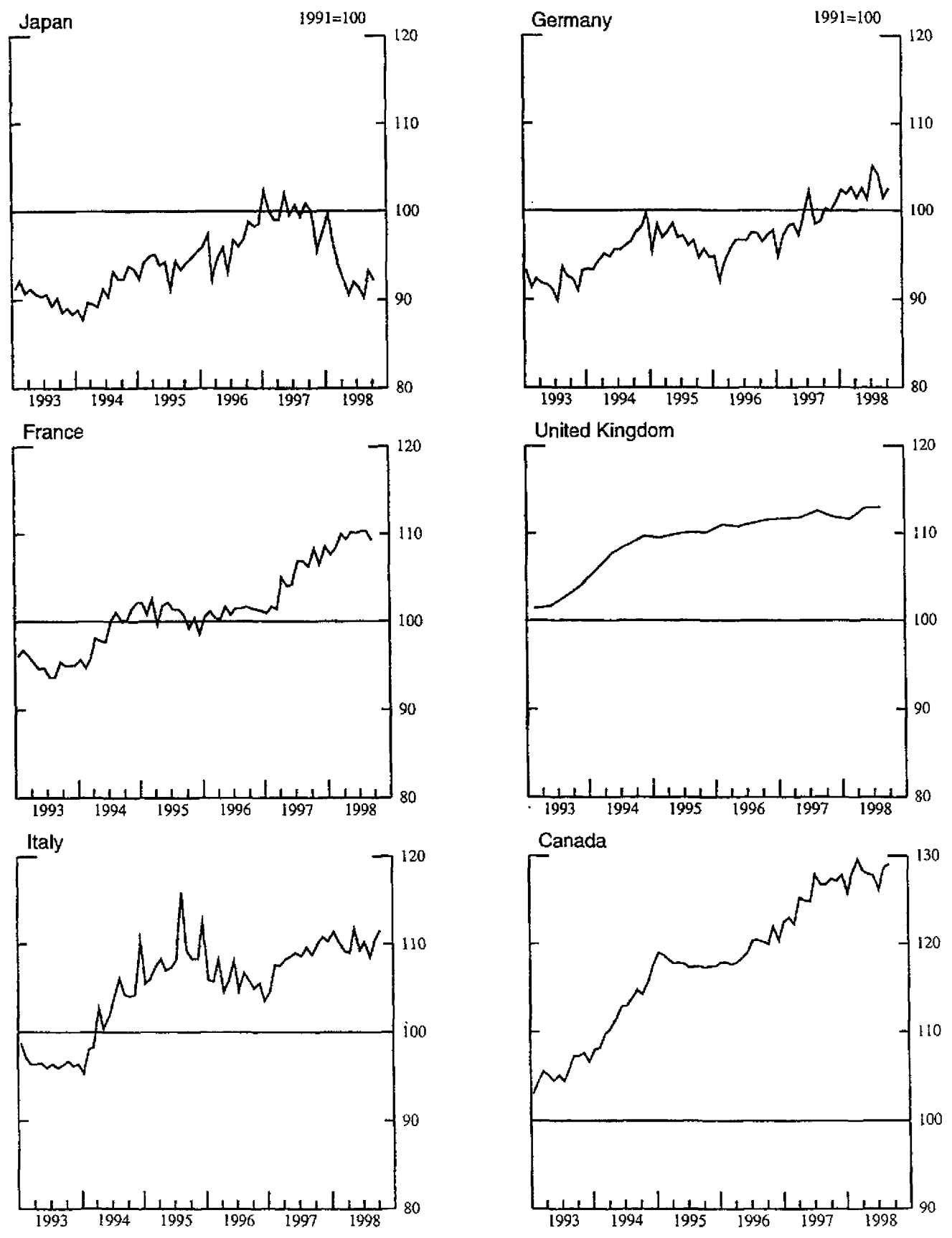
3. Level of index, 1977 = 100.

**EXTERNAL BALANCES**  
(Billions of U.S. dollars, SAAR)

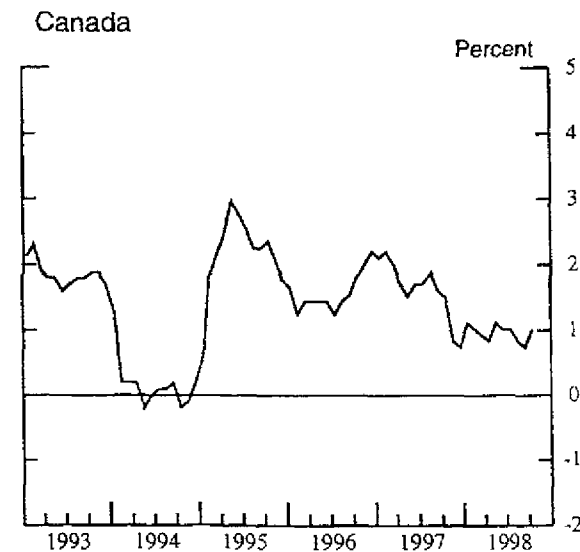
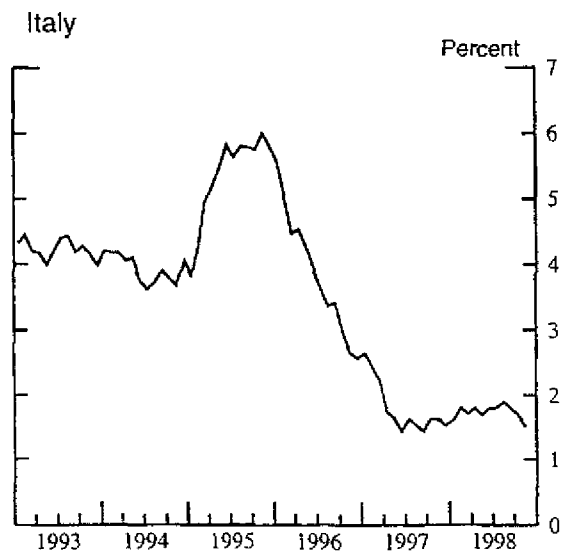
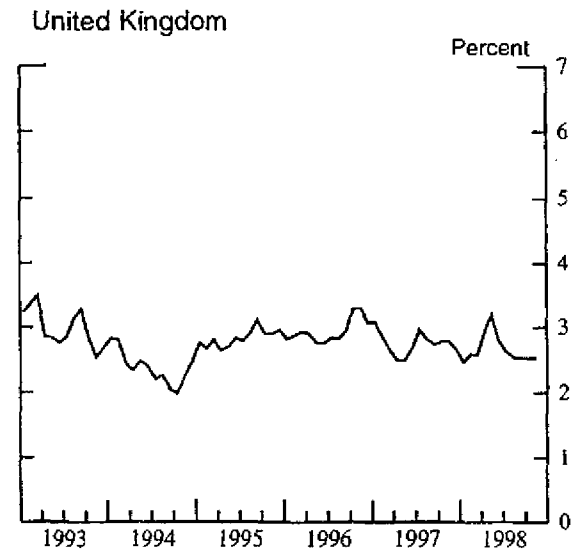
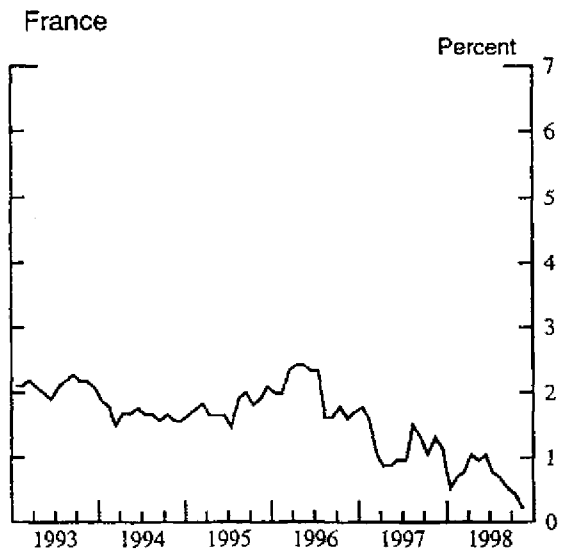
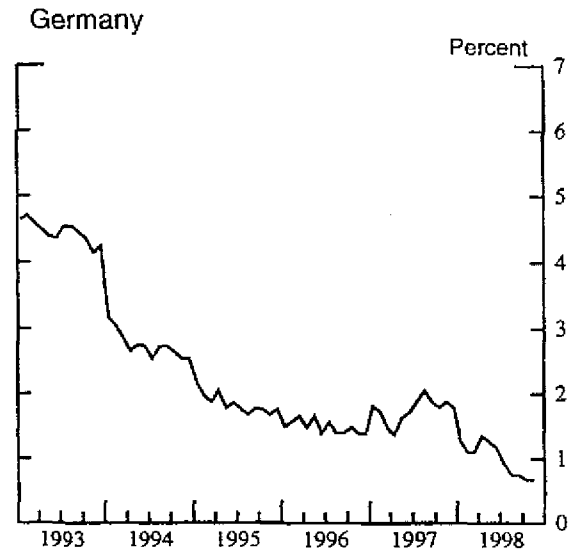
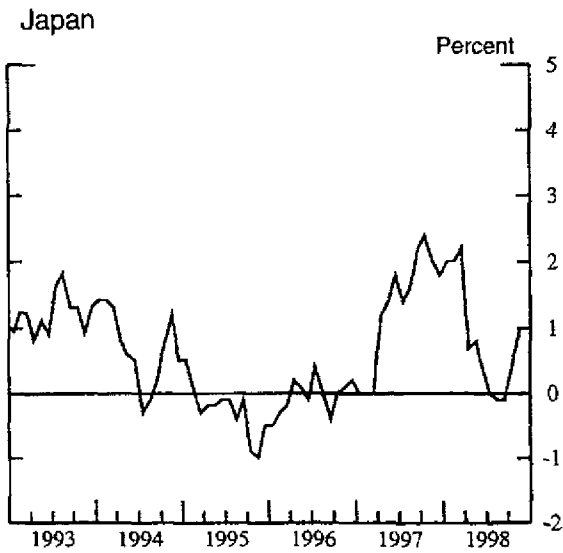
	1998					
	Q1	Q2	Q3	Aug	Sep	Oct
Japan: trade	98.0	114.0	107.3	94.9	112.7	144.6
current account	115.9	111.8	130.7	130.3	149.8	145.3
Germany: trade <sup>1</sup>	65.4	81.8	77.6	57.1	80.8	91.6
current account <sup>1</sup>	-16.0	15.4	-15.4	-28.8	-13.7	-27.8
France: trade	25.5	26.4	31.6	26.0	44.2	NA
current account	35.7	36.8	41.1	27.2	41.4	NA
U.K.: trade	-31.5	-30.2	-34.4	-25.2	-50.5	NA
current account	-3.3	4.0	NA	...	...	...
Italy: trade	22.6	29.9	28.0	29.2	29.1	NA
current account <sup>1</sup>	10.3	30.9	NA	NA	NA	NA
Canada: trade	14.5	10.0	13.9	14.9	12.8	NA
current account	-12.0	-14.5	-11.5	...	...	...

1. Not seasonally adjusted.

### Industrial Production in Selected Industrial Countries



### Consumer Price Inflation in Selected Industrial Countries (12-month change)



**Economic Situation in Other Countries**

Activity in most of the Asian developing economies remains depressed, although there are signs that Korea and the ASEAN economies may be nearing a trough, while Chinese growth has shown a modest pickup. Trade balances across the region have improved sharply over the past year owing primarily to reductions in imports, while exports remain weak. Inflation in these countries has generally stabilized, although in many cases it remains higher than before the crisis began.

In contrast, the downturn in most key Latin American economies has worsened considerably in recent months. Real GDP was down sharply in the third quarter in both Brazil and Argentina in response to the high interest rates needed to defend their currencies, while activity in Venezuela has been dampened by extremely low oil prices. All of these countries still show substantial trade deficits despite slower import growth, owing largely to the effects of lower prices for oil and other exported commodities. Inflation remains relatively high in Mexico and Venezuela, but is quite low in Argentina and deflationary pressures have been seen in Brazil.

The Russian economy continues to contract. An agreement on domestic debt restructuring has been announced, although foreign lenders are generally unhappy with the terms. Meanwhile, negotiations on rescheduling of Soviet-era debt continue. The latest draft budget currently under consideration by the Duma falls well short of what the IMF has indicated will be necessary in order for further assistance to be made available.

**Individual country notes.** In Korea, recent data suggest that activity may be bottoming out, although special factors have complicated our interpretation of the evidence. We estimate that seasonally-adjusted real GDP rose at an annual rate of a little over 2 percent in the third quarter, compared with declines of 5 percent in the second quarter and 23 percent in the first quarter. However, our estimate of seasonally-adjusted third-quarter growth was artificially boosted due to the fact that the three-day Korean thanksgiving holiday fell in October this year; normally the holiday is in September. This distortion is also clearly seen in the industrial production data. Nevertheless, industrial output in the September-October period combined was down 4 percent from the same period one year earlier, much less than the 12.4 percent fall recorded in the July-August period. The unemployment rate rose further to a seasonally adjusted 8.5 percent in October.

## KOREAN ECONOMIC INDICATORS

	1996	1997	1998				
			Q2	Q3	Sep	Oct	Nov
Real GDP <sup>1</sup>	7.1	5.5	-5.1	2.3	...	...	...
Industrial Production <sup>2</sup>	7.1	6.7	-12.0	-8.2	0.1	-8.0	n.a.
Consumer Prices <sup>2</sup>	4.9	4.4	8.2	7.0	6.9	7.2	6.8
Trade Balance <sup>3</sup>	-15.0	-3.2	45.6	42.4	45.6	41.4	n.a.
Current Account <sup>3</sup>	-23.0	-8.2	46.4	38.0	44.4	33.0	n.a.

1. Percent change from previous period, SAAR estimated by staff.

2. Percent change from year earlier.

3. Billions of U.S. dollars, AR, NSA.

In a major step in the process of corporate restructuring, the five largest conglomerates (chaebols) reached agreement on a variety of reforms with the government and creditor banks. The chaebols have agreed to reduce substantially the number of their operating units through mergers and spin-offs. This should allow them to focus on core industries, with the aim of improving efficiency and establishing more management transparency. Under the agreement, the chaebols will have to close units that are judged to have little chance of survival, and creditor banks are to halt new loans to these weak subsidiaries. The chaebols have reiterated their promises to end cross-debt guarantees among their conglomerates and to lower their debt-to-equity ratios (414 percent as of June) to 200 percent by the end of 1999. All funds raised through the sales of noncore units and any capital increases are to be used to make debt repayments to banks. If the chaebols fail to abide by these promises, their creditor banks are supposed to halt new loans to the groups or demand payment of outstanding debts.

Recent indicators for the ASEAN region also show some signs that the pace of contraction has slowed. Real GDP fell again in the third quarter in Indonesia and Malaysia, but at a much lower rate than earlier in the year. Although industrial production remains well below year-earlier levels across the region, only in the Philippines and Singapore has the decline intensified in recent months. Real GDP growth in the Philippines was unexpectedly strong in the third quarter, but this likely reflects an increase in agricultural production, which rebounded from a very low second-quarter level.

## ASEAN ECONOMIC INDICATORS: GROWTH

	1996	1997	1998					
			Q2	Q3	Aug	Sep	Oct	
<b>Real GDP<sup>1</sup></b>								
Indonesia	8.0	4.7	-35.8	-2.8	...	...	...	
Malaysia	8.6	7.8	-8.9	-2.3	...	...	...	
Philippines	5.8	5.2	-3.1	4.4	...	...	...	
Singapore	6.9	7.7	-2.1	-3.8	...	...	...	
Thailand	6.4	-0.4	...	...	...	...	...	
<b>Industrial Production<sup>2</sup></b>								
Indonesia	6.6	6.2	-22.1	-23.0	...	...	...	
Malaysia	11.0	10.7	-6.1	-10.3	-11.6	-10.9	-10.4	
Philippines	8.4	8.8	0.4	-5.8	-7.9	-7.8	n.a.	
Singapore	3.3	4.6	-1.0	-4.4	-6.3	-1.7	-7.9	
Thailand	7.2	-0.4	-15.7	-11.7	-10.4	-8.9	-5.4	

1. Percent change from previous period, SAAR estimated by staff.

2. Percent change from year earlier.

## ASEAN ECONOMIC INDICATORS: INFLATION

	1996	1997	1998					
			Q2	Q3	Aug	Sep	Oct	Nov
<b>Consumer Prices<sup>1</sup></b>								
Indonesia	8.0	6.5	52.2	79.7	81.0	82.4	79.4	78.0
Malaysia	3.5	2.7	5.7	5.6	5.6	5.5	5.2	5.6
Philippines	8.4	5.1	9.0	9.6	10.5	10.0	10.2	11.2
Singapore	1.4	2.0	0.3	-0.8	-0.8	-1.4	-1.7	n.a.
Thailand	5.8	5.6	10.3	8.2	7.6	7.0	6.7	4.7

1. Percent change from year earlier.

In a possible sign of returning confidence in the region, ASEAN stock markets have rallied and currencies across the region have strengthened significantly since mid-September, although they remain well below their pre-crisis levels. Inflation appears to have stabilized across the region, mainly reflecting weak domestic demand. Twelve-month inflation in Indonesia declined somewhat in November for the second consecutive month, reflecting in

part the rupiah's appreciation, while prices in Singapore continue to fall. All the ASEAN countries are now running trade surpluses, with balances up sharply across the region relative to last year. The improvement has resulted mainly from a reduction in imports rather than increases in export revenues. However, in recent months imports across the region appear to have stabilized; Thai imports rose in October.

Against the backdrop of exchange controls introduced in September, the authorities in Malaysia are continuing their efforts to reflate the economy by aggressively lowering interest rates and loosening fiscal policy. Some progress has been made in restructuring the region's deeply troubled financial and corporate sectors, although the pace of reform has been very slow. In Thailand the restructuring process was dealt a blow by the unelected Thai Senate, which has delayed the passage of crucial amendments to the bankruptcy and foreclosure laws, possibly until as late as March 1999.

ASEAN ECONOMIC INDICATORS: TRADE BALANCE<sup>1</sup>

	1996	1997	1998					
			Q2	Q3	Jul	Aug	Sep	Oct
Indonesia	6.9	11.9	24.8	23.1	26.4	21.6	21.4	n.a.
Malaysia	-0.1	-0.2	13.8	16.5	11.7	18.0	19.8	20.9
Philippines	-11.9	-10.5	-1.0	2.0	0.4	1.7	4.0	1.5
Singapore <sup>2</sup>	-5.9	-5.8	9.5	11.0	7.5	9.7	15.8	12.7
Thailand	-16.1	-4.6	10.4	12.7	11.7	11.2	15.2	13.3

1. Billions of U.S. dollars, AR, NSA.

2. Non-oil trade balance.

In **Hong Kong**, real GDP declined in the third quarter for the fourth consecutive quarter, and the unemployment rate in October was 5 percent, double its level at the beginning of the year. Twelve-month inflation in October was near zero. Hong Kong's merchandise trade deficit has continued to narrow in recent months, reflecting continued weakening of imports. Foreign exchange reserves were \$89 billion at the end of October, up very slightly from their recent low in September. In early December, the Hong Kong Monetary Authority relaxed rules on property lending in an effort to stimulate residential and other construction, allowing banks to make loans up to 85 percent (formerly 70 percent) of a property's value.

**HONG KONG ECONOMIC INDICATORS**

	1996	1997	1998				
			Q2	Q3	Aug	Sep	Oct
Real GDP <sup>1</sup>	4.5	5.3	-1.6	-4.7	...	...	...
Consumer Prices <sup>2</sup>	6.3	5.8	4.4	2.8	2.7	2.3	0.1
Trade Balance <sup>3</sup>	-17.8	-20.6	-18.0	-9.7	-1.1	-2.3	-1.2

1. Percent change from previous period, SAAR estimated by staff.

2. Percent change from year earlier.

3. Billions of U.S. dollars, AR, NSA. Imports are c.i.f.

In **China**, industrial production continued to strengthen in October and November following some pickup in the third quarter, while the price level appears to have stabilized after falling earlier in the year. The apparent pickup in activity is largely a result of strong fixed asset investment by state enterprises and the government; these investments were up nearly 20 percent in the August-October period from a year-earlier, compared with an increase of only about 11 percent in the first half of 1998. The increase in state investment appears to have come at the cost of a reduction in the pace of enterprise and bank reforms. However, some reforms continue. China announced in November that the People's Bank would be restructured at the end of 1998, with the establishment of nine branches that cut across provincial lines. In late November, China ordered the Communist Party and state ministries to end their direct management of business enterprises, effective at the beginning of 1999, although these enterprises will continue to be owned by the state.

**CHINESE ECONOMIC INDICATORS**

(Percent change from year earlier except where noted)

	1996	1997	1998				
			Q2	Q3	Sep	Oct	Nov
Real GDP	9.7	8.8	6.8	7.6	...	...	...
Industrial Production	13.0	11.1	8.1	8.6	10.2	10.6	11.0
Consumer Prices	8.3	2.8	-0.9	-1.4	-1.5	-1.1	-0.8
Trade Balance <sup>1</sup>	12.2	40.3	47.4	51.2	46.8	37.0	33.6

1. Billions of U.S. dollars, AR, NSA.

China's trade surplus has fallen in recent months, reflecting weakening exports. The average value of exports in the September-November period was 11 percent below its year-



earlier level, while the value of imports was down 2½ percent. Foreign direct investment inflows were \$36 billion in the first 10 months of 1998, up about 1 percent from the year-earlier period. Total reserves less gold, which increased \$33 billion in 1997 before stabilizing in the first nine months of 1998, were \$145 billion in September. On December 9, China launched a \$1 billion global bond issue at a spread of 288 basis points above U.S. Treasury securities.

In **Taiwan**, real GDP rose sharply in the third quarter. The improvement reflects in part an increasing trade surplus as a result of a decline in imports. The value of imports was down 16 percent from its year-earlier level in the third quarter; exports were down 10 percent over the same period. Inflation has picked up sharply since September as a result of an increase in food prices following damage from two typhoons. Inflation excluding food prices remains quite low. Foreign exchange reserves rose to \$88 billion in November, the highest level since July 1997.

#### TAIWAN ECONOMIC INDICATORS

	1996	1997	1998				
			Q2	Q3	Sep	Oct	Nov
Real GDP <sup>1</sup>	5.7	6.8	2.1	6.2	...	...	...
Industrial Production <sup>2</sup>	1.8	6.8	4.3	5.0	6.7	1.6	n.a.
Consumer Prices <sup>2</sup>	3.1	0.9	1.7	0.6	0.4	2.6	3.9
Trade Balance <sup>3</sup>	14.8	7.7	5.4	14.0	13.2	-0.2	19.2
Current Account <sup>3</sup>	11.0	7.7	3.0	2.1	...	...	...

1. Percent change from previous period, SAAR estimated by staff.

2. Percent change from year earlier.

3. Billions of U.S. dollars, AR, NSA.

In October and November, several Taiwanese companies defaulted on loan obligations, fueling liquidity problems—including bank runs—at a number of small financial institutions. As a result, banks have reportedly become much less willing to lend. The financial turmoil contributed to weakness in the stock market, which the government countered by establishing a stock stabilization fund. The fund was widely credited with spurring a stock market rally preceding the December 5 parliamentary elections, in which the ruling Nationalist Party widened its majority from 51 percent to 55 percent of the legislature.

Recent data for Mexico indicate that the economy is continuing to expand at a healthy pace, although export growth has slackened as a result of a slump in world oil demand. Third-quarter GDP, September industrial production, and October employment were all strong. However, the trade deficit widened in October to its highest level since before the 1995 recession as a fall in oil exports nearly offset moderate growth in other export categories. Imports continued to expand in October, although at a slower pace than earlier this year, in response to the weak peso. The third-quarter current account deficit was nearly \$19 billion.

**MEXICAN ECONOMIC INDICATORS**

	1996	1997	1998				
			Q2	Q3	Sep	Oct	Nov
Real GDP <sup>1</sup>	5.1	7.0	6.1	7.7	...	...	...
Industrial Production <sup>2</sup>	10.4	9.2	5.0	6.1	6.0	n.a.	n.a.
Unemployment Rate (%)	5.5	3.7	3.2	3.2	3.3	3.1	n.a.
Consumer Prices <sup>2</sup>	27.7	15.7	15.3	15.9	15.9	16.7	17.4
Trade Balance <sup>3</sup>	6.5	0.6	-4.8	-9.2	-8.4	-9.6	n.a.
Imports <sup>3</sup>	89.5	109.8	124.0	123.2	130.8	133.2	n.a.
Exports <sup>3</sup>	96.0	110.4	119.2	114.4	122.4	123.6	n.a.
Current Account <sup>3</sup>	-2.3	-7.4	-13.8	-18.8	...	...	...

1. Percent change from previous period, SAAR estimated by staff.

2. Percent change from year earlier.

3. Billions of U.S. dollars, AR, NSA.

The technical deadline for the government's 1999 budget was midnight December 15, but debate was delayed because of the negotiations over the \$61 billion bank bailout program (known as Fobaproa). The Mexican congress decided on December 14 that it would hold an "extraordinary period of sessions" beginning December 17 to debate the country's 1999 budget. The government's proposal has been attacked by both of the two main opposition parties. This is the second consecutive year that the legislature has faced a serious budget debate, owing to the majority achieved by the opposition parties in the July 1997 election. In general, the budget proposal contains a conservative fiscal stance with a fiscal deficit of 1.25 percent of GDP in 1999 and 1 percent in 2000, down from 1.4 percent in 1998. With the resolution of Fobaproa reform, the major sticking point in the debate

appears to be the proposed 15-percent tax on telephone usage the government has proposed to fill the gap caused by plunging oil revenue.

In recent weeks, financial markets in Mexico have continued to fluctuate under pressure from events in international markets (particularly Brazil) and uncertainty over the congressional debate on Fobaproa and the government budget. However, markets have been somewhat less volatile than during the August-October period. Between mid-November and December 15, the peso has strengthened about 1 percent; the stock market has decreased 5 percent; and spreads on Mexican Brady bonds, adjusted for collateral, fell 37 basis points. The 28-day Cetes rate has risen by 200 basis points, reflecting a tightening of monetary policy by the Bank of Mexico.

In **Brazil**, activity has plunged because the central bank has kept interest rates at very high levels to defend the *real*. Real GDP declined by nearly 6 percent (SAAR) in the third quarter after the central bank doubled its overnight interest rate to about 40 percent in early September. Industrial output, which had already weakened over the summer, dropped sharply in September and fell further in October. The decline in production in the interest-rate-sensitive durable goods sector was particularly large. In November, motor vehicle sales were about 40 percent below their year-earlier level. Reflecting the fall in activity, year-over-year inflation has declined in recent months as inflation has been negative on a month-to-month basis.

Reflecting the fall in economic activity, imports in October were down 10 percent from the previous year. However, declines in commodity prices have caused the value of exports to decline 5 percent from the previous year. Brazil's trade deficit for the year through October totaled \$5.2 billion (AR), down somewhat from the same period last year. The current account deficit for the year through September 1998 was about \$31 billion (AR), slightly higher than over the same period in the previous year, as a narrowing in the trade deficit was more than offset by higher interest payments on foreign debt and by higher repatriations of dividends and capital.

On November 13, an IMF-led package of financial assistance for Brazil totaling \$41.5 billion was announced. The package contained \$18 billion in funds from the IMF under a three-year stand-by arrangement, \$14.5 billion from bilateral donors, and \$9 billion in loans from the World Bank and Inter-American Development Bank. The government had made

## BRAZILIAN ECONOMIC INDICATORS

	1996	1997	1998				
			Q2	Q3	Sep	Oct	Nov
Real GDP <sup>1</sup>	2.9	3.2	5.4	-5.9	...	...	...
Industrial Production <sup>2</sup>	1.7	3.9	1.8	-1.5	-2.4	-1.2	n.a.
Open Unemployment Rate (%)	5.8	6.1	8.8	8.5	8.3	8.3	n.a.
Consumer Prices <sup>3</sup>	9.1	4.3	4.5	3.6	3.2	3.0	n.a.
Trade Balance <sup>4</sup>	-5.5	-8.4	-1.6	-7.2	-9.6	-6.0	n.a.
Current Account <sup>4</sup>	-24.3	-33.8	-31.6	-37.7	-58.2	-47.9	n.a.

1. Percent change from previous period, SAAR.

2. Percent change from previous period, SA.

3. Percent change from year earlier.

4. Billions of U.S. dollars, AR, NSA.

significant progress in passing portions of its fiscal program, which calls for a reduction in the deficit. However, on December 2 the lower house of congress rejected a controversial civil servant pension reform measure. The rejection, which came only two hours after the IMF Executive Board had approved the IMF loan, raised doubts about Brazil's political commitment to fiscal reform. (Brazil's successful completion of fiscal targets is crucial to the continuation of the IMF program.) The fiscal situation, as well as weak economic data, have depressed stock prices since late November, although short-term market interest rates somewhat surprisingly have risen by only a couple of percentage points.

Reflecting recent events, net capital outflows on December 11 and 14 were \$600 million and \$300 million respectively, relative to net outflows averaging \$100 million per day over the first nine days of December. Slight inflows were registered on December 15, largely reflecting the foreign acquisition of a Brazilian telecommunications firm. Reserves stood at \$39 billion on December 14. On December 15, the central bank announced that it was adding \$4.8 billion in IMF money to its reserves, and would add a further \$4.5 billion in bilateral money on Friday. Despite the outflows, the central bank has reduced its overnight interest rate from 40 percent in mid-November to about 32 percent on December 15, presumably because it believes the international support package has boosted confidence and because it has been concerned about the sharp decline in economic activity.

In **Argentina**, there is clear evidence that the economy has entered a downturn; real GDP growth decelerated to 2.9 percent in the third quarter on a year-over-year basis, which we estimate represents about a 10 percent decline (SAAR) from the second quarter. Consumer prices fell in November, and the 12-month inflation rate remained below 1 percent. External balances continue to show significant deficits; the cumulative trade deficit through October this year was over \$3.5 billion (AR) compared with about \$1.5 billion (AR) over the same period a year ago. International reserves less gold were about \$23 billion at the end of November, roughly unchanged from a month ago.

On the fiscal front, the Senate approved the 1999 government budget without any changes to key economic assumptions. The budget projects economic growth of 4.8 percent, which is widely regarded as being too optimistic. The Senate also approved a tax reform bill (earlier approved by the lower House) that contained some fiscal reforms, including a crackdown on tax evasion, that the IMF had been pushing for under its three-year \$2.8 billion Extended Fund Facility to Argentina.

#### ARGENTINE ECONOMIC INDICATORS

	1996	1997	1998				
			Q2	Q3	Sep	Oct	Nov
Real GDP <sup>1</sup>	4.2	8.4	11.0	-10.5	...	...	...
Industrial Production <sup>2</sup>	3.1	8.6	5.1	0.0	-2.2	-6.4	n.a.
Unemployment Rate (%) <sup>3</sup>	17.2	14.9	13.2	13.2	...	...	...
Consumer Prices <sup>2</sup>	0.1	0.3	1.1	1.1	1.1	0.9	0.9
Trade Balance <sup>4</sup>	1.8	-2.2	-0.2	-5.9	-4.4	-3.2	n.a.
Current Account <sup>4</sup>	-3.8	-9.3	-7.2	n.a.	...	...	...

1. Percent change from previous period, SAAR estimated by staff.

2. Percent change from year earlier.

3. Unemployment figures available only twice a year (May and August for 1998). The annual figure is the average of the two surveys. The second and third quarter figures are for May and August respectively.

4. Billions of U.S. dollars, AR, NSA.

**Venezuelan** economic activity continues to decline, driven by the slump in oil prices; real GDP contracted about 5 percent in the third quarter on a year-over-year basis, which we estimate translates into a 15 percent (SAAR) decline from the second quarter. The twelve-month inflation rate remained high at over 30 percent in November, although it was down

slightly from the previous month. Weak oil prices and an overvalued currency continue to hurt external balances.

In the presidential election held on December 6, Hugo Chavez scored a convincing victory, capturing over 55 percent of the vote. This changes the political scene in Venezuela because, for the first time in 40 years of democracy, power will not rest with one of the two traditional political parties. Chavez, the leader of a failed coup attempt in 1992, ran on a platform that was often critical of free markets. However, he has made very conciliatory statements since winning, assuring investors that the government would honor all its commitments. As a result, the stock market has rallied, climbing over 20 percent on December 8, the first day of trading after the election results. Chavez's government will not take over until early February. No specific new economic measures have been announced yet, nor has the new cabinet been named.

#### VENEZUELAN ECONOMIC INDICATORS

	1996	1997	1998				
			Q2	Q3	Sep	Oct	Nov
Real GDP <sup>1</sup>	-0.4	5.1	-7.0	-14.9	...	...	...
Unemployment Rate (NSA, %)	11.8	11.7	11.3	11.0	...	...	...
Consumer Prices <sup>2</sup>	103.3	37.6	39.0	34.4	34.3	32.8	31.2
Non-oil Trade Balance <sup>3</sup>	-4.9	-6.8	-9.7	-12.2	-13.1	n.a.	n.a.
Trade Balance <sup>3</sup>	13.6	11.4	2.5	-1.5	-1.7	n.a.	n.a.
Current Account <sup>3</sup>	8.8	6.0	-0.3	n.a.	...	...	...

1. Percent change from previous period, SAAR estimated by staff.

2. Percent change from year earlier.

3. Billions of U.S. dollars, AR, NSA.

The **Russian** economy remains in turmoil. Real GDP fell sharply in September, and industrial output was down 11 percent year-over-year in October. The ruble has fallen by about 16 percent relative to the dollar over the last month following a period of relative exchange rate stability between late September and mid-November. The sharp increase in the cost of imports since August has caused inflation to soar, from 6 percent on a twelve-month change basis in July to nearly 70 percent in November.

The Russian government has announced terms for restructuring the domestic debt frozen in August. Under the arrangement, investors will receive ruble cash worth

10 percent of half of the nominal value of their debt holdings as of August 19. The cash is to be paid in three equal installments, the second two including 30 percent annual interest. An additional 20 percent is to be paid in three-year zero-coupon bonds (which will reportedly be acceptable as tax payments and for the purchase of shares in Russian banks); the remaining 70 percent will be restructured into four-to-five-year coupon bonds, with a 30 percent interest rate in the first year, falling by 5 percentage points a year to 10 percent in the fifth year. The value of the debt to be restructured is about 280 billion rubles, which was worth \$45 billion when it was frozen in August; at current exchange rates it is worth about \$13 billion. Nonresidents hold about one-quarter of the debt. Final arrangements for currency conversion and repatriation are still to be negotiated; foreign investors are quite unhappy with the terms being discussed. The government also continues to negotiate with foreign creditors on rescheduling of its Soviet-era external debt, while maintaining that it will meet in full all obligations of the Russian Federation, issued since 1991.

The Cabinet has finally submitted a draft 1999 budget to the Duma. The plan aims to trim the deficit from 5½ percent of GDP in 1998 to 2½ percent next year, with a primary surplus of 1¾ percent. This is unlikely to satisfy the IMF, which has made known that it would like to see a primary surplus of 3-4 percent of GDP next year. The draft budget includes the expectation that external financing next year will amount to over 1 percent of GDP, or about 46 billion rubles. At the current exchange rate of about 21 rubles to the dollar, this would amount to over \$2 billion. The IMF continues to stress that further assistance will not be forthcoming without a coherent budget and some signs that it is being implemented. Nevertheless, talks are continuing, with another IMF mission to Russia scheduled for January.

## RUSSIAN ECONOMIC INDICATORS

	1996	1997	1998				
			Q2	Q3	Sep	Oct	Nov
Real GDP <sup>1</sup>	-3.5	0.8	-5.4	-22.7	-17.0	n.a.	n.a.
Industrial Production <sup>2</sup>	-5.2	1.9	-1.3	-11.7	-14.5	-11.1	n.a.
Unemployment Rate (%)	9.3	9.0	10.0	11.5	11.5	11.6	n.a.
Consumer Prices <sup>2</sup>	52.8	14.8	7.3	26.2	52.2	58.8	66.7
Ruble Depreciation <sup>2</sup>	12.5	12.7	7.0	39.4	61.3	64.0	65.7
Trade Balance <sup>3</sup>	25.3	19.8	0.4	12.6	32.4	n.a.	n.a.
Current Account <sup>3</sup>	12.1	3.3	-17.3	n.a.	...	...	...

1. Percent change from previous period, AR.

2. Percent change from year earlier.

3. Billions of U.S. dollars, AR, NSA.