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August 14, 1985

RECENT DEVELOPMENTS

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

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SELECTED DOMESTIC NONFINANCIAL DATA
(Seasonally adjusted)

	Latest data			Percent change from		
	Period	Release date	Data	Preceding period	Three periods earlier	Year earlier
				(At annual rates)		
Civilian labor force	July	08-02-85	115.3	5.6	-.2	1.3
Unemployment rate (%)[1]	July	08-02-85	7.3	7.3	7.3	7.5
Insured unemployment rate (%)[1]	May	08-01-85	2.8	2.6	3.0	2.8
Nonfarm employment, payroll (mil.)	July	08-02-85	97.7	3.0	2.4	3.3
Manufacturing	July	08-02-85	19.4	-.4	-1.5	-.6
Nonmanufacturing	July	08-02-85	78.3	3.8	3.3	4.3
Private nonfarm:						
Average weekly hours (hr.)[1]	July	08-02-85	34.9	35.1	35.0	35.3
Hourly earnings ($)[1]	July	08-02-85	8.57	8.57	8.54	8.35
Manufacturing:						
Average weekly hours (hr.)[1]	July	08-02-85	40.4	40.4	40.2	40.5
Unit labor cost (1967=100)	June	07-31-85	84.6	-7.1	-7.9	-5.6
Industrial production (1977=100)	June	07-18-85	124.6	1.9	1.9	1.9
Consumer goods	June	07-18-85	120.8	2.0	3.3	1.9
Business equipment	June	07-18-85	142.6	4.2	6.8	5.2
Defense & space equipment	June	07-18-85	174.3	11.8	12.5	10.9
Materials	June	07-18-85	114.2	-3.1	-4.5	-.9
Consumer prices all items (1967=100)	June	07-23-85	321.8	2.6	3.3	3.7
All items, excluding food & energy	June	07-23-85	313.7	3.1	3.3	4.4
Food	June	07-23-85	308.5	.8	-.9	2.3
Producer prices: (1967=100)						
Finished goods	July	08-09-85	294.4	3.7	1.1	.9
Intermediate materials, nonfood	July	08-09-85	324.2	-3.7	-1.5	-.6
Crude foodstuffs & feedstuffs	July	08-09-85	227.2	-13.6	-15.1	-11.8
Personal income ($ bil.)[2]	June	07-17-85	3,187.0	6.4	3.9	6.0
				(Not at annual rates)		
Mfgrs. new orders dur. goods ($ bil.)	June	07-30-85	106.7	3.6	7.2	8.5
Capital goods industries	June	07-30-85	39.3	14.3	17.5	13.7
Nondefense	June	07-30-85	28.3	10.6	4.1	2.1
Defense	June	07-30-85	11.0	25.1	75.9	60.6
Inventories to sales ratio:[1]						
Manufacturing and trade, total	June	08-14-85	1.38	1.35	1.38	1.33
Manufacturing	June	07-31-85	1.47	1.46	1.47	1.46
Trade	June	08-14-85	1.31	1.25	1.29	1.22
Ratio: Mfgrs.' durable goods inventories to unfilled orders[1]	June	07-31-85	.551	.555	.554	.530
Retail sales, total ($ bil.)	July	08-13-85	113.7	.4	-1.4	5.7
GAF[3]	July	08-13-85	25.0	.9	-.4	7.5
Auto sales, total (mil. units.)[2]	July	08-05-85	10.4	-.7	-5.1	-3.5
Domestic models	July	08-05-85	7.5	-2.1	-13.1	-11.0
Foreign models	July	08-05-85	2.9	3.1	24.5	23.1
Housing starts, private (thous.)[2]	June	07-17-85	1,705	1.9	-9.7	-7.2
Leading indicators (1967=100)	June	07-31-85	168.5	1.0	.5	1.1

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

Economic activity appears to have been growing recently at a moderate pace. Payroll employment and industrial production rose further in July, while household and business spending continued to expand, albeit less rapidly than earlier in the year. Meanwhile, price inflation has been holding steady, and wage increases have remained moderate.

Industrial Production and Capacity Utilization

Preliminary indications suggest that industrial production increased 0.2 per cent in July, about the pace of the past few months. Output of consumer goods increased 0.3 percent in July reflecting gains in the production of autos and home goods. Autos were assembled at an annual rate of 8.3 million units--up from a rate of 8.0 million units in June. Production of supplies for construction also increased in July as did output of materials. However, production of equipment fell, with output reductions in both the defense and nondefense components. Capacity utilization was essentially unchanged in June and July, following a pattern of small declines during the preceding ten months.

Employment and Unemployment

Employment continued to expand in recent months, but job gains have remained uneven across industries. Nonfarm payroll employment rose 240,000 in July, close to the average monthly increase during the first half of this year. Three-fourths of the July advance was in private service-producing industries, with continued large increases reported in the trade sector, particularly at eating and drinking establishments. In contrast, gains in

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

	1985 Q1	1985 Q2	1985 May	June	July
	--Annual rate--		---Monthly rate---		
Total	2.1	2.0	.2	.3	.2
Final products	.4	4.2	.6	.3	.1
Consumer goods	.0	3.5	.8	.4	.3
Durable	1.5	-2.8	.4	1.4	.6
Nondurable	-.2	5.8	.9	.1	.2
Business equipment	3.3	5.3	.1	-.2	-.3
Defense and space equipment	7.9	11.4	1.0	.9	-.3
Construction supplies	4.6	6.1	.6	.4	.3
Materials	3.5	-2.7	-.6	.3	.2
Durable goods	-.2	-6.1	-1.6	.6	.6
Nondurable goods	.0	.6	.8	.2	.2
Energy materials	15.7	1.5	.3	-.3	-.5

services industry were somewhat smaller than the average monthly increase over the past year, reflecting in part slower job growth in business services.

In the goods-producing sector, the number of construction jobs rose 23,000 in July, reversing a similar decline in June. Since the start of the year, hiring at construction sites has increased about 200,000, associated with a higher level of residential building activity as well as strength in commercial and highway construction. In contrast, manufacturing employment edged down in July--although by less than in recent months--bringing the cumulative loss in factory jobs since January to more than 200,000. Although weakness has been pervasive throughout the manufacturing sector this year, job cutbacks have been particularly evident in the metals and machinery industries.

As measured by the household survey, employment and the labor force have been quite volatile in recent months, probably reflecting seasonal adjustment problems connected with the summer flow of workers into the labor market. In July, large increases in both employment and labor force participation left the civilian unemployment rate unchanged, remaining at 7.3 percent for the sixth consecutive month.

Personal Income and Consumption

Growth in personal income continued to decelerate in the second quarter. Abstracting from movements associated with the delayed payment of tax refunds, real disposable income is estimated to have risen at less than a 1 percent annual rate after registering a 2-1/2 percent increase in the first quarter. Limited advances in interest income, sluggish growth in manufacturing payrolls, and a decline in farm income have all contributed to the reduced pace of income growth.

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

	1983	1984	1984 H2	1985 Q1	1985 Q2	1985 May	1985 June	1985 July
	-Average monthly changes-							
Nonfarm payroll employment[2]	293	327	296	273	180	301	28	243
Strike adjusted	293	329	299	267	174	298	41	233
Manufacturing	79	52	26	-26	-42	-41	-26	-7
Durable	61	45	27	-17	-30	-22	-26	-20
Nondurable	18	7	-1	-9	-12	-19	0	13
Construction	25	29	21	28	27	17	-23	23
Trade	85	106	104	91	79	127	61	82
Finance and services	103	106	107	150	95	120	64	90
Total government	4	17	25	20	12	55	-34	52
Private nonfarm production workers	260	253	220	182	135	164	47	146
Manufacturing production workers	73	33	11	-33	-44	-46	-25	7
Total employment[3]	331	270	147	282	-250	15	-590	492
Nonagricultural	338	266	144	290	-175	131	-416	505

1. Average change from final month of preceding period to final month of period indicated.
2. Survey of establishments. Strike-adjusted data noted.
3. Survey of households.

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

	1983	1984	1984 H2	1985 Q1	1985 Q2	1985 May	1985 June	1985 July
Civilian, 16 years and older	9.6	7.5	7.3	7.3	7.3	7.3	7.3	7.3
Teenagers	22.4	18.9	18.5	18.5	18.3	18.9	18.3	19.5
20-24 years old	14.5	11.4	11.2	11.1	11.3	11.8	11.2	11.2
Men, 25 years and older	7.8	5.7	5.5	5.4	5.4	5.0	5.6	5.4
Women, 25 years and older	7.2	6.0	5.9	6.0	6.1	6.1	6.1	5.9
White	8.4	6.5	6.3	6.3	6.3	6.2	6.5	6.4
Black	19.5	15.9	15.5	15.5	15.0	15.6	14.0	15.0
Fulltime workers	9.5	7.2	7.1	7.0	6.9	6.8	6.8	7.0
Memo:								
Total national[1]	9.5	7.4	7.2	7.2	7.2	7.2	7.2	7.2

1. Includes resident Armed Forces as employed.

There are also indications of a slowdown in consumer expenditures from their earlier, unsustainable pace. Auto sales, which had been well maintained into the second quarter, dropped back substantially in June and edged down further in July to an annual rate of 10.4 million units. The recent drop has been in sales of domestic units and apparently reflects both the phasing out of interest-assisted sales promotions, as well as competition from foreign cars. Sales of foreign models were at a record 2.9 million unit rate in July; since May, the increased supply of Japanese cars has significantly cut into the domestic small car market. Retail sales for goods other than autos, gasoline, and nonconsumption items increased 0.5 percent in July; however, the June change was revised down, and as a result, July sales were no higher than the second-quarter average.

So far in 1985, consumption growth has outpaced income gains, dropping the saving rate to an average of slightly less than 5 percent over the first half of the year, well below the 6.5 percent average of the past decade. Despite the slowing in income growth, consumer surveys in July continue to indicate favorable spending attitudes, in large part owing to lower interest rates and the availability of price discounts. Measures of buying plans for automobiles and houses in the Michigan and Conference Board surveys remained at high levels in July, but there was somewhat less enthusiasm for the purchase of major appliances.

Business Fixed Investment

Business spending for equipment has picked up a bit, but the recent data point to some moderation in the rate of growth in outlays for structures. For equipment, shipments of nondefense capital goods rose 3.2

PERSONAL INCOME AND EXPENDITURES
(Based on seasonally adjusted data)

	1984	1985 Q1	1985 Q2	1985 Apr.	1985 May	1985 June
	- - Percentage changes at annual rates[1] - -					
Total Personal Income						
Nominal	9.2	6.3	4.9	11.9	-6.5	6.4
Real[2]	5.8	3.0	1.8	10.3	-10.2	2.6[e]
Disposable Personal Income						
Nominal	8.9	1.6	12.6	38.5	21.7	-25.9
Real	5.6	-1.6	9.3	36.7	18.0	-29.6[e]
Expenditures						
Nominal	7.5	8.6	8.4	14.8	7.3	6.7
Real	4.2	5.2	5.2	13.0	3.7	2.7[e]
	- - Changes in billions of dollars[3] - -					
Total personal income	21.0	14.8	10.3	31.3	-17.3	16.8
Wages and salaries	11.4	9.9	9.0	8.4	6.0	12.5
Private	9.6	7.0	7.3	3.6	7.4	10.8
Manufacturing	2.6	.7	-.3	-1.7	.5	.4
Other income	10.6	8.5	1.9	23.5	-22.9	5.2
Disposable personal income	17.2	-5.8	24.6	84.6	49.2	-59.9
Expenditures	14.1	11.9	19.8	30.3	15.1	13.9
Durables	2.4	-.6	1.5	6.3	.9	-2.6
Motor vehicles and parts	.7	-.4	1.0	4.7	.1	-1.7
Furn. and household equip.	1.1	-.3	.3	1.8	.2	-1.1
Nondurables	4.3	1.6	6.5	17.0	-.7	3.1
Clothing and shoes	1.1	.9	.5	1.9	-1.3	1.0
Gasoline and oil	-.2	.9	.5	1.7	.6	-.8
Services	7.5	10.8	11.8	7.0	14.9	13.4
Personal saving rate (percent)	6.1	4.5	5.3	5.4	6.5	3.9

e--staff estimate.
1. Annual changes are measured from final quarter of preceding period to final quarter of period indicated. Changes for quarterly periods are compounded rates of change; monthly changes are not compounded.
2. Total personal income is deflated by the personal consumption expenditure deflator.
3. Average monthly changes are from the final month of the preceding period to the final month of period indicated; monthly figures are changes from the preceding month.

NOTE: The expenditures data for recent months do not reflect the latest revisions to retail sales estimates.

RETAIL SALES
(Seasonally adjusted percentage change)

	1984	1985		1985		
	Q4	Q1	Q2	May	June	July
Total sales	2.0	1.6	2.6	-.4	-1.4	.4
(REAL)[1]	1.5	1.1	2.2	-.3	-1.2	--
Total less automotive group, nonconsumer stores, and gasoline stations	1.4	1.1	1.2	.0	-1.0	.5
GAF[2]	3.2	1.1	1.6	.3	-1.6	.9
Durable	4.1	2.5	4.1	-.3	-2.5	.7
Automotive group	4.2	4.4	5.3	-.4	-1.9	-.5
Furniture and appliances	5.2	1.1	1.6	5.6	-4.6	.9
Nondurable	.8	1.1	1.7	-.4	-.7	.2
Apparel	2.9	1.1	3.6	-.1	.6	-1.7
Food	.2	1.3	1.2	-.8	-.4	.3
General merchandise[3]	2.5	1.0	.7	-1.8	-1.2	2.1
Gasoline stations	1.1	-.6	4.8	-.4	-2.2	-1.1

1. BCD series 59. Data are available approximately 3 weeks following the retail sales release.
2. General merchandise, apparel, furniture and appliance stores.
3. General merchandise excludes mail order nonstores; mail order sales are also excluded in the GAF grouping.

AUTO SALES, PRODUCTION & INVENTORIES
(Millions of units; seasonally adjusted annual rates)

	1984	1985		1985			
	Q4	Q1	Q2	Apr.	May	June	July
Total sales[1]	10.3	10.9	10.9	11.0	11.3	10.5	10.4
Imports	2.8	2.4	2.7	2.3	2.8	2.8	2.9
Domestic	7.5	8.5	8.3	8.6	8.5	7.7	7.5
Domestic production	7.7	8.4	8.0	8.1	8.0	8.0	8.3
Domestic inventories	1.44	1.49	1.51	1.53	1.49	1.51	1.60
Days' supply[2]	58	55	56	54	54	60	66

1. Components may not add to totals due to rounding.
2. Day's supply for quarter are based on end of quarter stocks and average sales for the quarter using Federal Reserve seasonal adjustment factors.

percent in June and 2.8 percent for the second quarter as a whole. The June gains were concentrated in aircraft and parts, communications equipment and electrical machinery. In real terms, equipment outlays are estimated to have advanced at about an 11-1/2 percent annual rate, after declining in the first quarter.

For structures the value of nonresidential construction put in place fell 1.5 percent in June, and the previously-reported advance of 0.9 percent in May was revised to a 1.2 percent decline. Growth in outlays for the second quarter as a whole still posted a sizable 2.9 percent increase on the strength of a robust advance in April; however, all of the major components of nonresidential construction have been flat or registered declines since April.

Indicators of future business investment suggest that spending increases will be relatively restrained in coming months. Although new orders for nondefense capital goods jumped 10.6 percent in June, they were down slightly for the second quarter as a whole. Meanwhile, growth in new commitments for commercial and industrial construction has slowed in recent months as office vacancy rates have continued to rise and industrial capacity utilization has remained below its longer-run average.

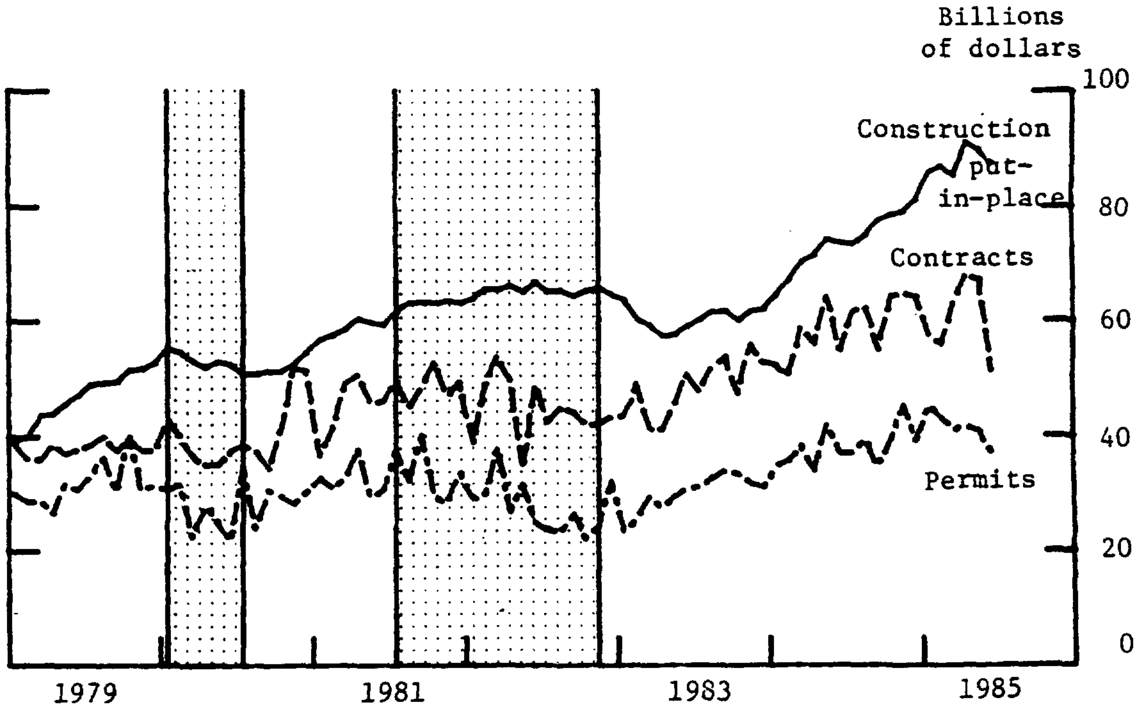
Business Inventories

The pattern of investment in business inventories has been volatile from month to month; but, on the whole, the rate of accumulation has been quite moderate. For the second quarter, stocks at all manufacturing and trade establishments rose at an annual rate of only $5.3 billion in book value terms, compared with a $21.3 billion rise in the first quarter

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

	1984	1985				
	Q4	Q1	Q2	Apr.	May	June
Producers' durable equipment						
Nondefense capital goods						
Shipments	3.2	-3.5	2.8	-2.4	-1.1	3.2
Orders	-4.0	1.7	-1.2	-6.4	.5	10.6
Unfilled orders	-2.3	.7	-1.6	-1.2	-.9	.5
Imports of capital goods excluding autos	-16.0	10.7	-2.5	-1.5	-2.1	.7
Exports of capital goods excluding autos	2.2	4.4	-5.5	-12.3	1.0	-1.1
Sales of heavy-weight trucks (thousands of units, A.R.)	316	312	276	286	264	278
Nonresidential structures						
Nonresidential construction	4.1	8.2	2.9	4.8	-1.2	-1.5
Commercial building	7.9	11.1	2.1	3.1	-1.7	-1.8
Office	8.3	9.3	2.5	1.9	-1.2	-.1
Other commercial	7.4	13.3	1.6	4.5	-2.2	-3.7
Industrial building	3.2	5.0	7.8	18.5	-5.0	-6.1

NONRESIDENTIAL CONSTRUCTION, CONTRACTS, AND PERMITS[1]



1. Source: F.W. Dodge and Census.

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

	1984	1985				
	Q4	Q1	Q2	Apr.	May r	June p
Book Value Basis:						
Total	31.8	21.3	5.3	17.2	-29.0	27.7
Manufacturing	4.7	1.9	-.8	-1.5	-13.8	12.7
Wholesale	6.4	6.6	7.8	1.2	.6	21.7
Retail	20.7	12.9	-1.7	17.4	-15.8	-6.7
Automotive	11.7	8.7	-1.3	7.3	-16.4	5.2
Ex. auto	9.0	4.1	-.4	10.1	.6	-11.9
Constant Dollar Basis:						
Total	11.5	15.0	—	8.5	-7.0	—
Manufacturing	-.1	2.1	—	1.4	-4.6	—
Wholesale	3.5	2.8	—	2.6	2.4	—
Retail	8.1	10.1	—	4.5	-4.8	—
Automotive	5.0	6.2	—	1.2	-5.0	—
Ex. auto	3.1	3.9	—	3.3	.2	—

INVENTORIES RELATIVE TO SALES[1]

	Cyclical Reference Points[2]		1984	1985				
Book Value Basis:	81 low	82 high	Q4	Q1	Q2	Apr.	May r	June p
Total	1.39	1.53	1.37	1.38	1.37	1.36	1.35	1.38
Manufacturing	1.60	1.77	1.48	1.48	1.47	1.48	1.46	1.47
Wholesale	1.06	1.28	1.16	1.17	1.17	1.14	1.13	1.22
Retail	1.36	1.43	1.41	1.42	1.38	1.39	1.38	1.40
Automotive	1.59	1.88	1.51	1.54	1.45	1.47	1.42	1.47
Ex. auto	1.29	1.35	1.39	1.39	1.36	1.36	1.37	1.38
Constant Dollar Basis:								
Total	1.62	1.75	1.55	1.56	—	1.54	1.53	—
Manufacturing	1.91	2.11	1.77	1.78	—	1.78	1.76	--
Wholesale	1.34	1.52	1.37	1.38	—	1.35	1.34	—
Retail	1.34	1.44	1.36	1.38	—	1.36	1.35	--
Automotive	1.49	1.81	1.40	1.47	—	1.41	1.36	—
Ex. auto	1.28	1.37	1.35	1.36	—	1.34	1.35	--

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

of this year. Manufacturers, in particular, have continued to maintain a conservative inventory stance in the face of sluggish sales and stiff competition from imports. A moderate increase in the book value of factory stocks in June largely offset declines in the preceding two months, and with shipments relatively flat over the first half of the year, the overall inventories-shipments ratio has remained fairly stable.

In the trade sector, wholesale inventories rose sharply in June after remaining virtually unchanged in April and May, while retail stocks fell at a nearly $7 billion annual rate. For the second quarter, wholesalers' inventories expanded at an annual rate a $7.8 billion rate--similar to the increase in the preceding two quarters. However, because of a sharp decline in sales, wholesalers' inventory-sales ratio rose significantly in June, and stocks at certain outlets such as machinery and electrical goods dealers may have become somewhat higher than desired. In the retail sector, a sizable drop in inventories held by nonauto merchandisers was only partially offset by a rise in the book value of stocks held by auto dealers.

Data for July indicate that stocks of automobiles rose further as auto production has remained firm despite weaker sales. However, if the current strike by auto-hauling teamsters is not settled soon, dealer stocks will be depleted while auto makers may have to cut production to prevent excessive build-up of inventories at factories and distribution points.

Housing

Housing activity, while relatively vigorous, has not yet shown much response to the general reduction in mortgage interest rates that occurred in the spring and early summer. Sales of new homes in May and June were about the same as the first-quarter average, and with ample iventories of unsold units, builders have been cautious about expanding activity further. Consequently, single-family housing starts edged down in June for the third consecutive month. However, other indicators suggest that construction may pick up in the near term: building permit issuance has been relatively strong, consumer attitudes toward home buying have been quite positive, and informal trade reports indicate sales levels near the cyclical peak of early 1984.

Construction of rental apartments, which account for approximately 70 percent of all multifamily starts, was strong on balance during the first six months of the year. Although the average vacancy rate for all multifamily rental housing continues to rise and in the second quarter reached a 10-year high of 7.7 percent, rent concessions on new buildings may have prevented the absorption rate for newly constructed apartments from weakening noticeably in recent quarters.

The regional pattern of housing activity has shifted significantly since late 1983. Activity in the South has slackened, especially for multifamily construction, as overbuilding has been reported in a number of key markets (chart). Starts in the Northeast, on the other hand, are higher than at any time since 1973, house prices in this region are rising at rates well above the national average.

Federal Sector

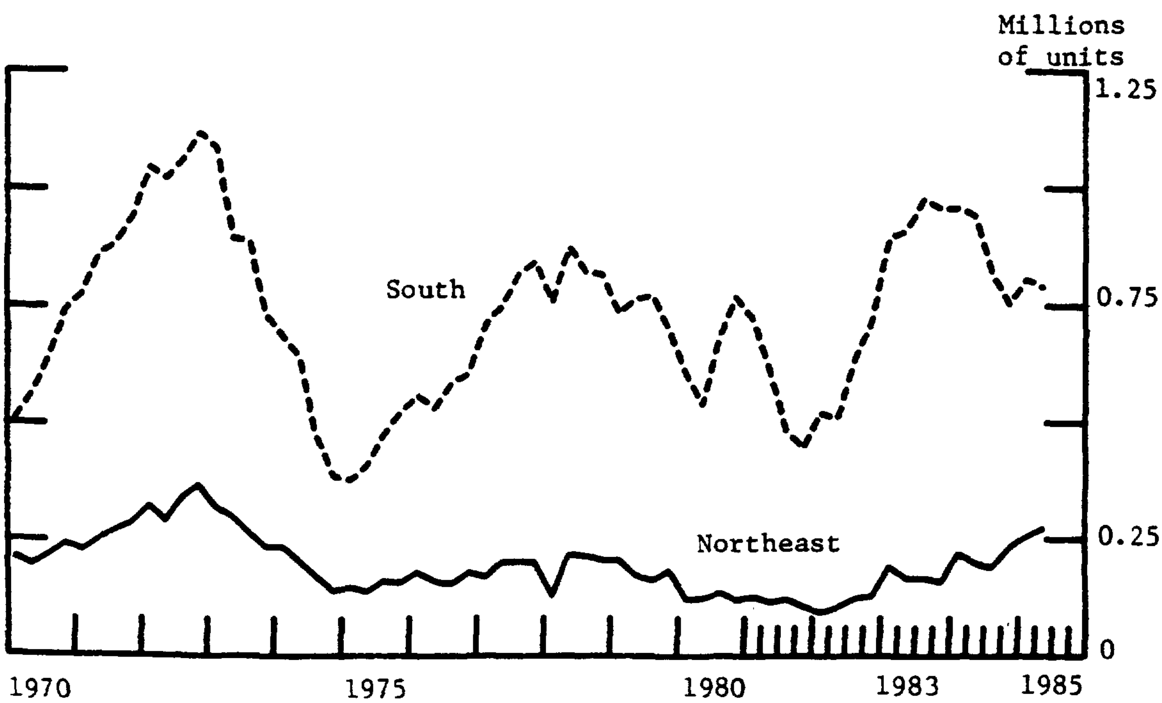
After declining in the first quarter, the federal deficit increased in the second quarter to $216 billion at an annual rate (national income account basis). The quarterly swings in the deficit this year mostly reflect delays in the processing of refund payments; after adjustment for

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

	1984		1985		1985		
	Annual	Q4	Q1	Q2	Apr.	May	June[1]
All units							
Permits	1.68	1.56	1.67	1.73	1.70	1.78	1.71
Starts	1.75	1.60	1.80	1.77	1.93	1.67	1.71
Single-family units							
Permits	.92	.84	.94	.94	.95	.93	.95
Starts	1.08	1.05	1.12	1.07	1.16	1.04	1.03
Sales							
New homes	.64	.62	.67	.66	.63	.67	.67
Existing homes	2.87	2.81	2.97	3.05	3.04	3.04	3.07
Multifamily units							
Permits	.76	.73	.73	.79	.76	.85	.76
Starts	.67	.55	.67	.70	.78	.63	.68
Mobile home shipments	.30	.29	.28	n.a.	.29	.29	n.a.

1. Preliminary estimates.
n.a.--not available.

HOUSING STARTS IN TWO REGIONS
(Seasonally adjusted annual rates)



NIA FEDERAL RECEIPTS AND EXPENDITURES
(Billions of dollars, SAAR)

	1984		1985	
	Q3	Q4	Q1	Q2
Receipts:				
Personal	319.7	327.9	362.2	317.2
Refund timing adjustment[1]			-27.6	27.6
Adjusted personal taxes[2]	319.7	327.9	334.6	344.8
Other receipts[3]	386.5	394.0	409.2	410.7
Total receipts	706.2	721.9	771.4	727.9
Adjusted total receipts[2]	706.2	721.9	743.8	755.5
Expenditures:				
Defense purchases	220.3	231.6	233.9	240.9
Transfer payments	353.8	360.4	370.3	367.6
Net interest	122.0	126.4	128.2	130.9
Other expenditures[4]	190.7	201.3	204.1	207.1
Total expenditures	886.8	919.7	936.5	946.5
Deficit	180.6	197.8	165.1	218.6
Adjusted deficit[2]	180.6	197.8	192.7	191.0

1. An estimate of the shift in the timing of refund payments from their normal seasonal pattern.
2. The adjusted series are an estimate of what the totals would have been if refunds had followed their normal seasonal pattern.
3. Corporate profits tax accruals, social insurance contributions and indirect business taxes.
4. Nondefense purchases, grants in aid to states and localities and subsidies less current surplus of government enterprises.

this factor, the deficit was around $190 billion (annual rate) in each of the past two quarters.

Constant-dollar defense spending increased at around a 9-1/2 percent annual rate in the second quarter after remaining about unchanged in the first quarter. Defense spending continues to be very volatile because of the lumpy nature of many large procurement programs. Meanwhile, real nondefense expenditures fell in the second quarter, although notable increases were posted for highway construction grants and farm subsidy payments.

The Congress passed the first budget resolution for FY1986 on August 1. The resolution which is summarized in the following table, calls for changes in taxes and mandatory spending programs and sets targets for discretionary programs that would cut $277 billion from the congressional baseline over the next three years. Revenues would be increased by extending mandatory medicare and social security taxes to state and local govenrment workers. Defense spending would be cut by freezing the level of real budget authority in 1986 and limiting the real growth rate to 3 percent in the out-years. The nondefense spending cuts would be spread over a broad range of programs (3-year savings are shown in parentheses) including medicare ($11 billion), housing subsidies ($4 billion), Strategic Petroleum Reserve acquisitions ($4 billion), rural housing credit ($6 billion), agriculture ($12 billion) and federal worker civilian pay ($11 billion).

State and Local Sector

Activity in the state and local sector was strong in the second quarter as real outlays for goods and services grew at a 5 percent annual rate, after considerable weakness over the preceding half year. The rise

FY1986 CONGRESSIONAL BUDGET PLAN[1]
(Fiscal years, billions of dollars)

	1986	1987	1988	Total 1986-88
Revenues:				
Baseline	793	864	953	2610
Tax increases	3	5	8	16
Budget resolution	796	869	960	2625
Total outlays[2]:				
Baseline	1020	1109	1196	3325
Defense cuts	-28	-45	-65	-137
Nondefense program cuts	-22	-31	-41	-94
Debt service savings	-3	-9	-18	-30
Budget resolution	968	1024	1073	3065
Total deficit:				
Baseline	227	245	244	716
Total deficit reduction	-55	-90	-132	-277
Budget resolution	172	155	113	440

1/ The baseline used by the Senate is shown. The House baseline deficit is larger by $2 billion in 1986 and by lesser amounts in 1987 and 1988 because some impacts of FY1985 supplemental appropriations were included in House baseline spending estimates.

2/ Both the administration and the Congress have presented their budget plans on a total budget basis, which includes the outlays of off-budget entities such as the Federal Financing Bank, in this year's budget deliberations.

NOTE: Detail may not add to totals because of rounding.

in the second quarter reflects a 35 percent (annual rate) increase in real outlays for construction. Although construction activity accounts for only about 10 percent of state and local government outlays, recent changes in this area have been large enough to influence the movement of total spending.

The fiscal position of state and local governments continues to be strong, although the aggregate operating and capital accounts surplus apparently declined somewhat in the second quarter. However, states appear to be adopting cautious fiscal policies because of concerns about possible cuts in federal aid and elimination of deductions for state and local taxes on federal income tax returns. Many states have acted on legislation to increase state cigarette taxes, and several states have raised fuel taxes this year.

Exports and Imports

The U.S. merchandise trade deficit grew about 10 percent in June, and for the second-quarter as a whole the deficit averaged $134 billion at an annual rate, the largest quarterly deficit on record. The increased second-quarter deficit resulted both from a small rise in imports and a drop in exports. The decline in exports was widespread across commodity categories while the small rise in imports occurred as increases in oil and automotive product imports offset declines in the other major commodity categories. The high level of imports continues to reflect the lagged effects of the appreciating dollar and the strength of U.S. demand for foreign goods.

Prices of non-oil imports declined slightly in the second quarter despite the falling exchange value of the dollar; since the third quarter of 1984, non-oil import prices have declined 3 percent. The price of imported oil firmed a bit early in the second quarter, but those increases were partly reversed in June. Further discussion of international developments is included in section IV.

Prices

Recent price reports indicate that inflation has continued at a moderate pace. Producer prices of finished goods rose 0.3 percent in July, after a downward-revised 0.2 percent decline in June,[1] while the consumer price index for all urban consumers rose 0.2 percent in June for the second consecutive month.

In the food sector, a surge in the prices of fresh vegetables boosted the July PPI for finished foods 1.3 percent; the index had declined in each of the four preceding months. Excluding the spurt in vegetable prices, downward price pressure continues to be fairly widespread in the food sector, owing to abundant meat supplies, favorable crop prospects, and declining exports. The prices of crude foods fell in July for the seventh month in a row, and recent commodity prices point to a further drop in August. With respect to energy prices, the PPI energy indexes declined for the second consecutive month in July and CPI energy price advances slowed to a moderate 0.2 to 0.3 percent monthly pace in May and June. Private survey data for July suggest some decline on a seasonally adjusted basis in retail gasoline prices, and weakness in world crude oil

1. Starting with June, the PPI indexes for finished goods, energy items, and other relevant groupings reflect the introduction of new, unlagged series for refined petroleum products derived from the PPI industry-based revision program. Before June, the indexes for refined petroleum products are still based on average revenue data, which were reported with a one-month lag. The June data for these indexes incorporate price changes for the two-month period from April to June.

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

	Relative Importance Dec. 1984	1983	1984	1985 Q1	1985 Q2	1985 May	1985 June
				--Annual rate--		--Monthly rate--	
All items[2]	100.0	3.8	4.0	4.1	3.3	.2	.2
Food	18.7	2.6	3.8	2.6	-.9	-.1	.1
Energy	11.5	-.5	.2	-.8	9.6	.3	.2
All items less food and energy[3]	69.8	4.9	4.7	5.4	3.4	.3	.3
Commodities[3]	26.3	5.0	3.1	6.6	-1.4	-.2	-.2
Services[3]	43.5	4.8	5.6	5.0	6.4	.7	.5
Memorandum:							
CPI-W[4]	100.0	3.3	3.5	4.0	3.1	.2	.2

1. Changes are from final month of preceding period to final month of period indicated.
2. Official index for all urban consumers, based on a rental equivalence measure for owner-occupied housing after December 1982.
3. Data not strictly comparable. Before 1983, they are based on unofficial series that exclude the major components of homeownership; beginning in 1983, data include a rental equivalence measure of homeowners' costs.
4. Index for urban wage earners and clerical workers, based on a rental equivalence measure for owner-occupied housing after December 1984.

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

	Relative Importance Dec. 1984	1983	1984	1985 Q1[r]	1985 Q2[r]	1985 June[r]	1985 July
				--Annual rate--		--Monthly rate--	
Finished Goods	100.0	.6	1.7	.5	1.5	-.2	.3
Consumer foods	24.4	2.3	3.5	-3.0	-8.2	-.1	1.3
Consumer energy	11.5	-9.2	-4.1	-21.3	25.9	-3.3	-1.4
Other consumer goods	42.4	1.9	2.2	6.5	1.3	.2	.4
Capital equipment	21.6	1.9	1.8	6.2	1.9	.4	.0
Intermediate materials[2]	95.1	1.4	1.7	-2.5	1.1	-.4	-.3
Exc. energy	80.1	3.0	2.1	-1.0	1.2	.2	-.1
Crude food materials	53.0	8.0	-1.2	-24.9	-19.9	-.3	-1.1
Crude energy	31.7	-4.6	-1.3	-13.1	2.9	-1.5	-.3
Other crude materials	15.4	15.5	-3.3	-13.3	3.4	.2	.7

1. Changes are from final month of preceding period to final month of period indicated.
2. Excludes materials for food manufacturing and animal feeds.
r--Revised to reflect new, unlagged series for petroleum products starting in June.

markets also suggests a favorable outlook for energy prices in the near term.

Excluding food and energy items, consumer prices rose 0.3 percent in June for the third successive month. The commodity component fell 0.2 percent in both May and June, while service prices, by contrast, accelerated somewhat in the second quarter. Over the first half of this year, however, the pace of nonenergy service prices has been about the same as in 1984; the prices of nonfood nonenergy commodities have risen a little less rapidly than last year. At the producer level, capital equipment prices remained unchanged in July, while prices of intermediate materials, excluding food and energy, fell 0.1 percent.

Wage and Labor Costs

Wage inflation in the private nonfarm economy appears to have leveled off over the past year. The employment cost index (ECI) for wages and salaries rose 4-1/2 percent at an annual rate (not seasonally adjusted) in the first half of 1985, little changed from the 4-1/4 percent rate for 1984. Wage increases have continued to be quite small in the unionized sector, averaging about 3-1/2 percent so far in 1985. The smallest contract settlements this year have occurred in manufacturing and construction, reflecting competitive pressures from foreign and domestic nonunion firms.

Moderate wage and salary increases in 1985 have been accompanied by considerably slower rates of increase in employee benefit costs. The employment cost index for total compensation rose only 4.1 percent in the first half of 1985. Since the beginning of the year, moderate benefit increases have held compensation growth below wage inflation, reversing the

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

	1982	1983	1984	1985 Q1	1985 Q2	1985 H1
Hourly earnings index, wages of production workers[1]						
Total private nonfarm	6.1	3.9	3.1	3.5	3.1	3.3
Manufacturing	6.0	2.7	3.3	5.2	3.5	4.4
Nonmanufacturing	6.2	4.5	3.0	2.8	2.8	2.8
Employment cost index, wages and salaries of all persons[2]						
Total	6.3	5.0	4.2	4.7	4.3	4.5
By occupation:						
White collar	6.5	6.0	4.4	5.7	4.9	5.3
Blue collar	5.6	3.8	3.6	3.8	4.1	3.9
Service workers	8.5	4.6	6.2	.3	2.0	1.1
By bargaining status:						
Union	6.5	4.6	3.4	2.7	4.3	3.5
Nonunion	6.1	5.2	4.5	5.8	4.3	5.0
Employment cost index, compensation of all persons[2]						
Total	6.4	5.7	4.9	5.0	3.3	4.1
Major collective bargaining agreements[3]						
First-year wage adjustments	3.8	2.6	2.4	--	--	2.8
Total effective wage change	6.8	4.0	3.7	--	--	3.0
Labor costs and productivity, all persons[1]						
Compensation per hour	7.2	3.9	4.3	5.0	3.4	4.3
Output per hour	1.4	3.9	2.4	-3.1	.5	-1.3
Unit labor costs	5.8	.0	1.9	8.4	2.9	5.7

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

pattern that had existed since the BLS began collecting benefit data for the ECI in 1981. The smaller increases in fringe benefits are reported to be largely the result of efforts by employers to negotiate lower-cost health insurance plans. In addition, the recent appreciation of the assets of pension funds as well as smaller projected future benefits associated with lower inflation may be resulting in smaller employer contributions.

Productivity in the nonfarm business sector rose 1/2 percent at an annual rate in the second quarter, following a decline of 3.1 percent in the first quarter. With productivity growth essentially flat over the past year, the growth in unit labor costs, at 4-1/2 percent, has fully reflected the increases in hourly compensation.

SELECTED FINANCIAL MARKET QUOTATIONS[1]
(Percent)

	1982/1983 Cyclical low	1984 Highs	1985 March highs	1985 June lows	1985 FOMC July	1985 Aug. 13	Change from: 1984 highs	Change from: FOMC July
Short-term rates								
Federal funds[2]	8.46	11.63	8.58	7.38	7.92	7.83	-3.80	-.09
Treasury bills[3]								
3-month	7.08	10.67	8.80	6.66	6.94	7.14	-3.53	.20
6-month	7.62	10.77	9.13	6.81	7.04	7.35	-3.42	.31
1-year	7.73	11.13	9.25	6.98	7.14	7.52	-3.61	.38
Commercial paper								
1-month	8.00	11.42	8.94	6.95	7.43	7.70	-3.72	.27
3-month	7.97	11.35	9.12	7.01	7.39	7.70	-3.65	.31
Large negotiable CDs[3]								
1-month	8.08	11.52	8.89	7.09	7.46	7.79	-3.73	.33
3-month	8.12	11.79	9.29	7.18	7.47	7.80	-3.99	.33
6-month	8.20	12.30	9.92	7.30	7.55	7.92	-4.38	.37
Eurodollar deposits[4]								
1-month	8.68	11.89	8.89	7.45	7.66	7.93	-3.96	.27
3-month	8.71	12.20	9.58	7.50	7.74	8.11	-4.09	.37
Bank prime rate	10.50	13.00	10.50	9.50	9.50	9.50	-3.50	—
Treasury bill futures								
Sept. 1985 contract			9.99	6.77	6.93	7.13	—	.20
Dec. 1985 contract			10.30	7.12	7.24	7.44	—	.20
Intermediate- and long-term rates								
U.S. Treasury (constant maturity)								
3-year	9.33	13.49	11.22	8.73	8.89	9.33	-4.16	.44
10-year	10.12	13.99	12.02	9.83	10.07	10.46	-3.53	.39
30-year	10.27	13.94	11.97	10.23	10.33	10.71	-3.23	.38
Municipal revenue (Bond Buyer index)	9.21	11.44	10.25	9.10	9.25	9.40[5]	-2.04	.15
Corporate--A utility Recently offered	11.64	15.30	13.23	11.50	11.40e	11.79e	-3.51	.39
Home mortgage rates								
S&L fixed-rate	12.55	14.68	13.29	12.05	12.13	12.23[6]	-2.45	.10
S&L ARM, 1-yr.	n.a.	12.31	11.14	9.83	9.72	9.57[6]	-2.74	-.15

	1983 Highs	1984 Lows	1985 Highs	1985 FOMC July	1985 Aug. 13	Percent change from: 1984 lows	Percent change from: FOMC July
Stock prices							
Dow-Jones Industrial	1287.20	1086.57	1359.54	1332.89	1315.30	21.1	-1.3
NYSE Composite	99.63	85.13	113.49	111.60	108.54	27.5	-2.7
AMEX Composite	249.03	187.16	237.49	232.59	232.05	24.0	-0.2
NASDAQ (OTC)	328.91	225.30	307.77	298.51	297.02	31.8	-0.5

1. One-day quotes except as noted.
2. Averages for two-week reserve maintenance period closest to date shown. Last observation is for the maintenance period to date, which ends Aug. 14, 1985.
3. Secondary market.
4. Averages for statement week closest to date shown.
5. One-day quotes for preceding Thursday.
6. One-day quotes for preceding Friday.
e--estimated

Market rates of interest have risen somewhat--generally by 1/4 to 3/8 of a percentage point--since the July FOMC meeting. Traders found little in the Board's midyear monetary policy report or in Chairman Volcker's remarks to support a bullish case for fixed-income securities, and the slightly firmer tone of the federal funds market in recent weeks reinforced their caution. Disappointment regarding the Congressional budget compromise and some economic indicators that were stronger than anticipated also weighed on market sentiment.

Although market participants evidently have not attached primary importance to the money numbers, the persistence of M1 growth above the Committee's long-run target range has been a negative psychological factor. M1 growth has slowed markedly from the May-June pace but was still in the area of 9 percent in July. M2 also posted an increase of that magnitude last month, with large inflows to money market deposit and savings accounts offsetting weakness in small time accounts and other components. M3, on the other hand, grew at only a 4 percent rate, as depository institutions ran off managed liabilities and institutional money funds shrank. Asset expansion at S&Ls may have continued weak, while bank funding needs were satisfied in part through a sizable gain in government deposits.

Aggregate borrowing is estimated to have strengthened a bit in July, mostly as a result of heavy public sector debt issuance. Business credit demands apparently diminished; corporate borrowing remained focused on the bond markets. In the household sector, fragmentary data suggest some moderation in the growth of consumer credit recently. Mortgage debt expansion probably has been well maintained, with a strong flow of credit

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

	1983:Q4 to 1984:Q4	1985 Q1	1985 Q2	1985 May	1985 June	1985 July pe	Growth from Q4 1984 to July 1985pe
	------- Percentage change at annual rates ------						
1. M1	5.2	10.6	10.2	13.8	19.8	9	11(13)[2]
2. M2	7.7	12.0	5.3	8.6	13.9	9	9
3. M3	10.4	10.7	5.2	7.7	10.8	4	8
							Levels in billions of dollars June 1985
Selected components							
4. Currency	7.2	6.3	6.7	10.4	10.3	7	164.5
5. Demand deposits	1.1	7.0	8.6	15.7	23.0	1	260.7
6. Other checkable deposits	10.5	21.1	16.1	15.5	22.9	24	160.3
7. M2 minus M1[3]	8.6	12.5	3.8	6.9	12.2	9	1881.9
8. Overnight RPs and Eurodollars, NSA[4]	7.3	64.7	-29.9	93.4	-18.8	-10	62.7
9. General purpose and broker/dealer money market mutual fund shares, NSA	17.0	32.7	-0.7	-27.2	22.3	1	175.4
10. Commercial banks	8.1	13.6	9.3	8.4	16.8	7	820.0
11. Savings deposits, SA, plus MMDAs, NSA[5]	5.2	29.2	11.8	9.2	30.1	19	429.2
12. Small time deposits	11.1	-1.8	6.6	7.4	2.5	-7	390.8
13. Thrift institutions	7.3	7.9	6.6	8.7	7.7	5	841.9
14. Savings deposits, SA, plus MMDAs, NSA[5]	-3.6	17.8	10.5	6.5	12.6	20	338.0
15. Small time deposits	15.5	1.7	4.1	10.4	4.3	-5	503.9
16. M3 minus M2[6]	22.1	5.5	4.8	4.4	-1.5	-14	630.4
17. Large time deposits	26.0	9.1	6.3	2.5	-11.5	-11	424.2
18. At commercial banks, net[7]	16.0	2.6	8.4	-4.0	-19.0	-7	267.8
19. At thrift institutions	48.8	21.0	2.6	13.2	2.3	-18	156.4
20. Institution-only money market mutual fund shares, NSA	33.6	31.2	7.7	78.5	68.0	-41	67.1
21. Term RPs, NSA	45.6	-19.5	16.8	-51.7	-29.7	-41	67.1
22. Term Eurodollars, NSA	-8.3	2.4	-11.7	4.5	-37.1	-38	78.4
	— Average monthly change in billions of dollars —						
MEMORANDA:							
23. Managed liabilities at commercial banks (24+25)	4.7	4.1	-2.5	5.2	-3.8	-7	439.0
24. Large time deposits, gross	3.2	1.4	-1.0	-1.5	-4.3	-4	326.8
25. Nondeposit funds	1.5	2.7	-1.5	6.7	0.5	-3	112.2
26. Net due to related foreign institutions, NSA	0.9	0.5	-1.4	3.4	-4.2	-3	-34.5
27. Other[8]	0.5	2.2	-0.2	3.2	4.7	0	146.7
28. U.S. government deposits at commercial banks[9]	0.2	-1.4	1.9	8.0	-5.2	8	17.4

1. Quarterly growth rates are computed on a quarterly average basis. Dollar amounts shown under memoranda for quarterly changes are calculated on an end-month-of-quarter basis.
2. Figure in parentheses calculated from Q2 1985 base.
3. Nontransactions M2 is seasonally adjusted as a whole.
4. Overnight and continuing contract RPs issued to the nonbank public by commercial banks plus overnight Eurodollar deposits issued by branches of U.S. banks to U.S. nonbank customers, both net of amounts held by money market mutual funds. Excludes retail RPs, which are in the small time deposit component.
5. Growth rates are for savings deposits, seasonally adjusted, plus money market deposit accounts (MMDAs), not seasonally adjusted. Commercial bank savings deposits excluding MMDAs increased during June and July 1985 at rates of 14.9 percent and 13 percent respectively. At thrift institutions, savings deposits excluding MMDAs increased during June and July 1985 at rates of 9.2 percent and 18 percent respectively.
6. The non-M2 component of M3 is seasonally adjusted as a whole.
7. Net of large-denomination time deposits held by money market mutual funds and thrift institutions.
8. Consists of borrowings from other than commercial banks in the form of federal funds purchased, securities sold under agreements to repurchase, and other liabilities for borrowed money (including borrowings from the Federal Reserve and unaffiliated foreign banks, loan RPs and other minor items). Data are partially estimated.
9. Consists of Treasury demand deposits at commercial banks and Treasury note balances.
pe—preliminary estimate.

through the mortgage-backed securities market. State and local government bond issuance has been kept at high levels in part by advance refundings, and the federal government has continued to borrow heavily to finance its deficit.

Monetary Aggregates and Bank Credit

July's 9 percent growth rate, coming on the heels of almost 20 percent growth (annual rate) in June, placed M1 a bit above the parallel band associated with the 3 to 8 percent target range for the second half of the year. It also suggests that there will be another sizable decline in M1 velocity in the current quarter--possibly again in excess of what might be anticipated on the basis of most models of money demand.

The deceleration of M1 in July was attributable to a moderation in the expansion of currency holdings and a sharp reduction in the growth of demand deposits, which changed little after expanding at an average rate of nearly 20 percent during May and June. Other checkable deposits, meanwhile, continued to rise rapidly as spreads between market interest rates and rates on NOW accounts remained relatively narrow.

M2 growth was reduced in July by both the slowdown in M1 and a slackening in the expansion of its nontransactions components. The July increase in M2, nonetheless, left this aggregate around the 9 percent upper bound of its 1985 target range. The deceleration in the non-M1 portion of M2 was widespread across subcomponents. Small time deposits, which had grown slowly in June, contracted in July, as the spread between yields on market instruments and rates on these deposits widened.

At the same time, a flattening in the term structure of retail deposit rates has encouraged savers to direct their funds to other M2

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

	1984 Q4	1985 Q1	Q2	May	June	July[p]	Levels in bil. of dollars, July[p]
	Commercial Bank Credit						
1. Total loans and securities at banks	9.8	10.3	9.1	13.3	9.3	9.7	1813.7
2. Securities	0.2	5.5	5.4	20.3	9.1	15.8	416.5
3. U.S. government securities	3.4	10.3	-0.4	22.1	3.2	19.8	271.0
4. Other securities	-5.6	-3.4	16.7	17.1	20.3	8.3	145.5
5. Total loans	12.8	11.7	10.3	11.2	9.3	8.0	1397.2
6. Business loans	7.8	10.2	2.7	6.0	0.7	1.5	484.2
7. Security loans	37.5	16.5	87.8	82.1	80.0	9.0	40.3
8. Real estate loans	12.1	10.9	12.0	12.0	11.0	12.1	401.4
9. Consumer loans	16.1	17.4	14.7	14.5	12.5	12.4	274.3
	Short- and Intermediate-Term Business Credit						
10. Business loans net of bankers acceptances	7.9	9.3	3.7	6.5	0.8	0.2	480.5
11. Loans at foreign branches[2]	26.0	-46.9	19.1	26.1	57.4	-12.2	19.5
12. Sum of lines 10 & 11	8.7	6.8	4.3	7.5	2.6	-0.2	500.0
13. Commercial paper issued by nonfinancial firms[3]	51.2	-6.0	33.8	43.4	14.0	1.5	78.3
14. Sums of lines 12 & 13	13.7	5.1	8.0	12.2	4.2	0.2	578.4
15. Bankers acceptances: U.S. trade related[4,5]	-6.5	-5.5	-7.8	3.4	3.4	n.a.	35.4 (June)
16. Line 14 plus bankers acceptances: U.S. trade related	12.4	4.4	7.0	11.7	3.9	n.a.	613.6 (June)
17. Finance company loans to business[4]	23.2	20.8	n.a.	10.2	n.a.	n.a.	142.2 (May)
18. Total short- and intermediate-term business credit (sum of lines 16 & 17)	14.4	7.3	n.a.	11.4	n.a.	n.a.	753.8 (May)

n.a.—not available.
p—preliminary.
1. Average of Wednesdays for domestically chartered banks and average of current and preceding ends of months for foreign-related institutions.
2. Loans at foreign branches are loans made to U.S. firms by foreign branches of domestically chartered banks.
3. Average of Wednesdays.
4. Based on average of current and preceding ends of month.
5. Includes acceptances financing U.S. imports, U.S. exports and domestic shipment and storage of goods.

components such as savings deposits and MMDAs. Savings deposits grew at a 16 percent rate in July--the strongest performance in almost three years--while MMDAs increased at a 22 percent pace. Assets of M2-type money market mutual funds were about unchanged in July, as their returns adjusted to earlier declines in market interest rates, and overnight RPs and Eurodollar deposits ran off along with other wholesale liabilities.

The slow growth of M3 in July left this aggregate at about the midpoint of its 6 to 9-1/2 percent target range for the year. An $8 billion inflow of U.S. government deposits permitted commercial banks to reduce their managed liabilities while still expanding their assets at a brisk rate. The decline in bank CDs and other domestic liabilities might have been even sharper had banks not advanced $3 billion to their foreign branches to pay down relatively costly Eurodollar deposits. Asset growth at thrift institutions probably continued moderate; thrifts allowed large time deposits to run off in July and only partially substituted FHLB advances for them. Institution-only money funds, which accounted for much of the strength in M3 during May and June, contracted sharply in July when their yields fell relative to market interest rates.

Bank credit expanded at more than a 9-1/2 percent annual rate in July, approximately the average pace over the first half of the year. The composition of asset growth shifted, however, as banks acquired a sizable volume of Treasury securities for their investment accounts and experienced some reduction in the growth of their loans. The main factor in the slowing of loan growth was the leveling off of security loans after a period of sharp expansion. Business loans at domestic banking offices, which had been sluggish throughout the second quarter, remained so in July.

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

	1984		1985				
	Year	H2	Q1	Q2P	May	JuneP	Ju.
Corporate securities - total[1]	9.88	12.09	12.32	17.11	14.88	21.90	14.05
Public offerings in U.S.	8.00	9.58	9.35	14.86	13.28	19.50	11.90
Stocks--total[2]	1.89	1.71	2.21	3.43	3.54	3.80	3.20
Nonfinancial	1.08	.97	1.12	1.81	1.45	2.00	1.45
Utility	.22	.19	.43	.44	.33	.30	.20
Industrial	.86	.78	.70	1.37	1.12	1.78	1.25
Financial	.81	.74	1.08	1.62	2.09	1.80	1.75
Bonds--total[1]	6.11	7.87	7.14	11.43	9.74	15.70	8.70
By industry							
Nonfinancial	2.80	3.89	4.14	5.78	3.78	10.15	4.95
Utility	.87	1.19	.79	1.35	1.64	1.25	.60
Industrial	1.93	2.70	3.35	4.43	2.14	8.90	4.35
Financial	3.31	3.98	3.00	5.65	5.96	5.55	3.75
By quality[3]							
Aaa and Aa	1.85	2.62	1.23	2.70	2.55	2.22	3.20
A and Baa	2.11	2.71	3.97	5.33	3.73	9.29	2.30
Less than Baa	1.09	1.47	.94	1.65	1.95	1.55	1.55
No rating (or unknown)	.25	.28	.27	.48	.15	.68	.35
Memo items:							
Equity based bonds[4]	.63	.96	.46	1.10	.89	1.10	1.00
Mortgage-backed bonds	.81	.79	.73	1.27	1.36	1.96	1.31
Variable rate notes	.72	.89	.99	1.50	.42	2.98	.31
Bonds sold abroad - total	1.88	2.51	2.98	2.25	1.60	2.40	2.15
Nonfinancial	.84	1.03	1.06	1.01	.56	1.07	1.10
Financial	1.04	1.48	1.92	1.24	1.04	1.33	1.05

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

Real estate and consumer lending continued in July near the June pace, which for consumer lending was appreciably slower than for the earlier part of the year.

Business Finance

Overall demands for shorter-term business credit appear to have weakened further in July. At banks, the sum of domestic office plus foreign branch loans to businesses was flat. Outstanding commercial paper of nonfinancial corporations meanwhile rose only marginally. Net paydowns of merger-related paper contributed to the substantial slowing of growth in this latter source of financing over the past two months, but the more general weakness in short-term credit apparently reflected limited inventory financing requirements and a preference for longer-maturity debt during a period of comparatively low bond rates.

Corporate bond issuance remained quite large in July, although well below June's record-setting volume (which was boosted by two huge bond issues to retire equity). Some companies used bond proceeds to pay down short-term debt, but a substantial amount continued to be devoted to the purchase of equity shares in mergers or other financial restructurings. Thus, while a large volume of new equity issues came to market, net funds raised in equity markets continued to be deeply negative.

Industrial firms have been active issuers of bonds in the last two months. Offerings by financial firms in July fell below their second-quarter level as auto finance companies sharply reduced their presence in the long-term debt markets. Several highly rated companies marketed large issues, and a substantial share of the total volume in July was rated Aa and Aaa. Corporate borrowing in the U.S. tax-exempt market apparently continued to be light.

The demand for Eurodollar issues has softened with the recent weakening of the dollar on exchange markets, but U.S. corporations have continued to market issues abroad. Some of this borrowing has been accomplished through issuance of non-U.S. dollar bonds, including those denominated in Australian and New Zealand currencies, with arrangements to swap the proceeds into dollars. (See Part IV for additional information on innovations in off-shore finance.)

Several broad stock price indexes touched record highs in mid-July. Share prices have fallen since then, however, as interest rates have edged up and as second-quarter reports show some weakening in corporate profits. The weakness in earnings appears to have been most pronounced among industrial firms. Increased interest expenses damped profits of some companies carrying heavy debt burdens acquired in recent merger-related or restructuring activities, while sluggish demand and import competition continued to place pressure on profit margins in a number of sectors. Despite the evident softening in profits, corporate cash flow probably rose in the aggregate, and the financing gap of nonfinancial corporations in the second quarter likely remained near its first-quarter level. Lower interest rates bolstered earnings of financial firms, including many commercial banks and thrifts, and profits of home builders apparently improved.

U.S Government Securities Markets

The staff is projecting a combined (on- and off-budget) deficit of $49 billion in the third quarter. To meet its financing requirements, the Treasury is expected to borrow $54 billion from the public, including $47-1/2 billion in the form of marketable securities. The bulk of these marketable obligations will be coupon issues; bill financing is expected to account for only $6 billion. Financing patterns could be altered, however, if difficulties are encountered in achieving an increase in the federal debt ceiling by late September, when the current ceiling would become binding.

Recently, the Treasury has sold unusually large amounts of nonmarketable securities. Nonmarketable borrowings totaled $6-3/4 billion last quarter, and they may approach that sum in the current three months; this compares with a quarterly average of $2-1/2 billion in calendar 1984. The principal factor in this borrowing is the issuance of securities to state and local governments, largely in connection with advance refunding operations.

Borrowing by the federally sponsored credit agencies is expected to slow in the third quarter to $6-1/4 billion--still a substantial figure. The Federal Home Loan Bank System will maintain a strong borrowing pace to fund a sizable volume of advances to S&Ls, and Fannie Mae likely will continue to finance significant mortgage acquisitions.

Net borrowing by the Farm Credit Banks generally has been marginally negative for the last three years, but paydowns have quickened this year as heavy debt burdens and other problems of farmers have curtailed loan demand in the agricultural sector. So far in 1985, outstanding debt of the Farm Credit Banks has declined about $4 billion.

Investor concern about the creditworthiness of the Farm Credit Banks intensified during late July in the wake of press reports about studies to reorganize the system. The market reacted strongly, and interest rate spreads between Farm Credit securities and Treasury securities widened considerably. A Farm Credit System 5-year bond traded between 10 and

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

	1985				
	Q2	Q3[e]	June	July[p]	August[e]
Treasury financing					
Combined surplus/deficit(-)	-32.0	-48.8	-1.4	-24.5	-23.5
Means of financing deficit:					
Net cash borrowing from the public	45.2	53.8	11.9	23.9	14.5
Marketable borrowings/ repayments(-)	38.5	47.4	8.6	20.6	12.5
Bills	2.4	6.2	.6	2.6	2.3
Coupons	36.1	41.2	8.0	18.0	10.2
Nonmarketable	6.7	6.4	3.3	3.3	2.0
Decrease in the cash balance	-10.1	-2.8	-12.9	-.1	11.8
Memo: Cash balance at end of period	24.0	26.8	24.0	24.1	12.3
Other[2]	-3.1	-2.2	2.4	.7	-2.8
Federally sponsored credit agencies, net cash borrowing[3]	7.9	6.3	3.5	.6	2.4
FHLBs	4.2	3.7	2.1	.7	1.5
FNMA	3.2	3.0	1.3	.3	1.0
Farm Credit Banks	-.7	-1.6	-.3	-.8	-.4
FHLMC	.5	.6	.2	.2	.2
SLMA	.7	.6	.2	.2	.1

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

15 basis points over the 5-year Treasury note in early July when it was brought to market, but since the press reports, the spread has widened to about 30 basis points.

Tax-exempt Securities Markets

Issuance of long-term tax-exempt bonds remained strong in July: offerings totaled $12 billion, near the monthly average for the second quarter. In the short-term market, volume was buoyed by a $2.3 billion offering of revenue anticipation notes by the State of California.

Refunding bonds constituted about one-third of the dollar volume of long-term offerings in July. During the first seven months of the year, refunding issues reached almost $20 billion, exceeding by a wide margin the previous high volume for a full year. Tax reform proposals that would prohibit advance refunding bonds after 1985 may have bolstered their volume this year, but most market sources indicate that the lower level of interest rates prevailing in recent months has been the primary influence. Offerings of tax-exempt securities for new capital also have been large; July's volume totaled $8.3 billion, a little above the average in the previous three months and for 1984 as a whole. Issuance of mortgage revenue bonds for single-family housing picked up a bit in July from its reduced pace in May and June; throughout 1985, offerings of tax-exempt bonds for multifamily housing construction have been above the levels of recent years.

Commercial banks have become more active purchasers of tax-exempt securities, reportedly the result of their high relative yields and of improved profits at banks. In addition, a provision in the tax reform package that would eliminate the remaining tax deductibility of interest expenses for carrying tax-exempt bonds bought after this year has encouraged purchases by commercial banks. Acquisitions by property and casualty insurance companies also appear to have increased a bit. Nonetheless, the property/casualty industry continues to record large underwriting losses, despite recent sharp increases in commercial insurance rates, and their purchases of municipals are small by historical standards.

GROSS OFFERINGS OF TAX-EXEMPT SECURITIES
(Monthly rates, not seasonally adjusted, billions of dollars)

	1984		1985				
	Year	Q4	Q1	Q2P	May	JuneP	JulyP
Total	10.60	15.75	8.74	14.33	13.46	13.70	16.40
Short-term[1]	1.71	1.14	.72	2.82	.88	2.70	4.40
Long-term	8.89	14.61	8.02	11.51	12.58	11.00	12.00
Refundings[2]	1.05	1.34	1.84	3.51	3.67	4.00	3.70
New capital	7.84	13.27	6.18	8.00	8.91	7.00	8.30
Total housing	1.69	2.36	1.42	1.51	1.75	1.20	2.00
Single-family[3]	1.12	1.45	.63	.87	1.01	.50	1.20

p--preliminary.
1. Does not include tax-exempt commercial paper.
2. Includes all refunding bonds, not just advance refundings.
3. Data from the Department of Housing and Urban Development.

Mortgage Market

Interest rates on most home mortgages have backed up a bit since the last FOMC meeting, but remain near their lowest levels of the decade. Contract rates on commitments for conventional fixed-rate mortgage loans at S&Ls averaged 12.23 percent last week, up 29 basis points from their July low. With yields on adjustable-rate loans little changed in the interim, ARMs have continued to provide a first-year rate advantage of well over 200 basis points relative to new commitments on fixed-rate loans. In early July, the proportion of conventional loans closed with adjustable-rate features at major types of originators edged down to 55 percent, slightly above most earlier months of this year but still less than the two-thirds proportion recorded in mid-1984 when initial rate spreads were wider and interest rate levels were higher.

Growth of residential mortgage debt was strong in the second quarter--perhaps just under 10 percent at an annual rate. Expanding demands for mortgage credit during the spring and early summer largely have been met through mortgage pools. All three federally related housing credit agencies have been active issuers or guarantors of pass-through securities, and new issues of such securities in the second quarter, bolstered by heavy swaps, were close to a record. Issuance of pass-through securities continued to be strong in July.

Diversified investors have been the key suppliers of funds to the residential mortgage market this year. By contrast, thrift institutions have slowed markedly their net takings of both loans and mortgage-backed securities. In June, FSLIC-insured institutions ran off $5 billion of mortgage-backed securities which, together with their slower net acquisition of loans, led to a record decline of $2.7 billion in their mortgage assets. Total asset growth has been sluggish at thrifts since the beginning of the year, partly the result of new net worth requirements imposed by the Federal Home Loan Bank Board in January, but the prevailing lower market interest rates also have made it possible for some institutions to realize capital gains by selling mortgage assets.

The Federal National Mortgage Association recently announced tighter underwriting and mortgage eligibility standards for certain conventional home loans that it purchases, effective October 15 of this year. Implemented against a backdrop of high delinquency and foreclosure rates, this change extends a trend toward stricter requirements by private mortgage

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

Period	Total	GNMAs	FHLMCs	FNMAs	Memo: FNMA and FHLMC swap issues
1984-Q1	4.9	2.7	.9	1.3	1.6
Q2	4.0	2.3	1.1	.5	1.5
Q3	5.1	2.2	1.4	1.5	2.7
Q4	6.0	2.0	2.8	1.2	3.5
1985-Q1	6.4	2.7	2.4	1.3	3.0
Q2	7.6	3.3	2.9	1.5	3.4
1985-Jan.	5.6	2.7	2.0	.9	2.3
Feb.	6.9	2.7	2.4	1.8	3.3
Mar.	6.6	2.8	2.8	1.1	3.3
Apr.	6.4	2.6	2.0	1.9	3.3
May	7.9	3.6	3.3	1.0	3.3
June r	8.4	3.6	3.3	1.5	3.7
July p	8.7	3.3	3.9	1.5	4.0

r—revised.
p—preliminary.

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

	Mortgage commitments		Net change in mortgage assets[1]		
	New (1)	Outstanding[2] (2)	Total (3)	Mortgage loans (4)	Mortgage-backed securities (5)
1984-Oct.	16.9	69.2	5.5	5.2	.3
Nov.	16.9	69.2	4.5	5.9	-1.4
Dec.	17.5	69.6	3.4	2.8	.6
1985-Jan.	16.9	68.7	3.5	4.3	-.9
Feb.	16.1	68.6	3.2	2.5	.6
Mar.	16.0	67.9	5.1	5.0	.1
Apr.	16.5	66.5	4.1	4.9	-.8
May r	16.8	65.9	1.7	2.9	-1.2
June	16.3	66.3	-2.7	2.2	-5.0

1. Data are adjusted to account for structural changes through mergers, acquisitions, liquidations, terminations, or de novo institutions.
2. End of month. Includes loans in process.
r—revised.

insurers and other market participants and is intended to reduce the credit risk on mortgages. Market participants interpret this latest action by FNMA as an attempt to address particularly risky practices and does not change standards, such as maximum carrying cost burdens relative to income, on most loans that FNMA buys.

Consumer Installment Credit

Consumer installment credit growth slowed in June to a 16-1/2 percent annual rate, the lowest since late 1984, and well below the average of 21 percent during the preceding three months. The reduction in growth occurred entirely in revolving credit--which appears to have expanded by less than one percent in June compared with gains of 25 to 30 percent in earlier months this year. Some banks reported a heavy volume of repayments by credit card users that may have stemmed from receipt of delayed tax refunds.

Rapid expansion of consumer borrowing during the second quarter lifted the ratio of consumer installment debt to disposable personal income to a new high. Accompanying debt repayment burdens have been restrained by two factors: average maturities of new auto loans have lengthened considerably since the previous peak in the ratio in 1979, and revolving credit, which allows borrowers flexibility in matching payments with variations in income, has become relatively more important in consumer installment debt.

Aggregate data suggest that debt repayment problems of the household sector may not have worsened much further in the second quarter following broad increases in delinquency rates in the first quarter. Automobile finance companies experienced only a slight rise in delinquencies, and these rates were well below historical averages. While measures of

CONSUMER INSTALLMENT CREDIT

	1983	1984	1985 Q1	1985 Q2	1985 Apr.	1985 May	1985 June-p
	-------- Percent rate of growth, SAAR --------						
Change in outstandings—total	14.6	20.0	21.8	20.2	20.8	22.4	16.5
By type:							
Automobile credit	13.4	20.6	22.0	24.4	23.0	24.5	24.3
Revolving credit	17.7	23.9	30.0	18.1	25.0	28.0	.8
All other[1]	14.0	17.5	17.3	17.3	16.5	17.3	17.4
	---------- Billions of dollars, SAAR ----------						
Change in outstandings--total	48.7	76.8	98.4	96.4	99.2	108.5	81.4
By type:							
Automobile credit	16.9	29.5	37.9	44.5	41.9	45.5	46.0
Revolving credit	12.4	19.6	28.5	18.5	25.5	29.2	.8
All other[1]	19.5	27.8	32.1	33.5	31.9	33.9	34.6
By major holder:							
Commercial banks	19.5	40.4	54.9	44.8	46.2	49.3	39.0
Finance companies	9.3	9.3	16.6	21.9	22.6	28.5	14.6
All other	20.0	27.1	27.0	29.7	30.4	30.7	27.8
	----------- Annual percentage rate -----------						
Interest rates							
At commercial banks[2]							
New cars, 48 mos.	13.92	13.71	13.37	13.16	n.a.	13.16	n.a.
Personal, 24 mos.	16.68	16.47	16.21	16.09	n.a.	16.09	n.a.
Credit cards	18.78	18.77	18.85	18.74	n.a.	18.74	n.a.
At auto finance companies[3]							
New cars	12.58	14.62	13.85	11.95	11.92	11.87	12.06
Used cars	18.74	17.85	17.86	17.80	17.78	17.84	17.77

1. Includes primarily personal cash loans, home improvement loans, mobile home loans, and sales finance contracts for non-automotive consumer durable goods.
2. Average of "most common" rates charged, on loans of specified type and maturity, during the first week in the middle month of each quarter.
3. Average rate for all loans of each type made during the period, regardless of maturity.
n.a.—not available.
p -- preliminary

mortgage delinquencies on all types of properties at savings and loan associations reached new record levels during the second quarter, an informal staff inquiry about delinquencies on second mortgages at large finance companies revealed flat or declining delinquency rates during the past six months. None of the companies contacted was planning to slow its expansion of second-mortgage credit or to tighten its credit standards.

Foreign Exchange Markets

On balance since the last FOMC meeting, the weighted-average value of the dollar, shown in Chart 1, has depreciated 4 percent, and is currently 16 percent below its late-February peak. The dollar declined sharply in the early part of the intermeeting period, and since that time has not experienced much net change in value.

The dollar's decline in early July appeared to be motivated in part by increasing market concern about the pace of monetary growth in the United States and some indications of weaker-than-anticipated U.S. economic activity. These concerns seem to have been attenuated in more recent weeks as new economic data provided some encouraging, although still mixed, signals concerning economic activity in the United States. Moreover, dollar interest rates have risen on balance in the weeks since Chairman Volcker's Humphrey-Hawkins testimony, and concern about rapid money growth has appeared to lessen. These developments seem to have contributed to the relative stability of the dollar in recent weeks.

Chart 2 displays an average of short-term foreign interest rates and a comparable short-term dollar rate. The differential between these two series has tended to narrow in the last five weeks as most foreign rates have continued to ease while dollar rates have risen on balance. A similar pattern is evident in the behavior of domestic and foreign long-term rates. As can be seen in the chart, the interest advantage of assets denominated in foreign currencies generally increased during the steep fall of the dollar from its late-February peak, while the recent

Chart 1

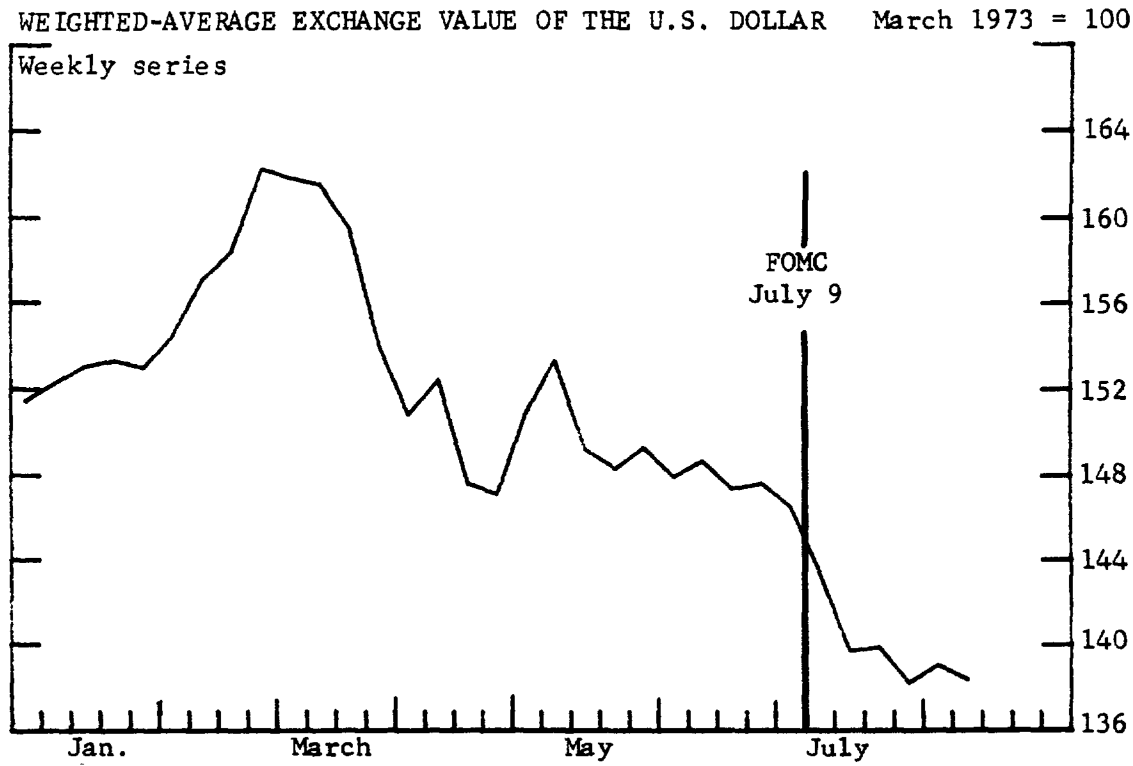
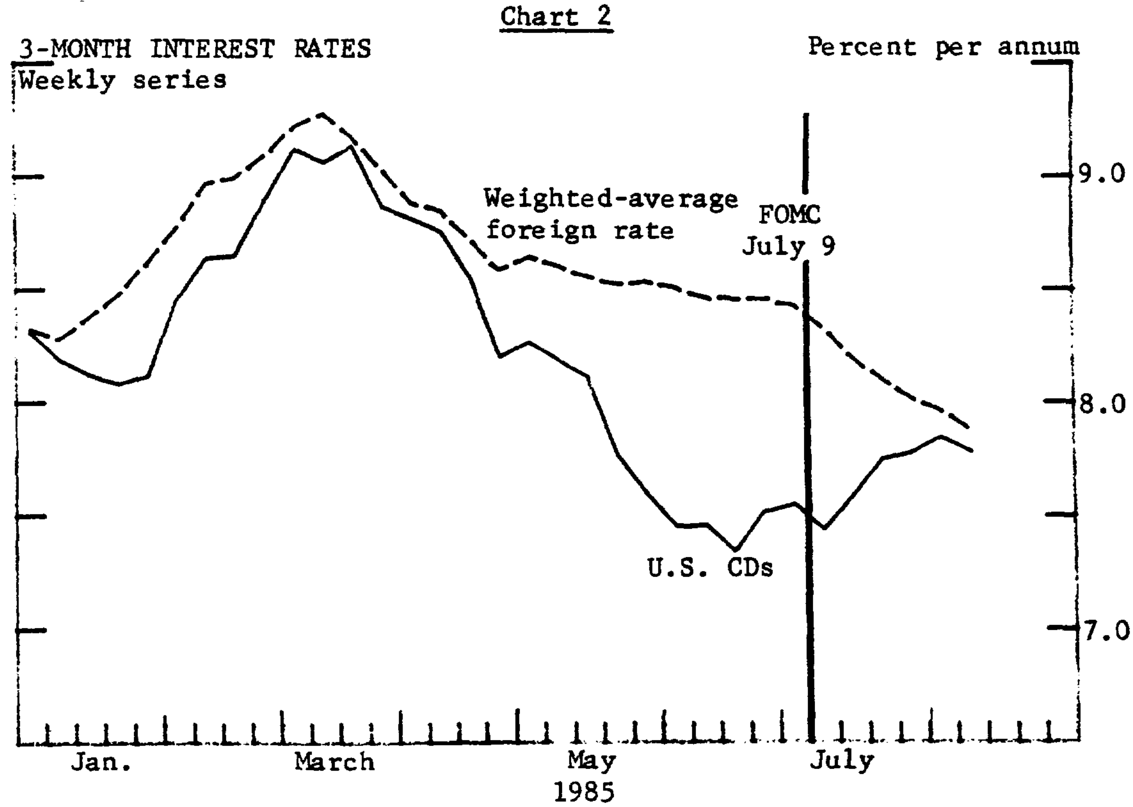


Chart 2



narrowing of the interest differential has accompanied a period of relative stability of the dollar.

Foreign authorities have continued to respond cautiously to the dollar's decline. Official rate reductions were announced by the United Kingdom, France, and Sweden when the dollar was depreciating rapidly shortly after the last FOMC meeting. Subsequently, only the Bank of England has announced a further reduction in its money market dealing rates, to around 11-1/2 percent, and this move was taken during a period of particular strength of sterling. German short-term market rates have fallen about 60 basis points since the last FOMC meeting, but no official rate reductions have been announced to date.

An EMS realignment, entailing an effective 7.8 percent reduction of the lira relative to all other EMS currencies, was announced on Saturday, July 20. On the preceding Thursday, in the context of discussions of medium-term economic objectives, the Italian government had apparently decided to seek a devaluation of the lira within the EMS during the weekend of July 20. On Friday, the lira suddenly depreciated 18 percent against the dollar -- from 1860 to 2200 lira per dollar -- just prior to the Milan fixing. Several transactions were conducted at this rate.

In the three weeks since the EMS realignment, the lira has been relatively stable within its new EMS intervention limits, but the Belgian franc and French franc have experienced intermittent bouts of intense downward pressure. Pressure on the Belgian and French currencies appeared to derive from a market perception that considerations of relative competitiveness provided scope for devaluations of these currencies within the EMS. Since the previous EMS realignment in March 1983, the deterioration in the French and Belgian competitive positions (as measured by real exchange rate changes) was not substantially less than that of Italy. Thus, when the EMS realignment of July 20 did not incorporate devaluations of the French and Belgian currencies along with the devaluation of the lira, speculation of further EMS adjustments emerged.

the Belgian franc is experiencing mild downward pressure.

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On July 25, the Mexican authorities announced a 16.7 percent devaluation of the controlled peso exchange rate, which is used for around 80 percent of Mexico's international transactions, as part of a package of adjustment measures. The devaluation of the controlled peso rate followed by two weeks the abolition of the official "free" rate that applied to the balance of the country's international transactions.

These transactions were moved to the so-called "super-free" rate, in effect resulting in a 27.2 percent devaluation. The controlled exchange rate continued to be depreciated by 21 centavos per day after July 25, but, effective August 5, began to be set daily on a discretionary basis. During the first week of the new exchange rate regime, the peso depreciated at an average rate of 40 centavos per day. The new rate of crawl takes account of exchange market pressures, the level of Mexico's international reserves, and internal and external price developments. The July 25 measures were favorably received and the exchange rate in U.S. markets, which had been quoted at 370 pesos per dollar the day prior to the announcement of the package, appreciated to 332 pesos by August 13.

U.S. International Financial Transactions

Exchange rate and interest rate developments in the second quarter were reflected in the changing character of financial flows and financial instruments that affected the sources of financing for the current account deficit.

Foreign official reserve assets held in the United States rose by $7.7 billion in the second quarter (Summary Table, line 4), the largest increase since the sustained period of dollar depreciation in 1978. Foreign G-10 countries' net purchases of $6.0 billion replenished dollar reserves

. Official foreign net purchases of U.S. Treasury securities totalled $8.5 billion in the second quarter.

Private foreign net purchases of U.S. Treasury securities rose by $5.3 billion in the quarter and by $2.9 billion in June (Summary table, line 3). The June increase was primarily due to a $2.5 billion net purchase by Japanese residents which included more than half of the $1 billion foreign targeted Treasury issue that was issued in May but was not recorded as a capital inflow until June. The Japanese hoped, it appears, that a strong showing at the targeted Treasury auction would both tend to dampen protectionist sentiment in the United States and advance the fortunes of Japanese brokerage houses in the Eurobond market. In addition, the Treasury auction of domestic and targeted securities coincided with a run-up in U.S. domestic interest rates making Treasury securities relatively attractive investments.

The rate of foreign net purchases of U.S. corporate securities (Summary table, lines 2a and 2b) slowed somewhat in the second quarter as short-term interest rates prevailing in some non-dollar denominated foreign markets exceeded U.S. short-term rates. In addition, the perception of increased volatility in the foreign currency return on dollar denominated investments reduced the attractiveness to foreigners of purchasing dollar-denominated corporate securities. In response, U.S. corporations increased the proportion of their newly issued Eurobonds that were denominated in foreign currency. This phenomenon was particularly pronounced in July, when the share of Eurobonds issued by U.S. corporations denominated in foreign currencies rose to 36 percent from an average of about 16 percent over the previous six months. In the Euromarkets as a whole in July, fully 50 percent of new issues were foreign currency denominated, whereas the average for the previous 6 months was about 30 percent.

Declines in long-term interest rates in the United States and some flattening of the yield curve during the second quarter encouraged issuers to lock in fixed rates. In the second quarter, 77 percent of Eurobonds issued by U.S. corporations were fixed-rate bonds, up from 68 percent in the first quarter. In July, 95 percent were fixed rate. Another reason for this apparent shift was the reduction in U.S. bank or bank holding company issuance of Mandatory Convertible Securities (MCS), a type of floating rate note (FRN). About 70 percent of all U.S. corporate FRNs issued in the first quarter were MCSs, while in the second quarter only 26 percent of FRNs were MCSs. More than one-half of the largest banks have reached the limit on the share of MCSs that can be applied to capital.

Continued uncertainty about the direction and rate of change of currency and interest rate movements contributed to the emergence of two instruments in the Eurobond market that had previously appeared only in thin foreign markets: the capped floating rate note and the dual currency bond. The capped floating rate note, so called because of the maximum interest rate payable on the bond, yields an asymmetric risk opportunity by limiting the upside interest rate risk incurred by the borrower; the lender gets a somewhat higher spread. Of all FRNs issued in the second quarter, $2.6 billion (17 percent) were this kind of note. However, many issuers in fact detached the cap and sold (on behalf of the lender) what is essentially a long-dated interest rate put option to third parties who presumably would have received less favorable terms had they entered the market directly. Moreover, long-dated interest rate option contracts are not generally available.

The dual currency bond, where the currency of principal repayment and the currency of interest payments differ, represents an alternative response to greater market uncertainty about medium-term trends in the exchange rate. Issues in 1985 through July totalled $3.6 billion. With this kind of note, the holder is partially hedged against either a dollar appreciation or depreciation: the purchasing power gain or loss on one aspect of the bond (say, the principal) partially offsets the opposite change in the purchasing power of the other part of the bond (the interest payment stream).

In contrast to the securities and official accounts, both of which yielded net inflows during the second quarter, the banking sector yielded a net outflow for the quarter of $1.9 billion, spurred by the relatively large net outflow of $5.4 billion in June (Summary table, line 1). Similarly, the International Banking Data table (line 3) reveals interbank outflows in June that continued into July. Some of the net outflow during the quarter may have been related to weak credit demands in the United States. However, the interbank outflow represented by the July figure (which is a monthly average) appears to be related to end-of-period window dressing since similar movements occurred over the several days spanning the end of December 1984 and the beginning of the following January, June and July 1984, and December 1983 and the following January.

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

	1983 Year	1984 Year	1984 Q1	1984 Q2	1984 Q3	1984 Q4	1985 Q1	1985 Q2	1985 Apr.	1985 May	1985 Jun
Private Capital											
Banks											
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	13.4	22.0	12.9	0.7	9.9	-1.6	15.7	-1.9	3.0	0.5	-5.4
Securities											
2. Private securities transactions, net	1.6	8.0	2.2	-0.2	0.3	5.7	7.0	5.2	1.2	2.0	1.9
a) foreign net purchases (+) of U.S. corporate bonds	2.2	13.8	0.5	0.6	2.6	10.1	10.6	6.6	1.9	3.0	1.8
b) foreign net purchases (+) of U.S. corporate stocks	6.4	-0.8	1.0	-0.1	-1.0	-0.8	-1.1	0.4	0.1	*	0.3
c) U.S. net purchases (-) of foreign securities	-7.0	-5.0	0.7	-0.7	-1.3	-3.6	-2.5	-1.9	-0.8	-0.9	-0.2
3. Foreign net purchases (+) of U.S. Treasury obligations 1/	8.7	22.5	1.4	6.5	5.1	9.5	2.7	5.3	3.9	-1.6	2.9
Official Capital											
4. Changes in foreign official reserve assets in U.S. (+ = increase)	5.2	2.7	-3.0	-0.8	-0.5	7.1	-10.8	7.7	0.8	3.1	3.8
a) By area											
G-10 countries (incl. Switz.)	6.4	3.1	2.3	-0.7	-0.8	2.2	-5.5	6.0	1.5	2.0	2.5
OPEC	-8.5	-5.3	-2.8	-2.4	-0.6	0.6	-1.7	-2.1	-1.9	-0.6	0.4
All other countries	7.3	5.0	-2.6	2.4	0.8	4.3	-3.7	3.7	1.1	1.6	1.0
b) By type											
U.S. Treasury securities	7.0	4.7	-0.3	-0.3	-0.6	5.8	-7.2	8.5	1.5	2.5	4.4
Other 2/	-1.7	-2.0	-2.8	-0.5	**	1.2	-3.6	-0.9	-0.8	0.5	-0.6
5. Changes in U.S. official reserve assets (+ = decrease)	-1.2	-2.7	-0.7	-0.6	-0.8	-1.1	-0.2	-0.4	*	-0.2	-0.1
Other transactions (Quarterly data)											
6. U.S. direct investment (-) abroad	-4.9	-4.5	-3.1	2.0	2.0	-5.4	0.6	n.a.	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	11.3	22.5	3.3	9.3	5.2	4.7	2.7	n.a.	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) 3/ 4/	-1.8	6.3	1.3	5.7	0.3	-0.4	-4.4	n.a.	n.a.	n.a.	n.a.
9. U.S. current account balance 4/	-41.6	-101.5	-19.1	-24.5	-32.5	-25.5	-30.0	n.a.	n.a.	n.a.	n.a.
10. Statistical discrepancy 4/	9.3	24.7	4.8	1.9	11.0	7.0	16.7	n.a.	n.a.	n.a.	n.a.
MEMO:											
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-61.1	-108.4	-25.6	-25.7	-32.5	-24.6	-29.6	-33.4	-10.0	-11.0	-12.5

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

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1981 Dec.	1982 Dec.	1983 Dec.	1984 June	1984 Sept.	1984 Dec.	1985 Mar.	1985 May	1985 June	1985 July 3/
1. Net Claims of U.S. Banking Offices (excluding IBFs) on Own Foreign Offices	7.8	32.9	39.3	32.2	30.2	25.4	25.8	25.9	27.6	n.a.
2. Net Claims of U.S. Banking Offices on Own IBFs 1/	11.8	16.2	5.2	4.4	6.3	7.8	6.1	5.8	8.1	n.a.
3. Sum of lines 1 and 2 of which:	19.6	49.1	44.5	35.2	36.4	33.2	31.7	31.6	35.7	40.4
(a) U.S.-chartered banks	22.3	40.0	40.5	33.6	35.9	32.1	30.4	30.5	33.5	39.6
(b) Foreign-chartered banks	-2.6	9.1	4.0	1.6	.5	1.1	1.3	1.1	2.2	.8
4. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	13.2	15.8	18.6	19.9	20.2	20.7	19.1	19.4	20.2	19.6
5. Eurodollar Holdings of U.S. Nonbank Residents 2/	95.5	112.6	124.2	124.3	122.7	117.4	118.5	112.8	109.8	107.2

1. Corresponds to net claims of international banking facilities (IBFs) on all foreign residents, including all banks whether related or not, and all nonbanks.
2. Include terms and overnight Eurodollars held by money market mutual funds.
3. Through July 29, 1985.

Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactions accounts. Line 1 is an estimate constructed as the residual of line 3 minus line 2. Line 2 is data for the last Wednesday of the month for the sample of monthly IBF reporters. Line 3 is an average of daily data reported to the Federal Reserve by U.S. banking offices. Line 4 is an average of daily data. Line 5 is the month-end value for data through September 1983. For dates after September 1983, the overnight portion is an average of daily data and the term portion is an average of Wednesday data.

U.S. Merchandise Trade

In June, the U.S. merchandise trade deficit was larger than that recorded in May; for the second quarter as a whole it was the largest quarterly deficit on record. The increase in the deficit in the second quarter resulted from a substantial drop in exports and a relatively small increase in imports.

The value of agricultural exports dropped by 15 percent in the second quarter; much of the decline was in the volume of corn and soybeans. The decline in nonagricultural exports was also fairly large. Exports of industrial supplies fell by 7 percent (especially chemicals, fuel oil, coal, and paper), exports of capital goods dropped by 6 percent (particularly computers and parts and broadcasting equipment), and exports of consumer

U.S. MERCHANDISE TRADE 1/

	Year	1984		1985			
	1984	Q3	Q4	Q1	Q2	May	June
Value (Bil. $, SAAR)							
Exports	220.3	222.1	225.4	222.8	211.6	215.1	208.9
Agricultural	38.4	36.9	38.3	33.5	28.4	25.5	27.3
Nonagricultural	181.9	185.3	187.2	189.3	183.2	189.6	181.5
Imports	328.6	352.1	323.6	341.0	345.3	347.1	358.5
Oil	57.5	57.8	56.8	45.2	52.8	54.2	58.0
Nonoil	271.1	294.4	266.9	295.8	292.5	292.9	300.4
Trade Balance	-108.3	-130.0	-98.2	-118.2	-133.7	-132.0	-149.6
Volume (Bil 72$, SAAR)							
Exports							
Agricultural	16.3	15.7	17.3	15.3	13.1	11.7	12.7
Nonagricultural	63.0	64.3	64.7	64.4	62.3	64.4	61.6
Imports							
Oil	5.3	5.4	5.3	4.3	5.1	5.2	5.6
Nonoil	104.0	112.4	102.0	115.9	115.3	114.8	119.0

1/ International transactions and GNP basis. Monthly data are estimated.

goods fell by 8 percent. By area, declines occurred with both developing and industrial countries. Only with Canada did U.S. nonagricultural exports increase; shipments of automotive products, which account for one-third of U.S. nonagricultural exports to Canada, were unchanged between the first and second quarters.

The value of oil imports increased substantially in the second quarter from a relatively low first-quarter level. Nearly all of the rise was in volume; oil imports in the second quarter averaged 5.4 million barrels per day (mbd) compared with 4.6 mbd in the first quarter. It appears that most of the increase went into inventories as inventory accumulation returned to more normal rates following unusually large drawdowns in the first quarter; U.S. oil consumption declined somewhat in the second quarter. The average price of imported oil increased by about 10 cents per barrel in the second quarter; price increases in April and May were partly reversed in June.

OIL IMPORTS

	Year	1984		1985			
	1984	Q3	Q4	Q1	Q2	May	June
Volume (mbd, SA)	5.62	5.66	5.62	4.61	5.36	5.44	5.92
Price ($/BBL)	27.95	27.91	27.59	26.86	26.97	27.26	26.87
Value (Bil. $, SAAR)	57.48	57.76	56.79	45.22	52.78	54.18	58.04

The value of nonoil imports declined somewhat in the second quarter. A reduction in imports of machinery, industrial supplies, consumer goods and foods was partly offset by an increase in automotive imports (largely from Japan). While imports from industrial countries rose somewhat, shipments from developing countries in Latin America and Asia fell by 8 percent.

<u>Foreign Economic Developments</u>. The pace of economic activity in several major foreign industrial economies appears to have increased in the second quarter. However, this represents in part a recovery from unusually low first-quarter levels and does not necessarily signal a move toward sustained higher rates of real growth in foreign industrial countries as a group. Japanese industrial production increased sharply in the second quarter following a decline in the first quarter. A similar pattern prevailed in Germany, where, as in neighboring European countries, first-quarter activity was depressed by severe winter weather. The rapid growth of U.K. industrial production in the second quarter in large part reflected the increase in coal production following the ending of the miners' strike in March. Despite the increased activity in several countries, unemployment rates in general have held steady at or near record high levels.

Inflation rates in major foreign industrial countries have shown no discernible trend in recent months. There are indications that the rise in U.K. inflation earlier in the year will prove temporary, with a reversal of the previous rise in mortgage rates helping to hold down increases the U.K. retail price index.

The Japanese trade surplus widened further in the second quarter, and for the first half of the year was nearly $50 billion (s.a.a.r.). Germany also registered a record trade surplus in the first half. The U.K. trade deficit was reduced in the second quarter as fuel oil imports dropped following the ending of the coal miners' strike. In Italy, in contrast, the trade deficit widened in the first five months of the year compared with the same period last year.

REAL GNP AND INDUSTRIAL PRODUCTION IN MAJOR INDUSTRIAL COUNTRIES
(PERCENTAGE CHANGE FROM PREVIOUS PERIOD, SEASONALLY ADJUSTED)

	Q4/Q4 1983	Q4/Q4 1984	1984 Q3	1984 Q4	1985 Q1	1985 Q2	1985 FEB.	1985 MAR.	1985 APR.	1985 MAY	1985 JUNE	LATEST 3 MONTHS FROM YEAR AGO+
CANADA												
GNP	7.1	4.3	1.6	.8	.9	N.A.	*	*	*	*	*	4.2
IP	16.1	4.4	3.1	-.1	.2	N.A.	-.3	.2	.5	.0	N.A.	3.9
FRANCE												
GDP	.9	1.6	1.2	-.2	-.0	N.A.	*	*	*	*	*	.7
IP	2.4	1.3	3.1	-2.5	-.5	N.A.	3.9	1.5	-2.2	1.5	N.A.	.8
GERMANY												
GNP	3.1	2.5	2.4	1.0	-.8	N.A.	*	*	*	*	*	.6
IP	6.0	3.6	5.7	1.4	-1.2	1.6	-.3	.9	-.2	1.0	2.0	7.7
ITALY												
GDP	1.2	2.0	1.1	-.6	.7	N.A.	*	*	*	*	*	1.9
IP	1.7	1.8	1.8	-1.8	1.5	N.A.	8.8	-.4	-3.8	.8	N.A.	1.8
JAPAN												
GNP	3.9	6.5	.6	2.4	.1	N.A.	*	*	*	*	*	5.1
IP	8.6	10.7	1.5	2.8	-.6	2.9	.7	-1.9	2.8	2.4	-1.2	6.7
UNITED KINGDOM												
GDP	3.7	2.7	1.1	1.5	.8	N.A.	*	*	*	*	*	2.8
IP	5.4	-.3	.6	.7	1.9	2.1	-.1	1.8	.7	.6	-.6	5.4
UNITED STATES												
GNP	6.3	5.7	.4	1.0	.1	.4	*	*	*	*	*	1.9
IP	14.3	7.2	1.6	-.2	.5	.5	.1	.3	.2	.1	.1	2.4

* DATA NOT AVAILABLE ON A MONTHLY OR QUARTERLY BASIS.

+ IF QUARTERLY DATA, LATEST QUARTER FROM YEAR AGO.

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CONSUMER AND WHOLESALE PRICES IN MAJOR INDUSTRIAL COUNTRIES
(PERCENTAGE CHANGE FROM PREVIOUS PERIOD)

	Q4/Q4 1983	Q4/Q4 1984	1984 Q1	1984 Q2	1984 Q3	1984 Q4	1985 Q1	1985 Q2	1985 APR.	1985 MAY	1985 JUNE	1985 JULY	LATEST 3 MONTHS FROM YEAR AGO
CANADA													
CPI	4.6	3.7	1.2	.9	.9	.7	1.2	1.1	.4	.2	.6	N.A.	4.0
WPI	3.5	3.6	1.6	1.2	.5	.3	1.0	N.A.	.2	.2	.0	N.A.	2.7
FRANCE													
CPI	9.8	6.8	1.7	1.8	1.7	1.4	1.4	1.8	.7	.5	.4	.4	6.3
WPI	14.6	10.5	3.4	2.9	2.2	1.6	1.6	.9	.4	.5	-.1	N.A.	6.4
GERMANY													
CPI	2.7	2.0	.9	.5	.0	.7	1.1	.6	.2	.1	.1	-.2	2.4
WPI	.9	1.0	1.7	.8	-1.4	.0	1.9	.9	-.3	-.1	-.8	-1.2	.9
ITALY													
CPI	13.0	8.8	2.8	2.1	1.4	2.2	2.6	2.2	.9	.6	.5	.3	8.7
WPI	9.1	8.8	3.2	2.2	1.2	1.9	2.7	N.A.	.6	.3	.0	N.A.	8.3
JAPAN													
CPI	1.9	2.4	.9	.6	-.2	1.2	.6	.5	.4	.1	-.1	.5	2.4
WPI	-3.3	.5	.1	-.1	.8	-.3	.4	-.7	-.4	-.2	-.3	-.4	-.4
UNITED KINGDOM													
CPI	5.1	4.8	.6	2.0	.9	1.2	1.3	3.4	2.1	.5	.2	N.A.	7.0
WPI	5.6	6.0	1.8	2.3	.6	1.3	1.7	2.0	1.2	.2	.1	N.A.	5.6
UNITED STATES													
CPI (SA)	3.2	4.1	1.3	.9	.9	.9	.8	1.0	.4	.2	.2	N.A.	3.7
WPI (SA)	.8	1.7	1.2	.4	.0	.1	.2	.6	.4	.2	-.2	.3	.9

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TRADE AND CURRENT ACCOUNT BALANCES OF MAJOR INDUSTRIAL COUNTRIES 1/
(BILLIONS OF U.S. DOLLARS; SEASONALLY ADJUSTED)

			1984				1985		1985			
	1983	1984	Q1	Q2	Q3	Q4	Q1	Q2	MAR.	APR.	MAY	JUNE
CANADA												
TRADE	14.4	15.9	3.5	4.0	4.1	4.4	4.0	3.6	1.6	1.5	1.2	.9
CURRENT ACCOUNT	1.4	1.8	.0	.4	.5	.9	.5	N.A.	*	*	*	*
FRANCE												
TRADE 2/	-5.9	-2.7	-1.5	-1.2	.4	-.3	-1.1	-.4	-.1	-.4	-.1	.2
CURRENT ACCOUNT 2/	-4.9	-.1	-.7	-.4	.9	.1	-.7	N.A.	*	*	*	*
GERMANY												
TRADE	16.4	18.8	4.3	3.2	5.0	6.3	4.5	N.A.	1.5	1.9	2.2	N.A.
CURRENT ACCOUNT (NSA)	4.2	5.8	.8	-.1	-.9	6.0	1.3	3.0	.8	1.3	2.0	-.2
ITALY												
TRADE	-7.9	-10.7	-2.2	-2.9	-1.4	-4.2	-3.8	N.A.	-1.4	-1.4	-.7	N.A.
CURRENT ACCOUNT (NSA)	.8	-3.2	-1.7	-1.0	1.3	-1.7	N.A.	N.A.	*	*	*	*
JAPAN												
TRADE 2/	31.3	44.5	10.0	11.1	10.1	13.2	11.6	13.0	3.2	3.8	4.8	4.4
CURRENT ACCOUNT	21.0	35.0	7.2	9.2	7.4	11.5	9.4	12.1	2.5	3.8	4.1	4.2
UNITED KINGDOM												
TRADE	-.8	-5.7	-.2	-1.8	-2.1	-1.6	-1.5	-.4	-1.1	-.3	.3	-.3
CURRENT ACCOUNT 2/	4.4	.9	1.4	-.3	-.7	.5	.1	1.5	-.5	.3	.9	.3
UNITED STATES												
TRADE	-62.0	-108.3	-25.6	-25.6	-32.5	-24.6	-29.6	-33.4	-10.4	-10.0	-11.0	-12.5
CURRENT ACCOUNT	-40.8	-101.5	-19.1	-24.5	-32.5	-25.5	-30.0	N.A.	*	*	*	*

1/ THE CURRENT ACCOUNT INCLUDES GOODS, SERVICES AND PRIVATE AND OFFICIAL TRANSFERS.
2/ QUARTERLY DATA ARE SUBJECT TO REVISION AND ARE NOT CONSISTENT WITH ANNUAL DATA.

* COMPARABLE MONTHLY OR QUARTERLY CURRENT ACCOUNT DATA ARE NOT PUBLISHED.

Individual Country Notes. Recent data on industrial production in Japan suggest that the economy is expanding, although at a slower pace than experienced last year. Following a first-quarter decline, Japanese industrial production grew 12.2 percent (s.a.a.r.) in the second quarter and was 6.7 percent above its year-earlier level. Housing starts also showed continued strength, standing about 6 percent above their year-earlier levels in June.

Price increases have continued to be modest. The Tokyo consumer price index rose 2.8 percent during the 12 months ending in July, and wholesale prices declined by 1.2 percent over the same period. Japan's external surpluses widened further in the second quarter. The cumulative trade surplus for the first half of the year was just under $50 billion (s.a.a.r.) and the corresponding cumulative current account surplus was $43 billion.

On July 26, the Nakasone government approved guidelines for its fiscal 1986 budget. These guidelines suggest continued fiscal austerity, with the overall increase in covered nominal expenses being limited to 1.5 percent. Although the Prime Minister called for a study of possible tax reforms earlier in the week, it is not expected that a large tax cut will be implemented in 1986.

The final version of the "Action Program" that is intended to increase the openness of the Japanese economy was announced on July 30. The program, which will be implemented over a three-year period, will include a phased reduction in tariffs on a wide variety of manufactured and agricultural products as well as an easing of some non-tariff barriers. Additional measures to liberalize Japanese financial markets were also announced as part of the "Action Program," including timetables for the removal of interest rate restrictions on large time deposits and for the issuing of euro-yen floating rate notes by residents.

Industrial production in Germany rose 2 percent (s.a.) in June, after a 1 percent increase in May. Despite this recent strength, the average second-quarter level of industrial production barely surpassed the level in the fourth quarter of last year, owing to the sharp decline in the early months of this year associated with exceptionally severe winter weather. Preliminary GNP estimates confirm the second-quarter recovery. Early indications are that sources of strength in recent months have been exports and investment in equipment, while consumption has remained flat and the construction sector continues to experience severe problems. The rate of unemployment, at 9.4 percent (s.a.) in July, remained near its peak of recent years. Consumer prices fell 0.2 percent (n.s.a.) in July to a level 2.3 percent above July of last year.

Reflecting the strength of foreign demand, the trade surplus for the first half of the year, at $10.2 billion (n.s.a.), was the largest ever. The current account surplus for the first half of the year was $4.3 billion (n.s.a.) compared with $700 million in the same period last year.

The federal budget for 1986 was recently approved by the cabinet. It provides for 2.4 percent nominal growth in expenditures over budgeted 1985 spending and a federal deficit unchanged from that expected for this year, about 1.2 percent of nominal GNP.

Industrial production in France increased by 1.5 percent (s.a.) in May, only partially reversing the 2.2 percent decline of the previous month. The May level of industrial production showed no change from its year-earlier value. The recorded unemployment rate was unchanged at 10.6 percent (s.a.) in both May and June, kept down in part by government training programs for new entrants into the job market.

Consumer prices increased by 0.4 percent (n.s.a.) in July as the year-over-year inflation rate eased to 6.1 percent. The government has revised upward its official inflation forecast for 1985 from 4-1/2 percent to 5 percent.

The trade account was in surplus by $200 million (s.a.) in June, the first monthly surplus this year. In the first half of 1985, the trade deficit was just under $3 billion (s.a.a.r.), about the same as in 1984 as a whole.

Industrial production in the United Kingdom grew 8.6 percent (s.a.a.r.) in the second quarter, in large part the result of the increase of coal production that followed the March 5 ending of the coal miners' strike. June industrial production declined by 0.6 percent (s.a.) and was 4.7 percent above its year-earlier level.

Recent data on consumer prices suggest that the sharp acceleration in inflation that took place in the spring will be temporary. Although the retail price index was 7 percent above its year-earlier level in the second quarter, prices advanced only 0.2 percent (n.s.a.) in June. The recent 3/4 percentage point drop in mortgage rates should lower the price index by about 1/3 percent.

The U.K. trade deficit was $1.5 billion (s.a.a.r.) in the second quarter and the corresponding current account surplus was $6 billion. Both external balances have improved significantly from the first quarter, when the ongoing coal miners' strike led to a high level of fuel oil imports.

The Bank of England lowered its official interest rates by 1 percentage point in July amid calls by several industry officials for even larger reductions. Statements by Chancellor of the Exchequer Nigel Lawson have suggested that the climate for future interest rate cuts will depend in part on the strength of the pound.

Gross domestic product in Canada increased 0.4 percent (s.a.) in April, the eighth consecutive monthly increase. On a year-over-year basis, this measure of production was up 4.5 percent. Industrial production was unchanged (s.a.) in May and was 3.9 percent above its year-earlier level. The unemployment rate declined slightly in July to 10.4 percent (s.a.), moving 0.8 percentage point below its level in March.

Consumer prices increased by 0.6 percent (n.s.a.) in June, raising the inflation rate over the past 12 months to 4.1 percent. Wholesale prices were unchanged (n.s.a.) in June, and their year-over-year increase was only 2.6 percent.

The trade surplus declined slightly in June to $900 million (s.a.). Over the first six months of the year, the trade surplus was $15 billion (s.a.a.r.), about the same as the surplus recorded in the corresponding period last year.

Real GNP in Italy rose 2.6 percent (s.a.a.r.) in the first quarter. Industrial production in the first five months of 1985 was 1.9 percent higher than in the same period in 1984. The official household surveys held in June and July showed a jump in consumer confidence. This increase in confidence came in the wake of the public's rejection of the referendum designed to reinstate 1984's lost wage indexation points.

In July, the cost of living index was 8.7 percent above its year-earlier level. During the first six months of 1985, industrial wages were nearly 11 percent higher than in the first half of 1984. This rise in real industrial wages occurred despite an unemployment rate that has remained at historically high levels (10.2 percent).

The trade deficit in May was $700 million (s.a.), and the cumulative trade deficit in the first five months of 1985 was $14.2 billion (s.a.a.r.), compared with $9.3 billion in the same period in 1984.

In conjunction with the devaluation of the lira announced on July 20, the government proposed new measures designed to reduce the budget deficit by raising revenues by an amount equivalent to about 1 percent of GDP.

Economic Situation in Major Developing Countries

On July 25, Mexico took some corrective actions intended to return the country to the adjustment path from which it had deviated during the past nine months. The measures included (a) a 16.7 percent devaluation of the controlled exchange rate, which applies to about 80 percent of the country's international transactions, (b) the elimination of the requirement that an import license be obtained on goods which together account for about 37 percent of Mexico's imports, thereby making more than 60 percent of Mexico's imports subject to tariffs rather than quantitative restrictions, and (c) steps to cut public sector spending, bringing the total of such cuts since the beginning of the year to the equivalent of 3.9 percent of total budgeted spending or 1.4 percent of GDP. However, the cuts in public spending announced so far will not prevent Mexico from exceeding the 1985 public sector deficit target of 4.1 percent of GDP specified under its IMF program approved only two months ago. Overspending of 3 to 4 percent of GDP is occurring because of higher-than-expected interest payments on the internal public debt owing to a sharp rise in interest rates, because of the failure of the inflation rate to decline as anticipated, and because the budget was exceeded in the first half of the year prior to the July 7 mid-term elections. Moreover, revenues are falling short of estimates, partly because of the lowering of oil export prices and a lower volume of oil exports.

The Argentine public appears to be accepting the country's new adjustment program. However, with Congressional elections scheduled for early November, it may be difficult to achieve the fiscal objective of the program. Congressional delays in enacting the proposed "forced savings" plan, which is an important element of the fiscal program, are a complicating factor. In July, wholesale prices were 0.9 percent lower than in June, but, even with a price freeze, the July cost of living index was 6.2 percent higher than the June level, largely because of the effects of some price increases dating back to the days before the freeze took effect. Since there was no wage increase in July, this could bring about an increase in labor complaints about the program. Following the introduction of the adjustment program, the central bank's reserves are reported to have increased significantly, bringing about a substantial increase in the liquidity of the financial system. Unregulated interest rates declined in late June and early July to levels close to those of the regulated rates, and the premium for the dollar in the free market, which had virtually disappeared when the new adjustment program was announced, rose steadily to about 20 percent in mid-July. The central bank has taken steps to absorb excess liquidity. The moves were followed by only a slight increase in unregulated interest rates and only a slight decline in the premium for the dollar. Bank lending in excess of credit ceilings, apparently made possible by non-compliance with reserve requirements, is reported to have contributed to the excess liquidity. The new adjustment program was approved by the IMF Executive Board on August 9.

Brazil is seeking a new IMF stand-by arrangement for 18 months that might total SDR 1.5 billion. The major sticking point in the negotiations has been the allowable size of the fiscal deficit. Serious revenue losses occurred because of the implementation of a 3-1/2 month price freeze on state- and federally-run enterprises and utilities. On July 4, the government announced a set of measures aimed at narrowing the 1985 operational deficit to about 0.4 percent of GDP. These measures by themselves are unlikely to provide the basis for an IMF agreement since the Fund staff does not believe they are adequate to achieve a substantial reduction in Brazil's current inflation rate of over 200 percent. The new government wants to renegotiate some aspects of the multi-year commercial bank rescheduling agreement drafted by the previous government, but the banks will not complete the rescheduling until the IMF and Brazil reach agreement on a new economic program. Brazil's bank creditors have agreed to a standstill on repayment of 1985 maturities and have extended the life of trade lines, interbank lines and redeposit facilities through the end of August.

After subsiding during the first quarter of 1985, Brazil's trade surplus has again strengthened to the $13 billion annual rate that prevailed during 1984. Industrial production during January-June 1985 was 6.3 percent higher than during the same period last year; the rate of increase has been slowing since the first quarter. Several important strikes by steel and auto workers were recently settled, resulting in a shorter work week (40 hours vs. 48 hours) and in more frequent wage readjustments for inflation (quarterly vs. semi-annually). Inflation over the 12 months ending in July was 217 percent, down only slightly from 224 percent over the twelve months of 1984.

Peru's new government has frozen nearly all prices, reduced domestic interest rates that were already negative in real terms, increased wages (particularly the minimum wage), and frozen dollar accounts for 90 days. A 10.7 percent devaluation was followed by an announcement that the exchange rate will remain indefinitely at the new rate. The price of gasoline was raised to the domestic-currency equivalent of $1.25 per gallon. Peru's new President, Alan Garcia, has said publicly that his country will pay no more than 10 percent of export receipts in debt service over the next year, and that priority in future repayments will be given to those creditors who are granting fresh credits to Peru. The new administration also requested a postponement of repayments of medium- and long-term public sector debt to foreign banks that fall due before January 31, 1986. (Principal payments have been rolled over by the banks since mid-1984.) Peru's interest arrears to banks were about $275 million at the end of July and are accumulating at a rate of about $27 million a month.

Chile's three-year IMF extended arrangement for SDR 70 million was approved in principle by the IMF on July 15 and took effect August 9 when the critical mass of bank financing had been committed.

On July 26, the IMF Executive Board agreed to monitor the implementation of an economic program proposed by the Colombian government, clearing the way for a $1.0 billion commercial bank loan. The financing is to be used for development projects, and disbursements will be conditional on satisfactory reports from the IMF. Although other Latin American countries have negotiated debt-refinancing agreements that involve IMF surveillance, the Colombian agreement is unique in that it does not involve rescheduling.

The circulation of the terms sheet for the multi-year rescheduling agreement to Venezuela's 450 creditor banks was completed on July 9.

The final signing of the agreement may begin in early September. Before this occurs, however, Venezuela must show further progress in the review for registration of some $12 billion in private sector debt. Over $11 billion of this private sector debt has been reviewed so far.

On July 8, the Philippines obtained the seventh, 90-day extension of its moratorium on the repayment of principal on non-trade external debt to commercial banks. The Philippines met its end-May IMF targets and, on July 30, drew the second tranche of SDR 106 million of the SDR 615 million stand-by arrangement established last December. This will allow the Philippines to draw the first $400 million of the $925 million in new money that the commercial banks agreed last May to provide.