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September 25, 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	Aug.	09-06-85	115.3	-.2	-.3	1.5
Unemployment rate (%)[1]	Aug.	09-06-85	7.0	7.3	7.3	7.5
Insured unemployment rate (%)[1]	June	08-22-85	2.8	2.8	2.9	2.7
Nonfarm employment, payroll (mil.)	Aug.	09-06-85	98.0	3.5	2.4	3.3
Manufacturing	Aug.	09-06-85	19.4	2.3	-.7	-.8
Nonmanufacturing	Aug.	09-06-85	78.6	3.8	3.2	4.3
Private nonfarm:						
Average weekly hours (hr.)[1]	Aug.	09-06-85	35.1	35.0	35.1	35.2
Hourly earnings ($)[1]	Aug.	09-06-85	8.60	8.57	8.55	8.35
Manufacturing:						
Average weekly hours (hr.)[1]	Aug.	09-06-85	40.5	40.3	40.4	40.5
Unit labor cost (1967=100)	July	08-30-85	84.1	-7.1	-6.5	-5.2
Industrial production (1977=100)	Aug.	09-13-85	124.8	3.9	2.3	1.1
Consumer goods	Aug.	09-13-85	121.3	9.0	4.3	2.4
Business equipment	Aug.	09-13-85	140.7	2.6	-3.4	1.2
Defense & space equipment	Aug.	09-13-85	175.0	10.4	8.9	8.9
Materials	Aug.	09-13-85	114.5	2.1	1.1	-1.4
Consumer prices all items (1967=100)	Aug.	09-24-85	323.0	2.2	2.4	3.3
All items, excluding food & energy	Aug.	09-24-85	315.7	4.2	3.6	4.2
Food	Aug.	09-24-85	308.9	.4	.8	1.5
roducer prices: (1967=100)						
Finished goods	Aug.	09-13-85	293.5	-3.7	-1.0	.8
Intermediate materials, nonfood	Aug.	09-13-85	324.0	-.7	-3.1	-.5
Crude foodstuffs & feedstuffs	Aug.	09-13-85	218.6	-45.4	-20.5	-13.6
Personal income ($ bil.)[2]	Aug.	09-19-85	3,198.9	3.5	4.5	5.0
				(Not at annual rates)		
Mfgrs. new orders dur. goods ($ bil.)	Aug.	09-24-85	107.9	3.4	4.8	5.9
Capital goods industries	Aug.	09-24-85	38.0	4.7	10.6	9.1
Nondefense	Aug.	09-24-85	27.2	1.9	6.3	1.8
Defense	Aug.	09-24-85	10.8	12.5	23.0	33.4
Inventories to sales ratio:[1]						
Manufacturing and trade, total	July	09-24-85	1.37	1.39	1.36	1.35
Manufacturing	July	09-24-85	1.47	1.47	1.48	1.47
Trade	July	09-16-85	1.29	1.31	1.26	1.25
Ratio: Mfgrs.' durable goods inventories to unfilled orders[1]	July	09-16-85	.548	.550	.558	.529
Retail sales, total ($ bil.)	Aug.	09-13-85	116.1	1.9	1.1	8.1
GAF[3]	Aug.	09-13-85	25.1	1.7	-.4	6.9
Auto sales, total (mil. units.)[2]	Aug.	09-05-85	12.4	18.9	9.2	24.5
Domestic models	Aug.	09-05-85	9.5	27.0	11.9	26.1
Foreign models	Aug.	09-05-85	2.8	-1.9	1.0	19.6
Plant and equipment expen.[4]						
Total nonfarm business	1985	09-11-85	383.98	—	—	8.3
Manufacturing	1985	09-11-85	153.44	—	—	10.5
Nonmanufacturing	1985	09-11-85	230.54	—	—	6.9
pital appropriations	1985-Q2	09-23-85	28,605	-4.5	—	16.2
ousing starts, private (thous.)[2]	Aug.	09-18-85	1,749	6.2	4.0	10.0
Leading indicators (1967=100)	July	08-30-85	168.7	.4	1.1	2.9

1. Actual data used in lieu of percent changes for earlier periods.
2. At annual rates.
3. Excludes mail order houses.
4. ~~Planned-Commerce~~ July and August 1985 Survey.

Economic activity appears to have expanded moderately in the third quarter. Auto sales surged in August and September in response to financing programs aimed at reducing inventories of 1985 models. However, growth in most other components of aggregate demand has been sluggish in recent months. Industrial production was up a bit in August, but there were offseting downward revisions in the production data for the preceding three months. Virtually all measures of prices and wages show inflation remaining relatively quiescent.

Motor vehicles

Toward the end of the summer, final sales were boosted by a very rapid advance in consumer outlays for automobiles. These sales gains, however, mainly reflected manufacturers' attempts to liquidate inventories of 1985 models and may not translate into a significantly higher level of auto production in coming months. Moreover, while strong demand is stimulating production of light trucks, output of heavy-weight trucks appears likely to decline in response to weak demand.

Autos. In mid-August, U.S. auto manufacturers introduced financing incentives and rebates on a wide range of 1985 models. In effect, the concessions amounted to a reduction in finance rates from around 12 percent to about 7-1/2 to 7-3/4 percent; this is roughly equivalent to a price cut of a bit less than 10 percent. In response to the incentives, sales of domestic autos shot up to a 12-1/2 million unit annual rate in late August and were maintained close to that pace through the first 20 days of September. In addition, sales of foreign cars continued at the advanced 2.8 million unit rate that began in May with the loosening of the import restrictions for Japanese cars.

The financing programs do not include 1986 model cars, and it is possible that auto manufacturers hoped that an aggressive liquidation of 1985 inventories would help support higher sticker prices on the new models. Preliminary announcements by domestic producers for 1986 model cars indicate a 4 to 6 percent markup over 1985 model prices; this is equivalent to a 3 percent price increase for comparably-equipped 1986 model cars. Consumers therefore will face a sharp increase in the effective price of cars once the incentive programs end.

A significant proportion of new car sales in the fourth quarter of each year usually comprises carryovers from the previous model year. The effect of the incentive programs probably has been to shift much of this "carryover" demand for 1985 models into the third quarter, and producers undoubtedly expect a substantial "payback of borrowed demand" after the incentives end in early October. Fourth-quarter assembly plans have not been altered to any significant extent since the incentive programs were announced.

Trucks. Purchases of domestic light trucks including minivans--vehicles largely used by households--were at a 3.5 million unit rate in August, down from the record 3.9 million units reported in July. Sales of foreign trucks, which are virtually all light-duty models, also dropped from the record July pace. In part, these declines appear to have resulted from capacity constraints as well as from lingering supply problems stemming from the Teamsters' strike. Also, financing concessions

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

	1985						
	Q1	Q2	May	June	July	Aug.	Sept.
Total auto sales[1]	10.9	10.9	11.3	10.5	10.4	12.4	--
Imports	2.4	2.7	2.8	2.8	2.9	2.8	--
Domestic	8.5	8.3	8.5	7.7	7.5	9.5	12.1[2]
Domestic production	8.4	8.0	8.0	8.0	8.3	8.3	--
Domestic inventories	1.49	1.51	1.49	1.51	1.60	1.55	--
Days' supply[3]	55	56	54	60	66	50	--
Memorandum:							
Sales of domestic light-duty	3.7	3.5	3.4	3.6	3.9	3.5	--
Foreign truck sales[4]	.7	.8	.8	.7	1.0	.6	--

1. Components may not add to totals due to rounding.
2. First 20 days.
3. Days' supply for the quarter are based on end-of-quarter stocks and average sales for the quarter.
4. An estimated 99 percent are light trucks.

for many of the popular minicargo vans were less generous than those for cars. So far this year, sales of domestic light trucks have averaged more than 3-1/2 million units at an annual rate--up from 3-1/4 million units in 1984; sales of foreign models are up about one-fourth from their 1984 pace.

Heavy-weight trucks. The market for heavy-weight trucks used by businesses continued to weaken in August with sales at an annual rate of only 216,000 units--the lowest rate in two years. Assemblies of diesel units in August were reported to be down sharply from a year earlier, and officials at International Harvester and General Motors expect their output to continue to slip. Because the average transaction price for these vehicles is very high--around $70,000 for the cab and chassis and another $30,000 for the basic trailer--these units account for close to half of total expenditures for trucks but only about 10 percent of unit truck sales.

Industrial production

Industrial production increased 0.3 percent in August. However, estimates for the preceding three months were revised down, and the August level of output is slightly lower than that initially reported for July. For the first eight months of 1985 industrial production has increased at an annual rate of about 1-3/4 percent.

In August, the production of automotive products rose sharply, reflecting a spurt in the production of consumer trucks; output of domestic automobiles was unchanged, at 8.3 million units. There also were gains in August in the manufacture of home goods, as well as in the production of defense and space equipment and business equipment.

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

	1985 Q1	1985 Q2	1985 June	1985 July	1985 Aug.
	--Annual rate--		--Monthly rate--		
Total	2.1	1.3	.3	.0	.3
Final products	.4	3.4	.1	.0	.5
Consumer goods	.0	2.7	.5	-.2	.7
Durable	1.5	-3.5	1.0	-.7	2.7
Nondurable	-.2	4.7	.4	.0	.0
Business equipment	3.3	3.8	-.9	-.1	.2
Defense and space equipment	7.9	10.4	.9	.4	.9
Construction supplies	4.6	7.4	1.3	.4	.1
Materials	3.5	-3.1	.3	-.1	.1
Durable goods	-.2	-6.6	.4	.0	.4
Nondurable goods	.0	.7	.3	.8	.4
Energy materials	15.7	1.1	-.1	-1.2	-.7

CAPACITY UTILIZATION: MANUFACTURING AND MATERIALS
(Percent, seasonally adjusted)

	1982 low	1985 Q1	1985 Q2	1985 June	1985 July	1985 Aug.
Total industry	69.5	81.0	80.7	80.6	80.4	80.5
Manufacturing, total	68.0	80.5	80.3	80.2	80.0	80.2
Advanced processing	69.5	80.0	79.6	79.4	78.9	79.2
Motor vehicles	47.0	84.9	82.7	82.2	83.4	86.7
Primary processing	65.1	81.6	81.8	81.9	82.2	82.5
Materials, total	68.4	81.5	80.4	80.2	79.9	79.8
Durable goods materials	60.9	79.3	77.2	76.7	76.5	76.5
Metal materials	45.7	68.7	68.5	69.3	68.1	69.5
Nondurable goods materials	70.6	80.7	80.6	80.9	81.5	81.7
Energy materials	82.2	87.5	87.5	87.3	86.2	85.6

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

	1984	1985 H1	1985 June	1985 July	1985 Aug.
	- - - - Average monthly changes - - - -				
Nonfarm payroll employment[2]	327	230	52	249	288
Strike adjusted	329	225	65	240	322
Manufacturing	52	-34	-28	-43	37
Durable	45	-24	-26	-46	42
Nondurable	7	-11	-2	3	-5
Construction	29	28	-20	15	25
Trade	106	84	53	47	75
Finance and services	106	122	61	87	187
Total government	17	22	0	136	-11
Private nonfarm production workers	253	156	31	94	267
Manufacturing production workers	33	-40	-34	-27	35
Total employment[3]	270	16	-590	492	310
Nonagricultural	266	57	-416	505	343

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)

	1984	1985 H1	1985 June	1985 July	1985 Aug.
Civilian, 16 years and older	7.5	7.3	7.3	7.3	7.0
Teenagers	18.9	18.4	18.3	19.5	17.3
20-24 years old	11.4	11.2	11.2	11.2	10.7
Men, 25 years and older	5.7	5.4	5.6	5.4	5.2
Women, 25 years and older	6.0	6.1	6.1	5.9	5.9
White	6.5	6.3	6.5	6.4	6.2
Black	15.9	15.2	14.0	15.0	14.0
Fulltime workers	7.2	6.9	6.8	7.0	6.7
Memo:					
Total national[1]	7.4	7.2	7.2	7.2	6.9

1. Includes resident Armed Forces as employed.

Output of materials was little changed in August with slightly higher production of durable and nondurable goods offset by further reductions in the output of energy materials. The level of materials output in August was about 1-1/2 percent below the level of a year earlier.

Employment and unemployment

Both the household and payroll surveys reported employment gains of about 300,000 in August, and the civilian unemployment rate fell to 7 percent after no change over the past six months. Gains in the service industry led the August job increase, and hiring was brisk in trade, and in the finance, insurance, and real estate sectors. Employment in manufacturing also rose in August, although the July data were revised to show a sizable decline. The August advance is the first since January, but much of it occurred in transportation equipment, where the shift during recent years in the timing of model changeovers may have caused an overstatement of the seasonally-adjusted gain. Elsewhere, factory employment was little changed. Manufacturers also increased the factory workweek from 40.3 to 40.5 hours.

Personal income and consumption

Income growth has slowed markedly this year. Nominal personal income rose only 0.3 percent in August after gains of 0.4 percent in both June and July and a decline in May. Wages and salaries, have increased, on average, about 0.4 percent per month since the first quarter--roughly two-thirds of their growth rate during 1984. Interest income edged down in August for a fifth month to a level 1.3 percent below the peak returns received in September 1984. Farm income was lower for a fourth consecutive month; so far this year, the level of farm income has been about one-fourth below the already-depressed 1984 average.

As previously discussed, personal consumption in August was dominated by the enthusiastic response of consumers to interest and price concessions on domestic autos. There also was some rebound in sales of general merchandise in August; however, total spending for nondurable goods was little changed for a second month. Outlays for services expanded a bit faster than their relatively sluggish July pace.

With spending, particularly for durable goods, far outpacing income, the saving rate fell again in August to 2.8 percent--the lowest rate since 1947. However, there is reason for some skepticism about the very low level of the currently estimated saving rate, as past data revisions by the Bureau of Economic Analysis have tended to add more to income than to expenditures.

The consumer surveys of the Conference Board and the Michigan Research Survey Center (SRC) taken in August continued to drift somewhat lower relative to their 1983 peaks. Nonetheless, the level of the SRC index of sentiment is still historically high, and this index has not sustained such a long period of favorable readings--more than two years---since the 1960s. In addition, plans to purchase automobiles have remained historically high, and SRC respondents indicated a continued willingness to use credit.

Business fixed investment

Spending for business fixed investment, on balance, has decelerated in recent months. The average level of nondefense capital goods shipments

PERSONAL INCOME AND EXPENDITURES
(Based on seasonally adjusted data)

	1984	1985 Q1	1985 Q2	1985 June	1985 July	1985 Aug.
	- - Percentage changes at annual rates[1] - -					
Total Personal Income						
Nominal	9.2	6.3	4.0	4.6	5.3	3.5
Real[2]	5.8	3.0	1.0	-.2	4.2	--
Disposable Personal Income						
Nominal	8.9	1.6	11.2	-29.5	5.7	2.2
Real	5.6	-1.6	8.2	-34.3	4.4	--
Expenditures						
Nominal	7.5	8.6	7.8	2.3	4.8	14.9
Real	4.2	5.2	4.8	-2.5	3.6	--
	- - Changes in billions of dollars[3] - -					
Total personal income	21.0	14.8	6.5	12.0	14.0	9.2
Wages and salaries	11.4	9.9	8.7	12.7	2.2	11.5
Other income	10.6	8.5	-1.5	.2	11.9	-1.5
Interest	5.5	.2	-1.5	-1.4	.5	-.9
Farm proprietors'	.8	-2.8	-2.8	.0	-.5	-1.2
Disposable personal income	17.2	-5.8	19.7	-68.0	12.7	4.9
Expenditures	14.1	11.9	16.4	4.9	10.0	31.1
Durables	2.4	-.6	-.3	-8.8	2.8	21.9
Nondurables	4.3	1.6	4.4	-.8	1.8	1.7
Services	7.5	10.8	12.3	14.4	5.4	7.4
Personal saving rate (percent)	6.1	4.5	5.1	3.7	3.8	2.8

1. Changes over periods longer than one quarter 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.

RETAIL SALES
(Seasonally adjusted percentage change)

	1985			1985		
	Q1	Q2	Aug./Q2	June	July	Aug.
Total sales	1.6	2.7	1.3	-1.0	.2	1.9
(REAL)[1]	1.1	2.3	—	-1.0	.3	—
Total less automotive group, nonconsumer stores, and gasoline stations	1.1	1.3	-.2	-.8	.1	.3
GAF[2]	1.1	1.5	.3	-1.8	-.3	1.7
Durable	2.5	4.3	3.1	-1.7	.4	4.0
Automotive group	4.4	5.6	6.0	-1.2	-.1	7.1
Furniture and appliances	1.1	2.0	-1.6	-3.6	-.6	-.3
Nondurable	1.1	1.7	.2	-.6	.0	.7
Apparel	1.1	3.3	-.8	-.5	-1.5	1.0
Food	1.3	1.4	-1.0	.3	-.2	-.8
General merchandise[3]	1.0	.6	1.7	-1.6	.4	2.9
Gasoline stations	-.6	5.1	-.2	-1.4	-.8	1.7

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.

in July and August was up a bit from the second-quarter average, extending the pattern of virtually flat shipments of the past half-year. As noted earlier, sales of heavy-weight trucks have weakened substantially, falling about 12 percent in both July and August. In addition, imports of capital goods, which figured importantly in capital spending earlier in the expansion, have declined since the spring.

Investment in nonresidential structures has been curtailed in the past few months, with the July level of spending 1-3/4 percent below the second-quarter average. The value of nonresidential construction put in place edged up 0.2 percent in July after a 2.3 percent drop in June. All of the major components of nonresidential construction have been flat or have posted declines in spending since April.

Indicators of future business investment have been sluggish. New orders for nondefense capital goods, while up in August, have been essentially flat for more than a year. Moreover, the Commerce Department survey of planned capital spending that was taken in July and August indicated an increase in nominal outlays of 8.3 percent for 1985, about 1 percentage point less than respondents expected in the spring survey.

Inventories

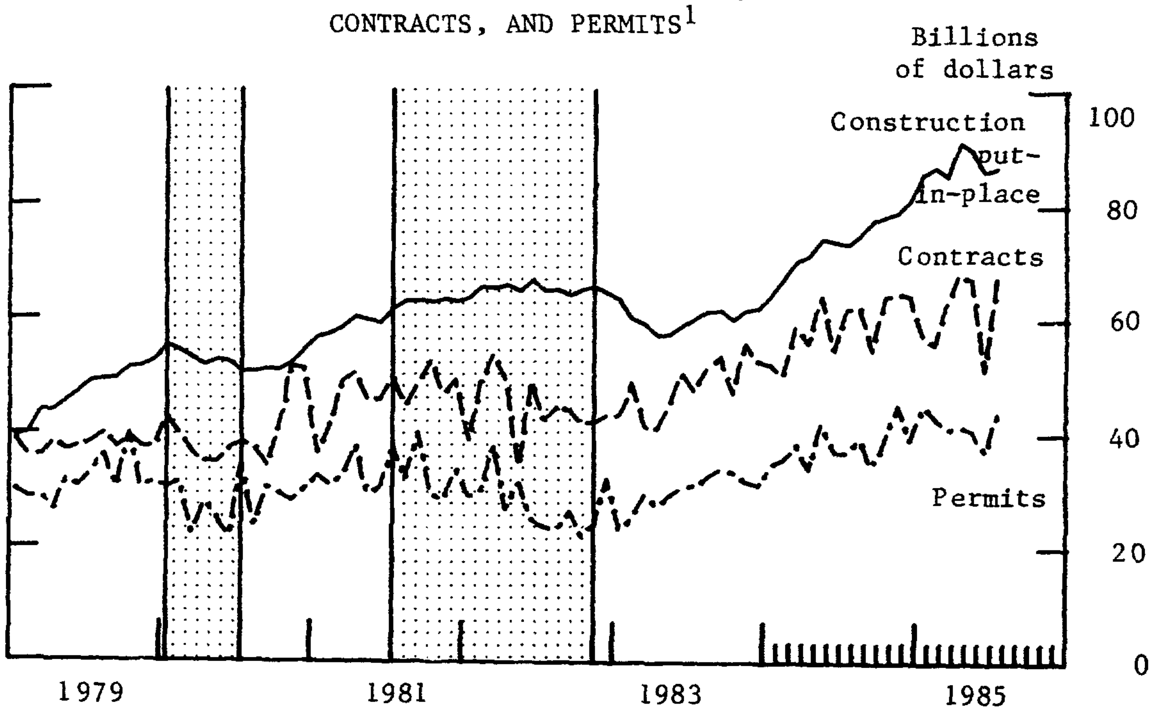
On the whole, businesses appear content with their current inventory levels. Since the beginning of this year, the inventory-sales ratio for manufacturing and trade has remained quite stable at around 1.55, based on constant-dollar data; at the end of July, stocks were only moderately higher than at the end of the first quarter.

At the manufacturing level, inventories have changed little since last fall. By stage of processing, manufacturers' stocks of raw materials

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

	1984	1985				
	Q4	Q1	Q2	June	July	Aug.
Producers' durable equipment						
Nondefense capital goods						
Shipments	3.2	-3.5	2.6	2.5	-1.6	1.7
Orders	-4.0	1.7	-1.6	9.3	-4.6	1.9
Unfilled orders	-2.3	.7	-1.7	.4	-.3	-.2
Imports of capital goods excluding autos	-16.0	10.7	-2.5	.7	-7.9	--
Exports of capital goods excluding autos	2.2	4.4	-5.5	-1.1	-.9	--
Sales of heavy-weight trucks (thousands of units, A.R.)	316	312	276	278	246	216
Nonresidential structures						
Nonresidential construction	4.1	8.2	2.6	-2.3	.2	--
Commercial building	7.9	11.1	1.5	-3.5	.6	--
Office	8.3	9.3	2.0	-2.0	3.6	--
Other commercial	7.4	13.3	.9	-5.1	-2.8	--
Industrial building	3.2	5.0	7.1	-7.6	2.0	--

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	May	June[r]	July[p]
Book Value Basis:						
Total	31.8	21.3	3.6	-29.0	22.6	-.3
Manufacturing	4.7	1.8	-2.0	-13.8	9.3	-7.7
Wholesale	6.4	6.6	6.5	.6	17.6	6.2
Retail	20.7	12.9	-.9	-15.8	-4.3	1.1
Automotive	11.7	8.7	-1.3	-16.4	5.2	-12.3
Ex. auto	9.0	4.1	.4	.6	-9.5	13.4
Constant Dollar Basis:						
Total	11.5	15.0	3.1	-7.7	8.2	4.8
Manufacturing	-.1	2.1	.5	-5.1	4.9	3.1
Wholesale	3.5	2.8	3.5	2.2	5.7	-.3
Retail	8.1	10.1	-1.0	-4.8	-2.4	2.0
Automotive	5.0	6.2	-.6	-5.2	2.2	-4.7
Ex. auto	3.1	3.9	-.4	.3	-4.6	6.6

INVENTORIES RELATIVE TO SALES[1]

	Cyclical Reference Points[2]		1984	1985				
	81 low	82 high	Q4	Q1	Q2	May	June[r]	July[p]
Book Value Basis:								
Total	1.39	1.53	1.37	1.38	1.37	1.35	1.39	1.37
Manufacturing	1.60	1.77	1.48	1.48	1.47	1.46	1.47	1.47
Wholesale	1.06	1.28	1.16	1.17	1.17	1.13	1.22	1.19
Retail	1.36	1.43	1.41	1.42	1.38	1.38	1.39	1.39
Automotive	1.59	1.88	1.51	1.54	1.45	1.42	1.46	1.42
Ex. auto	1.29	1.35	1.39	1.39	1.36	1.37	1.37	1.38
Constant Dollar Basis:								
Total	1.62	1.75	1.55	1.56	1.55	1.53	1.57	1.56
Manufacturing	1.91	2.11	1.77	1.78	1.78	1.76	1.78	1.78
Wholesale	1.34	1.52	1.37	1.38	1.38	1.34	1.43	1.39
Retail	1.34	1.44	1.36	1.38	1.35	1.35	1.36	1.35
Automotive	1.49	1.81	1.40	1.47	1.39	1.35	1.40	1.36
Ex. auto	1.28	1.37	1.35	1.36	1.34	1.35	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.

and supplies have drifted lower, reflecting longer-term adjustment in the production of basic metals and generally conservative production scheduling in the face of an uncertain sales outlook.

Investment in trade inventories also has been slow in recent months. Despite the high volume of imports, real wholesale inventories have expanded at an average annual rate of only $6-1/2 billion this year, about half the rate of growth during 1984. In the retail sector, apparel and general merchandise stocks were a bit high relative to sales through early summer. However, general merchandisers have pared stocks in recent months, and the sharp gain in sales in August may have pulled supplies down further.

Housing markets

Sales of new homes were up about 1 percent in July to a level about 5 percent above the average for the first half, and sales of existing homes recorded a sharp advance in August. In contrast, single-family housing starts, at a 1.07 million unit rate in August, have been on a plateau during the past three months. Starts of multi-family units have continued to be quite buoyant.

The recent levels of single-family housing starts and, to some extent, new home sales have been disappointing in view of historical relationships between mortgage interest rates and housing activity. While additional response to the lower rates still is expected, that response may be tempered somewhat by other, nonrate influences--in particular, higher premiums for private mortgage insurance and tighter qualification standards for mortgages with high loan-to-value ratios.

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

	1984		1985				
	Annual	Q4	Q1	Q2	June	July	Aug.[1]
All units							
Permits	1.68	1.56	1.67	1.73	1.71	1.69	1.75
Starts	1.75	1.60	1.80	1.77	1.70	1.65	1.75
Single-family units							
Permits	.92	.84	.94	.95	.96	.97	.98
Starts	1.08	1.05	1.12	1.08	1.03	1.06	1.07
Sales							
New homes	.64	.62	.67	.67	.69	.70	n.a.
Existing homes	2.87	2.81	2.97	3.05	3.06	3.14	3.43
Multifamily units							
Permits	.76	.73	.73	.78	.75	.73	.78
Starts	.67	.55	.67	.70	.67	.59	.68
Mobile home shipments	.30	.29	.28	.28	.27	.29	n.a.

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

Agriculture

High production and weak demand continue to depress commodity prices and farm income. Owing to favorable weather through late summer, crops this year are expected to be close to the previous 1981-82 highs. Output of feed grains may be the largest ever, and production of cotton and oil crops also is expected to increase this year. Wheat production, though down a bit this year, is still above consumption, making for further growth in the ample stockpile of this grain.

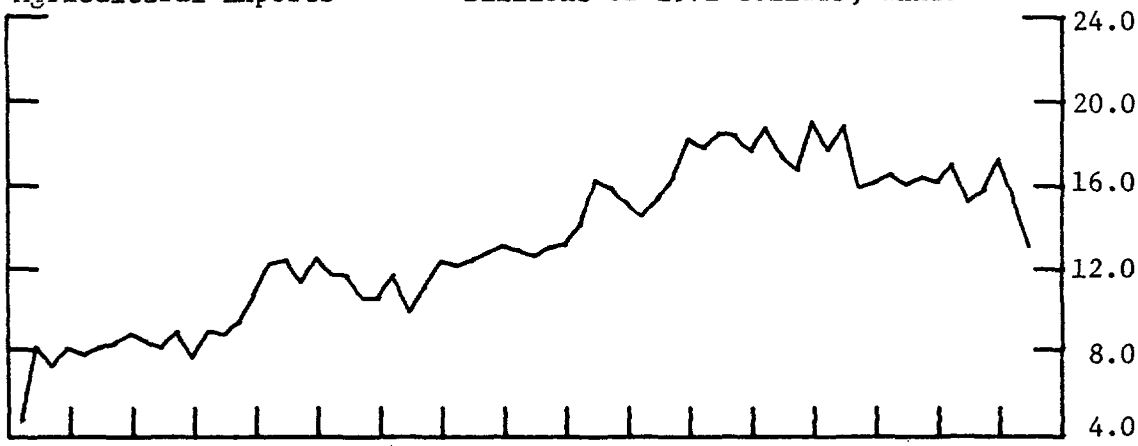
Agricultural exports have continued to decline this year, dropping in the first half of 1985 to the lowest level of any half-year period since 1977. A further decline was reported in July. This low volume of exports reflects weak foreign consumption of grain relative to the trend of the 1960s and 1970s, and higher foreign production of grain. For the year ahead, the USDA projects that world grain trade will be at the lower end of the range of recent years, and that the market share of the United States will be the smallest since the early 1970s.

Farm prices have declined almost without interruption since the start of the year. The producer price index for crude foods fell 3.8 percent in August, and the index of prices received by farmers dropped about 3 percent to the lowest level since 1978. The buildup in grain stocks has pushed cash prices for wheat and corn well below the floors established by government support programs (some output is not eligible for support); opportunities for forward pricing are limited by depressed futures prices. Livestock prices also have plummeted recently, pressured in part by a large sell-off of cattle herds; in mid-September, the spot

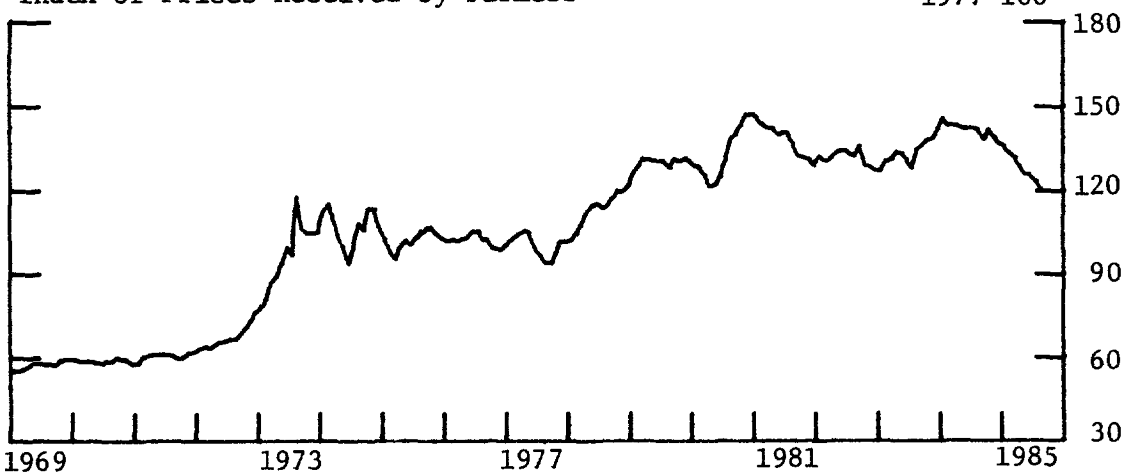
AGRICULTURE

USDA Index of Crop Production 1977=100

Agricultural Exports Billions of 1972 dollars, annual rate



Index of Prices Received by Farmers* 1977=100



* Seasonally adjusted by Federal Reserve staff.

price of choice steers at Omaha (a benchmark indicator of cattle prices) dipped below $50 for the first time in seven years, before turning up in late September.

Depressed farm prices have cut farm cash receipts and prompted further belt tightening among producers. Current operating expenses, in nominal terms, have been held essentially flat during the 1980s. In addition, nominal capital spending fell in each of the past five years and, according to USDA projections, will be down further in 1985. But even with these adjustments and considerable government aid, net cash flow to the farm sector this year probably will be no higher than the depressed 1984 receipts.

Government programs continue to provide a significant portion of farm income. With agricultural prices well below the "target prices" that trigger cash subsidies, government payments to farmers this year are likely to remain in the high range of the past two years. In addition, cash is flowing to the farm sector from a shift of stocks to the Commodity Credit Corporation. At mid-year, the volume of commodities owned or financed by the CCC was about $1 billion above 1984 levels; most observers expect CCC stockpiling to accelerate in the second half of this year.

Federal sector

For fiscal 1985 as a whole, the unified deficit will total about $200 billion ($210 billion including off-budget); this is an increase of $25 billion over the 1984 budget year. Receipts are expected to be nearly $70 billion higher, largely because of rising nominal incomes, but outlays are anticipated to increase even more ($95 billion). Spending increases have been particularly large for agricultural supports, defense, and interest.

Defense spending, in real terms on an NIPA basis, rose at a 7-1/4 percent annual rate in the second quarter and apparently a bit more rapidly in the third quarter. Despite smaller increases in defense appropriations in the last two years, orders for defense goods and other advance indicators suggest that defense spending will continue to show growth through the end of the year.

Action on the fiscal 1986 budget is now largely focused on the appropriation process in Congress. Thus far, nine of the 13 appropriation bills have passed the House, but only two have been passed by the Senate; none of the bills has been enacted. In addition, legislation cutting spending and raising revenues as mandated in the Congressional Budget Resolution must be reported to the budget committees by the end of this month. Meanwhile, in the Mid-session Review, the administration accepted the defense compromises of the Congressional Budget Resolution but restated most of the the Administration's February proposals for cuts in nondefense programs. This suggests further compromise between the executive branch and Congress will be necessary.

State and local sector

After picking up in the second quarter, outlays in the state and local sector continued to advance at a brisk pace in the third quarter. Employment in July and August, on average, was 135,000 above the second quarter. Real outlays for construction in July stood more than 5-1/2 percent above the average of the preceding three months. The substantial advances in state and local expenditures were largely financed by the continued strong marketing of long-term, tax-exempt securities.

The fiscal position of the sector appears weaker than in 1984. The combined operating and capital account surplus was down to $4-1/2 billion in the second quarter from $11 billion at year end. The surplus may drop lower in coming months as a result of significant tax cuts passed by eight states for fiscal 1986. While tax increases in recent legislative sessions have been numerous, many will be quite small because they are largely limited to cigarettes, alcohol, and fuel; large tax increases occurred in only five states.

Exports and imports

The merchandise trade deficit fell in July to $117 billion (annual rate), about 10 percent below the second-quarter average. The shrinkage of the deficit in July was attributable to a drop in the highly-volatile series on imports that was only partly offset by a moderate decline in exports. On average, for the four-month period ending in July, the value of imports was very much the same as in the first-quarter. For exports, much of the drop in July was in agricultural commodities; the value of nonagricultural exports was about the same as the second-quarter average.

Despite the falling exchange value of the dollar, prices of non-oil imports in both June and July continued downward and were about 1 percent lower than in the first quarter. The price of imported oil in July was about 75 cents per barrel less than in June and only a bit above the average of the second quarter. (Further discussion of international developments is included in section IV.)

Prices, wages, and productivity

Incoming wage and price data suggest that inflation remains generally moderate. Consumer prices have risen 0.2 percent in each of the last four months since last April, while producer prices of finished goods are up only slightly so far this year.

As discussed in more detail in the agricultural section, farm prices have declined since the beginning of the year, and developments in agricultural commodity markets suggest a further drop in September. At the consumer level, there have been monthly fluctuations, but on balance food prices have risen very little since December.

The CPI energy component, which spurted briefly in March and April has moved lower in recent months. Moreover, the outlook for world crude oil prices suggests sustained downward pressures over the near term.

Outside the food and energy areas, consumer prices have risen at a 0.3 percent monthly pace since the first quarter. After a runup in the first quarter, prices of goods other than food and energy on average have declined. Although swings in used car prices accounted for much of this pattern, low-priced imports--such as television sets---also have been a factor. Prices of services, in contrast, have risen recently at a 0.5 percent monthly rate, above their pace earlier this year; higher rents and telephone charges account for the pickup in the service component.

At the producer level, prices of capital equipment have risen slowly since the first quarter and are only 2 percent above a year earlier. Prices of intermediate materials, less food and energy, have been relatively flat for about a year.

So far in 1985, wages in the private nonfarm economy have continued to advance at the moderate rates of 1984. The hourly earnings index for production and nonsupervisory workers was unchanged in August after a small decline the month before; this measure has risen about 3 percent over the past 12 months. In manufacturing, wage increases have diminished from their higher rates early this year. Outside of manufacturing, wage adjustments remain small.

Revised data show productivity in the nonfarm business sector rising 1 percent at an annual rate in the second quarter of 1985, after a 3.1 percent decline in the first quarter. Over the past four quarters, productivity has been essentially flat; thus, the moderate increases in compensation per hour were completely passed through into unit labor costs, which are now measured to be 4-1/4 percent above a year earlier.

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

	Relative Importance Dec. 1984	1984	1985 Q1	1985 Q2	1985 July	1985 Aug.
			-Annual rate-		-Monthly rate-	
All items[2]	100.0	4.0	4.1	3.3	.2	.2
Food	18.7	3.8	2.6	-.9	.1	.0
Energy	11.5	.2	-.8	9.6	-.3	-.6
All items less food and energy	69.8	4.7	5.5	3.4	.3	.3
Commodities	26.3	3.1	6.6	-1.4	-.2	.1
Services	43.5	5.6	5.0	6.4	.5	.5
Memorandum:						
CPI-W[3]	100.0	3.5	4.0	3.1	.1	.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. 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	1984	1985 Q1	1985 Q2	1985 July	1985 Aug.
			-Annual rate-		-Monthly rate-	
Finished Goods	100.0	1.7	.5	1.5	.3	-.3
Consumer foods	24.4	3.5	-3.0	-8.2	1.3	-.7
Consumer energy	11.5	-4.1	-21.3	25.9	-1.4	-1.6
Other consumer goods	42.4	2.2	6.5	1.3	.4	.0
Capital equipment	21.6	1.8	6.2	1.9	.0	.2
Intermediate materials[2]	95.1	1.7	-2.5	1.1	-.3	-.1
Exc. energy	80.1	2.1	-1.0	1.2	-.1	-.1
Crude food materials	53.0	-1.2	-24.9	-19.9	-1.1	-3.8
Crude energy	31.7	-1.3	-13.1	2.9	-.3	-.9
Other crude materials	15.4	-3.4	-13.3	3.4	.7	-1.2

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

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

	1984	1984 H2	1985 Q1	1985 Q2	1985 June	1985 July	1985 Aug.
		--Annual rate--			--Monthly rate--		
Total private nonfarm	3.1	2.8	3.5	3.2	.5	-.1	.0
Manufacturing	3.3	3.1	5.2	3.5	.1	.2	.2
Durable	3.1	2.7	5.9	3.4	.0	.4	.3
Nondurable	3.7	3.8	4.0	3.8	.2	.0	.1
Contract construction	1.3	-.1	5.2	-.1	-.5	-.1	-.4
Transportation and public utilities	2.9	2.5	2.7	2.9	1.0	-.2	-.8
Finance, Insurance, and Real Estate	3.6	3.0	5.4	2.5	1.3	-.9	.0
Total trade	2.6	2.5	1.8	2.1	.1	.0	.0
Services	4.0	3.9	2.1	5.7	1.3	-.4	.2

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

III-T-1

SELECTED FINANCIAL MARKET QUOTATIONS[1]

(Percent)

	1982/1983 Cyclical low	1984 Highs	1985 March highs	1985 June lows	1985 FOMC Aug.	1985 Sept. 24	Change from: 1984 highs	Change from: FOMC Aug.
Short-term rates								
Federal funds[2]	8.46	11.63	8.58	7.38	7.92	7.89	-3.74	-.03
Treasury bills[3]								
3-month	7.08	10.67	8.80	6.66	7.12	6.84	-3.83	-.28
6-month	7.62	10.77	9.13	6.81	7.29	7.05	-3.72	-.24
1-year	7.73	11.13	9.25	6.98	7.43	7.36	-3.77	-.07
Commercial paper								
1-month	8.00	11.42	8.94	6.95	7.70	7.75	-3.67	.05
3-month	7.97	11.35	9.12	7.01	7.70	7.75	-3.60	.05
Large negotiable CDs[3]								
1-month	8.08	11.52	8.89	7.09	7.78	7.81	-3.71	.03
3-month	8.12	11.79	9.29	7.18	7.82	7.86	-3.93	.04
6-month	8.20	12.30	9.92	7.30	7.94	7.90	-4.40	-.04
Eurodollar deposits[4]								
1-month	8.68	11.89	8.89	7.45	7.89	8.10	-3.79	.21
3-month	8.71	12.20	9.58	7.50	7.99	8.23	-3.97	.24
Bank prime rate	10.50	13.00	10.50	9.50	9.50	9.50	-3.50	--
easury bill futures								
Dec. 1985 contract			10.30	7.12	7.30	7.04	--	-.26
Mar. 1986 contract			10.58	7.47	7.64	7.39	--	-.25
Intermediate- and long-term rates								
U.S. Treasury (constant maturity)								
3-year	9.33	13.49	11.22	8.73	9.20	9.22	-4.27	.02
10-year	10.12	13.99	12.02	9.83	10.20	10.33	-3.66	.13
30-year	10.27	13.94	11.97	10.23	10.48	10.62	-3.32	.14
Municipal revenue (Bond Buyer index)	9.21	11.44	10.25	9.10	9.47[5]	9.69[5]	-1.75	.22
Corporate--A utility Recently offered	11.64	15.30	13.23	11.50	11.73e	11.90e	-3.40	.17
Home mortgage rates								
S&L fixed-rate	12.55	14.68	13.29	12.05	12.24[6]	12.21[6]	-2.47	-.03
S&L ARM, 1-yr.	n.a.	12.31	11.14	9.83	9.47[6]	9.51[6]	-2.80	.04

	1983 Highs	1984 Lows	1985 Highs	1985 FOMC Aug.	1985 Sept. 24	Percent change from: 1984 lows	Percent change from: FOMC Aug.
Stock prices							
Dow-Jones Industrial	1287.20	1086.57	1359.54	1323.70	1321.12	21.6	-0.2
NYSE Composite	99.63	85.13	113.49	108.92	105.60	24.0	-3.0
AMEX Composite	249.03	187.16	237.49	231.84	224.01	19.7	-3.4
NASDAQ (OTC)	328.91	225.30	307.77	296.36	284.12	26.1	-4.1

1. One-day quotes except as noted.
verages for two-week reserve maintenance period est to date shown. Last observation is the average-to-date for the maintenance period ending September 25, 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

The monetary aggregates surged in August, again paced by strength in the more liquid types of deposits. M1 diverged further from its long-run target range and boosted M2 to the top of the parallel band associated with its 1985 target. Growth in nontransactions M2 was unchanged from July, and a preference for shorter-term assets remained evident, with savings deposits and MMDAs once again increasing rapidly and small time deposits decreasing further. M3 growth also rose in August as the decline in the M3-only component abated. Data for early September suggest some deceleration in M1 and M2, but a step-up in M3 growth.

In the early part of the intermeeting period, interest rates were subject to upward pressure as the market reacted to the rapid money growth and to economic data that were stronger than generally expected. More recently, however, market rates have declined after publication of some disappointing economic indicators, and short-term rates fell further after the announcement last weekend of a five-nation program to temper the dollar's exchange rate. On net, private money market rates are about unchanged over the period, but Treasury bill rates are somewhat lower--partly because of a paydown of bills related to debt ceiling problems. Long-term bond yields are a bit higher, with comparatively large increases for municipal securities, while commitment rates on home loans are little changed.

Spreads between Treasury rates and those on obligations of some federal agencies have widened over the period, owing mainly to heightened concern about the financial condition of the Farm Credit System. Problems related to EPIC, a real estate investment firm, had a more limited impact, affecting only a narrow segment of the mortgage-backed securities market.

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

	1983:Q4 to 1984:Q4	1985 Q1	1985 Q2	1985 June	1985 July	1985 Aug.p	Growth from Q4 1984 to Aug. 1985p
	------- Percentage change at annual rates ------						
1. M1	5.2	10.6	10.2	19.8	9.3	20.5	12.6 (16.1)[2]
2. M2	7.7	12.0	5.3	13.8	8.5	11.2	9.5
3. M3	10.4	10.7	5.2	10.5	4.2	8.6	7.9
							Levels in billions of dollars Aug. 1985p
Selected components							
4. Currency	7.2	6.3	6.7	10.3	6.6	12.3	167.1
5. Demand deposits	1.1	7.0	8.6	23.0	0.9	14.7	264.1
6. Other checkable deposits	10.5	21.1	16.1	22.9	24.7	38.1	168.8
7. M2 minus M1[3]	8.6	12.5	3.7	11.9	8.2	8.2	1907.4
8. Overnight RPs and Eurodollars, NSA	7.3	64.7	-29.9	-18.8	-11.5	71.5	65.8
9. General purpose and broker/dealer money market mutual fund shares, NSA	17.0	32.7	-0.7	22.3	2.7	6.1	176.7
10. Commercial banks	8.1	13.6	9.3	16.8	6.7	2.2	826.1
11. Savings deposits, SA, plus MMDAs, NSA[4]	5.2	29.2	11.8	30.1	19.6	15.7	441.9
12. Small time deposits	11.1	-1.8	6.5	2.2	-7.1	-13.3	384.1
13. Thrift institutions	7.3	7.9	6.5	7.0	3.6	0.9	844.5
14. Savings deposits, SA, plus MMDAs, NSA[4]	-3.6	17.8	10.5	12.6	20.6	22.0	350.1
15. Small time deposits	15.5	1.7	4.0	3.3	-7.9	-13.9	494.4
16. M3 minus M2[5]	22.1	5.5	4.8	-1.9	-12.6	-1.3	622.7
17. Large time deposits	26.0	9.0	6.4	-11.2	-11.3	4.3	421.7
18. At commercial banks, net[6]	16.0	2.6	8.3	-19.4	-7.6	9.0	268.0
19. At thrift institutions	48.8	21.0	2.6	2.3	-16.9	-3.9	153.7
20. Institution-only money market mutual fund shares, NSA	33.6	31.2	7.7	68.0	-41.1	-35.2	62.9
21. Term RPs, NSA	45.6	-19.5	16.2	-33.1	-37.7	27.8	66.3
22. Term Eurodollars, NSA	-8.3	2.4	-12.1	-37.1	-33.7	-11.0	75.4
	-- Average monthly change in billions of dollars --						
MEMORANDA:							
23. Managed liabilities at commercial banks (24+25)	4.7	4.1	-2.5	-3.9	-7.6	6.1	437.8
24. Large time deposits, gross	3.2	1.4	-1.0	-4.4	-3.6	1.8	325.0
25. Nondeposit funds	1.5	2.7	-1.5	0.5	-4.0	4.3	112.8
26. Net due to related foreign institutions, NSA	0.9	0.6	-1.3	-4.2	-4.3	7.2	-31.3
27. Other[7]	0.5	2.2	-0.2	4.7	0.2	-2.8	144.1
28. U.S. government deposits at commercial banks[8]	0.2	-1.4	1.9	-5.2	7.5	-8.2	16.7

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. 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 July and August 1985 at rates of 12.8 percent and 9.7 percent respectively. At thrift institutions, savings deposits excluding MMDAs increased during July and August 1985 at rates of 18.3 percent and 22.9 percent respectively.
5. The non-M2 component of M3 is seasonally adjusted as a whole.
6. Net of large-denomination time deposits held by money market mutual funds and thrift institutions.
7. Consists of borrowings from other than commercial banks in the form of federal funds purchased, securities sold under agreements to repurchase, and other liabilities for borrowed money (including borrowings from the Federal Reserve and unaffiliated foreign banks, loan RPs and other minor items). Data are partially estimated.
8. Consists of Treasury demand deposits and note balances at commercial banks.
p--preliminary.

Debt growth appears to have continued brisk in August, as many borrowers were taking on long-term debt at the same time that depositors were shifting toward more liquid assets. Gross corporate bond issuance was especially heavy in August, before moderating in September. Boosted by a large volume of refunding bonds, offerings of tax-exempt securities remained substantial in August and September. Similarly, issuance of federally related mortgage-backed securities has continued strong. By contrast, Treasury borrowing slackened somewhat in August, and a binding debt ceiling limited borrowing in September. Consumer credit expansion appears to have slowed in the summer from its earlier elevated pace, but was likely boosted around the end of August when sales of new cars soared in response to concessionary loan rates at finance companies.

Monetary Aggregates and Bank Credit

M1 jumped at more than a 20 percent clip last month as double-digit growth in demand deposits resumed, and other checkable deposits accelerated to a 38 percent annual rate, the most rapid increase in 2-1/2 years. From their authorization in January 1983, Super NOW accounts generally had dominated inflows to other checkable deposits. Since last May, however, 60 percent of the increase in not seasonally adjusted OCD has been in regular NOWs. The opportunity cost of regular NOWs over this period was lower than at any time since this account was authorized nationwide at the end of 1980.

The August increase lifted M1 further above its 3 to 8 percent target range, and with partial data for September suggesting still rapid, albeit slower growth, an even larger rate of decline in M1 velocity in the third quarter than over the first half is virtually assured. Statistical

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	June	July	Aug.	Levels in bil. of dollars Aug.p
	------ Commercial Bank Credit ------						
1. Total loans and securities at banks	9.8	10.3	9.1	9.3	10.1	6.9	1824.7
2. Securities	0.2	5.5	7.3	9.1	15.8	7.5	419.1
3. U.S. government securities	3.4	10.3	-0.4	3.2	19.8	-0.4	270.9
4. Other securities	-5.6	-3.4	16.7	20.3	8.3	22.3	148.2
5. Total loans	12.8	11.7	10.3	9.3	8.5	6.7	1405.6
6. Business loans	7.8	10.2	3.2	0.7	1.5	3.7	485.7
7. Security loans	37.5	16.5	87.8	80.0	9.0	-107.2	36.7
8. Real estate loans	12.1	10.9	12.0	11.0	12.1	11.4	405.2
9. Consumer loans	16.1	17.4	14.7	12.5	15.0	10.9	277.4
	------ Short- and Intermediate-Term Business Credit ------						
10. Business loans net of bankers acceptances	7.9	9.3	3.7	0.8	0.2	3.7	482.0
11. Loans at foreign branches[2]	26.0	-46.9	23.3	63.8	-12.1	-49.0	18.8
12. Sum of lines 10 & 11	8.7	6.8	4.3	2.6	0.0	1.7	500.8
13. Commercial paper issued by nonfinancial firms[3]	51.2	-6.0	33.8	14.0	0.0	43.0	81.0
14. Sum of lines 12 & 13	13.7	5.1	8.0	4.2	0.0	7.3	581.8
15. Bankers acceptances: U.S. trade related[4,5]	-6.5	-5.5	-12.2	-10.2	-27.4	-7.0	34.0
16. Line 14 plus bankers acceptances: U.S. trade related	12.4	4.4	6.8	3.3	-1.6	6.4	615.8
17. Finance company loans to business[4]	23.2	21.4	8.0	5.1	3.4	n.a.	143.2 (July)
18. Total short- and intermediate-term business credit (sum of lines 16 & 17)	14.4	7.5	7.1	3.7	-0.5	n.a.	755.8 (July)

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. Consists of acceptances that finance U.S. imports, U.S. exports and domestic shipment and storage of goods.

estimates of the historical relationship between M1 and income and interest rates fail to explain the prodigious expansion of M1 so far in 1985, especially in the third quarter. Yet staff inquiries of depository institutions and businesses have uncovered no evidence that any widespread factors other than lower interest rates--operating via both opportunity cost and compensating balance channels--have contributed importantly to M1 growth. It is plausible, as some market sources have suggested, that the strength in M1 and other liquid deposits partly reflects a widely held expectation--or hope--among savers that rates on term accounts will rebound; many of these individuals may be hesitant to roll over maturing time deposits, especially if those deposits had carried returns well into double digits.

The pickup of M2 growth in August, to an annual rate of 11-1/4 percent, is attributable to the acceleration of M1. Nontransactions M2 growth was unchanged last month as the sharp decline in small time deposits left growth in retail deposits weaker, about offsetting a swing from contraction to expansion in overnight RPs and Eurodollars. The rise in overnight RPs apparently was related to a midmonth rise in Treasury securities holdings of large banks in their trading accounts, coinciding with the midquarter financing.

M3 expanded at an 8-1/2 percent annual rate last month, about twice the July pace. Contributing to the acceleration was an increase in large time deposits after two months of significant declines. In August, thrift institutions reduced the rate at which they ran off large time deposits, and commercial banks were net issuers for the first time in three months. Banks' demands for managed liabilities were boosted during the month by an

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

	1984	1985					
	Year	Q1	Q2p	Q3e	Julyp	Aug.p	Sept.e
Corporate securities - total[1]	9.88	12.32	16.81	15.23	14.05	18.83	12.80
Public offerings in U.S.	8.00	9.35	14.55	12.50	11.90	14.80	10.80
Stocks--total[2]	1.89	2.21	3.14	3.17	3.20	3.50	2.80
Nonfinancial	1.08	1.12	1.84	1.45	1.45	1.70	1.20
Utility	.22	.43	.48	.17	.20	.20	.10
Industrial	.86	.70	1.36	1.28	1.25	1.50	1.10
Financial	.81	1.08	1.30	1.72	1.75	1.80	1.60
Bonds--total[1]	6.11	7.14	11.41	9.33	8.70	11.30	8.00
By industry							
Nonfinancial	2.80	4.14	5.78	4.85	4.95	5.85	3.75
Utility	.87	.79	1.35	1.57	.60	2.60	1.50
Industrial	1.93	3.35	4.43	3.28	4.35	3.25	2.25
Financial	3.31	3.00	5.63	4.48	3.75	5.45	4.25
By quality[3]							
Aaa and Aa	1.85	1.23	2.70	2.45	3.20	2.85	1.30
A and Baa	2.11	3.97	5.33	3.58	2.30	4.80	3.65
Less than Baa	1.09	.94	1.65	1.35	1.55	1.40	1.10
No rating (or unknown)	.25	.27	.46	.38	.35	.55	.25
Memo items:							
Equity based bonds[4]	.63	.46	1.10	.77	1.00	1.10	.20
Mortgage-backed bonds	.81	.73	1.27	1.57	1.30	1.70	1.70
Variable-rate notes	.72	.99	1.50	.36	.31	.66	.10
Bonds sold abroad - total	1.88	2.98	2.26	2.73	2.15	4.03	2.00
Nonfinancial	.84	1.06	1.01	1.07	1.10	1.40	.70
Financial	1.04	1.92	1.25	1.66	1.05	2.63	1.30

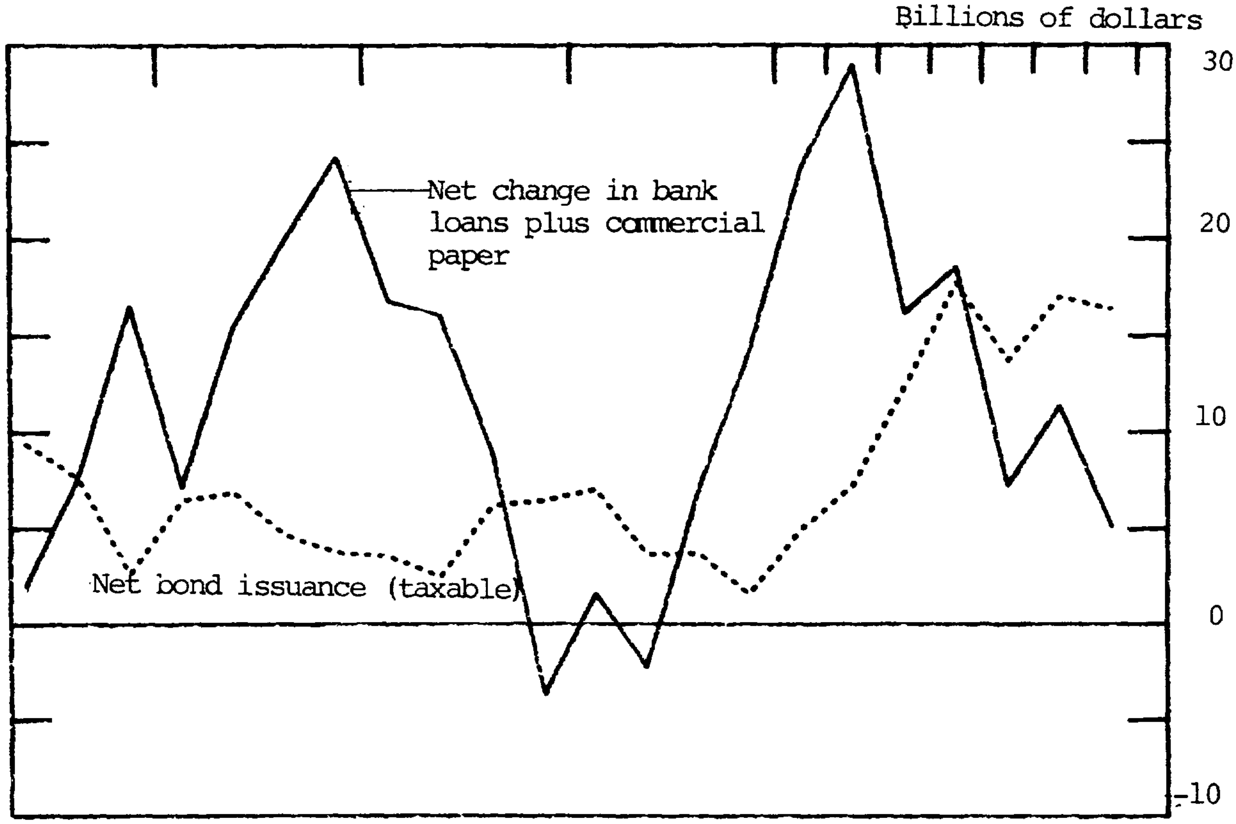
p--preliminary. e--staff estimate.
1. Securities issued in the private placement market are not included. Total reflects gross proceeds rather than par value of original discount bonds.
2. Includes equity issues associated with debt/equity swaps.
3. Bonds categorized according to Moody's bond ratings.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

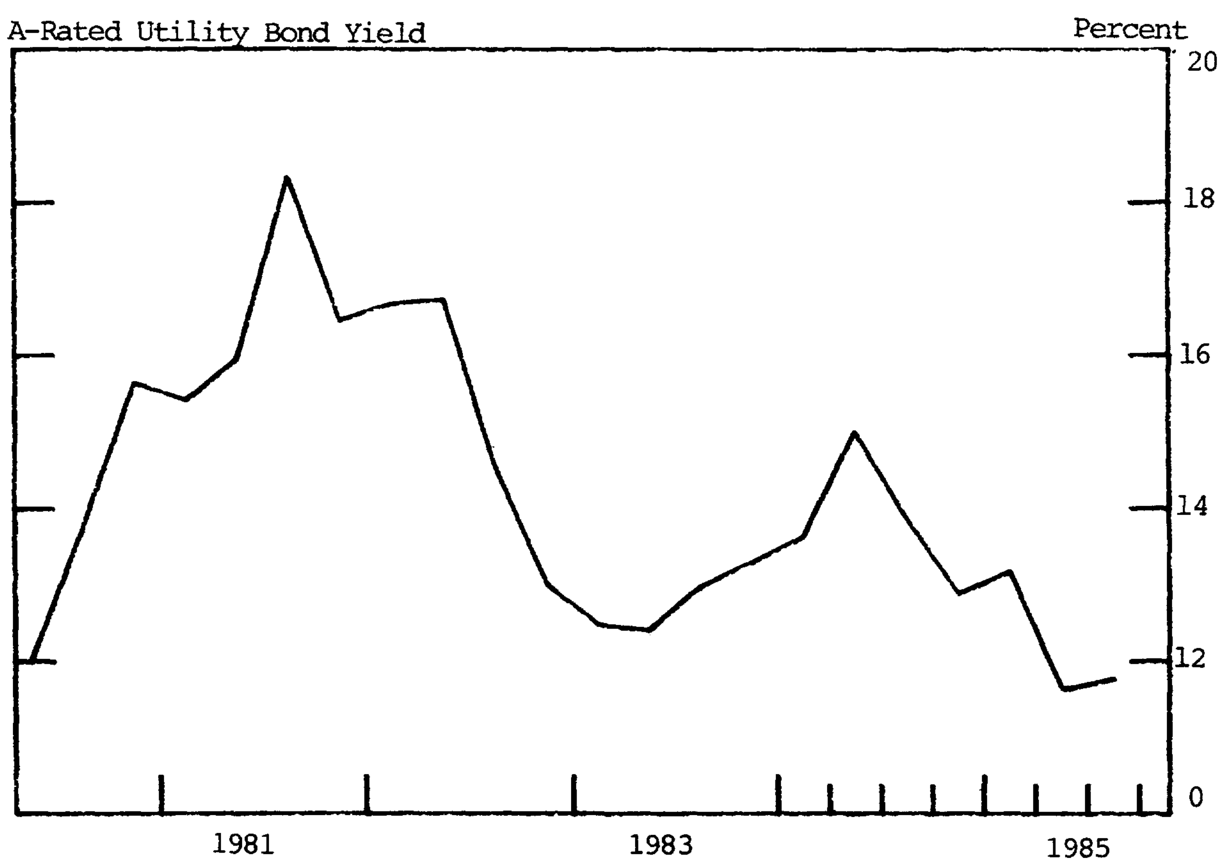
$8-1/4 billion drop in U.S. government deposits, but most of this outflow evidently was covered by a $7-1/4 billion net inflow from foreign branches.

A slowing in both investments and loan growth contributed to a drop in bank credit expansion in August to a 7 percent annual rate. Total loans decelerated for the fourth consecutive month, and growth over the third quarter as a whole likely will be in single digits for the first time in more than two years. The weakening in loans in August was concentrated in security loans, a highly erratic series which ran off sharply after several months of rapid expansion. Nevertheless, growth in domestically booked business loans was a sluggish 3-3/4 percent, and consumer loan growth declined to an 11 percent rate, its lowest this year. Preliminary data indicate that the growth of consumer loans may have slowed again in September. Concessionary financing programs introduced by car manufacturers and their finance subsidiaries in mid-August likely began to restrain automobile loans at banks during August. Real estate loans meanwhile continued to grow at about the pace seen for the last year.

Business Finance

Overall business credit growth likely moved higher in August, even though there was little evidence of it in bank loans. While both commercial paper and gross bond issuance posted strong increases, the continued weak growth in domestically booked business loans and a contraction in loans at foreign offices left total business loans at banks up at just a 1-3/4 percent annual rate last month. A sharp rise in commercial paper at the beginning of the month lifted the combined growth rate of business loans and paper to 7-1/4 percent, still somewhat below the second-quarter pace and less than half the average rate last year. In early September, Principal Borrowings of Nonfinancial Corporations





Note: Third-quarter 1985 credit flows are July-August values at a quarterly rate.

commercial paper fell below its average August level, and business loan growth at large banks was entirely attributable to merger and acquisition financings.

The relatively sluggish growth in short-term borrowing in 1985 contrasts with the robust pace of net bond issuance by nonfinancial corporations. The contrast has become sharper in recent quarters as long-term interest rates have hovered around their five-year lows, and many corporations have turned toward the bond markets to lock in these lower rates. In addition, a larger portion of gross bond issues in the third quarter has been in the longer-term category, even though short-maturity borrowings continue to offer an initial savings of some 350 to 400 basis points. In the third quarter, 37 percent of the volume of new offerings had maturities of 20 years or more, following a year and a half of more predominantly short-term issues.

NONFINANCIAL PUBLICLY OFFERED GROSS CORPORATE BOND VOLUME
(Domestic and Overseas)

	Total	Maturities of 20 years or more	Ratio
	---- Billions of dollars----		--Percent--
1983 H1	19.6	12.1	62
H2	8.7	3.4	39
1984 H1	14.2	3.4	24
H2	29.5	8.2	28
1985 H1	36.0	8.3	23
Q3 (through 9/20)	16.4	6.1	37

Certain sectors of the securities markets saw especially high volume last month. In particular, an unusually large quantity of Eurobonds was issued by U.S. corporations (especially financial), and such borrowings are estimated to have fallen back to a more normal level in September. The

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

	1985				
	Q2	Q3^e	July	Aug.^p	Sept.^e
Treasury financing					
Combined surplus/deficit(-)	-32.0	-48.9	-21.5	-27.7	0.3
Means of financing deficit:					
Net cash borrowing from the public	45.2	46.1	23.9	16.2	6.0
Marketable borrowings/ repayments(-)	38.5	37.2	20.6	13.2	3.4
Bills	2.4	2.3	2.6	2.9	-3.2
Coupons	36.1	34.9	18.0	10.3	6.6
Nonmarketable	6.7	8.9	3.3	3.0	2.6
Decrease in the cash balance	-10.1	6.5	-.1	12.3	-5.7
Memo: Cash balance at end of period	24.0	17.5	24.1	11.8	17.5
Other[2]	-3.1	-3.7	-2.3	-.8	-.6
Federally sponsored credit agencies, net cash borrowing[3]	8.6	4.2	1.2	2.2	.8
FHLBs	3.2	2.3	.7	1.1	.5
FNMA	4.2	1.5	.3	1.0	.2
Farm Credit Banks	-.3	-.9	-.3	-.2	-.4
FHLMC	.8	.9	.5	.2	.2
SLMA	.7	.4	.0	.1	.3

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.

August volume was second only to that last January, and to avoid depressing the prices of these offerings excessively, firms spread their new issues across a number of sub-markets. More than $2 billion equivalent of funds has been raised in 12 different foreign currencies this quarter, including a rash of dual-currency yen/dollar issues in August which were targeted at Japanese investors.[1] There also was a renewed surge in the volume of CMOs in August, fed by the very heavy issuance of federally related pass-through securities in recent months.

U.S. Government Securities Markets

Marketable federal borrowing was constrained in September by the debt ceiling, and the outlook for Treasury operations in the fourth quarter is clouded by uncertainties concerning the timing of congressional action to raise the limit. To date, the full Congress has not acted on the Treasury's request to lift the debt ceiling for FY1986 to just above $2 trillion. Although the federal government is expected to be able to meet all its expenditures through mid-October by drawing down cash balances, the debt ceiling constraint has already forced the Treasury to pay down bills and to postpone auctions of 4- and 7-year notes and 20-year bonds, which normally constitute the end-of-quarter financing.

The staff is estimating a combined (on- and off-budget) federal deficit of nearly $49 billion in the third quarter. Special issues to state and local units continue sizable, but the bulk of the $46 billion of borrowing has been through marketable coupon securities. In addition, the Treasury's cash balance is expected to decline over the quarter, providing $6-1/2 billion to finance the deficit. Looking ahead, the combined deficit

1. See Section IV, International Developments, for additional discussion.

for the fourth quarter is projected by the staff at about $70 billion, nearly all expected to be financed by borrowing from the public. In addition to regularly scheduled financings, there is likely to be a catch-up, once the debt ceiling is raised, from auctions cut back or postponed late in September.

The federally sponsored credit agencies reduced their borrowing in the third quarter from the elevated pace of the second quarter. The largest reductions were those of Fannie Mae, which supplemented its borrowing during the quarter by selling larger amounts of pass-through securities in the financial markets, and of the Federal Home Loan Banks, which drew down liquid assets. Also during the third quarter, the paydown of debt by the Farm Credit System accelerated.

The highly publicized problems of the Farm Credit System recently have been reflected in a deterioration of the market for its securities. Net income of the Farm Credit Banks declined sharply in the second quarter, owing to a marked increase in the provisions for losses on loans. Moreover, the Farm Credit Administration expects that a further rise in loan-loss

NET INCOME AND LOAN LOSS PROVISIONS OF THE 37 FARM CREDIT BANKS
(Millions of dollars)

	Net income	Provisions for loan losses
1979	462.7	83.9
1980	739.5	80.7
1981	867.6	104.5
1982	993.9	74.7
1983	542.8	38.8
1984	441.5	121.0
1985-Q1	90.6	70.3
-Q2	5.6	136.6

provisioning in the second half of the year will turn the Farm Credit System's small first-half profits into a loss for the year of $350 million to $450 million.

The system appears to have adequate resources to absorb this year's losses if it retains its ability to market debt; at the end of June, the Farm Credit Banks had a surplus account (essentially accumulated retained earnings) of $4.2 billion.[1,2] The Farm Credit System, however, will not be able to absorb the current rate of losses for long. Especially worrisome is evidence that loan problems have begun to appear at the Federal Land Banks, which provide longer-term loans for the purchase of farms and machinery. Previously, problem loans were thought to be concentrated in the Federal Intermediate Credit Banks, which provide short-term production loans. This development led the Governor of the Farm Credit Administration to announce that the system probably would require substantial federal assistance within the next 18 to 24 months.

That announcement prompted considerable widening of the yield spreads between the securities of the Farm Credit System and Treasury obligations, as well as some widening of yield spreads on the securities of other federally sponsored agencies. Securities of the Federal Home Loan Banks have been the most affected, primarily because of reports that the FHLBs

1. The Farm Credit System recently changed its regulations so that the Farm Credit Administration has greater control over the capital of the system. Previously, the 37 Farm Credit Banks had to approve assistance to financially weak banks in the system.

2. The system also had $5.0 billion of capital stock and participation certificates, but these accounts represent "paper capital". Farmers who borrow from a Farm Credit Bank are required to purchase capital stock equal to a certain percentage of the loan. This capital stock usually is "purchased" by signing a loan agreement for an amount greater than the volume of funds actually advanced to the farmer. When the farmer repays the funds advanced, the loan agreement and capital stock are retired.

might use their access to the financial markets to help fund the FSLIC's assistance to weak thrift institutions. The 6- and 9-month securities of the Farm Credit System generally are trading 50 to 90 basis points above the yields on Treasury securities, but some trades with spreads in excess of 100 basis points also have been reported.[1] In the past, yields on these securities have been close to those on Treasury securities.

There is some question about how meaningful quoted yields in secondary trading are, however; since the market is thin, quotes at different dealers vary widely, and spreads seem to widen sharply when large investors attempt to reduce their holdings of Farm Credit securities.[2] A good reading on the magnitude of current risk premiums on Farm Credit securities will be the spread on new 6-month securities to be priced September 25, which the market expects to be 75 to 80 basis points; the usual 9-month issue was omitted from this offering.

Tax-Exempt Securities Markets

Issuance of tax-exempt bonds has remained brisk in recent months, fluctuating around $12 billion--well above the $9 billion pace averaged in 1984. Refunding bonds continue to account for around a third of the offerings, bolstered by relatively low interest rates and concerns that advance

1. The 6- and 9-month securities are scheduled for issue every month by the Farm Credit System. It also periodically issues securities with maturities in the 1- to 10-year range, and the average maturity of its debt is just under 2-1/2 years. Because most of its loans to farmers carry variable interest rates, the Farm Credit System is not directly exposed to interest rate risk by focusing issuance in the short-term market; however, the floating-rate characteristic of these loans tends to heighten credit risk in a period of sharply rising interest rates.
2. Accurate measures of risk premiums are available in the very short-term market where the Farm Credit System issues "discount notes" on a daily basis. These spreads over Treasury securities were reported to have risen to the neighborhood of 90 to 100 basis points, compared with spreads of about 15 basis points before investor concern surfaced. More recently, however, spreads have eased a bit to about 75 to 90 basis points.

refunding bonds could be eliminated after year-end if the President's tax reform package is enacted in its present form.

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

	1984		1985				
	Year	Q4	Q1	Q2	July	Aug.[p]	Sept.[e]
Total	10.60	15.75	9.16	15.75	13.32	13.50	13.50
Short-term[1]	1.71	1.14	.83	3.25	2.57	1.50	1.50
Long-term	8.89	14.61	8.33	12.50	10.75	12.00	12.00
Refundings[2]	1.05	1.34	1.88	3.75	3.89	4.00	3.50
New capital	7.84	13.27	6.45	8.75	6.86	8.00	8.50
Total housing	1.69	2.36	1.46	2.43	2.29	1.38	2.00
Multifamily[3]	.37	.63	.82	1.08	.54	.93	.90

p--preliminary.
e--staff estimate.
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.

Offerings of bonds for new capital, both for public and private purposes, have remained substantial. Issuance of industrial development bonds (IDBs), which also are threatened with extinction by the tax reform proposal, appears to have picked up in a trend that is likely to accelerate toward year-end. Offerings of IDBs to fund multifamily housing projects have been strong all year, but the volume of other types of IDBs, for which evidence is fragmentary, had appeared to be rather sparse during the first half of the year.

Mortgage Markets

Despite the difficulties related to the EPIC situation, the home mortgage market on the whole has been fairly stable since the last FOMC meeting. In the primary market, interest rates have changed little, with adjustable-rate loans still enjoying a relatively large initial interest rate advantage.

Reflecting this advantage, adjustable-rate mortgages have continued to be popular; in early August, just over half of conventional home loans closed had an adjustable-rate provision.

The response of the mortgage securities markets to the problems faced by the EPIC partnerships and insurers of their mortgages has been limited. Although even federally guaranteed securities were affected initially, their prices promptly moved back into closer alignment with Treasury issues, and yields on thrift institution bonds backed by privately insured mortgages increased only slightly relative to those of other issuers, because the thrift bonds generally are over-collateralized. The market for pass-throughs relying on private insurance has shown sustained signs of weakness. Prices have been down, bid-asked spreads have widened, and trading has been lighter for all issues, particularly those involving the mortgage insurers most at risk in the EPIC defaults. However, no panic selling has been reported, and any losses to securities holders stemming directly from EPIC were expected to be minor.

New issue volume for pass-through securities guaranteed by federally sponsored agencies in August remained near the previous month's record high. Issuance was again bolstered by heavy swapping of loans for FHLMC or FNMA securities, but GNMA securities, which carry explicit government backing, accounted for a somewhat larger share than in most months this year. Data covering the first half of September indicate that heavy issuance of federally related pass-through securities has continued.

Press reports and inquiries among trade sources suggest that the EPIC incident has not had a more substantial damping effect on the home mortgage market to date largely because EPIC's securities and practices were so

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	Memo: Total issues less swaps
1984-Q1	4.9	2.7	.9	1.3	1.6	3.3
Q2	4.0	2.3	1.1	.5	1.5	2.5
Q3	5.1	2.2	1.4	1.5	2.7	2.4
Q4	6.0	2.0	2.8	1.2	3.5	2.5
1985-Q1	6.4	2.7	2.4	1.3	3.0	3.4
Q2 r	7.5	3.3	2.8	1.5	3.4	4.2
1985-Jan.	5.6	2.7	2.0	.9	2.3	3.3
Feb.	6.9	2.7	2.4	1.8	3.3	3.6
Mar.	6.6	2.8	2.8	1.1	3.3	3.3
Apr.	6.4	2.6	2.0	1.9	3.3	3.1
May r	7.8	3.6	3.2	1.0	3.2	4.6
June r	8.4	3.6	3.3	1.5	3.5	4.9
July r	9.6	3.9	4.2	1.5	4.4	5.2
Aug. p	9.4	4.2	3.0	2.2	4.3	5.1

r--revised.
p--preliminary.

atypical. The EPIC securities were privately placed and privately insured issues, while nearly all mortgage pass-through securities (98 percent in 1984) are guaranteed by federally related agencies and publicly traded. Moreover, the conventional mortgage loans backing the EPIC securities were originated at loan-to-value ratios that were exceptionally high by industry standards. Also, the underlying real estate--investor-held rental properties, geographically concentrated, and either model homes or remnants of unsold inventories--was much riskier than usual. Finally, the EPIC properties had been purchased, and the mortgages financed, within the same group of firms; ordinarily, property ownership and mortgage financing are widely dispersed.

The most noticeable impact of the EPIC situation has been on the private mortgage insurance industry. TICOR, the mortgage insurance company

CONSUMER INSTALLMENT CREDIT

	1983	1984	1985 Q1	1985 Q2	1985 May	1985 June[r]	1985 July
	Percent rate of growth, SAAR						
Change in outstandings--total	14.6	20.0	21.8	18.9	22.4	12.7	15.0
By type:							
Automobile credit	13.4	20.6	22.0	21.9	24.5	17.0	14.8
Revolving credit	17.7	23.9	30.0	17.6	28.0	-.8	9.6
All other[1]	14.0	17.5	17.3	16.8	17.3	15.8	18.1
	Billions of dollars, SAAR						
Change in outstandings--total	48.7	76.8	98.4	90.2	108.5	62.7	75.0
By type:							
Automobile credit	16.9	29.5	37.9	39.9	45.5	32.2	28.4
Revolving credit	12.4	19.6	28.5	17.9	29.2	-.9	10.3
All other[1]	19.5	27.8	32.1	32.4	33.9	31.4	36.3
By major holder:							
Commercial banks	19.5	40.4	54.9	38.6	49.3	20.3	21.9
Finance companies	9.3	9.3	16.6	21.9	28.5	14.6	19.6
All other	20.0	27.1	27.0	29.7	30.7	27.8	33.5
	Annual percentage rate						
Interest rates							
At commercial banks[2]							
New cars, 48 mos.	13.92	13.71	13.37	13.16	13.16	n.a.	12.72[4]
Personal, 24 mos.	16.68	16.47	16.21	16.09	16.09	n.a.	15.84[4]
Credit cards	18.78	18.77	18.85	18.74	18.74	n.a.	18.62[4]
At auto finance companies[3]							
New cars	12.58	14.62	13.85	11.95	11.87	12.06	12.46
Used cars	18.74	17.85	17.86	17.80	17.84	17.77	17.49

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.
4. Data are for August 1985.
n.a.--not available.
r--revised.

with the greatest exposure in the EPIC situation, recently announced that it had suspended the writing of all new mortgage insurance, in view of uncertainties about its ultimate losses in the EPIC case. Trade sources expect that other mortgage insurance companies will be less seriously affected and that no major disruption is likely in the availability of mortgage insurance. Even so, the trend toward tighter qualification standards and higher insurance premiums on a broad range of conventional home mortgages will likely be intensified by the EPIC incident.

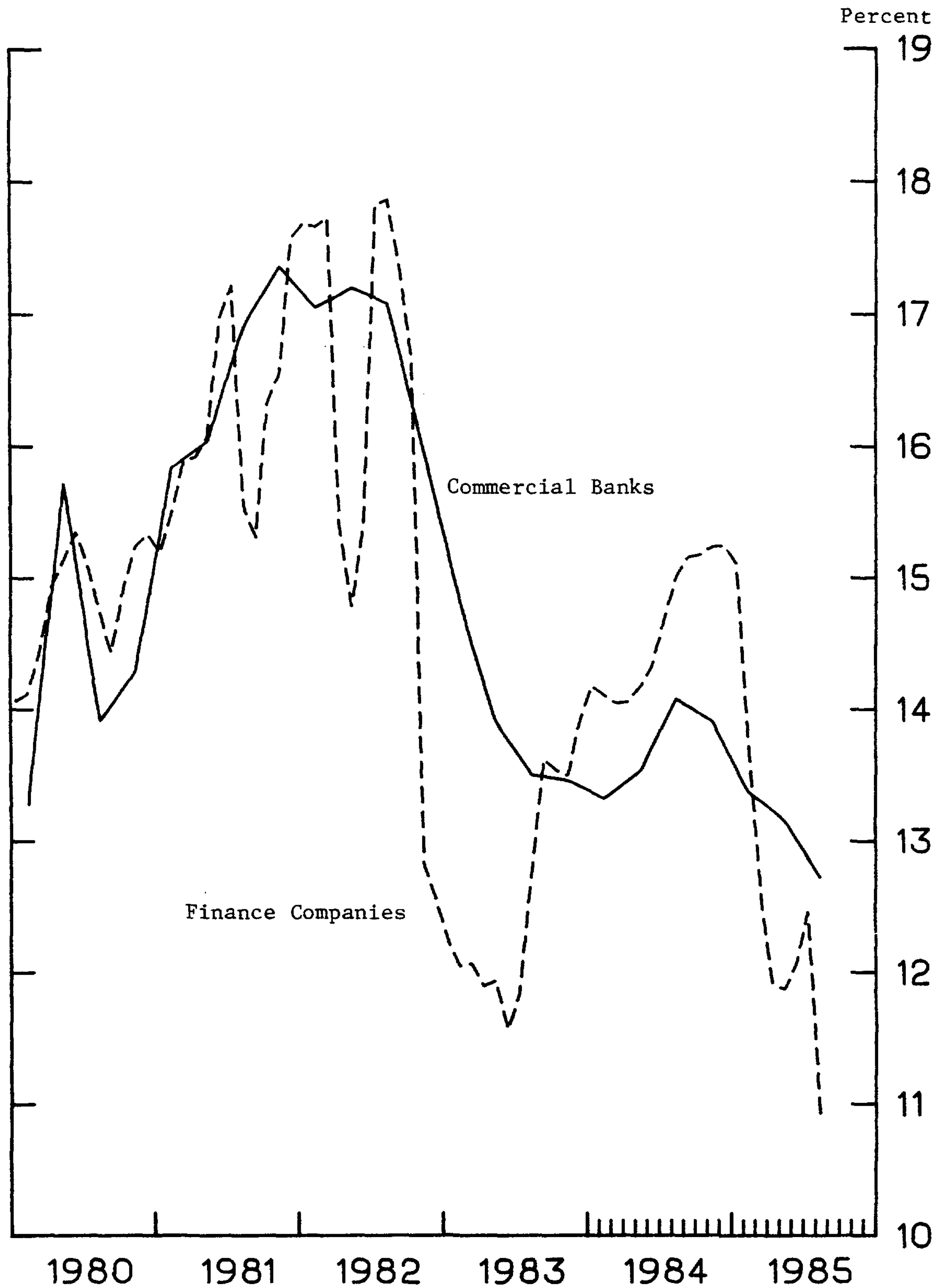
Consumer Installment Credit

Consumer installment credit expanded at a 15 percent annual rate in July. Coupled with June growth of 12-3/4 percent, the July increase provides evidence of a significant slowing from growth rates in excess of 20 percent earlier in the year. The deceleration in recent months was particularly apparent in the revolving credit category, which had soared during the first part of the year.

Consumer installment credit expansion probably continued to subside in August. Bank lending to consumers weakened during the month, and most of an anticipated surge in auto credit expansion related to promotional interest rates offered by the financing subsidiaries of various automakers may have been delayed into September because of a lag between the time that paperwork on a loan is handled at the dealership and the time that the loan is entered on the books of the ultimate creditor.

The incentive-financing programs initiated by the big three automakers in mid-August are considerably broader than those in force earlier this year, or those available during most of 1983. Below-market financing (at interest rates of 7.5 to 7.7 percent) is being offered on a wide selec-

INTEREST RATES ON NEW-CAR LOANS



Latest month charted is August 1985.

tion of 1985 models. Meanwhile, interest rates on new-car loans at a sample of commercial banks eased to 12-3/4 percent in early August, the lowest value for that series in six years.

Historically, interest rates on new-car loans at the captive finance companies have exceeded those at banks by 1 to 2 percentage points, but in recent years the finance companies' reduced-rate programs frequently have brought their average rate below the bank figure. Compared with credit costs at banks, the special incentive rates now offered by the auto finance companies would reduce the monthly payment on a $10,000 48-month loan by about $25, resulting in before-tax savings of $1,200 or so in interest expense over the life of the loan.[1]

Incoming data indicate that households experienced somewhat more difficulty in meeting loan obligations during the second quarter. The number of personal bankruptcy cases climbed 9 percent from the first-quarter level and was up 16 percent from last year's second quarter. Consumer loan delinquencies showed small increases during the quarter to a level midway between their highs and lows of the past 15 years. Evidence on the trend in mortgage delinquencies was mixed. The series for FSLIC-insured institutions reported by the FHLBB hit a new high in the second quarter, while the Mortgage Bankers Association series covering a wider range of institutions showed a drop in the proportion of home mortgages delinquent 60 days or more, to a still-high 1.83 percent from the previous quarter's record.

1. At an interest rate of 12-3/4 percent, the present value of this savings is approximately $935.

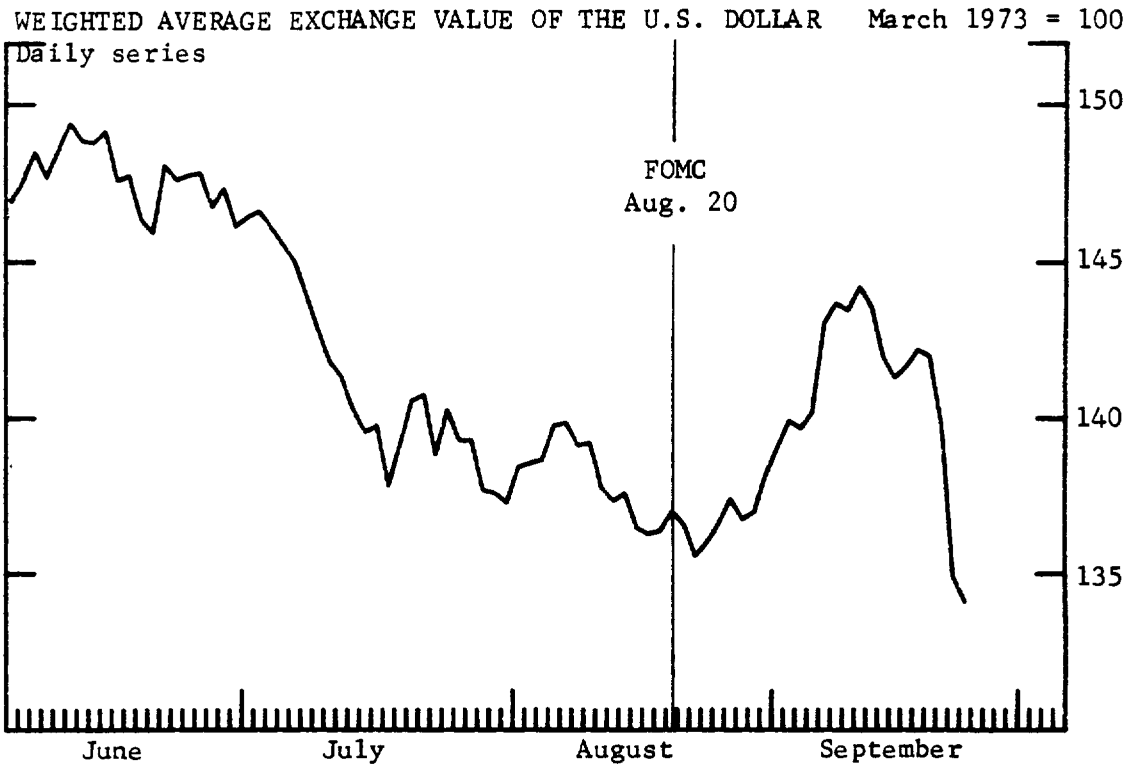
Foreign Exchange Markets

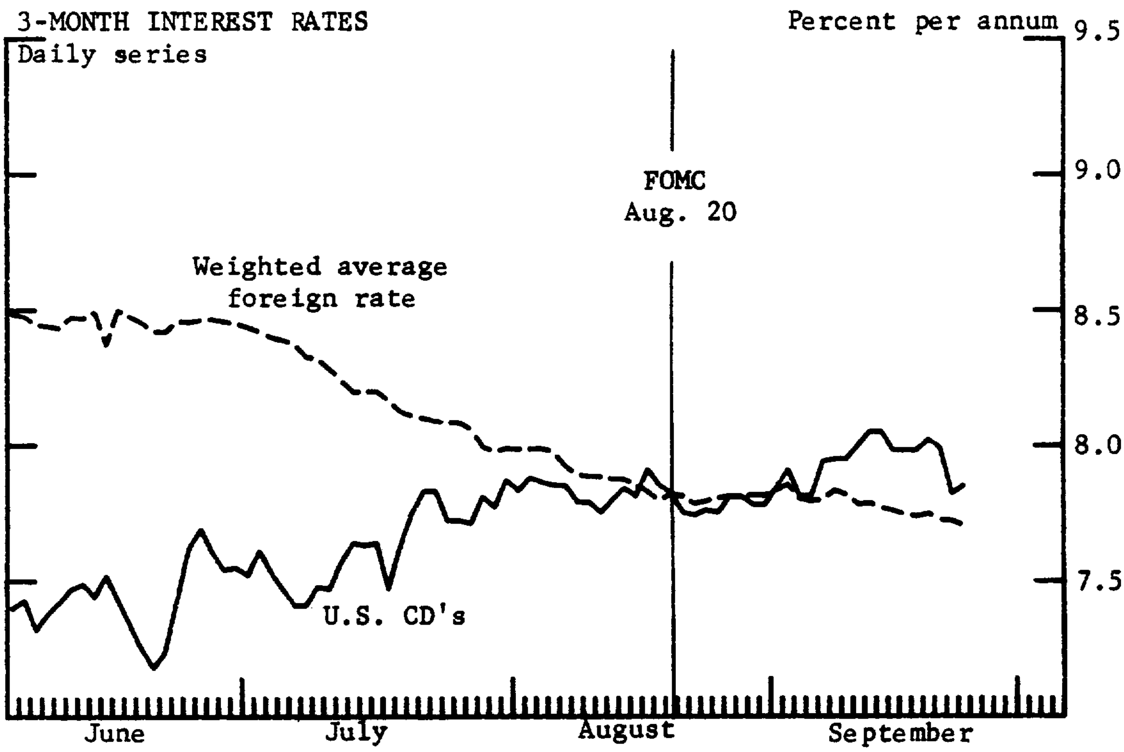
The weighted-average value of the dollar has decreased by about 2 percent on balance since the last FOMC meeting, as shown in Chart 1. This movement was dominated by the drop of more than 4 percent which took place on September 23 following the announcement by G-5 finance ministers and central bank governors that exchange rates should better reflect fundamental economic conditions.

In the period before the G-5 meeting, movements in the dollar continued to be strongly influenced by shifting expectations about the strength of the U.S. economy. From August 20 to September 11, the dollar appreciated by more than 5 percent as newly released data -- particularly the drop in the unemployment rate in August -- suggested to market participants that the U.S. economy was growing more strongly than they had previously thought. In the following ten-day period ending on September 20, the dollar declined by about 3 percent when U.S. growth expectations were revised downward in response to additional information, particularly a smaller-than-anticipated "flash" estimate of third-quarter real GNP growth.

The sharp drop of the dollar on Monday, September 23 following the G-5 meeting appeared to reflect a belief in the market that officials were prepared to take strong, concerted action to bring about a lower dollar on foreign exchange markets. The dollar's fall that day was evenly distributed among the major foreign currencies; the dollar's depreciation ranged from 4.6 percent against the pound to 5.1 percent against the yen. On Tuesday, September 24, the dollar moved slightly

Chart 1


WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR
March 1973 = 100
Daily series
150
145
140
135
FOMC
Aug. 20
June
July
August
September


3-MONTH INTEREST RATES
Percent per annum
Daily series
9.5
9.0
8.5
8.0
7.5
FOMC
Aug. 20
Weighted average
foreign rate
U.S. CD's
June
July
August
September

higher, but reversed only a small fraction of its decline the previous day. On Wednesday, the dollar was little changed on balance as of the close of trading in European markets.

. The New York Desk entered the market on Monday, selling a total of $149 million, about half against marks and half against yen. On Tuesday, the Desk sold an additional $127 million against yen. The foreign currencies acquired in Desk operations were added equally to System and Treasury balances.

.

The South African rand came under strong exchange market pressure in late July as domestic unrest in that country intensified. The rand weakened further in early August when increasing numbers of U.S. and foreign banks began reducing their exposure to public and private South African institutions. On August 27, the South African authorities announced a five-day suspension of trading in their foreign exchange and stock markets, following a 10 percent one-day fall in the value of the rand. While trading on South African financial markets was suspended, the government announced a freeze on most foreign debt repayments until the end of the year. In order to prevent investment capital from leaving the country, a dual exchange rate regime was instituted with a relatively free rate for commercial transactions and a less advantageous rate for financial transactions by nonresidents. When South African markets reopened on September 2, the commercial rand quickly rose to 45 cents after closing on August 27 at 36 cents. However, in subsequent weeks the commercial rand again weakened and is currently about 39 cents. The financial rand has traded recently at about a 5 percent discount relative to the commercial rate.

U.S. bank lending to foreigners in the second quarter. Claims on foreigners of U.S. chartered banks resumed their decline in the second quarter of 1985, decreasing about $9 billion (2 percent). As was the case in most of 1984, the drop in total claims was concentrated on the G-10 countries and offshore banking centers.

Since the beginning of 1984, U.S. bank claims on the non-OPEC developing countries have changed hardly at all; they show a small decrease in the first half of this year. There was no involuntary lending to these countries in the first half of 1985 except for Mexico's drawing in March of the final $950 million of the bank loan signed in April 1984. As happened in 1983-84, actual net new lending to non-OPEC developing countries this year was probably somewhat less negative, or perhaps even slightly positive, than is measured by changes in outstanding claims, because some loans are removed from banks' books by loan write-offs, exercise of official guarantees, and other decreases. Claims on OPEC countries, Eastern Europe and the smaller developed countries show small decreases for the past six quarters, while claims on the G-10 countries and offshore banking centers at the end of June were down $21 billion (13 percent) from the level of end-1983. Of that amount, a decline in dollar-denominated interbank claims accounted for approximately the entire amount.

TABLE 1. CLAIMS ON FOREIGNERS OF U.S.-CHARTERED BANKS
(Billions of dollars)

	1984			1985			Outstanding
	Year	1st Half	2nd Half	1st Half	Q-1	Q-2	6/30/85
Claims on:							
Total, all countries	-29.6	-6.7	-22.9	-7.1	1.6	-8.7	400.6
Non-OPEC developing countries	0.6	1.2	-0.6	-1.8	-0.9	-0.9	110.4
(Latin America)	1.9	1.8	0.1	-0.7	-0.4	-0.3	76.1
(Asia and Africa)	-1.3	-0.6	-0.7	-1.1	-0.5	-0.6	34.3
OPEC countries	-3.3	-2.2	-1.1	-2.0	-0.4	-1.6	23.6
Eastern Europe	-0.9	-0.4	-0.5	-0.1	-0.1	0.0	4.3
Smaller developed countries	-2.3	1.0	-3.3	-1.4	-0.8	-0.6	32.4
G-10 countries	-20.4	-10.3	-10.1	-0.9	4.8	-5.7	146.7
Offshore banking centers	-3.7	3.6	-7.3	-0.9	-0.6	-0.3	65.9
Miscellaneous	0.3	0.3	0	0.2	-0.4	0.6	17.5

U.S. INTERNATIONAL FINANCIAL TRANSACTIONS

Net capital inflows in July occurred through banks as well as through an increase in foreign net purchases of U.S. corporate bonds and continued foreign net purchases of U.S. Treasury securities, particularly by Japanese residents. (See Summary Table of U.S. International Transactions.)

Banking data for July show a sizeable net inflow into banking offices in the United States from abroad (including internatioal bankings facilities) when measured on an end-month to end-month basis. (see line 1.) This partially reflects a $2 billion reduction in deposits of U.S. bank holdings companies with the offshore offices of affiliated U.S. banks; over the same period commercial paper issued by bank holding companies fell by a similar amount.

Foreign net purchases of U.S. corporate bonds (line 2a) increased by over $4 billion in July, bringing the total for the first seven months of the year to nearly $22 billion. During this period there has been a marked increased in the proportion of Euromarket securities issued by U.S. corporations that have been denominated at issue in foreign currencies, particularly yen and Swiss francs. The proportion of straight dollar denominated issued fell to nearly 50 percent during July and August compared with an average of nearly 70 percent over the first half of 1985. Market commentary has suggested that the increased interest in securities denominated in foreign currency may indicate sensitivity to increasing exchange risk on the part of international investors.

A significant portion of the non-dollar issues have been in the form of dual currency bonds. The principal of these securities is

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 May	1985 June	1985 July
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	-0.5	0.6	-4.2	5.7
Securities											
2. Private securities transactions, net	1.6	8.0	2.2	-0.2	0.3	5.7	7.0	5.0	2.1	1.7	4.0
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	3.0	1.8	4.4
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	*	0.3	0.6
c) U.S. net purchases (-) of foreign securities	-7.0	-5.0	0.7	-0.7	-1.3	-3.6	-2.5	-2.1	-0.9	-0.4	-1.1
3. Foreign net purchases (+) of U.S. Treasury obligations 1/	8.7	22.5	1.4	6.5	5.1	9.5	2.7	5.1	-1.4	2.6	3.2
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	7.9	3.1	4.0	1.7
a) By area											
G-10 countries (incl. Switz.)	6.4	3.1	2.3	-0.7	-0.8	2.2	-5.5	6.1	2.0	2.6	
OPEC	-8.5	-5.3	-2.8	-2.4	-0.6	0.6	-1.7	-2.0	-0.6	0.5	-0.
All other countries	7.3	5.0	-2.6	2.4	0.8	4.3	-3.7	3.8	1.7	1.0	-0.9
b) By type											
U.S. Treasury securities	7.0	4.7	-0.3	-0.3	-0.6	5.8	-7.2	8.7	2.5	4.6	2.7
Other 2/	-1.7	-2.0	-2.8	-0.5	**	1.2	-3.6	-0.8	0.5	-0.6	-1.0
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	0.2
Other transactions (Quarterly data)											
6. U.S. direct investment (-) abroad	-4.9	-4.5	-3.1	2.0	2.0	-5.4	1.9	-4.1	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	2.1	4.9	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	-5.1	5.0	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	-30.3	-31.8	n.a.	n.a.	n.a.
10. Statistical discrepancy 4/	9.3	24.7	4.8	1.9	11.0	7.0	17.0	8.9	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	-33.0	-11.0	-11.9	-9.8

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.

denominated in U.S. dollars while interest is paid in a foreign currency. To date, instruments with Swiss franc and yen coupons have been issued; in August yen issues were far greater in number and value. These instruments appear to appeal particularly to Japanese investors because of certain accounting considerations that make high current interest payments combined with the risk of future capital losses attractive. Like zero coupon bonds, these instruments appear to provide the Japanese investor with desired financial characteristics that are not now available in the domestic or Euro yen markets.

Japanese purchase of U.S. Treasury issues have also been large in recent months. In July, Japanese net purchases of Treasury bonds and notes totalled more than $3.5 billion, more than accounting for the total of private foreign net purchases of Treasury securities. Japanese purchases of U.S. Treasury securities is the first seven months of 1985 came to nearly $10 billion, out of a total of $11 billion of U.S. net sales to private foreign residents.

The Japanese Ministry of Finance reports that net foreign bond buying by Japan for June and July totalled more than $15 billion. U.S. Treasury data indicate that approximately 40 percent of this total was U.S. Treasury securities. Recent market reports suggest serious concern exists within the Japanese government that unrestrained capital outflows may serve to weaken the yen and exacerbate both that country's trade surplus and protectionist pressures on its major trading partners. Press accounts indicate that the Japanese government recently may have entertained placing controls on the export of capital and may be currently seeking to persuade Japanese securities firms to approach increased purchases of foreign securities with greater caution.

Another recent development with possible implications for the yen/dollar exchange rate is the introduction of a yen-denominated bond in the United States. This $144 million equivalent offering by the Asian Development bank represents the first yen-denominated bond publicly offered in the U.S. market in the postwar period and only the third foreign currency issue since the first such issue in December of 1984. Because these three issues are registered with the Securities and Exchange Commission, they can be sold publicly to investors in the United States who are prohibited from purchasing instruments not registered with the S.E.C.. Thus such investors may now more readily diversify the currency exposures of their portfolios.

Foreign official reserve assets in the United States increased in July as G-10 countries continued to build their dollar holdings following the sizeable net sale of dollars through foreign exchange intervention in the first quarter. Preliminary data for August and the first week of September show little change in foreign official holdings at the Federal Reserve Bank of New York.

Data recently released by the Commerce Department show that foreign direct investment in the United States was $4.9 billion in the second quarter, up from $2.1 billion in the first quarter. The large inflow in the second quarter was primarily the result of two large loans by European companies to their U.S. affiliates that were related to corporate takeovers publicized in 1984. U.S. direct investment abroad shifted to a net outflow of $4.1 billion in the second quarter from a $1.9 billion net inflow in the previous quarter. The statistical discrepancy for the second quarter was an inflow of $8.9 billion, bringing the total for the first half of 1985 to $25.9 billion.

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1981	1982	1983	1984			1985			
	Dec.	Dec.	Dec.	June	Sept.	Dec.	Mar.	June	July	Aug.
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	26.0	27.6	30.8	25.7
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	8.1	8.9	6.9
3. Sum of lines 1 and 2 of which:	19.6	49.1	44.5	35.2	36.4	33.2	32.1	35.7	39.7	32.6
(a) U.S.-chartered banks	22.3	40.0	40.5	33.6	35.9	32.1	30.6	33.4	39.3	33.8
(b) Foreign-chartered banks	-2.6	9.1	4.0	1.6	.5	1.1	1.6	2.2	.4	-1.1
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	19.2	20.2	19.6	19.3
5. Eurodollar Holdings of U.S. Nonbank Residents 2/	95.5	112.6	124.2	124.3	122.7	117.4	118.7	109.1	106.9	107.8

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.

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 July, the U.S. merchandise trade deficit was smaller than that recorded in June and for the second quarter as a whole. The decrease in the deficit resulted from a sharp drop in imports that was partly offset by a moderate decline in exports. Data for August are scheduled to be released on Friday, September 27.

Import data oscillate widely from month to month. The decline in July brought the level of imports below rates recorded during the first half of the year; the decline was widespread across all major commodity categories. There were notable decreases in industrial supplies (particularly in steel and nonferrous metals), in machinery (especially business machines), in trucks from Canada, in passenger cars from Japan and Europe, in foods, and in other consumer goods.

U.S. MERCHANDISE TRADE[1/]

	Year	1984		1985			
	1984	Q3	Q4	Q1	Q2	June	July
Value (Bil. $, SAAR)							
Exports	220.3	222.1	225.4	222.8	213.0	214.1	208.1
Agricultural	38.4	36.9	38.3	33.5	28.3	27.1	24.6
Nonagricultural	181.9	185.3	187.2	189.4	184.6	187.0	183.5
Imports	328.6	352.1	323.6	341.0	345.0	357.2	325.2
Oil	57.5	57.8	56.8	45.2	52.8	58.0	47.0
Nonoil	271.1	294.4	266.9	295.7	292.2	299.1	278.3
Trade Balance	-108.3	-130.0	-98.2	-118.1	-132.0	-143.1	-117.1
Volume (Bil 72$, SAAR)							
Exports							
Agricultural	16.3	15.7	17.3	15.3	13.1	12.7	11.6
Nonagricultural	63.0	64.3	64.7	64.4	62.3	61.6	62.6
Imports							
Oil	5.3	5.4	5.3	4.3	5.1	5.6	4.7
Nonoil	104.0	112.4	102.0	115.9	115.3	119.0	109.7

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

The value of oil imports also fell substantially from the June level. This decline reflected a drop in volume of one million barrels per day from the June rate; the decline from the second-quarter average was smaller. The average price of imported oil dropped by about 75 cents per barrel from the June price and slightly more from the second-quarter average.

OIL IMPORTS

	Year	1984		1985			
	1984	Q3	Q4	Q1	Q2	June	July
Volume (mbd, SA)	5.62	5.66	5.62	4.61	5.40	5.92	4.92
Price ($/BBL)	27.95	27.91	27.59	26.86	26.97	26.87	26.13
Value (Bil. $, SAAR)	57.48	57.76	56.79	45.22	52.78	58.04	46.98

The value of exports also fell in July from both the June and second-quarter levels. Much of the drop was in agricultural commodities, particularly wheat; both prices and quantities declined. While the value of nonagricultural items decreased from June levels, the value recorded in July was about the same as the second-quarter rate. Compared with the second-quarter average, a decline in July in exports of machinery was offset by increases in exports of aircraft and of automotive products to Canada.

The Department of Commerce pointed out in its press release of August 30 that monthly totals of both exports and imports include a carryover from prior months' transactions; this results when import entries and export declarations transmitted by the U.S. Customs Service reach the Census Bureau too late for inclusion into the current statistical month. In July, the carryover amounted to 39 percent of the July monthly unadjusted total value for imports and 11 percent for exports. The net carryover for a 12-month period is small; it is estimated that calendar-year 1984 totals (exports, imports and trade balance) would have been affected by slightly more than one percent. However, the amount of the carryover varies from month to month and for an individual month or quarter may be proportionally large and affect in a significant way the monthly or quarterly variability of the data.

U.S. Current Account in 1985-Q2.

The U.S. current account was in deficit by $127 billion, SAAR, in the second quarter of 1985; this was a slightly larger deficit than in the first quarter. A larger merchandise trade deficit (exports dropped by 4-1/2 percent and imports increased slightly) was partly offset by increased income receipts from investment abroad.

Most of the increase was in receipts of income from U.S. direct investment abroad and was accounted for by a shift from large capital losses to small capital gains primarily in response to the decline in the exchange value of the dollar. The changes in other service transactions were relatively small. See the table on the next page.

September 25, 1985

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

		1984	1984		1985		$ Changes
		1984	Q3	Q4	Q1-r	Q2	85Q1-84Q
1.	Trade Balance	-108.3	-130.0	-98.2	-118.1	-132.0	-13.9
2.	Exports	220.3	222.1	225.4	222.8	213.0	-9.8
3.	Imports	328.6	352.1	323.6	341.0	345.0	4.0
4.	Investment income, net	19.1	13.0	16.0	10.1	22.3	12.2
5.	Direct investment, net	12.9	7.1	11.5	9.6	24.1	14.5
6.	Capital gains or losses 1/	-9.1	-15.3	-9.8	-11.5	1.3	12.8
7.	Other D.I. income	22.0	22.4	21.3	21.1	22.8	1.7
8.	Portfolio income net	6.2	5.9	4.5	0.6	-1.7	-2.3
9.	Military, net	-1.8	-1.0	-2.3	-0.8	-2.3	-1.5
10.	Other services, net	0.9	-0.5	-1.0	0.2	-1.8	-2.0
11.	Unilateral transfers	-11.4	-11.5	-16.4	-12.7	-13.4	-0.7
12.	Current Account Balance	-101.5	-130.0	-101.9	-121.3	-127.2	-5.9
13.	Excluding capital gains or losses	-92.4	-114.7	-92.1	-109.8	-128.5	-18.7
Memo:	Statistical discrepancy, not AR	24.7	11.0	7.0	17.0	8.9	-8.1

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

Foreign Economic Developments. The pace of economic activity in the major foreign industrial countries rose on balance in recent months, but progress remains uneven and influenced by special factors. Second-quarter real GNP growth accelerated strongly in Japan and Germany, while Canada, Italy, and the United Kingdom maintained their growth rates experienced in the first quarter. These outcomes reflect some rebounds from unusually weak first-quarter performances in Japan and Germany, and the end of the coal miners' strike in the United Kingdom. The most recent industrial production data for these countries show output significantly above year-earlier levels. Industrial activity in France and Italy remains subdued, with little or no growth in the second quarter. Consumer price inflation abroad has remained low, with a weighted average year-over-year rate for the six major countries currently at about 4.5 percent. Among those countries with still relatively high inflation rates, France has recorded slower rates recently, while Italy's year-over-year inflation rate has remained above 8.5 percent since late last year. The trade and current account surpluses of Japan and Germany rose strongly in the second quarter.

Individual Country Notes. In Japan real GNP grew 7.9 percent (s.a.a.r.) in the second quarter, rebounding strongly from revised growth of only 0.8 percent in the first quarter, but private sector investment and exports have been erratic. Real GNP in the first half of 1985 increased about 5 percent (s.a.a.r.) from the average level in the second half of 1984.

Recent data on Japanese industrial production also suggest that the economy is expanding, although at a slower pace than experienced last

September 23, 1985

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

	Q4/Q4	Q4/Q4	1984		1985		1985					LATEST 3 MONTHS
	1983	1984	Q3	Q4	Q1	Q2	MAR.	APR.	MAY	JUNE	JULY	FROM YEAR AGO+
CANADA												
GNP	7.1	4.3	1.6	.8	.9	1.0	*	*	*	*	*	4.5
IP	16.1	4.4	3.1	-.1	.2	.8	.1	.6	-.3	1.5	N.A.	3.9
FRANCE												
GDP	1.1	1.7	1.2	-.1	-.3	.6	*	*	*	*	*	1.4
IP	2.4	1.3	3.1	-2.5	-.8	.8	1.5	-2.2	1.5	-1.5	N.A.	.5
GERMANY												
GNP	2.9	2.8	2.1	1.1	-.8	N.A.	*	*	*	*	*	.4
IP	6.0	3.6	5.7	1.4	-1.2	1.6	.9	-.2	1.1	1.7	1.8	7.5
ITALY												
GDP	2.2	1.7	1.1	-.6	.8	.8	*	*	*	*	*	2.1
IP	1.7	1.8	1.8	-1.8	1.5	-.3	-.4	-3.8	.8	1.9	N.A.	1.3
JAPAN												
GNP	3.9	6.5	.6	2.4	.2	1.9	*	*	*	*	*	5.2
IP	8.6	10.6	1.6	2.7	-.7	2.7	-1.4	2.8	2.4	-2.0	1.7	6.2
UNITED KINGDOM												
GDP	3.7	2.8	1.1	1.6	.9	1.0	*	*	*	*	*	4.8
IP	5.4	-.5	-.1	1.0	2.1	2.0	1.4	1.0	.3	-.4	-1.0	5.1
UNITED STATES												
GNP	6.3	5.7	.4	1.0	.1	.5	*	*	*	*	*	2.0
IP	14.3	7.2	1.6	-.2	.5	.5	.3	.2	.1	.1	N.A.	2.4

* DATA NOT AVAILABLE ON A MONTHLY BASIS.

+ IF QUARTERLY DATA, LATEST QUARTER FROM YEAR AGO.

September 23, 1985

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 MAY	1985 JUNE	1985 JULY	1985 AUG.	LATEST 3 MONTHS FROM YEAR AGO
CANADA													
CPI	4.6	3.7	1.2	.9	.9	.7	1.2	1.1	.2	.6	.3	.2	4.0
WPI	3.5	3.6	1.6	1.2	.5	.3	1.0	.7	.2	.0	.2	N.A.	2.5
FRANCE													
CPI	9.8	6.8	1.7	1.8	1.7	1.4	1.4	1.8	.5	.4	.4	.1	6.0
WPI	14.6	10.5	3.4	2.9	2.2	1.6	1.6	.7	.6	.1	-.6	N.A.	5.4
GERMANY													
CPI	2.7	2.0	.9	.5	.0	.7	1.1	.6	.1	.1	-.2	-.3	2.2
WPI	.9	1.0	1.7	.8	-1.4	.0	1.9	.9	-.1	-.8	-1.2	-.7	.5
ITALY													
CPI	13.0	8.8	2.8	2.1	1.4	2.2	2.6	2.2	.6	.5	.3	.2	8.7
WPI	9.1	8.8	3.2	2.2	1.2	1.9	2.7	2.2	.3	.0	-.3	N.A.	7.9
JAPAN													
CPI	1.9	2.4	.9	.6	-.2	1.2	.6	.5	.1	-.1	.5	-.9	2.7
WPI	-3.3	.5	.1	-.1	.8	-.3	.4	-.7	-.2	-.3	.0	N.A.	-.3
UNITED KINGDOM													
CPI	5.1	4.8	.6	2.0	.9	1.2	1.3	3.4	.5	.2	-.2	.3	6.7
WPI	5.6	6.0	1.8	2.3	.6	1.3	1.7	2.0	.3	.1	.2	.2	5.6
UNITED STATES													
CPI (SA)	3.2	4.1	1.3	.9	.9	.9	.8	1.0	.2	.2	.2	.2	3.5
WPI (SA)	.8	1.7	1.2	.4	.0	.1	.2	.6	.2	-.2	.3	-.3	.8

September 23, 1985

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	MAY	JUNE	JULY	AUG.
CANADA												
TRADE	14.4	15.9	3.5	4.0	4.1	4.4	4.0	3.4	1.2	.7	.1	N.A.
CURRENT ACCOUNT	1.4	1.7	.0	.3	.5	.9	.6	.3	*	*	*	*
FRANCE												
TRADE 2/	-5.9	-2.7	-1.5	-1.2	.4	-.3	-1.1	-.4	-.1	.2	-.4	N.A.
CURRENT ACCOUNT 2/	-4.9	-.1	-.7	-.4	.9	.1	-.8	.5	*	*	*	*
GERMANY												
TRADE	16.4	18.8	4.3	3.2	5.0	6.3	4.5	6.2	2.2	2.1	N.A.	N.A.
CURRENT ACCOUNT (NSA)	4.2	5.8	.8	-.1	-.9	6.0	1.3	3.0	2.0	-.2	-.1	.8
ITALY												
TRADE	-7.9	-10.7	-2.2	-2.9	-1.4	-4.2	-3.8	-3.7	-.7	-1.6	N.A.	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	44.1	9.9	10.6	9.9	13.7	11.5	13.0	4.8	4.4	4.5	N.A.
CURRENT ACCOUNT	21.0	35.0	7.1	8.8	7.2	11.7	9.4	12.1	4.1	4.2	4.1	N.A.
UNITED KINGDOM												
TRADE	-.8	-5.7	-.2	-1.8	-2.1	-1.6	-1.5	-.3	.3	-.3	-.1	-.3
CURRENT ACCOUNT 2/	4.4	1.3	1.4	-.2	-.5	.5	-.6	1.6	.9	.4	.5	.3
UNITED STATES												
TRADE	-62.0	-108.3	-25.6	-25.6	-32.5	-24.6	-29.6	-33.0	-11.1	-11.9	-9.8	N.A.
CURRENT ACCOUNT	-40.8	-101.5	-19.1	-24.5	-32.5	-25.5	-30.3	-31.8	*	*	*	*

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 CURRENT ACCOUNT DATA ARE NOT PUBLISHED.

year. Reversing its decline in June, Japanese IP grew 1.7 percent (s.a.) in July to 6.3 percent above its year-earlier level. Retail sales also rose strongly in July, advancing 1.4 percent (s.a.). Housing starts, however, declined for the fourth consecutive month and in July were 0.5 percent below their year-earlier levels.

The Tokyo consumer price index rose 2.7 percent during the 12 months ending in August, down slightly from the 12-month inflation rate recorded in July. Japan's external surpluses continue at record rates. For the first seven months of 1985, the cumulative trade surplus was $50 billion (s.a.a.r.). Through July, the cumulative current account surplus was $44 billion (s.a.a.r.), up more than $12 billion from the corresponding period in 1984.

Concerned about growth of protectionist sentiment among Japan's trading partners, Prime Minister Nakasone instructed the Economic Planning Agency on September 3 to compile by end-September a list of domestic expansionary measures that would have an immediate impact on Japan's current account. Major areas singled out for study include private housing construction, plant and equipment investment, and consumption. Another working group, set up as part of Japan's "Action Plan" (announced on July 30), has been looking at measures that would expand domestic demand mostly in the medium term, and this group is scheduled to report to the Prime Minister by October 10. Concerns about growing foreign protectionist sentiment led the Japanese Ministry of Finance in early September to ask banks and securities companies to exercise self-restraint on foreign bond purchases. It is hoped that an associated reduction in Japanese demand for foreign assets would strengthen the yen.

Industrial production in Germany rose 2 percent in June, and more recent indicators of wholesale sales as well as business and consumer sentiments point to relatively strong demand through this summer. Preliminary real GNP data for the second quarter indicate a strong rebound (about 6 percent s.a.a.r.) from the depressed first-quarter level. The rate of unemployment, however, has remained at the near record level of 9.3 percent (s.a.) through July.

Consumer prices barely rose between January and August this year (0.4 percent a.r.). The year-on-year rate in August was 2.1 percent. Wages and productivity rose at an approximately equal pace in the first half of this year, compared with the first half of 1984, so that unit labor costs remained flat. In addition, import prices, reflecting exchange rate developments, have fallen in recent months.

Germany's trade surplus through July was $12.6 billion (n.s.a.) compared with $8.5 billion for the same period last year. The current account surplus increased by about the same margin, from $0.4 billion in January-July 1984, to $4.1 billion this year.

The federal budget for 1986 is currently being debated in the Bundestag. According to the proposed budget, spending will rise by 2.4 percent over budgeted 1985 spending, and revenues will increase by 2 percent. The federal deficit, at DM 25 billion, (1.4 percent of 1985 GNP), will increase only slightly.

Recent economic data from France indicate continued slow growth in real economic activity. Real GDP grew by only 2.4 percent (s.a.a.r.) in the second quarter, following a decline of 1.2 percent in the first quarter. On a year-over-year basis, second-quarter real GDP was up by only 1.4 percent. Industrial production decreased by 1.5 percent (s.a.) in June, leaving industrial production unchanged from its year-earlier level. The unemployment rate remained unchanged in August at 10.6 percent (s.a.).

The year-over-year French consumer price inflation rate, after remaining virtually unchanged at 6-1/2 percent during the first half of the year, moved lower in July and August. The 0.1 percent (n.s.a.) increase in consumer prices in August lowered the year-over-year inflation rate to 5.6 percent, only slightly above the government's revised 5 percent year-over-year inflation target for the end of this year.

The trade balance moved back into deficit by $430 million in July following the first monthly trade surplus of the year in June. For the first seven months of the year the trade deficit was $3.2 billion (s.a.a.r.), compared with $2.7 billion for the year 1984. The current account was in surplus by $500 million in the second quarter compared with a deficit of nearly $800 million in the first quarter.

On September 18 President Mitterrand's cabinet approved a draft budget for 1986. The target for the overall budget deficit remains 3 percent of GDP. (The actual deficit rate so far this year has been only slightly above target.) Both expenditures and revenues are scheduled to increase by slightly less than 4 percent. About 1 percent of public sector jobs will be eliminated through attrition. Income tax rates will be reduced by 3 percent. Selected business taxes will also be lowered.

The compulsory loan imposed on higher-income taxpayers in April 1983 will be repaid ahead of schedule in January of next year. The overall stance of the proposed budget--the last for the current government before legislative elections next March--continues the policy of relative macroeconomic restraint first adopted over two years ago.

Real GDP (average measure) in the United Kingdom grew 4.1 percent (s.a.a.r.) in the second quarter to 5 percent above its year-earlier level. Investment had risen sharply in the first quarter and then fell in the second quarter, as capital purchases had accelerated prior to the April 1 reduction in depreciation allowances applicable for tax purposes. The resumption of coal production following the ending in March of the coal miners' strike, however, provided an offsetting boost to measured growth. In July, the index of industrial production fell 1 percent (s.a.).

The sharp acceleration in U.K. price inflation that took place in the spring now seems to have been temporary. The retail price index fell slightly in July and rose only 0.3 percent in August to a level 6.2 percent above August 1984. The recent 1-1/4 percentage point drop in mortgage rates should moderate measured inflation further in September.

The U.K. trade deficit was $3.2 billion (s.a.a.r.) in August. For the first seven months of 1985, the cumulative trade deficit was $3.1 billion (s.a.a.r.), and the cumulative current account surplus was $2.7 billion (s.a.a.r.). The trade deficit for 1984 was $5.7 billion.

On September 2, Prime Minister Margaret Thatcher announced several changes in her cabinet. The changes are thought to reflect increased government priority on reducing unemployment, which rose slightly to

13.2 percent (s.a.) in August, and a desire to prepare for the next general election, which must be held by spring of 1988.

Real GNP in Canada rose 4.1 percent (s.a.a.r.) in the second quarter of 1985, matching its first-quarter growth. The bulk of this increase was accounted for by business fixed investment, up 22 percent (s.a.a.r.) and consumer expenditure, up 5 percent (s.a.a.r.). But even with the large increase in business spending, business fixed investment in the second quarter was still 12 percent below the 1981 average. Industrial production increased 1.5 percent in June, the largest monthly increase in six months. Unemployment in Canada declined to 10.3 percent in August bringing the total decline, since January, to 0.9 percentage points.

Canadian inflation continued to be moderate in 1985. Consumer prices in August were only 4 percent above year-earlier levels. This slower rate of inflation compares favorably with last year's pace of 4.5 percent. In addition, inflation in Canada's wholesale price index in July was only 2.2 percent above last year's level. Meanwhile, Canada's trade surplus through July was $13 billion (s.a.a.r.) compared with $16 billion for all of 1984. The current account balance narrowed in the second quarter, declining to $0.3 billion from the first quarter's $0.6 billion.

On September 1, the government announced the failure of two Canadian chartered banks, Canadian Commercial Bank (CCB) and Northland Bank. Both banks were based in Alberta and had substantial quantities of non-performing loans to the oil and agricultural sectors. CCB is currently being liquidated while a "curator" is seeking a merger for

Northland. The government intends to seek legislative authority to compensate uninsured depositors for all outstanding deposits and to propose reforms in the supervisory powers of the federal authorities. The problems of these two banks have been characterized by government officials as reflecting "particular and unique circumstances" and reportedly do not imply any wider problem concerning the soundness of the Canadian banking system. These were the first Canadian chartered banks to collapse since 1923. The combined assets of the two banks accounted for one percent of total bank assets in Canada.

Real GDP in Italy grew by 0.8 percent in the second quarter; growth in the first half of this year compared with the second half of last year was 1.9 percent (s.a.a.r.). Although industrial production grew by 2 percent in June, the second quarter was lower than the first quarter level and the first half of 1985 was only slightly above the second half of last year.

In August, the cost of living index was 8.6 percent above its level in August 1984, indicating that inflation has not abated in the last 10 months. The official government survey of businessmen, conducted at the beginning of July, indicated that businessmen expect easing of inflationary pressures with moderate real economic expansion.

The trade deficit for the first six months of 1985 was $15 billion (s.a.a.r.), as compared with $11 billion for all 1984.

The public sector deficit as measured by the Central Treasury cash requirement in the period from January to July of 1985 was up over 40 percent from the same period in 1984. Central government receipts rose by 9 percent, while expenditures grew 22 percent. The original target for 1985 for the deficit was equivalent to 15 percent of projected GDP, but even this target seems to be an unrealistic goal now.

Economic Situation in Major Developing Countries. Mexico has fallen out of compliance with its IMF program and will have to forego the last three drawings under its EFF agreement, but, in view of the recent earthquake, it may be eligible for emergency financial assistance from the IMF. Argentina has completed the process leading to the initial disbursement from its $4.2 billion bank credit and is expected soon to reduce sharply its arrears, but difficulties loom ahead regarding compliance with the end-September IMF performance tests. The prospects that Brazil will succeed in negotiating an IMF program in the near term were dealt a setback when the finance minister and central bank president resigned. Venezuela is continuing to make slow progress in registering private external debt for repayment at the preferential exchange rate. The Philippines has not yet met the qualitative program targets for the second IMF program review, and the September IMF drawing is being delayed.

Individual Country Notes. Despite cuts in public spending announced on three occasions this year, Mexico has fallen far out of compliance with the 1985 public sector deficit target of 4.1 percent of GDP specified under the program negotiated with the IMF in March. Mexico is expected to remain out of compliance through the end of its EFF program in December 1985 and will have to forego the final three drawings totaling SDR 908 million. The second phase of the Mexican multi-year debt rescheduling agreement was signed on August 29, amid reports that creditor banks may be reluctant to extend loans to Mexico on a voluntary basis in 1986. At the signing ceremony, Finance Secretary Silva-Herzog noted that the agreement was "predicated upon two fundamental principles: full payment of interest and net new money. However, if one of the assumptions does not hold, neither will the other." In his State of the Nation address on September 1, President de la Madrid stressed that Mexico must grow in order to be able to pay what it owes, but he reaffirmed his belief that the debt problem will not be solved by confrontation or by repudiating contracted obligations and that solutions must be sought through dialogue and negotiations. Mexican reserves declined by about $2.5 billion in the first eight months of the year. Pressure on the so-called "super-free" exchange rate increased in September. Even though the rate of crawl of the controlled exchange rate was accelerated, the spread between the two rates widened to about 30 percent on September 23. (The spread ranged from 15 to 18 percent in the last three weeks of August.) Concern has been growing over Mexico's lack of compliance with the IMF performance tests, the decline in international reserves, the prospects for world oil prices, the lagging non-oil exports, the upturn in the rate of inflation (4.4 percent in August), the reported reluctance of creditor banks to extend loans to Mexico on a voluntary basis in 1986, and the failure of the government to announce new corrective measures. The recent earthquakes in Mexico will complicate the establishment of a new macroeconomic program, but Mexico may be eligible for emergency financial assistance from the IMF.

Following reinstatement of Argentina's IMF stand-by agreement in early August, the commercial bank financing package, consisting of a $4.2 billion credit and the rescheduling of $13.4 billion in public and private sector debts maturing in 1982-85, began to be signed on

August 27. An initial disbursement of $2.2 billion from the new credit in late September will provide the means for bringing interest on public sector debt to banks current up to early September and for paying the overdue $750 million balance of the 1982 commercial bank bridge loan. Half of the $460 million drawn by Argentina in June under the $483 million bridge loan from the United States and 11 other countries was repaid in August from the IMF drawing of that month. The balance is to be repaid from the late September IMF drawing that is conditional on Argentina's compliance with the end-July IMF performance tests. While these tests appear likely to have been met, problems may arise regarding compliance with the end-September conditions. The central bank is continuing to provide subsidies to the domestic commercial banks and, as a result, it may have difficulty achieving the planned reduction in its operating losses, which have long been a source of monetary expansion. In addition, there are doubts about the extent to which central government transfers to the provinces have been reduced. On the plus side, total tax collections were sharply higher in July and August than in June. In August, consumer prices rose by 3.1 percent and wholesale prices rose by 1.5 percent, apparently because of seasonal factors. The free market exchange rate for the dollar has remained fairly stable for about two months around a level representing a premium of about 17 percent above the official rate.

Brazil's finance minister and central bank president resigned August 26 apparently in protest over the government's failure to attack the prospective fiscal deficit for 1985. Completion of negotiations on an IMF program is now unlikely until the end of 1985, at the earliest.

For the interim, commercial bank creditors agreed in late August to extend until mid-January 1986 the standstill on repayment of medium-term loans maturing in 1985 and to continue at present levels the trade lines, inter-bank lines, and the redeposit facility.

Inflation surged to 14 percent in August, a record monthly rate, and is likely to finish the year with a 12-month rate of inflation far above the 200 percent target of the government. Price controls introduced by the new democratic government in March have been relaxed, but further major adjustments in government enterprise prices for steel, electricity, and oil may be needed during the fall to help reduce the deficits of those enterprises. After subsiding during the first quarter of 1985, Brazil's trade surplus again strengthened to about a $1.1 billion monthly rate through August and the current account balance is likely to remain near zero in 1985. Industrial production during January-July 1985 was 6.8 percent higher than during the same period last year, and agricultural production has increased at a similar rate.

The final signing of the Venezuelan multi-year rescheduling agreement will probably occur sometime this fall. Lack of progress in reviewing applications to register private debt for repayment at the preferential exchange rate has held up completion of the rescheduling. The initial review of applications is now almost complete, but a flood of appeals has caused Venezuela to extend the deadline for registration to the end of this year.

After the Philippines drew the second tranche of SDR 106 million from its IMF stand-by arrangement on July 31, the creditor banks formally established a $3 billion short-term trade facility for the

Philippines on August 5 and, on August 12, released the first tranche of $400 million of the $925 million new money credit arranged last May. In late August the creditor banks began negotiations with five major Philippine public sector debtors aimed at rescheduling their external debt by mid-November. The Philippines met the end-July performance criteria under the IMF stand-by program, but has not yet met the qualitative program targets for the second program review (related to structural reforms in the sugar and coconut sectors). Until this review is satisfactorily completed, the Philippines will not be able to draw the third IMF tranche of SDR 106 million, or receive the second disbursement of $175 million under the $925 million new money facility. A new letter of intent was submitted to the IMF on September 18, which, if approved, would relax monetary and fiscal restraints somewhat in order to stimulate economic activity.