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October 28, 1987

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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No statistical evidence is available on production or spending for the period since the mid-October drop in stock prices. Data for the period prior to the turmoil in the financial markets generally showed continued strength in activity. Real GNP grew at a 3.8 percent annual rate in the third quarter, according to the Commerce Department's preliminary estimate, after rising at a 3-1/2 percent pace in the first half of the year. Much of the third-quarter strength was in manufacturing, reflecting increased demand for capital equipment and a further expansion of exports. Prices have continued to rise at a relatively moderate rate in recent months, and wages have registered only a hint of acceleration.

Employment and Unemployment

Labor demand, on balance, remained strong during the summer. Non-farm payroll employment rose 190,000 in September after adjusting for the effects of teachers' strikes in Chicago and Detroit, bringing the strike-adjusted average monthly increase in the third quarter to nearly 220,000. Factory hiring was especially brisk, with the number of workers on manufacturing payrolls up more than 50,000 per month between June and September. Job gains in manufacturing were widespread across both durable and nondurable goods industries, with the largest increases in primary metals, nonelectrical machinery, and chemicals.

In other industries, employment trends have weakened somewhat from the pace evident throughout most of this year. In construction, employment fell 33,000 in September, partly owing to continued weak housing market activity. In the finance, insurance, and real estate category,

CHANGES IN EMPLOYMENT¹

(Thousands of employees; based on seasonally adjusted data)

	1986	1987			1987		
		Q1	Q2	Q3	July	Aug.	Sept.
-Average Monthly Changes-							
Nonfarm payroll employment ²	159	254	163	197	308	152	132
Strike-adjusted	159	241	164	218	315	151	188
Manufacturing	-14	8	7	56	89	22	56
Durable	-17	0	0	34	19	49	35
Nondurable	4	8	7	21	70	-27	21
Construction	13	32	-8	-11	-6	5	-33
Trade	31	57	35	41	64	-12	71
Finance and services	110	124	100	89	153	83	32
Total government	30	18	18	5	-11	32	-6
Private nonfarm production workers	105	199	112	133	245	97	58
Manufacturing production workers	-7	6	11	47	62	20	59
Total employment ³	174 ^e	244	296	172	470	354	-309
Nonagricultural	174 ^e	203	332	174	429	481	-387

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.

e--Adjusted by board staff to eliminate distortions caused by the introduction of revised population estimates.

SELECTED UNEMPLOYMENT RATES

(Percent; based on seasonally adjusted data)

	1986	1987			1987		
		Q1	Q2	Q3	July	Aug.	Sept.
Civilian, 16 years and older	7.0	6.7	6.2	6.0	6.0	6.0	5.9
Teenagers	18.3	17.9	17.0	15.9	15.5	16.0	16.3
20-24 years old	10.7	10.4	10.1	9.4	9.8	9.1	9.3
Men, 25 years and older	5.4	5.2	4.8	4.6	4.7	4.7	4.4
Women, 25 years and older	5.5	5.1	4.6	4.7	4.7	4.7	4.7
White	6.0	5.7	5.3	5.1	5.1	5.1	5.1
Black	14.5	14.2	13.2	12.4	12.6	12.4	12.3
Fulltime workers	6.6	6.3	5.9	5.6	5.7	5.6	5.4
Memo:							
Total National ¹	6.9	6.6	6.1	5.9	5.9	5.9	5.8

1. Includes resident armed forces as employed.

slower mortgage originations and an incipient shakeout among some financial service firms caused employment to level off after nearly two years of steady increases. Employment growth in nonfinancial services also slowed from its pace earlier this year, but job gains in retail trade bounced back in September after their August decline.

The civilian unemployment rate edged down further in September to 5.9 percent. A drop in the jobless rate for adult men has accounted for most of the overall decline in unemployment in recent months, reflecting the improvements in the industrial sector. The jobless rate for adult women, who are concentrated in the service-producing sector, has changed little since May, after dropping sharply earlier this year. In addition, more recent data on initial claims for unemployment insurance, which averaged a bit less than 300,000 per week between mid-September and mid-October, suggest that labor demand remained strong into the fourth quarter.

Industrial Production

The industrial production index rose another 0.2 percent in September after a sharp gain over the preceding few months. On a quarterly average basis, production rose at an 8-3/4 percent annual rate in the July-September period. Output of business equipment continued to advance in September and in the third quarter was up about 10 percent at an annual rate. Much of the strength in this area has occurred in manufacturing equipment, particularly in metalworking machinery and general industrial equipment.

Output of consumer goods edged down in September, owing largely to a sharp drop in truck production. However, truck output had been quite robust in the preceding few months, and for the third quarter as a

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

	1987		1987		
	Q2	Q3	July	Aug.	Sept.
	--Annual rate--		---Monthly rate---		
Total Index	4.2	8.8	1.1	.3	.2
Products	3.6	9.3	1.3	.2	.2
Final products	3.0	9.3	1.4	.2	.2
Consumer goods	1.5	8.0	1.5	.1	-.3
Durable consumer goods	-5.8	9.4	2.8	.7	-1.2
Nondurable consumer goods	4.1	7.5	1.1	-.1	.0
Equipment	4.7	10.9	1.3	.3	.8
Business equipment	5.6	10.2	1.3	-.1	.5
Defense and space equip.	1.6	2.4	.0	.8	.7
Oil and gas well drilling	15.1	159.6	13.0	9.1	8.2
Intermediate products	5.6	9.0	.9	.2	.2
Construction supplies	-2.0	9.5	.9	-.3	.2
Materials	5.3	8.0	.9	.5	.1
Durable goods materials	5.2	9.8	.9	.9	-.1
Nondurable goods materials	9.5	9.5	2.1	-.1	.6
Energy materials	1.2	2.4	-.5	.5	.0

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

	1978-80	1982	1967-86	1984	1987			
	High	Low	Avg.	High	June	July	Aug.	Sept.
Total industry	86.9	69.5	81.5	81.8	80.3	81.1	81.2	81.2
Manufacturing	86.5	68.0	80.6	81.3	80.8	81.5	81.6	81.5
Durable	86.3	63.7	78.7	79.9	77.8	78.5	78.8	78.8
Nondurable	87.0	74.2	83.5	84.2	85.2	85.8	85.7	85.5
Mining	95.2	76.9	87.2	86.6	76.6	76.8	77.4	78.2
Utilities	88.5	78.0	87.3	84.8	79.0	80.0	79.0	78.8
Industrial materials	89.1	68.5	82.3	82.8	79.8	80.4	80.8	80.8
Metal materials	93.6	45.7	77.8	70.8	71.5	73.9	76.6	77.4
Paper materials	97.3	79.9	91.4	97.5	96.3	99.6	99.9	100.2
Chemical materials	87.9	63.5	80.8	78.3	83.1	84.2	84.5	85.1

whole, production was up nearly 11 percent (not at an annual rate). So far in October, truck production appears to be running at about the September pace. For autos, assemblies were at an annual rate of 6.1 million units in September--close to the low 6.0 million unit rate in August. Automakers' production schedules for the fourth quarter have been pared from 7.5 million to 7.3 million units at an annual rate, but these plans still appear rather high given the present sales and inventory situation, and some cutbacks from current plans are likely in coming months. Among other consumer goods, the production of goods for the home, particularly appliances, eased in September after strong gains in July and August, while production of nondurable consumer goods has changed little since last spring.

Materials production, which rose 5-1/2 percent over the past year, was about unchanged in September. Further gains in basic metals, notably steel, were more than offset by weakness in consumer durable parts, mainly those used for motor vehicles. However, significant increases in output have continued in some trade-sensitive industries such as textiles, paper, and chemicals.

Capacity Utilization

Capacity utilization in manufacturing, mining, and utilities was at 81.2 percent in September, about equal to the average of the last 20 years. Over the past year, operating rates have been trending upward, almost fully reversing the two-year decline that began in the third quarter of 1984. In September, a further rise in the operating rate for primary metals, reflecting another advance in iron and steel production, offset a sharp drop in the rate for motor vehicles and parts. Most

other industries experienced only small changes in operating rates last month.

Because Federal Reserve estimates of capacity growth in recent years (2-1/2 percent annually) have been above BEA estimates of capital stock growth (2 percent annually for the gross capital stock and 1 percent per year for the net stock), it has been suggested that FRB measures of capacity utilization are too low.¹ However, the difference between capacity growth and capital stock growth can be explained in part by increases in the productivity of capital associated with a shift in investment expenditures from structures to equipment. A series on capital productivity derived by the staff from Bureau of Labor Statistics data suggests that this shift has boosted the growth of capital productivity about 0.6 percentage point per year. If BEA's capital stock series are adjusted by this amount, then their rates of growth in recent years more closely approximate that of the Federal Reserve's capacity measure.

In addition to utilization rates, other measures of production tightness in manufacturing do not point to widespread problems with bottlenecks. In particular, data from the purchasing managers' survey, while showing longer delivery lags recently, indicate that lead times for orders of production materials--that is, how far in advance of expected delivery that managers place orders--have changed little over the past year and still are well below levels reached in 1983 and 1984. In addition, separate data indicate that the backlog in unfilled orders (excluding aircraft) has continued to trend down, suggesting that, by

1. The Federal Reserve's estimates of capacity utilization are based on the index of industrial production, and on surveys of utilization rates, physical capacity and output data, and BEA capital stock data.

and large, producers currently are not unduly pressed by this year's pickup in orders.

Personal Income and Consumption

Nominal personal income advanced nearly \$23 billion at an annual rate in the third quarter, somewhat more than the pace of the first half of this year. Gains in total income last quarter were boosted by a \$14-1/2 billion increase in wages and salaries and a pickup in personal interest income that reflected, in part, higher interest rates. Disposable personal income, which has been influenced in recent quarters by fluctuations in personal tax payments, stood in the third quarter about 4-1/4 percent above its 1986-Q4 level. However, price increases have erased much of the gain in nominal incomes this year, and the level of real disposable income in the third quarter was less than 1 percent above its 1986-Q4 level.

Real consumption spending moved up at a brisk pace in the third quarter, rising nearly 5 percent at an annual rate, after an average gain of only 1/2 percent during the first half of the year. Spending on motor vehicles accounted for roughly half of the third-quarter increase; however, sales of domestic autos dropped off sharply during the first twenty days of October following the expiration of the end-of-model year incentive plans. Excluding motor vehicles, real consumer outlays on goods were virtually unchanged, while spending on services posted a healthy gain.

Taking a longer view, consumption spending clearly has decelerated, reflecting the marked slowing in real income growth. Excluding motor vehicles, growth in real expenditures has slowed from nearly 4-1/2 percent in 1985 to about 2 percent during the first three quarters of this

PERSONAL INCOME
(Billions of dollars; based on seasonally adjusted data)

	1986	1987			1987		
		Q1	Q2	Q3	July	Aug.	Sept.
		----Average Monthly Change----					
Total personal income	14.2	23.5	10.6	22.8	21.9	21.0	25.4
Wages and salaries	7.5	12.9	8.6	14.5	10.8	19.3	13.4
Private	5.6	10.1	6.6	12.5	8.7	17.3	11.4
Other labor income	.7	.8	.7	.8	.8	.7	.8
Proprietors' income	2.6	6.7	-2.9	1.5	2.7	-3.4	5.1
Farm	.5	3.5	-4.4	-.8	-.3	-6.6	4.4
Rent, dividends and interest	1.7	2.7	2.3	5.6	4.9	5.8	6.1
Transfer payments	2.5	2.1	2.5	1.4	3.5	-.1	.8
Less: Personal contributions for social insurance	.8	1.7	.5	1.0	.7	1.3	.9
Less: Personal tax and nontax payments	3.2	-1.2	7.0	4.2	2.6	5.6	4.5
Equals: Disposable personal income	11.0	24.7	3.6	18.5	19.2	15.5	20.9
Memo: Real disposable income	6.3	6.1	-7.4	--	13.3	1.8	--

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 REAL PERSONAL CONSUMPTION EXPENDITURES
 (Percent change from preceding period;
 based on seasonally adjusted data)

	1986 ¹	1987			1987	
		Q1	Q2	Q3	July	Aug.
		----Annual rate----			--Monthly rate--	
Personal consumption expenditures	4.1	-.7	1.9	4.8	.3	1.3
Durable goods	12.4	-21.2	10.5	19.9	.3	6.3
Excluding motor vehicles	12.7	-3.8	2.2	3.0	1.6	-.9
Nondurable goods	2.9	1.3	-1.9	-.3	.0	.3
Excluding gasoline	2.4	2.9	-3.3	.7	-.2	.6
Services	2.4	5.4	2.1	4.1	.6	.5
Excluding energy	3.0	7.3	1.8	3.4	.4	.5
Memo:						
Personal saving rate (percent)	4.3	4.4	3.0	3.0	3.4	2.2

1. Percent change from fourth quarter of 1985 to fourth quarter of 1986.

SALES OF AUTOMOBILES AND LIGHT TRUCKS¹
 (Millions of units at an annual rate; FRB seasonals)

	1986	1987				
		Q2	Q3	July	Aug.	Sept.
Autos and light trucks ²	16.1	15.0	16.4	15.4	17.7	16.1
Autos	11.5	10.3	11.4	10.5	12.2	11.6
Light trucks	4.7	4.8	5.0	4.9	5.5	4.5
Domestically produced ³	12.0	11.0	11.9	11.3	13.1	11.5
Autos	8.2	7.2	7.8	7.2	8.5	7.8
Light trucks	3.7	3.8	4.1	4.1	4.6	3.6
Imports	4.2	4.0	4.4	4.1	4.6	4.6
Autos	3.2	3.1	3.6	3.3	3.7	3.7
Japanese	2.4	2.1	2.4	2.1	2.4	2.6
Korean ⁴	.2	.3	n.a.	.4	.5	n.a.
European ⁴	.7	.7	n.a.	.8	.7	n.a.
Light trucks	.9	.9	.9	.8	.9	.9

1. Data for sales of light trucks and imported automobiles for the current month are preliminary and subject to revision.

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

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

4. Sales of European and Korean cars are included in the total but were not available separately for September.

RETAIL SALES
(Seasonally adjusted percentage change)

	1987			1987		
	Q1	Q2	Q3	July	Aug.	Sept.
Total sales	-1.1	2.4	2.4	.6	1.7	-.4
Previous estimate ¹			n.a.	.5	1.3	n.a.
(REAL) ²	-2.5	1.0	n.a.	.5	1.3	n.a.
Previous estimate ¹			n.a.	.5	.8	n.a.
Total less auto dealers, nonconsumer stores, and gasoline stations	1.7	.7	.7	.1	.5	-.3
Previous estimate ¹		.7	n.a.	.3	.3	n.a.
GAF ³	2.1	.8	1.3	.9	.3	-.4
Durable	-5.9	4.2	4.8	1.5	3.1	-.9
Auto. dealers & parts	-10.8	8.1	7.5	1.7	5.7	-1.4
Furniture and appliances	-.1	-1.1	1.0	2.4	-.8	-1.0
Other durable goods	2.1	.5	1.9	1.1	-.6	-.5
Nondurable	2.1	1.3	.9	.0	.9	-.1
Apparel	2.1	.6	1.8	.3	-.2	.6
Food	.1	.7	.2	-.8	1.0	-.4
General merchandise ⁴	3.2	1.8	1.2	.4	1.2	-.5
Gasoline stations	4.6	4.2	4.1	2.4	2.3	.7

1. Based on incomplete sample counts approximately one month ago.

2. BCD series 59. Data are available approximately 3 weeks following the retail sales release.

3. General merchandise, apparel, furniture and appliance stores.

4. General merchandise excludes mail order nonstores; mail order sales are also excluded in the GAF grouping.

n.a.--Data are unavailable because of a future release date.

year. Spending on nondurables, which has changed little since mid-1986, has accounted for much of the deceleration in consumption growth. Spending on a wide range of durable goods also decelerated sharply during the first three quarters of this year, adding to the slowing in consumer outlays. In contrast, spending on services has continued to rise briskly this year, with gains posted for most categories.

Business Fixed Investment

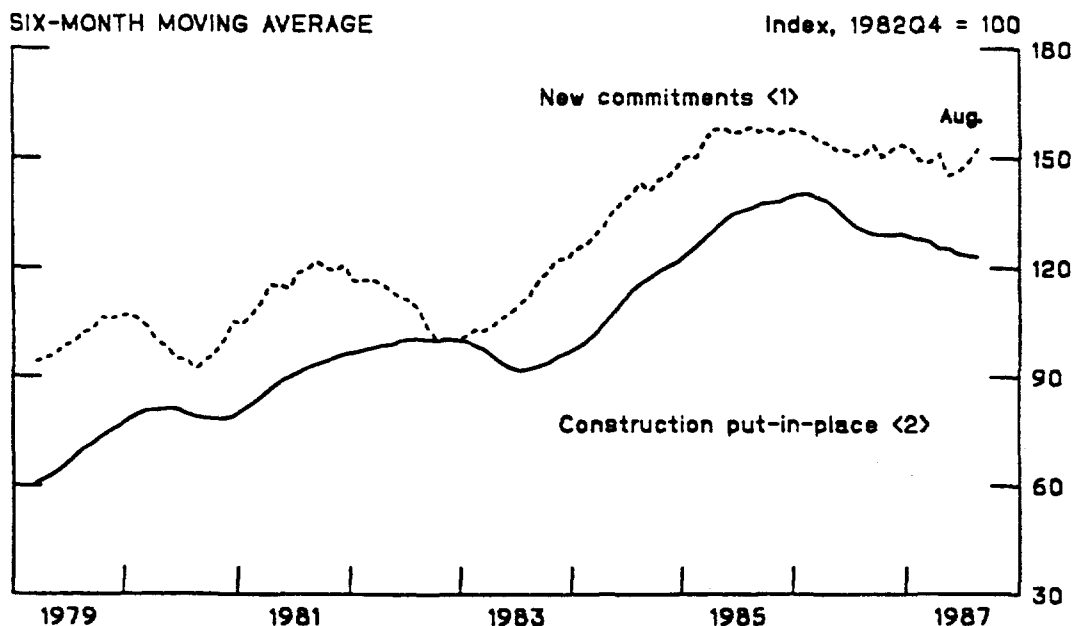
Real outlays for business fixed investment are estimated by the BEA to have grown at a 24 percent annual rate in the third quarter. Outlays for nonresidential structures were up at a 16 percent annual rate, reflecting for the most part, a sharp expansion of petroleum drilling, which has trended up since the middle of 1986 in response to the rise in oil prices. In addition, the third-quarter construction figures reflected an increase for public utilities and a rise in the office sector--the first in more than two years. It appears that continuing demand for office buildings--partly from foreign investors--has supported real estate prices, thus encouraging continued development despite high vacancy rates.

For equipment, real outlays rose at a 27 percent annual rate in the third quarter. More than half of the rise reflected a sharp increase in purchases of office and computing equipment. The third-quarter jump in this category followed two years of generally trendless outlays and may signal a renewed willingness by businesses to invest in information processing equipment. Apart from computers, outlays advanced at a 15 percent annual rate, paced by stronger purchases of motor vehicles in response to the recent sales incentive programs and higher spending for a wide range of other types of equipment.

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

	1987			1987		
	Q1	Q2	Q3	July	Aug.	Sept.
<u>Producers' durable equipment</u>						
Nondefense capital goods						
Shipments	-3.2	2.7	4.3	.9	1.3	2.3
Aircraft	-13.7	4.1	-2.4	-8.4	-7.5	22.5
Excl. aircraft	-1.8	2.5	5.2	2.1	2.3	.2
Orders	-3.8	9.0	2.6	6.7	-7.7	-1.3
Aircraft	-26.2	30.5	-4.6	38.4	-32.2	-19.4
Excl. aircraft	.6	5.9	3.9	1.5	-2.3	1.5
Sales of heavy-weight trucks (thousands of units, A.R.)	277	312	327	309	295	377
<u>Nonresidential structures</u>						
Nonresidential construction	-3.8	-.1	--	1.3	2.3	--
Commercial building	-5.4	-1.5	--	-.7	3.9	--
Office	-5.2	-5.4	--	5.1	3.0	--
Other commercial	-5.5	2.3	--	-5.9	4.9	--
Industrial building	-13.8	4.3	--	-3.2	6.5	--
Public utilities, institutional, and other	.1	.2	--	4.0	.1	--
Rotary drilling rigs in use	3.4	6.8	16.3	10.7	4.6	6.9

Nonresidential Construction and New Commitments



<1> Sum of contracts (from F.W.Dodge) and permits (from Census) for industrial, commercial, and institutional construction.

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

Indicators of near-term spending also were quite favorable through September. New orders for nondefense capital goods other than aircraft advanced about 4 percent (not an annual rate) in the third quarter, after an even larger gain during the preceding quarter. Moreover, new commitments for nonresidential construction have continued to hold steady. In tandem, these indicators point to continued gains in capital spending through year-end. In light of normal planning and ordering lags, the recent drop in stock prices should not influence near-term spending very much. In terms of equipment, stepped-up cancellations of orders are unlikely because ordered machinery typically is part of a longer-run plan for expansion or modernization that would not be amended unless firms experience a sizable decline in product demand. Similarly, for structures, near-term expenditures generally are associated with projects that already are well in train. Should the BEA third-quarter estimate hold up, it is likely that investment growth for the year will end up closer to the summer survey results than the staff previously had expected.

Business Inventories

In conjunction with the pickup in activity in the third quarter, manufacturers stepped up inventory investment. The recent inventory buildup was fairly widespread by industry and occurred at all stages of fabrication. However, the stock accumulation was about matched by higher sales, and inventory-shipments ratios remained relatively low in most industries at the end of August.

In the trade sector, inventory-sales ratios for nonauto retail establishments in general, and for stores that carry mostly discretionary consumption goods in particular, had leveled off by the end of

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

	1986	1987		1987		
	Q4	Q1	Q2	June	July ^r	Aug. ^p
Current Cost Basis:						
Total	-1.1	41.2	47.0	37.7	35.9	16.2
Manufacturing	-.7	7.7	6.1	-2.7	20.5	24.6
Wholesale	-4.9	8.8	14.1	5.0	-5.3	-10.8
Retail	4.5	24.8	26.7	35.4	20.7	2.4
Automotive	5.2	19.9	9.3	12.4	8.5	-4.6
Ex. auto	-.7	4.8	17.4	23.0	12.2	7.0

Constant Dollar Basis:

Total	-2.9	34.1	20.7	14.7	15.7	-17.4
Manufacturing	-4.9	5.3	-4.4	-24.9	20.9	6.9
Wholesale	-4.7	3.6	9.6	8.2	-11.1	-13.6
Retail	6.7	25.2	15.5	31.4	6.0	-10.7
Automotive	4.1	21.3	3.0	12.4	-5.0	-10.7
Ex. auto	2.6	3.9	12.5	19.0	11.0	.0

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

	1986		1987		1987		
	Q4	Q1	Q2	June	July ^r	Aug. ^p	
Range in Preceding 12 months: ²							
Current Cost Basis:	low	high					
Total	1.47	1.57	1.50	1.51	1.51	1.49	1.50
Manufacturing	1.61	1.73	1.65	1.65	1.63	1.60	1.62
Wholesale	1.21	1.29	1.25	1.24	1.23	1.23	1.21
Retail	1.44	1.59	1.51	1.58	1.60	1.58	1.59
Automotive	1.33	2.12	1.64	2.03	1.96	1.92	1.91
Ex. auto	1.43	1.49	1.47	1.46	1.49	1.49	1.49

Constant Dollar Basis:

Total	1.49	1.54	1.49	1.51	1.51	1.51	1.51	1.50
Manufacturing	1.62	1.67	1.64	1.64	1.63	1.62	1.63	1.64
Wholesale	1.24	1.30	1.28	1.26	1.27	1.27	1.26	1.25
Retail	1.43	1.57	1.46	1.55	1.57	1.57	1.56	1.53
Automotive	1.42	2.05	1.56	1.97	1.88	1.84	1.80	1.68
Ex. auto	1.43	1.49	1.43	1.44	1.49	1.49	1.49	1.49

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 necessary coincident.
r--Revised estimates.

p--Preliminary estimates.

August after moving up throughout most of the spring and early summer. In the auto sector, car sales outpaced assemblies in late summer, reducing dealers' stocks considerably by the end of September; however, the slow pace of sales thus far in October suggests that inventory levels recently have started to move back up.

Housing Markets

Recent data indicate that housing market activity was stable in the third quarter. In the single-family market, housing starts ticked up in September, but permits changed little and the picture for both series in the third quarter as a whole was one of flatness. Sales data for new and existing homes also leave an impression of reasonably steady demand. However, conventional fixed-rate mortgage interest rates rose almost 60 basis points in September and continued to move up through mid-October; that rise, together with homebuilders' pessimistic attitudes, suggests the likelihood of some near-term decline in construction. In addition, the decline in household wealth associated with the recent drop in stock prices could further damp housing activity, although this effect may be cushioned by the concurrent drop in mortgage interest rates.

In the multifamily sector, the third-quarter construction rate, 480,000 units (annual rate), also was close to the second-quarter average and well below the first-quarter pace. The weakness in this sector continues to reflect tax law changes, which have reduced rates of return on multifamily rental investment, and a substantial excess supply of units in some regions. These factors--combined with the runup in interest rates until recently--are reflected in widespread builder pessimism concerning the outlook for apartment construction, too.

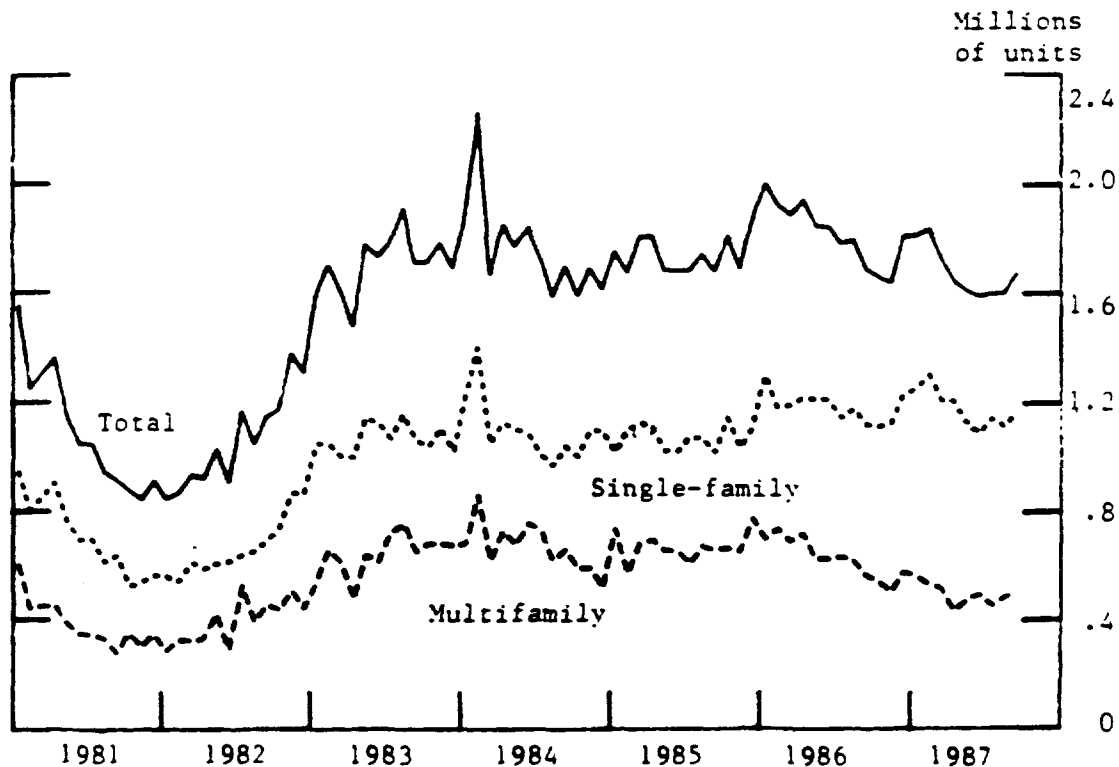
PRIVATE HOUSING ACTIVITY
(Seasonally adjusted annual rates, millions of units)

	1986	1987			1987		
	Annual	Q1	Q2	Q3	July	Aug.	Sept. ¹
All units							
Permits	1.75	1.68	1.54	1.49	1.49	1.50	1.49
Starts	1.81	1.80	1.61	1.62	1.60	1.60	1.67
Single-family units							
Permits	1.07	1.15	1.04	1.00	.99	1.02	.99
Starts	1.18	1.26	1.14	1.14	1.14	1.11	1.17
Sales							
New homes	.75	.72	.68	n.a.	.67	.69	n.a.
Existing homes	3.57	3.62	3.61	3.43	3.43	3.41	3.45
Multifamily units							
Permits	.68	.54	.50	.49	.49	.48	.50
Starts	.63	.54	.47	.48	.46	.49	.50
Mobile home shipments	.24	.23	.23	n.a.	.25	.23	n.a.

1. Preliminary estimates.

n.a.--Not available.

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



Incoming data continue to show large increases in home prices in series that do not make adjustments for improvements in house quality or changes in the regional mix of sales. For example, the median price of new homes, a series that is not adjusted for these influences, rose almost 17 percent during the year ended in August; in contrast, only modest house price increases--about 2 percent for the year ended in June--were recorded in data for which such adjustments were made. In the resale market, the median sales price--again, unadjusted--rose 6 percent during the 12 months ended in September.

State and Local Governments

Real purchases of goods and services by state and local governments increased at a 3 percent annual rate in the third quarter, about the same pace as on average in the first half of the year. Real outlays for construction were up a bit after a large second-quarter drop, but, on balance, building has changed little over the past year. Elsewhere, growth in real compensation for state and local employees slowed sharply, largely owing to teachers' strikes in Detroit and Chicago during September.

As a whole, the state and local government sector apparently recorded a large deficit in its operating and capital accounts (which exclude social insurance funds) in the third quarter. Indirect business tax accruals rose somewhat faster than in recent quarters, owing in part to the start of many recent sales and excise tax hikes. However, that increase was more than offset by a decline in federal grants and a reduction in personal income tax receipts after a second-quarter advance that was boosted by capital gains tax collections.

Federal Government

In September the federal government recorded a surplus of \$15.4 billion and, for the fiscal year as a whole, the deficit dropped to \$148 billion, \$73 billion below the record \$221 billion imbalance in FY1986. Growth of receipts was particularly strong in FY1987, amounting to about \$85 billion; expanding incomes and employment accounted for a substantial portion of the gain. However, as much as \$20 billion of the rise from last year can be traced to the initial effects of the Tax Reform Act of 1986, especially the surge in payments for capital gains that apparently were realized in 1986 to take advantage of the special treatment of such income under the old law. In FY1988, tax reform is expected to reduce revenues by roughly \$15 billion, as the remainder of the individual tax rate reductions are put in place.

Federal spending increased only 1.2 percent last year, compared with an average annual rise of 8 percent during the preceding five years. Improving conditions led to lower outlays in the agriculture, income security, and interest categories. Program cuts also were a factor, moderating the rise in defense spending and affecting outlays for education, transportation, housing, and general fiscal assistance to state and local governments. Asset sales, which are scored on the spending side of the budget and include loan prepayments, direct loan sales, and the Conrail sale, totaled nearly \$8 billion last year.² In addition, outlays in FY1987 were lower because roughly \$5 billion of spending originally scheduled for that year was accelerated to late FY1986 or postponed until FY1988.

2. It is estimated that the loss of interest and other receipts associated with assets sold in FY1987 will increase outlays by about \$1 billion per year in FY1988 and future years.

Total Federal Government Receipts and Outlays
(Budget basis, billions of dollars)

Fiscal year				Memo:
	Receipts	Outlays	Deficit	Deficit as a percent of GNP
1978	399.6	458.7	59.2	2.7
1979	463.3	503.5	40.2	1.6
1980	517.1	590.9	73.8	2.8
1981	559.3	678.2	78.9	2.6
1982	617.8	745.7	127.9	4.1
1983	600.6	809.5	208.9	6.3
1984	666.5	851.8	185.3	5.0
1985	734.1	946.3	212.3	5.4
1986	769.1	989.8	220.7	5.3
1987	854.1	1002.1	148.0	3.4

Relative to GNP, the deficit fell from an average of 5-1/2 percent in recent years to less than 3-1/2 percent in FY1987, the lowest since FY1981. However, the special, one-time factors noted above--tax reform, asset sales, and timing changes for outlays--accounted for nearly half of the deficit reduction. Thus, even with appreciable expansion of GNP, the lower FY1987 ratio is not likely to be sustained without substantial further policy actions.

Congress has yet to enact final budget legislation for the current fiscal year. Since October 1, the federal government has been operating under a temporary continuing resolution that expires November 10. And, on October 20, the President issued the initial sequestration order under the new Gramm-Rudman law, specifying defense spending cuts of \$11.5 billion and nondefense discretionary outlay reductions of the same amount. These cuts will be implemented unless alternative deficit reductions are enacted before November 20. In an effort to avoid the final sequester order for FY1988 and to calm financial markets, the President and Congressional leaders have begun negotiations to reduce the FY1988 and future budget deficits. Meanwhile, the House and Senate continue to work on a budget reconciliation bill with tax increases and cuts in entitlement spending. In addition, Congress is drafting an omnibus spending bill to substitute for the thirteen regular appropriation bills that fund discretionary defense and nondefense programs. Under the revised Gramm-Rudman process, the reconciliation and spending bills must provide a minimum of \$23 billion in deficit reduction or else the President must sign the final order sequestering enough budget authority to achieve the deficit reduction through lower spending. (A

more complete description of the new Gramm-Rudman law is provided in an appendix.)

Prices

Recent inflation reports suggest that prices are rising at a relatively moderate pace, although there has been considerable variation from month to month and across the major sectors. The GNP fixed-weight price index rose 2.7 percent at an annual rate in the third quarter, held down, in part, by small advances in private investment prices.³

The consumer price index for all urban consumers rose 0.2 percent in September after a 0.5 percent advance in August; the producer price index was up 0.3 percent in September, after being unchanged in August. So far this year, these measures have risen at annual rates of about 4-3/4 and 3-1/2 percent, respectively.

Energy prices dropped back in September, after large increases in preceding months. The CPI energy component was down 0.5 percent last month, as retail prices responded to the drop in crude oil prices in August and early September. From mid-September to late-October, spot prices of crude oil have moved in a relatively narrow range.

Retail food prices jumped 1/2 percent in September, after holding steady in August, and prices at the producer level surged more than 1 percent after two months of declines. Much of the recent volatility in these price indexes reflects short-term swings for supply-sensitive products such as eggs and fresh vegetables. On average, retail prices for other food groups have risen only moderately in recent months.

3. In particular, residential structures prices are estimated by the BEA to have risen only about 1-1/2 percent at an annual rate, after an average gain of 6 percent in the first half of the year. However, preliminary estimates of residential structures prices are based on very limited information and often are subject to substantial revision.

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

	Relative Importance Dec. 1986	1986	1987			1987	
			Q1	Q2	Q3	Aug.	Sept.
			--Annual rate--			--Monthly rate--	
All items ²	100.0	1.1	6.2	4.6	3.6	.5	.2
Food	16.2	3.8	2.5	6.5	1.4	.0	.5
Energy	7.4	-19.7	26.1	7.9	5.0	1.7	-.5
All items less food and energy	76.4	3.8	5.2	4.0	3.7	.4	.2
Commodities	26.1	1.4	5.1	3.8	3.0	.1	.3
Services	50.3	5.2	5.3	3.8	4.2	.5	.1
Memorandum: CPI-W ³	100.0	.7	6.3	4.8	3.8	.5	.2

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

2. Official index for all urban consumers.

3. Index for urban wage earners and clerical workers.

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

	Relative Importance Dec. 1986	1986	1987			1987	
			Q1	Q2	Q3	Aug.	Sept.
			--Annual rate--			--Monthly rate--	
Finished goods	100.0	-2.3	4.3	4.7	1.9	.0	.3
Consumer foods	26.3	2.9	-6.7	14.3	-3.0	1.3	1.1
Consumer energy	8.6	-38.0	59.8	10.9	-3.0	1.5	-3.7
Other consumer goods	40.6	3.0	4.2	-.3	5.1	.3	.6
Capital equipment	24.5	2.1	.4	1.4	4.2	.2	.7
Intermediate materials ²	95.0	-4.5	7.8	5.2	5.1	.5	.0
Exc. energy	82.9	.1	3.3	4.5	5.1	.3	.5
Crude food materials	42.5	-1.4	-10.3	34.0	-5.6	.1	.5
Crude energy	40.9	-27.5	50.0	15.8	2.1	.5	-2.7
Other crude materials	16.6	1.7	15.9	33.7	35.3	1.0	3.8

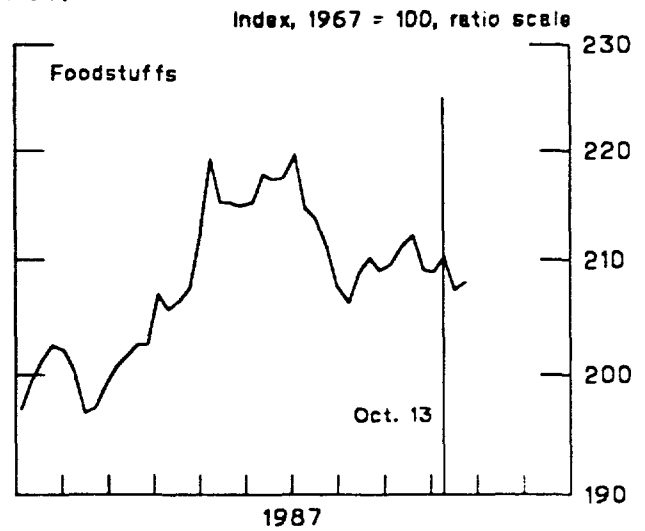
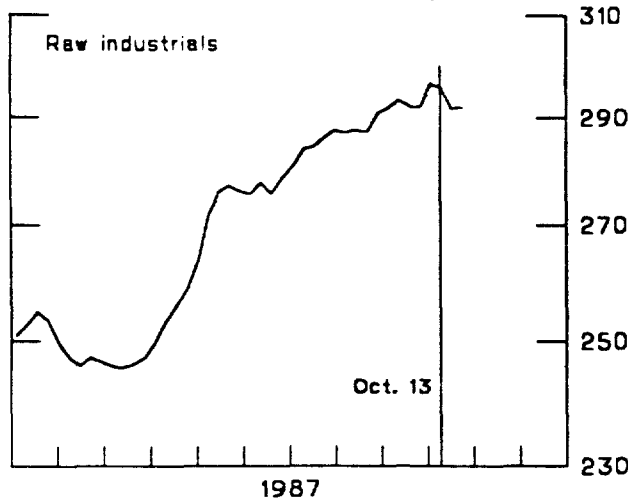
1. Changes are from final month of preceding period to final month of period indicated.

2. Excludes materials for food manufacturing and animal feeds.

Commodity Prices

COMMODITY RESEARCH BUREAU INDEXES (SPOT)

Index, 1967 = 100, ratio scale



PRICES OF SELECTED COMMODITIES

	Percent change		
	Dec. 30 to Sept. 15	Sept. 15 to Oct. 13	Oct. 13 to Oct. 27
Gold	18.0	.1	3.2
Silver	44.2	1.4	-4.1
Platinum	25.4	-1.7	-3.9
Aluminum (COMEX futures)	60.3	5.0	-3.3
Copper	35.4	4.2	-2.2
Steel scrap	32.7	24.1	.0
Rubber	21.8	-1.5	-1.9
Hides	45.9	2.8	-4.9
Cotton	22.8	-8.5	-7.5
Wheat	7.8	2.1	-.9
Corn	8.5	4.6	6.2
Soybeans	7.8	.0	1.3

Excluding food and energy items, the CPI rose 0.4 percent in August and 0.2 percent in September, a bit below the average pace from January through July. The services component edged up only 0.1 percent in September--after an August advance of 0.5 percent, as increases in most categories were offset by declines in prices for out-of-town lodging, telephone rates, and a less-than-seasonal increase for tuition. The index for CPI commodities less food and energy was up 0.3 percent, boosted by large increases for apparel. So far this year, this index has accelerated to an annual rate of about 4 percent, owing both to a swing in used car prices and rapid increases in import prices. In contrast, inflation in nonenergy services has averaged less than 5 percent since last December, below its 1986 pace.

At the producer level, the average pace of domestic price increases for finished goods (less food and energy) has been about 2-1/2 percent at an annual rate through September of this year, similar to that in 1986. By contrast, prices have accelerated notably this year at earlier stages of processing, owing to the higher levels of industrial activity, the lower exchange value of the dollar, and the effects on petroleum-based products of earlier increases in crude oil prices. Price increases have picked up markedly for a broad range of intermediate materials, but were particularly large for primary metal and paper products, where capacity utilization rates have moved up substantially this year. Prices also have continued to climb for crude materials less food and energy. The September increase, of nearly 4 percent, was led by metal scrap, logs and timber, and hides. After the mid-September PPI pricing date, prices in spot commodity markets moved up further for steel scrap, as well as for primary aluminum, but receded for lumber and

cotton. Since the stock market plunge, prices of many commodities have fallen, but for the most part the declines have been limited.

Wages and Labor Costs

Available indicators suggest that wage inflation may have picked up slightly in recent months. The hourly earnings index for production and nonsupervisory workers rose 0.3 percent in September after a 0.5 percent advance in August. The twelve-month change moved up to 2.9 percent in September, the highest since early 1986.

Similarly, data from the employment cost index, based on a separate survey of employers, show hourly compensation in private industry up 3.3 percent in the 12 months ended in September, as compared with 3.0 percent in the year ended in June.⁴ Pay increases in most industries and occupations continued their patterns of recent years, with compensation gains largest in service-producing industries, for white-collar workers, and in the nonunion sector.

In the union sector, wage settlements negotiated in major private industry agreements during the first three quarters of this year averaged 2.1 percent in the first contract year and 2.3 percent over the life of the contract, exclusive of lump-sum payments and COLAs. When COLAs and deferred wage adjustments from existing contracts are included, overall union wages have risen more than 3 percent at an annual rate so far this year, after a 2-1/4 percent advance in 1986. Recent union wage developments were dominated by the new contracts reached between the United Auto Workers union and Ford and General Motors. Under those contracts, workers receive an initial 3 percent

4. The increase in compensation was 1.0 percent in the third quarter alone, but BLS does not seasonally adjust the data and the staff has not been able to establish reliable seasonal factors yet for this relatively short time series.

HOURLY EARNINGS INDEX¹
(Percentage change; based on seasonally adjusted data)²

	1986	1987			1987		
		Q1	Q2	Q3	July	Aug.	Sept.
		--Annual rate--			--Monthly rate--		
Total private nonfarm	2.3	2.1	2.6	2.7	.2	.5	.3
Manufacturing	1.7	1.5	2.1	2.1	.0	.4	.9
Durable	1.3	.3	2.1	2.5	.0	.5	.7
Nondurable	2.3	3.5	2.2	1.5	.0	.2	1.3
Contract construction	2.2	-2.7	3.4	.4	-.5	.3	-.2
Transportation and public utilities	2.8	3.2	3.5	2.2	.5	.1	.1
Total trade	1.8	.7	2.5	3.2	.3	.4	.5
Services	3.1	4.2	3.2	4.1	.4	1.0	-.4

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.

EMPLOYMENT COST INDEX
(Percentage change from 12 months earlier; not seasonally adjusted)

	Dec. 1985	Dec. 1986	1987	
			June	Sept.
Total private nonfarm compensation	3.9	3.2	3.0	3.3
By industry:				
Goods-producing	3.4	3.1	2.3	2.6
Service-producing	4.4	3.2	3.6	3.8
By occupation:				
White-collar	4.8	3.5	3.4	3.7
Blue-collar	3.2	2.7	2.5	2.7
Service workers	3.0	3.1	3.1	2.7
By bargaining status				
Union	2.6	2.1	1.9	2.0
Nonunion	4.6	3.6	3.4	3.7
Memo:				
Wages and salaries	4.1	3.1	3.0	3.3
Benefits	3.5	3.4	3.3	3.1

increase in their base wage rates, followed by lump sum payments equal to about 3 percent of annual pay in the second and third years of the agreements. In addition, the contracts retain the current COLA formula, improve the profit sharing plan, and restrict the use of layoffs, overtime, and outsourcing. If inflation averages 4-3/4 percent annually over the next three years (the assumption used by the UAW in costing out the contract), the new agreements would raise labor costs at GM and Ford by about 18 percent.

APPENDIX¹

AMENDMENTS TO THE GRAMM-RUDMAN-HOLLINGS BALANCED BUDGET ACT

Legislation that restores an automatic spending cut mechanism to the Gramm-Rudman-Hollings Balanced Budget Act², but eases the deficit targets that can trigger automatic cuts, was signed by the President on September 30. On October 20, OMB issued a report that found that legislation that met a deficit reduction target of \$23 billion for FY1988 had not yet been enacted. This report triggered a first round of automatic cuts (in the form of a preliminary sequester of budgetary resources designed to cut outlays by \$23 billion) that will become final on November 20, unless legislative or administrative deficit cuts that total at least \$23 billion are implemented by that date. As noted in the Greenbook text, legislation designed to meet or exceed these targets is currently before Congress and is the subject of negotiations between the Administration and congressional leaders.

Deficit Targets

The original Gramm-Rudman-Hollings Act established a set of deficit targets that called for a \$108 billion deficit in 1988 and a zero deficit by 1991 (see table 1). The amendments ease these limits by raising the deficit target for 1988 to \$144 billion and extending the period over which the deficit would be reduced to zero to 1993. For FY1988 through FY1992, the amended law would trigger automatic spending cuts if the official "snapshot" deficit projection computed before the start of a fiscal year exceeds the deficit target for that fiscal year by more than \$10 billion. In the final year, FY1993, there is no error allowance; automatic cuts would be indicated if the "snapshot" deficit estimate is above zero. The original Act had a similar error allowance.

The amended Act creates "safe harbors" for FY1988 and FY1989 that limit the size of automatic cuts. For FY1988 a deficit reduction target of \$23 billion is specified if the official deficit estimate exceeds the \$154 billion target and error allowance (the official OMB report released on October projected a \$163 billion deficit for FY1988). The size of the final automatic cut or sequester is then given by the difference between this \$23 billion reduction target and the amount of deficit reducing legislation enacted between January 1, 1987 and November 20, 1987. For 1989 the deficit reduction target is capped at \$36 billion. The required deficit reduction target will be given by the difference between the official OMB deficit estimate and the \$136 billion target, up to the \$36 billion cap (provided that the official

1. Prepared by Wolfhard Ramm, Senior Economist, Government Finance Section, Division of Research and Statistics.

2. These amendments to the original Gramm-Rudman-Hollings Act were included in the bill that increased the permanent federal debt ceiling from \$2.1 trillion to \$2.8 trillion. The short title of the amendments is the Balanced Budget and Emergency Deficit Control Act of 1987.

estimate exceeds the target by more than the \$10 billion error allowance). Automatic cuts, if required, would be equal to the difference between the deficit reduction target and the actual amount of deficit reduction (from a baseline deficit measure specified in the amendments) enacted by congress between January 1, 1988 and October 15, 1989. For FY1990 and beyond, the automatic cut mechanism is controlled only by the annual deficit target; automatic cuts equal to the difference between the official "snapshot" deficit projection and the target deficit will be required (provided that this difference is greater than \$10 billion for FY1990, FY1991, and FY1992).

The difficulty of achieving the deficit reduction requirements of this scheme over the next two years (through the presidential and congressional elections) obviously will depend on the performance of the economy. In 1988, at least \$23 billion of deficit reduction has to be put into place, through either congressional action or the automatic spending cut process. If all \$23 billion of these savings carry over into 1989, then the CBO baseline deficit estimate for 1989, adjusted for these deficit cuts, would be \$169 billion. Thus, if the CBO projections prove accurate, only \$23 billion of additional deficit reduction would be needed to push the projected deficit below the critical limit for FY1989 of \$146 billion (the \$136 billion target plus \$10 billion error allowance). If the Administration's \$166 billion current services projection for FY1989 proves more accurate, then no additional deficit reduction would be required in 1989.

Baseline Estimates

The original Act specified in considerable detail the calculation of the baseline budget estimates that will determine the need for and size of any automatic outlay cuts. However, presumably in view of the greater role assigned to OMB and the diminished role of CBO and GAO, additional restrictions on key economic and technical estimating assumptions are imposed by the amendments. The amendments also introduce an inflation adjustment into the estimation of baseline spending for discretionary programs.

Economic and technical estimating assumptions for the FY1988 snapshot report that was issued by OMB on October 20 had to be the same as those used by OMB in the preparation of the August 20, 1987 sequestration report. For 1989 and beyond, the economic and technical assumptions must be consistent with the specifications contained in the Act and must be presented in the Administration's July 15 mid-session budget report (except for the inflation adjustment assumption referred to below, which must be based on the GNP deflator assumption used in the January budget submission).

Estimates of the deficit (and deficit reductions achieved by congressional action in 1988 and 1989) are to be based on a baseline

concept that is similar to the CBO's baseline concept.³ Estimates of tax receipts and outlays for entitlements and other mandatory spending programs, e.g. interest, are based on current law mandates. Estimates of discretionary spending, including defense, are based on enacted appropriation levels. If an appropriation has been enacted for the forecast year, then that level is used. If not, then the prior year's appropriation level, with adjustment for inflation, is used. The rates at which spending out of appropriations are assumed to occur are tightly constrained in the amended law.

The amendments also exclude certain budgetary maneuvers from counting toward deficit reduction targets. Financial and real asset sales, loan prepayments (including REA loans), and shifts in the timing of outlays (such as the one-day delay of the military payday initiated at the end of FY1987) will not be included in deficit level or deficit reduction calculations for sequestration purposes.

Automatic Spending Cut Mechanism

The automatic spending cut mechanism of the original Gramm-Rudman-Hollings Act was invalidated by the Supreme Court because it assigned an executive function, the issuance of the report specifying the sequestration of budgetary resources,⁴ to the General Accounting Office, an agency that is substantially controlled by congress. The amendments to the Act remedy this defect by having OMB prepare the report with "due regard" to an earlier CBO report.

Key steps in the determination of the need for and implementation of any automatic spending cuts are summarized in table 2. For FY1988, an initial advisory estimate of the deficit, as of October 10, was issued by CBO on October 15 and the official estimate that triggered the automatic cut process was issued by OMB on October 20. The OMB report found that the deficit for 1988 as of the snapshot date would be \$163 billion, indicating that a total of \$23 billion in automatic and

3. The concept is derived from the so-called Gradison base that was specified for deficit calculations in the original Gramm-Rudman-Hollings law, except for the inclusion of an inflation adjustment to prior year appropriations for discretionary programs when the appropriation for the forecast year has not yet been enacted.

4. The Gramm-Rudman-Hollings Act implements automatic spending cuts through a process, termed sequestration, of permanently extinguishing the spending authority for effected programs.

legislated cuts would be required for 1988.⁵ The report also found that for the year to date enacted legislation and administrative actions have not cut the deficit (such actions have increased the deficit by \$.8 billion). Therefore, OMB also issued an initial spending cut order for the required \$23 billion maximum on October 20. Congress now has until November 20 to enact further deficit cutting legislation. On November 20 permanent cuts equal to the difference between any enacted deficit reductions and the \$23 billion target go into effect. Within 10 days of the final sequester order, the majority leader in either house may introduce a joint congressional resolution (legislation that would require the President's signature to go into effect) that would modify the order.

The calculation of cuts under a sequester order is much the same as it was under the original Act. Half of the cuts would come from defense spending and half from a uniform reduction of the portion of nondefense spending that is subject to sequestration. As under the old law, a large portion of the budget is wholly or partially exempt from the automatic spending cut process. Totally exempt programs account for over half of the federal budget and include social security, net interest, outlays from prior year appropriations and legal obligations, federal civilian and military retirement, certain low income programs, unemployment benefits, and offsetting receipts. Guaranteed student loans, medicare and some other health programs are subject to special rules that limit the size of automatic cuts. Defense outlays out of prior obligations are also exempt from sequestration. The newly enacted amendments give the President limited authority to reallocate, with congressional approval, some of the defense cuts within the defense category. The \$23 billion sequester for FY1988 translates into a uniform 8.5 percent cut in the budgetary resources (authority to obligate and spend) available for nonexempt domestic programs and a uniform 10.5 percent reduction in the budgetary resources available for military spending.

Congressional Budget Process

Other features of the congressional budget process--the timetable for the submission of the President's budget, the preparation of the congressional budget resolution, and the passage of reconciliation and appropriation legislation--remain as under prior law (see table 3). A fallback spending cut procedure (requiring Congress to pass and the President to sign a joint congressional resolution) that would go

5. The CBO report estimated the FY1988 deficit at \$179 billion and also concluded that the amended Gramm-Rudman-Hollings law required the issuance, on October 20, of a preliminary order that would cut FY1988 spending by \$23 billion. The CBO deficit estimate is \$16 billion above the OMB estimate because of conceptual and definitional differences (\$3 billion), economic assumption differences (\$14 billion), and different technical estimating assumptions (-\$1 billion).

into effect if the new automatic spending cut mechanism is invalidated in court is also retained. Senate rules for dealing with budget reconciliation legislation are also tightened a bit.

Provisions of the original Gramm-Rudman-Hollings Act that provide for the suspension of the automatic cut mechanism if the economy performs poorly, or is expected to perform poorly, during the period beginning two quarters before the start of the fiscal year to which the cuts would apply and ending at the end of that fiscal year, are retained. Congress can suspend automatic cuts if OMB and CBO project two quarters of less than one percent real growth or if the Department of Commerce reports two consecutive quarters of less than zero growth for this period.

SELECTED FINANCIAL MARKET QUOTATIONS¹
(Percent)

	1987				Change from:	
	Spring	FOMC			Record	FOMC
	highs	Sept. 3 ²	Sept. 22	Oct. 16 ³	Oct. 27	Oct. 16 ³ Sept. 22
Short-term rates						
Federal funds ⁴	6.90	6.85	7.20	7.59	7.09	-.50 -.11
Treasury bills ⁵						
3-month	6.02	6.19	6.49	6.93	5.23	-1.70 -1.26
6-month	6.28	6.30	6.75	7.58	6.01	-1.57 -.74
1-year	6.80	6.98	7.11	7.74	6.37	-1.37 -.74
Commercial paper						
1-month	6.96	6.88	7.34	7.94	7.04	-.90 -.30
3-month	7.16	6.97	7.44	8.65	7.38	-1.27 -.06
Large negotiable CDs ⁶						
1-month	7.07	6.90	7.36	7.92	7.03	-.89 -.33
3-month	7.33	7.01	7.43	8.90	7.51	-1.39 .08
6-month	7.65	7.35	7.80	9.12	7.58	-1.54 -.22
Eurodollar deposits ⁴						
1-month	7.05	7.01	7.36	7.79	7.86	.07 .50
3-month	7.36	7.11	7.44	8.69	8.81	.12 1.37
Bank prime rate	8.25	8.25	8.75	9.25	9.00	-.25 .25
Intermediate- and long-term rates						
U.S. Treasury (constant maturity)						
3-year	8.35	8.48	8.64	9.52	8.06	-1.46 -.58
10-year	8.92	9.29	9.37	10.23	8.92	-1.31 -.45
30-year	9.07	9.47	9.53	10.24	9.04	-1.20 -.49
Municipal revenue ⁷ (Bond Buyer)	8.68	8.47	8.65	9.59	9.01	-.58 .36
Corporate A utility (recently offered)	10.27	10.60e	10.96e	11.50	10.70e	-.80 -.26
Home mortgage rates ⁸						
S&L fixed-rate	10.81	10.63	10.99	11.58	11.36	-.22 .37
S&L ARM, 1-yr.	8.01	7.84	7.99	8.45	8.37	-.08 .38

	1986	1987		Change from:	
		Record	FOMC	Record	FOMC
	Highs	highs	Sept. 22	Oct. 27	highs Sept. 22
Stock prices					
Dow-Jones Industrial	1955.57	2722.42	2568.05	1846.49	-32.17 -28.10
NYSE Composite	145.75	187.99	178.48	130.51	-30.58 -26.88
AMEX Composite	285.19	365.01	351.33	238.52	-34.65 -32.11
NASDAQ (OTC)	411.16	455.26	437.90	296.34	-34.91 -32.33

1. One-day quotes except as noted.
2. Day prior to increase in discount rate on Sept. 4, 1987.
3. Last business day prior to stock market decline on Monday, Oct. 19, 1987.
4. Average for two-week reserve maintenance periods closest to date shown, except Sept. 3 which is one-week average ending Sept. 2, and last observation, which is the average to date

- for the week ending Oct. 28, 1987.
5. Secondary market.
6. Averages for statement week closest to date shown.
7. One-day quotes for closest Thursday.
8. Quotes for week ending Friday closest to date shown.
- e--estimate.

DOMESTIC FINANCIAL DEVELOPMENTS

Prices of financial assets have fluctuated violently over the intermeeting period, in often disorderly markets. Stock prices have plunged about 30 percent on balance while interest rates on long-term Treasuries, although moving over a wide range, are down considerably on net. Long-term rates increased sharply during the first part of the intermeeting period as concerns intensified about prospects for the dollar, given incoming trade data and evidence of monetary tightening abroad, and as nervousness mounted about the course of U.S. economic policy. With the federal funds market also showing greater firmness than generally anticipated, short-term rates rose too, including a half-point increase in the prime rate to 9-1/4 percent on October 6.

The unprecedented collapse in equity prices on October 19 and the accompanying flight to quality more than reversed the rise in Treasury yields. As a result, Treasury bill rates have decreased 3/4 to 1-1/4 percentage points, on balance, since the September FOMC meeting. The federal funds rate also has moved somewhat lower since October 19, as the Federal Reserve has sought to bolster liquidity. The prime rate was lowered 1/4 percentage point on October 22. Other private short-term rates also have moved down recently, after rising considerably more than Treasury rates early in the intermeeting period. With volatile trading patterns, spreads between private and Treasury rates are difficult to assess accurately, but there appears to have been some increase in risk premiums.

Long-term Treasury rates, which had increased around 3/4 percentage point between the last FOMC meeting and October 19, are down about

1/2 point over the entire intermeeting period. Private long-term rates also have moved down recently. In corporate markets, lower-quality issues have been adversely affected by the recent loss of confidence, while issues of higher-rated firms have benefited. Indeed, yields on higher-rated corporate debt have fallen below the levels prevailing at the time of the last meeting.

As a result of these price and rate movements, nonfinancial corporations have abandoned takeovers and buyouts and have intensified buybacks of their shares. Firms with higher-grade bond ratings have rushed to market in response to the recent drop in rates, and bond issuance by nonfinancial corporations for October appears to be near that of September. Low-rated bond offerings have been limited to issues already in train to fund earlier merger-related borrowings.

Treasury borrowing is expected to be heavy in the current quarter as a result of seasonal patterns and the postponement of some bill auctions from September to October. State and local debt issuance has continued to be damped by prevailing interest rate levels and tax reform restrictions, the lower volume resulting in excess underwriting capacity and prompting cutbacks in staffing by investment bankers. Available data indicate that mortgage debt growth likely weakened in September and October. Consumer credit growth for the third quarter appears to have picked up to its strongest pace in a year, boosted in part by the August-September auto sales promotions.

The plunge in securities prices appears to have prompted moves to short-term liquid assets--money market mutual funds and deposits--and likely will produce a bulge in money growth. Growth of the monetary

aggregates had eased a bit in September, reflecting in part higher opportunity costs of holding liquid balances. M2, with an annual growth rate last month of 5-1/4 percent, remained well below the lower bound of its 1987 target range. M3, which grew at a 5-3/4 percent rate in September, continued to expand along the lower bound of its growth cone. M1 was about flat last month and had grown at a 6 percent annual rate since the fourth quarter.

Corporate Securities Markets and Business Finance

The plunge in stock prices on Monday, October 19, in which the Dow-Jones Industrial Average fell almost 23 percent in massive, record trading, was preceded by several weeks of substantial price retrenchment, as investors apparently became increasingly skittish about the outlook for interest rates and the value of the dollar. Although share prices increased on balance over the remainder of last week in an environment of exceptionally large price swings and huge trading volumes, major indexes ended the week about 15 percent lower, down about a quarter from their August peaks. This week, prices have declined further, falling another 7 percent on net over Monday and Tuesday.

The unprecedented trading volumes have caused serious back office problems; on Thursday, the NYSE, followed by other exchanges, announced that trading hours would be shortened by two hours on Friday, and the shortened hours were extended through this week. In recent days, securities exchanges and brokerage firms have been struggling to process the deluge of transactions, seeking to match trades and to effect clearance and settlement within the customary time constraints.

Several steps were taken after the initial market plunge to ease pressures and stabilize the markets. On Tuesday, October 20, the NYSE asked member firms to refrain from using the Exchange's automated order delivery systems for computer-assisted program trading, amid concerns that large-block sales of stock by major institutions had exacerbated Monday's downward movement in prices. Throughout the week, futures traded at discounts to the underlying indexes, creating arbitrage opportunities, although it is not clear how much arbitrage trading actually occurred given the trading halts and slow price quotations for many stocks. The SEC and the exchanges have indicated that the role of index-related strategies, including dynamic hedging strategies known as portfolio insurance as well as arbitrage, will be examined carefully in assessments of recent market turbulence.

In other actions, the Chicago Mercantile Exchange (CME) raised the maintenance margins for S&P futures contracts from \$5,000 to \$7,500 per contract, effective at the close of trading on October 19, and the Chicago Board of Trade raised its margin requirements later in the week. Last Friday the CME imposed regulations that limit the daily price swings in its S&P 500 stock-index futures contracts to no more than 30 points. Subsequently, the CME again raised margin requirements.

The turbulence in markets created serious problems for traders, specialists, and market makers on the exchanges; to date, four small member firms on the NYSE have failed, and three specialist firms, one on the NYSE and two on the AMEX, have had to be taken over by larger organizations. The Chicago Board Options Exchange reported losses by their floor traders in the neighborhood of \$150 million or more; such

losses created financial difficulties for First Options of Chicago, the country's largest options clearing firm and a subsidiary of Continental Illinois Bank. Nonetheless, on the whole, the institutions and exchanges appeared to withstand these losses reasonably well, and no major investment houses are reported to be in serious danger of failure.¹

In corporate bond markets, low-rated securities initially experienced sharp price declines, and yield spreads against Treasuries widened greatly. Liquidity of junk bonds faded quickly and, except for merger- and LBO-related offerings already under way, new issues of low-rated bonds ground virtually to a halt. High-rated issues, in contrast, benefited from investors' flight to quality and from the general decline in interest rates: rates on recently offered corporate A utilities have fallen 80 basis points since the stock market plunge, and are about 25 basis points lower than at the time of the September FOMC. New offerings of A- or higher-rated issues surged as corporate treasurers sought to take advantage of the improved rates; bond issuance by nonfinancial corporations in October appears to be near that of September. Commercial paper rates also showed sharp declines, reflecting in part probable strong demand by money market mutual funds, which experienced strong inflows of funds.

Merger activity, which had boosted short-term borrowing by non-financial firms in September, also was jolted by the market decline. With prices of target companies plunging, a number of pending

1. Apart from the general trading activity, several large U.S. investment banking firms potentially stand to incur losses of more than \$100 million each as part of an underwriting of British Petroleum Company stock associated with the U.K. government's privatization program.

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

	1986	1987					
	Year	Q1	Q2	Q3 ^P	Aug. ^P	Sept. ^P	Oct. ^e
Corporate securities - total ¹	28.18	29.79	24.33	26.04	21.16	29.46	18.34
Public offerings in U.S.	24.48	26.81	22.23	23.30	18.40	27.20	16.70
Stocks--total ²	5.15	5.50	5.70	4.98	3.70	6.00	2.70
Nonfinancial	2.51	2.74	3.45	2.40	1.40	2.70	1.70
Utility	.64	.74	.71	.64	.40	.40	.10
Industrial	1.87	2.00	2.74	1.76	1.00	2.30	1.60
Financial	2.64	2.76	2.25	2.58	2.30	3.30	1.00
Bonds--total ¹	19.33	21.31	16.53	18.32	14.70	21.20	14.00
Nonfinancial	9.62	8.98	6.07	6.57	5.25	6.70	6.25
Utility	3.61	2.05	1.54	2.45	2.63	2.60	2.30
Industrial	6.01	6.93	4.53	4.12	2.62	4.10	3.95
Financial	9.71	12.33	10.46	11.75	9.45	14.50	7.75
By quality ³							
Aaa and Aa	4.70	3.30	2.25	2.76	2.39	2.38	6.00
A and Baa	6.05	7.31	5.05	4.23	4.22	4.11	3.00
Less than Baa	3.42	3.06	2.91	3.58	2.54	3.76	2.40
No rating (or unknown)	.20	.08	.22	.10	.09	.13	.20
Memo items:							
Equity-based bonds ⁴	.86	1.37	1.29	.47	.43	.67	.50
Mortgage-backed bonds	4.14	7.26	5.18	6.30	5.35	8.55	1.75
Variable-rate notes	1.02	2.43	1.65	2.65	2.65	3.35	.35
Bonds sold abroad - total	3.55	2.92	1.82	2.47	2.72	1.65	1.50
Nonfinancial	1.50	1.14	.97	1.27	2.10	.75	.90
Financial	2.05	1.78	.85	1.20	.62	.90	.60
Stocks sold abroad - total	.15	.06	.28	.27	.04	.61	.14
Nonfinancial	.09	.06	.24	.16	.04	.28	.14
Financial	.06	.00	.04	.11	.00	.33	.00

1. Securities issued in the private placement market are not included. Total reflects gross proceeds rather than par value of original discount bonds.

2. Includes equity issues associated with debt/equity swaps.

3. Bonds categorized according to Moody's bond ratings or Standard and Poors if unrated by Moody's. Excludes mortgage-backed and asset-backed bonds.

4. Includes bonds convertible into equity and bonds with warrants that entitle the holder to purchase equity in the future.

p--preliminary.

e--staff estimate.

acquisitions and leveraged buyouts were cancelled. At the same time, more than 200 large corporations announced share-buyback programs intended to provide support for their firms' equity prices and to fend off future takeover attempts. The outlook for mergers and takeovers remains clouded, but share retirements presumably will continue to be high owing to the acceleration in buyback programs. Gross new issues of equity, which had been light prior to October 19 as a result of declining share prices, have evaporated.

Treasury and Agency Financing

In the government securities market, the fall in the stock market led to very heavy demand, as investors sought higher quality and more liquid assets. Trading volume more than doubled early in the week of October 19 and was said to be heavy in both short-term and longer-term securities. Because of substantial price swings, dealers reportedly were reluctant to take on positions and were said, at times, to be executing trades only on behalf of customers. The heavy demands also led to shortages of actively traded issues, thereby prompting the FOMC on October 22 to suspend, temporarily, the limit on securities that the System would lend to any one dealer. Nevertheless, a large number of delayed settlements continued to be reported. In this environment, bid-asked spreads on Treasury bills increased between 4 and 8 basis points.

In view of the tumult in the securities markets, on October 22 the President announced urgent consultations between the Executive branch and Congress to ensure effective measures to curb the FY 1988 budget deficit. Whatever the outcome of the negotiations, the budget deficit in the current quarter is likely to rise to somewhat more than \$75

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

	1987				
	Q3 ^p	Q4 ^e	Oct. ^e	Nov. ^e	Dec. ^e
<u>Treasury financing</u>					
Total surplus/deficit(-)	-28.6	-78.3	-25.4	-24.7	-28.2
Means of financing deficit:					
Net cash borrowing from the public	22.0	60.4	26.8	20.6	13.0
Marketable borrowings/repayments	16.9	51.7	26.4	13.9	11.4
Bills	-12.9	8.3	11.6	-1.9	-1.4
Coupons	29.8	43.4	14.9	15.8	12.7
Nonmarketable	5.1	8.7	.3	6.7	1.6
Decrease in the cash balance	3.7	17.6	-2.8	16.0	4.4
Memo: Cash balance at end of period	36.4	18.8	39.2	23.2	18.8
Other ²	2.9	.3	1.4	-11.9	10.8
<u>Federally sponsored credit agencies, net cash borrowing</u>					
FHLBs	4.7	4.1	2.1	1.2	.8
FNMA	1.6	.9	.6	.1	.2
FCBs	-1.3	-1.4	-1.1	-.1	-.2
FHLMC	.6	.5	.2	.2	.1
FICO	.0	1.1	.6	.0	.5
SLMA	2.0	1.1	.2	.8	.1

p--preliminary

e--staff estimate.

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.

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

billion, from less than \$30 billion in the third quarter. This increase is largely a result of seasonal influences, including two social security payments in December, and a much diminished pace of asset sales. The staff expects the Treasury to reduce its cash balances to smooth borrowing needs, but borrowing from the public still is projected by the staff to rise to \$60 billion. Part of this pickup reflects the net issuance of approximately \$11 billion of Treasury bills that was deferred from September to October because of the debt ceiling constraint. Most of the remainder of the Treasury's borrowing in the fourth quarter will consist of marketable coupon issues, although a temporary increase in issues of SLGS is anticipated in November.

The size and composition of the Treasury's quarterly refunding scheduled for the first week of November will be announced in the afternoon of October 28. This announcement is likely to call for the usual auctions of 3-, 10-, and 30-year issues but to provide for a much smaller volume of the 30-year bond than the \$9 billion issued in each of the last two refundings. Alternatively, the 30-year auction might be postponed. The existing statutory limit on outstanding bonds with coupon rates exceeding 4-1/4 percent would permit no more than about \$5 billion to be issued. Repeal of the limit, which Congress is currently considering as part of the reconciliation bill, is unlikely to occur before the refunding.

Borrowing by federally sponsored credit agencies is expected to slow somewhat in the fourth quarter despite the inclusion of borrowing by the newly created Financing Corporation (FICO), established to

provide capital for the FSLIC. Apart from FICO, the decline in borrowing is spread across all agencies. The mortgage-related agencies--the Federal Home Loan Banks, Fannie Mae, and Freddie Mac--are expected to reduce their pace of borrowing owing both to seasonal factors and to the effect of higher mortgage rates on real estate borrowing. Seasonal influences also account for the expected reduced borrowing by the Student Loan Marketing Association, while farm loan liquidation continues to cause the Farm Credit Banks to reduce their outstanding debt.

FICO's first issue, a \$500 million bond with a maturity of 30 years, came to market on September 30. It carried a yield of 10.73 percent, which represented a spread of 90 basis points over comparable Treasury bonds. The spread subsequently narrowed to about 80 basis points in secondary trading. In early October, FICO issued an additional \$100 million 30-year bond to a single investor.

Through mid-October, spreads of other sponsored agency issues were unchanged to wider compared with the previous several months. FNMA's 4- and 7-year bonds were priced in early October with approximately the same spreads over comparable Treasuries as in July and September. In contrast, spreads on FHLB securities widened appreciably in October as investor demand was reported to be less than in recent months. The spread on FCB issues rose from August to September. Because the September issues were priced during the period when the debt ceiling had forced the Treasury to postpone bill auctions, part of the relative rise in the rates on these issues can be attributed to the reduced supply of Treasury bills. Since the stock market collapse, sponsored agency rates have declined along with other market rates, but not to the same extent

as Treasury securities. As a result, spreads have widened significantly in spite of the strong demand for agency issues, which are viewed as being of high quality.

Municipal Securities Markets

Through mid-October, rates on tax-exempt bonds had climbed about 1-1/2 percentage points from their lows at the end of August, and almost 1 point since the last FOMC meeting. However, rates fell about 1/2 point as investors moved into bonds after the collapse in stock prices.

Municipal dealers and mutual bond funds had appeared uneasy early in the intermeeting period. Some closed-end funds reportedly sold bonds to build cash positions and thus be better prepared for outflows, though there were no indications of heavy redemptions by mutual bond fund investors. Since the stock market plunge, institutional investors reportedly have returned to the municipal market, and dealer inventories have fallen to their lowest level in more than two years. Although moving down last week, municipal bond yields have not kept pace with those on Treasuries, and the ratio of tax-exempt to taxable yields, which had increased in mid-October, rose substantially further.²

Issuance of tax-exempt bonds slowed to near \$5 billion in September, and has risen only a bit in October; several offerings were postponed, at least temporarily, when market conditions deteriorated in midmonth. At \$1 billion, the September volume of refunding bonds was

2. To eliminate possible arbitrage opportunities opened up by the sudden fall in market rates, the Treasury recently prohibited issuers of advance refunding bonds from moving invested proceeds from marketable securities to SLGS unless the yields on the SLGS conformed to market rates; as the lower rate on SLGs would result in negative arbitrage earnings, issuers stopped trying to reinvest these funds. Apparently, several billion dollars of bonds were refinanced prior to the Treasury action.

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

	1985	1986	1987			1987		
	Year	Year	Q1	Q2	Q3 ^p	Aug.	Sept. ^p	Oct. ^f
Total tax-exempt	19.81	14.04	10.86	9.62	8.02	8.89	5.74	7.20
Short-term ¹	1.96	1.79	.56	1.80	1.82	2.39	.62	1.20
Long-term	17.85	12.25	10.30	7.82	6.20	6.50	5.12	6.00
Refundings ²	4.85	5.29	7.24	2.98	1.63	1.42	.98	n.a.
New capital	13.00	6.96	3.06	4.84	4.57	5.08	4.14	n.a.
Total taxable	.03	.38	.27	.29	.15	.03	.22	n.a.

1. Does not include tax-exempt commercial paper.

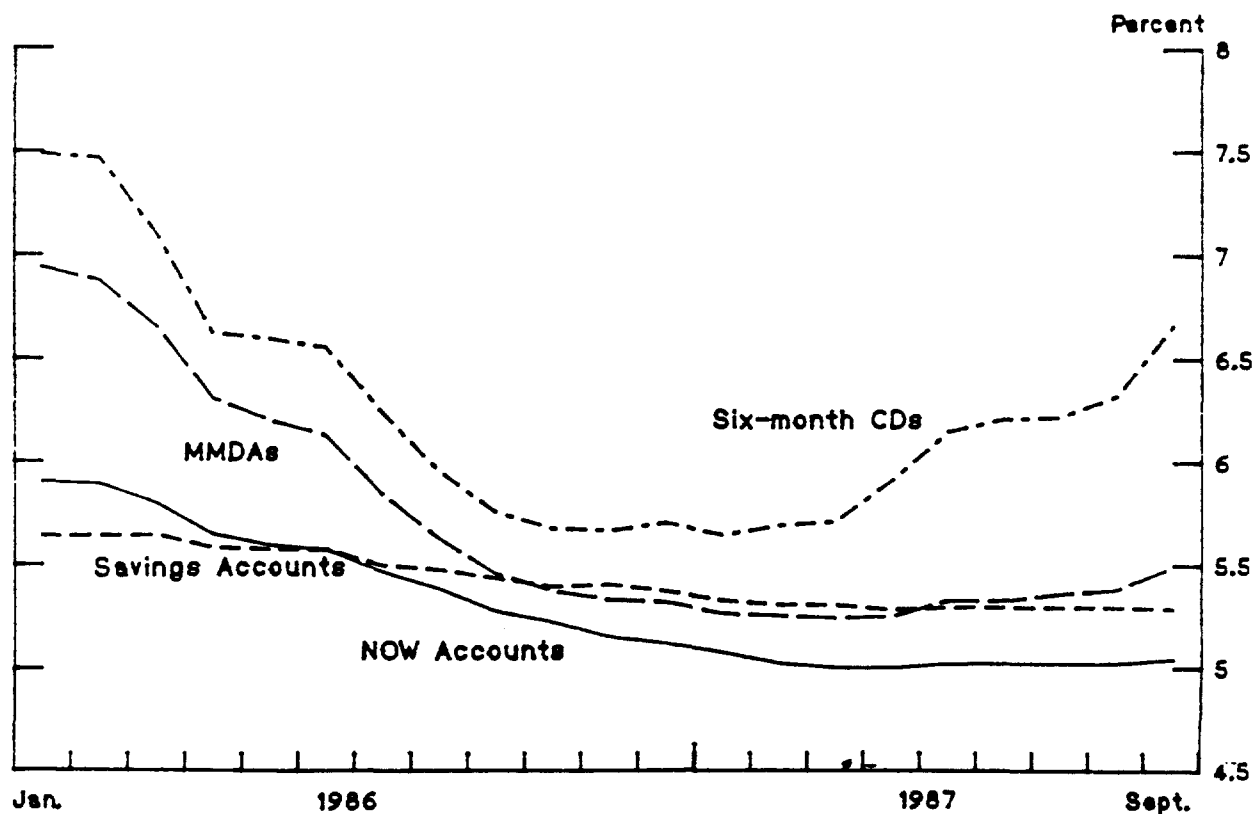
2. Includes all refunding bonds, not just advance refundings.

f--staff forecast.

n.a.--not available.

p--preliminary.

Rates Paid on Selected Retail Accounts at Commercial Banks
(Effective Annual Yield)



the lowest for any month since January 1986, owing to the rise in interest rates that began in the second quarter. Offerings of bonds for new capital, which typically are less sensitive to interest rate movements, just matched the average volume sold over the first eight months of the year. The pace of issuance of all tax-exempt bonds so far this year is the lowest since 1983, reflecting in part the effects of tax reform as well as some winding down of construction plans by state and local governments.

The continued reduction in municipal bond issuance this year has led to cutbacks in the investment banking industry. In mid-October Salomon Brothers announced the termination of its municipal market operations and Kidder, Peabody & Company reduced its municipal staff sharply. This week, L.F. Rothschild & Company stopped their municipal underwriting, while retaining a retail trading operation.

Monetary Aggregates and Bank Credit

The plunge in equity prices and the accompanying move to short-term liquid assets may well boost the growth of the monetary aggregates this month. Inflows to money market mutual funds surged to \$9-1/2 billion in the week ended October 21, in part as investors shifted from equity to mutual funds. Preliminary data show a strong pickup in M1 deposits last week, and there could be a further late-month bulge in these accounts as stock transactions are settled; as these funds are reallocated, they might remain within M2, at least for awhile.

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

	1985:Q4 to	1987					Growth from Q4 1986 to Sept. 1987 ^P
	1986:Q4	Q2	Q3	July	Aug.	Sept. ^P	
	----- Percentage change at annual rates -----						
1. M1	15.3	6.4	-0.1	1.6	5.3	0.3	6.1
2. M2	9.0	2.3	2.9	2.6	6.1	5.3	4.1
3. M3	8.9	4.2	4.9	2.3	7.4	5.7	5.4
							Levels in billion of dollars Sept. 1987
<u>Selected components</u>							
4. M1-A	10.0	2.7	-2.3	-0.5	3.2	-1.9	495.6
5. Currency	7.5	6.6	6.7	6.3	6.9	8.1	194.5
6. Demand deposits	11.6	0.0	-8.2	-4.8	0.8	-9.7	294.0
7. Other checkable deposits	28.5	14.0	4.5	6.2	9.5	4.7	255.5
8. M2 minus M1 ²	6.9	0.8	4.0	2.9	6.3	7.1	2123.6
9. Overnight RPs and Eurodollars, NSA	14.7	-24.3	9.0	3.2	48.2	32.4	79.8
10. General purpose and broker/dealer money market mutual fund shares, NSA	17.3	-1.1	6.1	1.1	17.2	20.9	216.5
11. Commercial banks	6.8	-1.4	1.7	2.7	2.9	0.4	907.7
12. Savings deposits, SA, plus MMDAs, NSA	16.0	0.8	-2.4	-2.9	0.7	-3.5	540.5
13. Small time deposits	-4.2	-4.6	7.9	11.0	6.3	6.2	367.2
14. Thrift institutions	4.3	5.0	3.8	3.4	5.0	1.8	923.4
15. Savings deposits, SA, plus MMDAs, NSA	12.0	9.7	-4.0	-7.6	-4.3	-9.4	418.1
16. Small time deposits	-1.2	1.0	10.6	13.0	12.6	11.5	505.3
17. M3 minus M2 ⁴	8.7	12.1	12.7	1.5	12.4	7.3	747.9
18. Large time deposits	3.0	9.3	6.4	-0.3	4.4	7.5	469.6
19. At commercial banks, net ⁵	2.7	18.3	4.4	-4.6	0.0	2.3	314.3
20. At thrift institutions	3.4	-8.4	10.4	8.8	13.5	17.3	155.2
21. Institution-only money market mutual fund shares, NSA	30.3	-11.4	1.9	31.0	0.0	-38.8	80.7
22. Term RPs, NSA	31.1	70.7	23.3	-5.6	2.3	15.7	108.1
23. Term Eurodollars, NSA	3.2	-0.5	27.1	-44.2	98.9	68.2	98.6

-- Average monthly change in billions of dollars --

MEMORANDA:

24. Managed liabilities at commercial banks (25+26)	2.0	6.9	2.0	8.5	4.6	10.0	544.9
25. Large time deposits, gross	0.6	6.3	-0.8	-1.1	-1.0	-0.2	370.6
26. Nondeposit funds	1.4	0.6	2.8	-7.4	5.6	10.2	174.3
27. Net due to related foreign institutions, NSA	0.6	1.5	4.2	-5.8	6.3	12.2	10.9
28. Other	0.8	-0.9	-1.4	-1.6	-0.7	-2.0	163.4
29. U.S. government deposits at commercial banks	0.4	3.4	-1.5	-3.2	4.4	-5.9	23.3

1. Dollar amounts shown under memoranda are calculated on an end-month-of-quarter basis.

2. Nontransactions M2 is seasonally adjusted as a whole.

3. 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 August at a rate of a 9.5 percent and were unchanged for September. At thrift institutions, savings deposits excluding MMDAs increased during August at a rate of 9.0 percent and decreased at a 2.5 percent rate in September.

4. The non-M2 component of M3 is seasonally adjusted as a whole.

5. Net of large-denomination time deposits held by money market mutual funds and thrift institutions.

6. 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.

7. Consists of Treasury demand deposits and note balances at commercial banks.

p--preliminary.

In September, M1 was essentially unchanged as growth in OCDs slowed and runoffs in demand deposits resumed, reflecting the increasing opportunity costs of holding such deposits. Larger-than-usual corporate tax payments last month apparently had little if any effect on levels of demand deposits. M2 growth slowed, despite a slight pickup in the growth of its non-M1 component. For the quarter as a whole, M2 growth of 3 percent implies another significant increase in its velocity. M2-type money market mutual funds accelerated in September, as the rate advantage of these instruments over liquid retail deposits widened. Small time deposits continued to advance; their third-quarter growth rate of 9-1/2 percent followed five consecutive quarterly declines. As shown in the chart on page III-12, rates on these accounts, illustrated by the rate on 6-month retail CDs, tended to adjust to the increase in market interest rates through September much faster than the offering rates on the more liquid retail deposit instruments. Reflecting their rate disadvantage, savings deposits posted their first decline in two years, while MMDAs continued to run off briskly.

Growth of M3 also slowed in September. Institution-only money market mutual funds dropped sharply, as their yields lagged increases in interest rates on alternative market investments. Thrifts stepped up their issuance of large time deposits again last month and also increased their reliance on FHLB advances, likely reflecting their heavy issuance of ARMs as mortgage rates rose. Commercial banks continued

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

	1985:Q4 to 1986:Q4	Q2	Q3 ^P	1987 July	Aug.	Sept. ^P	Levels in bil. of dollars Sept. ^P
----- Commercial Bank Credit -----							
1. Total loans and securities at banks	9.8	7.7	7.3	1.3	10.8	9.7	2206.7
2. Securities	14.2	4.4	8.5	3.0	15.8	6.4	526.3
3. U.S. government securities	11.9	3.3	18.8	11.0	33.0	11.7	331.8
4. Other securities	18.0	6.1	-8.1	-9.8	-12.2	-2.5	194.5
5. Total loans	8.4	8.7	7.0	0.8	9.2	10.7	1680.4
6. Business loans	6.6	4.6	1.9	-5.2	0.2	10.8	560.6
7. Security loans	-3.7	40.7	26.5	-14.2	66.2	27.3	45.0
8. Real estate loans	14.1	19.3	13.6	13.8	16.1	10.4	556.2
9. Consumer loans	7.3	0.5	6.5	3.1	8.8	7.6	318.9
10. Other loans	5.4	0.2	-0.2	-17.4	4.2	12.7	199.7
----- Short- and Intermediate-Term Business Credit -----							
11. Business loans net of bankers acceptances	6.3	4.0	1.4	-4.8	-1.7	10.9	554.2
12. Loans at foreign branches ²	-8.6	-14.7	22.9	45.9	73.6	-48.6	16.6
13. Sum of lines 11 & 12	5.8	3.4	2.0	-3.4	0.6	8.9	570.8
14. Commercial paper issued by nonfinancial firms	-0.8	17.6	-11.4	-14.9	-16.6	-3.1	78.2
15. Sum of lines 13 & 14	4.9	5.1	0.4	-4.8	-1.7	7.6	649.0
16. Bankers acceptances: U.S. trade related ^{3,4}	-3.9	23.8	22.5	46.2	27.4	-6.7	35.7
17. Line 15 plus bankers acceptances: U.S. trade related	4.4	6.1	1.5	-2.3	-0.2	7.1	684.8
18. Finance company loans to business ³	11.7	17.9	n.a.	16.7	15.2	n.a.	191.3 (Aug)
19. Total short- and intermediate- term business credit (sum of lines 17 & 18)	5.8	8.6	n.a.	1.8	3.2	n.a.	872.1 (Aug)

1. Average of Wednesdays.

2. Loans at foreign branches are loans made to U.S. firms by foreign branches of domestically chartered banks.

3. Based on average of data for current and preceding ends of month.

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

n.a.--not available.

p--preliminary.

to rely heavily on managed liabilities last month to fund a fairly rapid expansion of domestic bank credit at a time of weak core deposit growth and shrinking Treasury balances, and borrowed heavily, on net, from their foreign branches.

Bank credit growth weakened a little in September to a 9-3/4 percent annual rate, as acquisitions of securities slowed. Bank loans accelerated for the second consecutive month, as merger-related strength in business lending overcame some slowing in real estate, consumer, and security loans. Business loans grew 10-3/4 percent at an annual rate. Strong demand was evident at domestic offices of large U.S. banks, where business lending surged in September after a string of monthly contractions; some of the strength, however, resulted from a rebooking of loans that had been placed at foreign branches, as some borrowers evidently chose to exercise their option to switch from LIBOR-based pricing to prime-based pricing. Business lending remained weak at small banks. Data for large weekly reporting banks through October 14 suggest some slowing in bank credit in the first half of this month. However, security loans, which had been declining, surged \$6-1/2 billion at 10 large New York City banks in the week of October 21.

Mortgage Markets

Following the general pattern of interest rates, mortgage rates rose early in the intermeeting period before dropping back. Prior to the stock market plunge, the average contract rate on new commitments for 30-year fixed-rate conventional home mortgages had risen more than 1/2 percentage point from the September FOMC, to 11.6 percent. The

Veterans Administration raised the ceiling rate on VA-guaranteed fixed-rate mortgages to 11 percent, effective October 5, only four weeks after the previous 10.5 percent level had been set. Rates in the secondary mortgage market were up more steeply, subjecting rates in the primary market to considerable upward pressure.

However, as mortgage securities participated in the recent shifting in demand to the fixed-income market, rates in the secondary market have moved sharply lower. For example, Fannie Mae reduced the yield it requires to purchase 30-year fixed-rate mortgages from 12 percent on October 16 to 11.1 percent on October 23--about the same level prevailing at the time of the September FOMC meeting. This week, secondary market rates have continued to decline. Primary mortgage rates followed the decline in secondary market rates last week, but as of the end of the week still were up about 40 basis points to 11.4 percent over the intermeeting period.

The average initial rate quoted on adjustable-rate mortgages indexed to the one-year, constant-maturity Treasury yield rose by 45 basis points by mid-October and retreated only a little after the stock market selloff. The spread between rates on fixed- and adjustable-rate mortgages widened to more than 3 percentage points--a record--in October. By early September, the proportion of conventional home mortgages closed having adjustable rate features had risen to 54 percent--the highest share since June 1985.

The greater importance of ARMs now seems to be generating new secondary market activity. Both the Federal Home Loan Mortgage

Corporation and the Federal National Mortgage Association have implemented programs that will broaden the secondary market for ARMs. In addition, the Treasury recently announced new regulations that allow issuance of REMICs backed by ARMs. Accordingly, the volume of security issues backed by ARMs is likely to increase.

As a result of the increases in interest rates prior to the stock market plunge, some borrowers with adjustable-rate mortgages are experiencing an increase in payments. The magnitude of the effect, however, has been mitigated by several factors. Because most ARMs adjust annually, perhaps half of all households with ARMs have not yet experienced an increase in their rates and payments. Furthermore, many of those who have seen some increase in rates in recent months likely still are paying a lower rate than at an earlier time during the life of their mortgages, because of reductions in short-term interest rates between mid-1984 and the fall of last year.

Reflecting the rising trend of interest rates through August, new commitments to originate mortgages at FSLIC-insured thrift institutions reached a 17-month low that month. With the further jump in interest rates from late August to mid-October, this information suggests that mortgage lending likely declined further in September and early October.

The slowing pace of mortgage lending resulted in a drop of 12 percent in issuance of new mortgage-pass-through securities in September, a decline of 56 percent from a year ago. In contrast, derivative mortgage security offerings, such as CMOs, surged to the second highest level of this year. However, a significant part of the increase reflected special mortgage-backed security issues backed by loans sold by the Farmers

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

	Mortgage transactions		Net change in mortgage assets ¹		
	Originations	Sales	Total	Mortgage loans	Mortgage-backed securities
1987-Jan. r	20.1	13.7	1.1	-3.4	4.5
Feb. r	21.3	12.1	.3	-.5	.9
Mar. r	22.7	11.6	2.3	1.8	.5
Apr. r	24.1	14.9	7.9	1.6	6.3
May r	22.4	12.0	11.8	3.1	8.7
June r	23.2	11.4	1.6	2.3	-.7
July r	21.8	12.2	3.2	.7	2.5
Aug. p	18.4	9.3	5.2	2.6	2.6

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

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

Period	Total	GNMAs	FHLMCs	FNMA's
1984	5.0	2.3	1.6	1.1
1985	9.0	3.8	3.2	2.0
1986	21.6	8.2	8.3	5.0
1987-Q1	24.0	10.4	8.4	5.2
Q2 r	24.8	9.6	8.4	6.9
Q3 p	17.6	7.8	5.1	4.6
1987-Jan.	25.2	10.6	8.2	6.4
Feb.	22.2	9.7	7.8	4.7
Mar.	24.5	10.7	9.1	4.6
Apr.	28.8	11.9	9.9	7.0
May r	23.2	8.4	7.8	7.1
June r	22.5	8.4	7.4	6.6
July p	21.5	8.8	6.8	5.8
Aug. p	16.7	8.2	4.4	4.0
Sept. p	14.7	6.5	4.2	4.1

r--revised. p--preliminary.

Home Administration. These issues were part of a series of issues undertaken to allow federal agencies to dispose of loan receivables in order to help reduce the fiscal 1987 federal deficit.

Consumer Installment Credit

Consumer installment credit growth accelerated to a 9-1/2 percent annual rate in August and likely remained around that pace in September, boosted by auto financing incentives offered through September by the top three domestic manufacturers. Excluding the auto component, installment credit grew 6-1/4 percent, down from July's pace but still above that for the first half of the year.

Revolving credit--which accounts for about one-quarter of all consumer installment credit--continued to grow faster in August than earlier in the year, although its growth is still below the pace of 1985 and 1986. The recent pickup may reflect in part a lessening in the shifting to credit under home equity lines. Growth in home equity loans at large commercial banks, not seasonally adjusted, slowed somewhat during August and September.

CONSUMER INSTALLMENT CREDIT
(Seasonally adjusted)

	Percent change (at annual rate)						Net change (billions of dollars)		Memo: Outstandings (billions of dollars)
			1987		1987		1987		1987
	1985	1986	Q1	Q2	July ^r	Aug. ^p	July ^r	Aug. ^p	Aug. ^p
Total ¹	17.1	10.5	1.5	5.5	6.8	9.5	3.35	4.66	595.8
Total, excluding auto	14.9	5.7	1.1	4.9	8.9	6.2	2.50	1.75	341.9
Selected types									
Auto	20.7	17.8	1.7	6.2	4.1	13.9	.85	2.91	253.9
Revolving	22.5	10.6	.6	6.6	11.7	8.9	1.34	1.03	139.8
All other	10.6	2.6	1.3	3.7	7.0	4.3	1.16	.72	202.2
Selected holders									
Commercial banks	15.7	8.1	.5	3.8	3.1	3.3	.69	.73	265.8
Finance companies	26.3	20.7	-1.3	5.8	6.1	16.8	.71	1.94	140.7
Credit unions	9.9	8.0	3.7	10.3	13.5	10.9	.91	.74	82.2
Savings institutions ²	30.0	10.7	10.0	10.1	18.2	22.3	.93	1.15	63.1

1. Includes items not shown separately.

2. Savings and loans, mutual savings banks, and federal savings banks.

r--revised. p--preliminary.

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

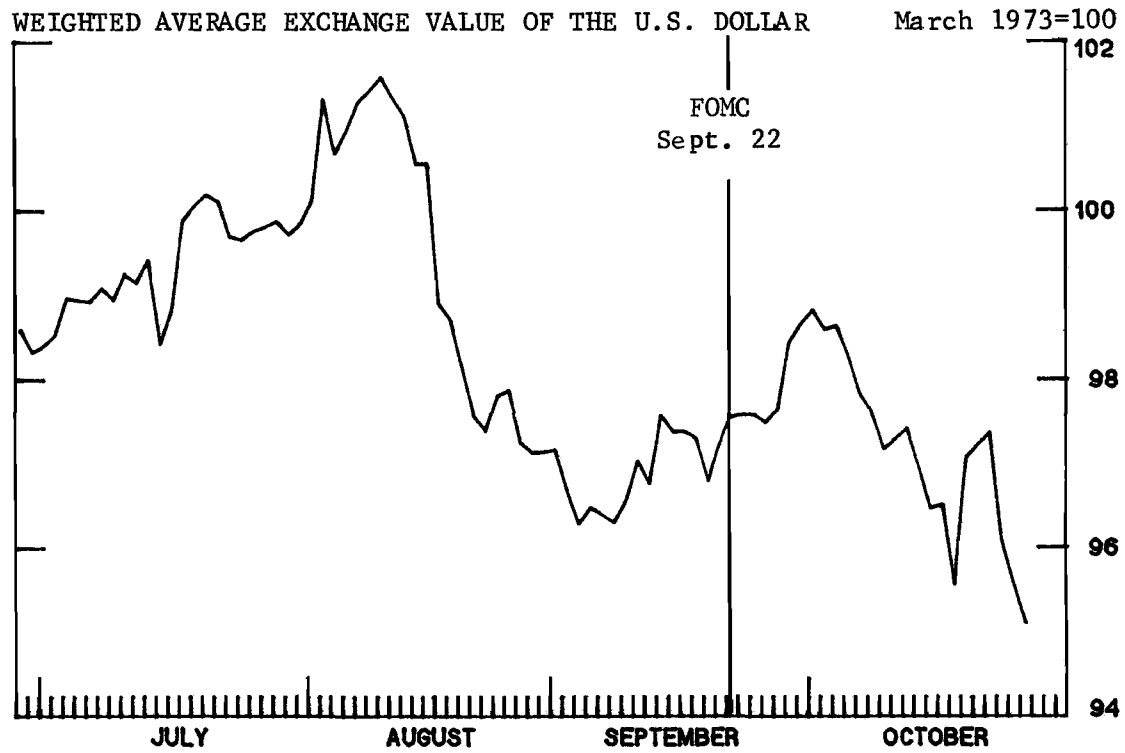
Foreign Exchange Markets

Although the dollar experienced a substantial swing during the period since the previous FOMC meeting on September 22, its movements were modest in comparison with those recorded in other financial markets. Toward the end of the intermeeting period downward pressure on the dollar intensified, particularly against the mark and other European currencies, and the Desk intervened to provide support. On balance, the weighted-average foreign-exchange value of the dollar declined about 3-1/4 percent from its level at the beginning of the intermeeting period. Against the mark, the dollar fell almost 3-3/4 percent.

In late September, the announcement by G-7 authorities of continued commitment to cooperation to maintain stable exchange rates seemed to blunt previous downward pressure arising from disappointing U.S. trade numbers. Heightened hostilities in the Persian Gulf may also have generated some buying pressure on the dollar. During early October, the dollar changed direction as market participants seemed to grow increasingly concerned about the slow pace of U.S. external adjustment. Indications that monetary authorities in Germany and Japan were tightening also began to raise doubts about the status of the Louvre accord.

In Germany, the interest rate on Bundesbank repurchases was increased twice by a total of 20 basis points, as German authorities expressed concern about inflation and the overshooting of German monetary targets. By mid-October short-term market interest rates in

Chart 1



Germany had increased by almost 85 basis points from levels at the time of the September 22 FOMC meeting, and German long-term bond yields had risen by more than 50 basis points. The latter increase is partly attributable to an announcement by the German government of its intention to apply a 10 percent withholding tax to investment income in 1990 as part of an effort to offset loss of revenue associated with scheduled tax reforms. In Japan, authorities indicated that they intended to allow a seasonal rise in short-term money market rates. Japanese short-term interest rates held steady, but Japanese long-term bond yields increased by about 60 basis points in the period from the September 22 FOMC meeting to mid-October. Despite these increases in Germany and Japan, U.S. short- and long-term interest rates increased by more during this period, and interest rate differentials moved in favor of the dollar until mid-October.

Since mid-October, financial markets in both the United States and foreign countries have experienced unprecedented turmoil, but until recently foreign exchange markets and the dollar largely have been spared. Some downward pressure on the dollar was apparent on October 14 following the announcement of yet another disappointing figure for U.S. trade, but the news seemed to have greater impact in domestic markets including particularly the stock market where selling pressure intensified toward the end of the week. Comments by Treasury Secretary Baker criticizing recent German policy, together with a strong suggestion that the dollar would be allowed to go lower, seemed to add to market uncertainty, but no immediate strong reaction was evident in foreign exchange markets. The dollar came under downward pressure on

Monday, October 19, however, until it was announced that Secretary Baker was meeting with German officials to discuss the developing crisis in financial markets.

The spectacular collapse of the New York stock market on October 19 was matched and in some cases exceeded by declines in most major overseas stock markets. The table below provides some comparative measures of recent developments in several leading markets. The New York, Tokyo, and Frankfurt markets all experienced roughly similar falls of about 12 percent during the week beginning October 19, while the London market fell by almost twice that amount. All four markets experienced additional large losses early in the following week. Other world stock markets recorded similar enormous losses.

In the immediate aftermath of the stock market fall, interest rates moved down in many countries in response to a combination of reduced growth prospects and a somewhat easier monetary stance, particularly in the United Kingdom. In Germany, the Bundesbank announced on October 20 that it would conduct its repurchase operation at a fixed rate of 3.80 percent, down 5 basis points from the average rate on the previous repurchase. Short- and long-term interest rates in Germany have moved lower since then by about 15 and 35 basis points, respectively. In Japan, short-term interest rates have been unchanged, but long-term bond yields have moved down about three-quarters percentage point. These declines in both countries were exceeded by declines of more than 125 basis points in U.S. short- and long-term interest rates, and interest rate differentials have moved against the dollar since mid-October.

STOCK INDICES IN SELECTED WORLD MARKETS
(Percentage changes from October 16 in parentheses)

	<u>United States</u> ¹	<u>Japan</u> ²	<u>Germany</u> ³	<u>United Kingdom</u> ⁴
End-December 1986	100.0	100.0	100.0	100.0
September 22, 1987 (previous FOMC)	128.8	130.5	94.5	140.3
October 16	114.8	137.8	90.8	138.0*
October 19	92.6 (-19.3)	130.5 (-5.3)	84.3 (-7.2)	124.0 (-10.1)
October 20	96.0 (-16.4)	114.8 (-16.7)	80.0 (-11.9)	109.5 (-20.7)
October 21	104.6 (-8.9)	125.6 (-8.9)	85.4 (-5.4)	116.2 (-15.8)
October 22	100.6 (-12.4)	127.3 (-7.6)	81.6 (-10.1)	109.2 (-20.9)
October 23	100.4 (-12.5)	121.2 (-12.0)	80.2 (-11.7)	106.3 (-23.0)
October 26	91.8 (-20.1)	116.4 (-15.5)	75.5 (-16.8)	99.4 (-27.9)
October 27	94.2 (-18.0)	118.7 (-13.9)	76.2 (-16.0)	100.6 (-27.1)

Note: Index values all reflect closing levels.

1. United States: New York Stock Exchange composite index, end 1986 = 138.6.

2. Japan: New Tokyo Stock Exchange index (first section), end 1986 = 1562.6.

3. Germany: Frankfurt Allgemeine Zeitung index, end 1986 = 675.9.

4. United Kingdom: Financial Times ordinary index, end 1986 = 1313.9.

* October 15 closing.

On October 23, the Bank of England announced that it would reduce its money market intervention rate by one-half percentage point to 9-3/8 percent, and U.K. clearing banks followed with announcements of cuts of similar size in their base lending rates. On the same day, the largest four Swiss commercial banks announced reductions of one-quarter percentage point in the interest rate paid on customers' time deposits.

. The Desk intervened on October 27 and 28 as the dollar came under strong downward pressure, buying \$300 million against marks (as of 11:00 a.m., October 28) after the dollar-mark rate fell below 1.76DM/\$.

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U.S. bank lending to foreigners in the second quarter. U.S.-chartered banks' claims on foreigners declined \$8.1 billion in nominal terms in the second quarter of 1987. After adjustment for the effect of a 1.2 percent increase in the average foreign exchange value of the dollar on the dollar value of nondollar claims, total claims on foreigners are estimated to have declined by about \$7 billion.

The nominal value of claims on non-OPEC developing countries rose \$0.4 billion in the second quarter, including an increase in claims on Latin American countries of \$0.5 billion. Claims on Mexico rose by \$1.4 billion, mainly reflecting the U.S. bank share of Mexico's drawing of \$3.5 billion in April under its new money "package" arranged earlier this year (\$0.5 billion was used to repay funds obtained from U.S. and foreign commercial banks through a bridge loan at the end of last year). During the quarter, there was also a \$1.1 billion decline in claims on Brazil, due in part to a reduced volume of money market claims on that country as well as other factors.

Total claims on non-OPEC developing countries in Asia and Africa were unchanged in the second quarter. However, (gross) claims on Taiwan increased by \$1.1 billion (20 percent), most likely in connection with borrowing by Taiwan residents in anticipation of appreciation of the Taiwan dollar relative to the U.S. dollar. During the same time period, Taiwan's external reserves (excluding gold) increased by \$6.2 billion. Claims on other major Asian borrowers except the Philippines generally declined. Claims on non-OPEC developing countries in Africa declined by \$100 million.

Claims on the G-10 countries declined in nominal terms by \$5.1 billion in the second quarter, offsetting most of the increase in the first quarter. The declines were broadly based. Claims on other developed countries declined slightly or were unchanged.

Indicative secondary market prices for bank loans to heavily indebted developing countries have dropped substantially since the middle of the second quarter (see table). This market is still

CLAIMS ON FOREIGNERS OF U.S.-CHARTERED BANKS
(billions of dollars)

	Changes (no sign = increase)					Outstanding 6/30/87
	<u>1985</u> <u>Year</u>	<u>1986</u> <u>Year</u>	<u>Q4</u>	<u>Q1</u>	<u>Q2</u>	
<u>Total, all countries</u>	-13.8	-1.9	0.5	6.3	-8.1	388.2
Non-OPEC developing countries	-6.7	-5.6	-0.4	0.6	0.4	100.5
of which:						
(Latin America)	-3.1	-1.2	-0.1	0.3	0.5	73.2
(Asia and Africa)	-3.3	-4.5	-0.3	0.4	0.0	27.5
OPEC countries	-3.3	-2.0	-0.4	0.8	-1.2	19.2
Eastern Europe	-0.2	-1.0	-0.2	-0.1	0.3	3.4
Smaller developed countries	-3.2	-4.4	-3.4	0.0	-0.3	25.7
G-10 countries	0.4	9.3	-0.9	5.8	-5.1	158.5
Offshore banking centers	-0.2	-1.2	3.2	1.2	-2.9	62.5
Miscellaneous	-0.4	2.8	2.5	-2.0	0.7	18.4
Memorandum:						
Total, adjusted for exchange rate changes (staff estimates)	-29	-11	0	-1	-7	

relatively illiquid. Most transactions are individually brokered, and relatively small transactions can cause discrete price movements. But the price declines that have occurred since Citibank initiated the recent extraordinary additions to loan loss reserves of U.S. commercial banks on May 19 are significant. The prices for loans to Brazil and Argentina have declined by about 40 percent since mid-May, and the prices of loans to Mexico have declined by about 15 percent over the same period. Even the prices of loans to countries that have a good

INDICATIVE PRICES FOR BANK LOANS TO
HEAVILY INDEBTED DEVELOPING COUNTRIES
 (average of bid and offer price, expressed
 as a percentage of par value)

	<u>12/2/86</u>	<u>5/18/87</u>	<u>6/29/87</u>	<u>7/17/87</u>	<u>8/24/87</u>	<u>10/19/87</u>
Argentina	66.0	59.8	48.0	47.8	44.0	36.0
Brazil	75.5	63.5	61.5	55.8	46.0	40.0
Chile	68.0	71.2	69.8	67.8	61.0	51.5
Colombia	86.5	86.5	85.2	82.0	81.0	74.2
Mexico	56.5	58.6	56.4	53.5	49.0	50.0
Philippines	73.5	71.2	69.5	67.8	64.0	52.0
Venezuela	74.5	73.0	70.5	67.5	60.0	50.8

Source: Salomon Brothers.

record of both servicing their external liabilities and undertaking structural reforms have declined significantly in the last five months. For example, the indicative prices of loans to Colombia and Chile have declined by 14 and 28 percent respectively since mid-May.

U.S. International Financial Transactions

Foreign official reserve assets in the United States increased by \$5.4 billion in August, after a \$6.4 billion decline in July. (See line 4 of the Summary of U.S. International Transactions table.) G-10 reserves increased by over \$1 billion

. One reason for the increase was the shift by certain countries from the Euromarkets back into Treasury bills when the normal weekly auctions resumed in August. Preliminary information for September from the FRBNY indicates a small

decrease in G-10 reserves,

Several other unrelated factors accounted for much of the rest of the overall increase in foreign reserve holdings in August.

Transactions in private and government securities resulted in a net outflow of \$0.8 billion in August (lines 2 plus 3). The net inflow from private securities transactions was reduced to \$0.9 billion, from \$4.8 billion in July and a monthly average of \$5.5 billion in the first half of 1987 (line 2). An outflow of \$1.7 billion was registered in the net sale of Treasury securities by private foreigners (line 3). This reversal of the pattern of net inflows through securities transactions was coincident with a peak in mid-August of the weighted-average foreign exchange value of the dollar and the New York Stock Exchange Composite Index.

Although foreign net purchases of both U.S. corporate bonds and stocks continued to be positive in August, the inflows declined significantly in both categories (lines 2a and 2b). The inflow from stock purchases of only \$0.2 billion contrasts with an inflow of \$2.3 billion in July and a monthly average of \$3.1 billion for the first half

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

	1985	1986	1986		1987				
	Year	Year	Q3	Q4	Q1	Q2	June	July	Aug.
<u>Private Capital</u>									
Banks									
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	33.6	21.1	12.4	8.2	12.7	-6.0	-8.4	11.2	4.6
Securities									
2. Private securities transactions, net	43.0	66.1	17.3	14.8	16.7	16.0	5.8	4.8	0.9
a) foreign net purchases (+) of U.S. corporate bonds	46.0	53.5	12.7	12.2	8.5	7.5	2.2	3.0	1.3
b) foreign net purchases (+) of U.S. corporate stocks	4.8	18.0	4.5	0.3	10.2	8.7	1.6	2.3	0.2
c) U.S. net purchases (-) of foreign securities	-7.9	-5.3	0.1	2.3	-1.9	-0.2	2.0	-0.6	-0.6
3. Foreign net purchases (+) of U.S. Treasury obligations	20.5	4.8	-1.3	-3.7	-2.7	-2.1	7.2	0.4	-1.7
<u>Official Capital</u>									
4. Changes in foreign official reserves assets in U.S. (+ = increase)	-2.0	33.0	14.6	1.7	15.1	11.6	2.0	-6.4	5.4
a) By area									
G-10 countries (incl. Switz.)	-0.4	32.6	14.7	0.9	15.7	13.0	1.4	-6.1	1.3
OPEC	-6.9	-8.3	-2.9	-4.8	-2.8	-2.0	-0.9	-1.2	*
All other countries	5.3	10.8	2.8	5.5	2.2	0.5	1.5	1.0	4.2
b) By type									
U.S. Treasury securities	-0.8	36.1	12.2	4.4	12.1	11.1	2.2	-5.2	7.2
Other 1/	-1.1	-3.0	2.4	-2.8	2.9	0.5	-0.3	-1.2	-1.8
5. Changes in U.S. official reserve assets (+ = decrease)	-3.9	0.3	0.3	0.1	2.0	3.4	0.6	0.4	-0.8
<u>Other transactions</u> (Quarterly data)									
6. U.S. direct investment (-) abroad	-17.3	-28.0	-5.7	-3.8	-9.8	-4.6	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	19.0	25.1	6.1	12.6	7.7	7.2	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) 2/ 3/	5.6	-4.9	1.4	-3.7	0.6	-2.0	n.a.	n.a.	n.a.
9. U.S. current account balance 3/	-116.4	-141.4	-36.6	-38.0	-36.8	-41.1	n.a.	n.a.	n.a.
10. Statistical discrepancy 3/	17.9	23.9	-8.5	11.8	-5.5	17.6	n.a.	n.a.	n.a.

MEMO:

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

-124.4 -147.7 -37.1 -38.6 -38.8 -39.5 n.a. n.a. n.a.

- Includes deposits in banks, commercial paper, acceptances, borrowing under repurchase agreements, and other securities.
- Includes U.S. government assets other than official reserves, transactions by nonbanking concerns, and other banking and official transactions not shown elsewhere. In addition, it includes amounts resulting from revisions of the data in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.
- Includes seasonal adjustment for quarterly data.

* Less than \$50 million.

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

of the year; more than half of the net decline between July and August was accounted for by Japanese residents. The inflow from foreign net purchases of U.S. corporate bonds, at \$1.3 billion, was approximately 50 percent of the monthly average for the first half of 1987. Data on new issues of corporate Eurobonds indicate a probable further weakening of the inflow in September; new issues by U.S. firms in the Euromarkets were down sharply at a time when the U.S. domestic market was very strong.

In addition to the large reductions in the inflows related to foreign purchases of U.S. securities, U.S. purchases of foreign securities increased slightly in August to net \$0.6 billion (line 2c). In September, foreigners were active issuers in the U.S. bond market. The World Bank issued \$750 million and the Nordic Investment Bank made the first offering of Danish-kroner denominated debt in the U.S. market.

Banks again reported substantial net capital inflows in August, but the total was down substantially from the very large July inflows. (See line 1 of the Summary of U.S. International Transactions table.) In September, as shown on the International Banking Data table, net claims of U.S. banking offices on their own foreign offices and IBFs fell sharply on a monthly average basis. These net inflows were evenly divided between U.S. and foreign-chartered banks and occurred during a period of rapid expansion of domestic bank credit, weak core deposit growth, and shrinking Treasury balances at banks. Since December 1986, banks have borrowed about \$30 billion net from their own foreign offices and IBFs. One factor that probably played an important role in explaining this massive inflow was the decision by several foreign monetary authorities to place a large part of the dollar proceeds of

INTERNATIONAL BANKING DATA
(Billions of dollars)

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>				
	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	June	July	Aug.	Sep.
1. Net Claims of U.S. Banking Offices (excluding IBFS) on Own Foreign Offices and IBFS	49.1	44.5	33.0	28.2	22.3	9.1	5.0	10.8	4.5	-7.8
(a) U.S.-chartered banks	40.0	40.5	32.1	32.4	31.7	21.6	16.3	22.8	18.5	12.6
(b) Foreign-chartered banks	9.1	4.0	.9	-4.2	-9.4	-12.4	-11.3	-12.0	-14.0	-20.4
2. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	15.8	18.6	20.7	18.7	16.8	16.0	15.6	16.1	17.2	17.1
3. Eurodollar Holdings of U.S. Nonbank Residents <u>1/</u>	112.6	124.3	117.4	111.9	123.2	134.0	135.7	128.1	136.5	145.2

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

Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactions accounts. Line 1 is an average of daily data reported to the Federal Reserve by U.S. banking offices. Line 2 is an average of daily data. Line 3 is an average of daily data for the overnight component and an average of Wednesday data for the term component.

foreign exchange market intervention in the Euromarkets. Another factor has been the increase in overnight Eurodeposits by U.S. nonbanks.

In September, there was a sharp increase in U.S. nonbanks' holdings of all Eurodollar deposits, bringing the increase in 1987 to date to \$22 billion. Of this total, almost 25 percent was in the form of overnight deposits, while 75 percent was in the form of CDs held in custody. These CDs probably were not the liabilities of U.S.-based banks, since the CDs outstanding at U.S.-based banks increased by only \$1.2 billion between the end of December 1986 and the end of August 1987. Available data do not indicate that the increase in U.S. nonbanks' holdings of Eurodollar CDs can be easily explained by movements in interest-rate differentials. The 3-month and 6-month Eurodollar CD rates did not increase relative to domestic CD rates during this period. Caution is necessary in interpreting these data on interest rates, however, since rates differ among banks, and the rates quoted need not reflect the rates offered on the particular CDs purchased by U.S. nonbanks.

Merchandise Trade

U.S. merchandise trade data, released on October 14, showed that the trade deficit in August, not seasonally adjusted, was smaller than in July, but for July-August combined the deficit was substantially larger than in the second quarter. A significant part of this variation reflected seasonal factors. Nevertheless, on a preliminary seasonally adjusted basis, the deficit in July-August was \$6 billion (annual rate) larger than in the second quarter, as shown in the following table.

Nonagricultural exports increased 7 percent in the July-August period from the second quarter, reflecting in part a bunching of deliveries of commercial aircraft to Brazil and Japan in July. The

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

	Exports			Imports			Balance
	Total	Ag.	Nonag.	Total	Oil	Non-oil	
1984	220	38	182	332	57	275	-112
1985	216	30	186	338	50	288	-122
1986	224	27	197	369	34	335	-144
1986-1	216	28	187	355	41	314	-140
-2	228	25	202	362	31	332	-135
-3	226	27	200	375	32	343	-149
-4	228	28	200	383	32	350	-154
1987-1	228	26	202	383	35	348	-155
-2	240	29	211	398	40	358	-158
J/A ¹	259	33	226	424	54	370	-164
----- Monthly BOP data - official use only -----							
Jul. ¹	265	35	230	430	54	376	-165
Aug. ¹	254	31	224	417	54	363	-163

1. Preliminary data, subject to revision.

remainder of the increase was widespread across commodity categories, suggesting a continued strong improvement in nonagricultural export volumes. Across regions, the largest increases were in the value of exports to developing countries (Latin American countries, Asian newly industrialized countries, and others). The volume of agricultural exports also surged, due to large wheat shipments to the Soviet Union, and strong soybean exports stimulated by poor weather in Argentina and a halting of soybean exports by Brazil.

The value of non-oil imports also rose noticeably in July-August, on a seasonally adjusted basis, though at a much slower pace than exports. Imports of machinery and industrial supplies, as well as imports of cars from Japan and Korea showed significant increases.

Import and export price data, to be released on October 29, will be discussed in the Greenbook supplement.

The value of oil imports in July-August was up \$14 billion (annual rate) from the second-quarter rate, as volumes rose 27 percent and prices 28 percent (not at an annual rate). Oil import prices have risen

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

	1986			1987			
	1986	Q3	Q4	Q1	Q2	J/A	A
Value (Bil. \$)	33.76	31.61	32.04	34.80	39.98	53.39	53.53
Price (\$/BBL)	14.18	11.39	12.75	15.64	17.32	18.28	18.37
Volume (mbd.)	6.52	7.61	6.89	6.09	6.31	8.05	8.03

steadily all year; the average level of these prices in August was \$18.37 per barrel, up nearly \$4 per barrel since January. The increased volumes appear to have gone into inventories, rather than consumption, reflecting the heightened tensions in the Persian Gulf. Preliminary data for September suggest that both volumes and prices will decline from their August levels.

Developments in the Foreign Industrial Countries

Indicators of economic activity in the major foreign industrial countries suggest that the rate of economic expansion in the third quarter was somewhat above the weak pace experienced during the first half of the year. In Japan, the failure of second-quarter GNP to increase masks the fact that domestic demand has continued to expand rapidly. Strong second-quarter growth in domestic demand of 4.8 percent was offset by a sharp decline in net exports. The continuing strength of the Japanese economy is indicated by the growth in retail sales and housing that occurred in August, and by the increase in industrial

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

	Q4/Q4 1985	Q4/Q4 1986	1986 Q4	1987 Q1	1987 Q2	1987 Q3	May	June	1987 July	Aug.	Sept.	Latest 3 months from year ago 2/
<u>Canada</u>												
GDP	4.0	1.8	.0	1.5	1.5	n. a.	*	*	*	*	*	3.1
IP	4.4	-.5	.6	1.8	1.1	n. a.	.3	1.1	.1	n. a.	n. a.	3.9
<u>France</u>												
GDP	1.7	2.0	-.3	.0	.7	n. a.	*	*	*	*	*	1.4
IP	2.0	-.3	-1.3	-.3	2.0	n. a.	1.0	1.9	-1.0	.0	n. a.	1.6
<u>Germany</u>												
GNP	1.7	2.4	-.3	-.8	1.0	n. a.	*	*	*	*	*	-.8
IP	3.4	.6	-.8	-2.8	2.8	n. a.	.5	-1.3	-1.0	4.6	n. a.	-.9
<u>Italy</u>												
GDP	3.1	2.5	.2	.1	1.4	n. a.	*	*	*	*	*	2.2
IP	1.0	2.8	1.6	3.0	2.0	n. a.	3.6	-2.9	-.5	-4.2	n. a.	3.2
<u>Japan</u>												
GNP	4.2	2.0	.7	1.3	.0	n. a.	*	*	*	*	*	2.8
IP	.9	-.5	-.0	1.4	-.2	3.4	-1.4	4.3	1.0	-1.1	2.5	4.6
<u>United Kingdom</u>												
GDP	2.7	4.3	1.2	1.1	.5	n. a.	*	*	*	*	*	3.7
IP	4.6	2.5	.1	1.0	.6	n. a.	.8	-1.7	2.2	.8	n. a.	3.1
<u>United States</u>												
GNP	3.3	2.2	.4	1.1	.6	.9	*	*	*	*	*	3.0
IP	1.7	1.0	1.0	.8	1.1	2.1	.6	.7	1.2	.3	.2	5.0

1. Asterisk indicates that monthly data are not available.
2. For quarterly data, latest quarter from year ago.

CONSUMER AND WHOLESALE PRICES IN MAJOR INDUSTRIAL COUNTRIES
(Percentage change from previous period) 1/

	Q4/Q4 1985	Q4/Q4 1986	1986			1987			1987				Latest 3 months from year ago
			Q2	Q3	Q4	Q1	Q2	Q3	June	July	Aug.	Sept.	
<u>Canada</u>													
CPI	4.2	4.3	.8	1.2	1.0	.9	1.4	1.2	.3	.7	.1	.0	4.6
WPI	2.5	1.1	-1.5	1.1	.6	-.6	1.4	n. a.	.3	.6	.6	n. a.	3.6
<u>France</u>													
CPI	4.8	2.1	.7	.6	.7	1.2	.9	.6	.2	.2	.2	.1	3.4
WPI	1.9	-3.4	-1.4	-.7	-.7	.4	.7	n. a.	*	*	*	*	-3.3
<u>Germany</u>													
CPI	1.8	-1.0	-.3	-.5	-.3	.6	.4	.0	.2	.0	-.1	-.2	.6
WPI	-1.1	-9.0	-2.6	-2.9	-1.6	-.2	.0	-.4	.1	-.4	.3	-.8	-2.2
<u>Italy</u>													
CPI	8.6	4.7	1.1	.6	1.2	1.3	1.0	1.1	.4	.3	.3	.7	4.6
WPI	5.9	-2.4	-1.8	-.8	.7	1.5	1.0	n. a.	.2	.1	.4	n. a.	3.6
<u>Japan</u>													
CPI	2.0	.1	.3	-.5	.0	-.3	1.2	-.2	-.2	-.5	.2	.8	.7
WPI	-3.7	-10.5	-4.2	-2.8	-1.5	-.5	-.5	1.3	.5	.9	.2	-.1	-1.2
<u>United Kingdom</u>													
CPI	5.5	3.4	1.3	.1	1.3	1.2	1.5	.2	.0	-.1	.3	.3	4.3
WPI	5.2	4.2	1.6	.4	.8	1.2	1.1	.5	-.1	.1	.3	.2	3.6
<u>United States</u>													
CPI (SA)	3.5	1.3	-.3	.6	.7	1.3	1.2	1.0	.4	.2	.5	.2	4.2
WPI (SA)	1.4	-1.8	-1.2	-.1	.7	.7	1.2	.6	.4	.2	.0	.3	3.3

1. Asterisk indicates that monthly data are not available.

TRADE AND CURRENT ACCOUNT BALANCES OF MAJOR INDUSTRIAL COUNTRIES 1/
(Billions of U.S. dollars, seasonally adjusted except where otherwise noted)

	1985	1986	1986			1987			1987			
			Q2	Q3	Q4	Q1	Q2	Q3	June	July	Aug.	Sept.
<u>Canada</u>												
Trade	12.4	7.5	2.3	1.7	1.8	2.3	2.1	n. a.	.1	.5	.7	n. a.
Current account	-.4	-6.7	-1.1	-1.5	-2.1	-1.3	-1.5	n. a.	*	*	*	*
<u>France</u>												
Trade	-2.6	-.1	-.8	-.1	.4	-1.0	-2.2	-1.1	-.6	-.5	-.2	-.4
Current account	.1	3.7	.5	1.2	.9	-.1	-.7	n. a.	*	*	*	*
<u>Germany</u>												
Trade (NSA)	25.5	52.5	12.5	14.1	16.2	15.1	15.4	15.2	4.6	5.4	3.5	6.3
Current account (NSA)	15.8	37.7	8.3	8.6	13.8	10.9	10.7	7.4	3.0	2.5	1.3	3.6
<u>Italy</u>												
Trade	-11.3	-1.6	-.7	.6	.1	-1.4	-3.8	n. a.	-2.1	-1.2	.4	n. a.
Current account (NSA)	-3.5	4.6	1.3	5.4	1.2	-2.2	n. a.	n. a.	*	*	*	*
<u>Japan</u>												
Trade	46.1	82.5	20.4	23.6	22.5	23.6	19.0	18.3	5.5	6.2	5.9	6.2
Current account 2/	49.2	85.5	21.6	23.8	24.3	24.9	20.9	n. a.	6.4	6.3	5.9	n. a.
<u>United Kingdom</u>												
Trade	-2.6	-12.4	-2.4	-4.3	-3.7	-1.7	-3.9	-5.0	-1.2	-1.5	-2.5	-1.1
Current account	3.9	-1.6	.2	-1.4	-1.1	1.0	-.3	-2.1	-.0	-.5	-1.5	-.1
<u>United States</u>												
Trade 2/	-122.1	-144.3	-33.6	-37.1	-38.6	-38.8	-39.5	n. a.	*	*	*	*
Current account	-116.4	-141.4	-33.8	-36.6	-38.0	-36.8	-41.1	n. a.	*	*	*	*

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

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

production that occurred in the third quarter. In Germany, the July-August average of industrial production increased, suggesting that the rebound in activity indicated by second-quarter GNP is continuing. Activity in Canada and the United Kingdom continues to expand strongly, while in France and Italy there are indications that growth is slowing.

The reduction in the Japanese current account surplus continued in August. In September the Japanese trade surplus increased, although it continued to decrease in volume terms. The trade deficits of France, Italy, and the United Kingdom continued to widen. In Germany and in Canada, there is not yet any indication of a reduction in their trade surpluses, despite some resurgence of growth in both countries.

Consumer price inflation abroad remains low, and the declines of wholesale prices seen earlier in 1987 have lessened. In Germany and Japan the most recent data for consumer prices shows small rises from year-earlier levels.

Stock markets in the major industrialized economies all experienced significant reductions in market value. Between September 30 and October 26 the Tokyo stock exchange index fell 15 percent, the London Financial Times index declined 29 percent, and the Frankfurt FAZ declined 20 percent.

In Japan, indicators of economic activity in the third quarter on balance were favorable. Industrial production (s.a.) rose 3.4 percent in the third quarter. Unemployment edged higher in August, to 2.8 percent from 2.7 percent in July, but remains below the 3.2 percent peak rate reached in May. Total new machinery orders (s.a.) declined sharply in July, and then rose slightly in August but remained well below the

June level. After declining in the two previous months, retail sales (s.a.) rose 0.6 percent in August to a level 3.7 percent above the year-earlier level. New housing starts (s.a.) remain strong, rising 3.5 percent in August to a level 32.6 percent above the year-earlier level.

Consumer price inflation has increased but remains low. In the third quarter, the Tokyo consumer price index was 0.7 percent above its year-earlier level. The all-commodities index of wholesale prices (n-s.a.) fell in September after rising in the three preceding months, but the index is still 0.2 percent below its year-earlier level. The rate of decline of wholesale prices has slowed markedly in recent months due to higher prices of domestic construction-related materials. Wage gains remain modest.

The rapid rate of Japanese money growth continued in September with M2+CDs increasing by 11.1 percent relative to a year earlier. This growth rate above the Bank of Japan's projection of "about 10 percent" for the third quarter remains a source of concern to Japanese policymakers.

Japan's trade surplus in dollar terms increased slightly in September. For the first nine months of 1987, the cumulative trade surplus was \$81.2 billion (s.a.a.r.), a slight increase from the \$79.9 billion (s.a.a.r.) one year ago. Adjustment continues in volume terms, with September export volume 2.8 percent below, and import volume 5.3 percent above year-earlier levels. The cumulative current account surplus for the first eight months of 1987 was \$87 billion (s.a.a.r.), somewhat higher than the \$78.7 billion (s.a.a.r.) of a year ago.

In Germany, industrial production rebounded sharply in August from declines in June and July. Officials reported that an unusual number of vacation days in August accounted for much of the unevenness in measured production from July to August. The average of the industrial production index for July and August rose 4.7 percent (s.a.a.r.) from the average for May and June, but remained slightly below the average for July and August last year. Manufacturing orders grew strongly in August, with their average level for July and August about 4.5 percent above the average level in the same interval last year. Despite the somewhat stronger activity, the unemployment rate in the third quarter rose slightly. The September unemployment rate of 9 percent equaled that reached in July and was slightly above rates observed during the first half of the year.

The rate of increase in prices remains very low, but there are some signs that the downward pressure on domestic prices is wanning. In September, the consumer price index stood 0.5 percent above its level of a year ago, the sixth successive month in a row to show a slight positive change from one year earlier. Import prices in September had reached a level 1.8 percent lower than a year ago. This represents a rebound from the declines earlier in 1987 that had ranged from 4.9 percent in June to 17.8 percent in January.

The trade surplus (n.s.a.) rose sharply in September. Through the first nine months of 1987, the cumulative trade surplus was \$45.7 billion (n.s.a.), exceeding the \$36 billion surplus for the same period in 1986. For the current account, the cumulative surplus through September

totaled \$29 billion (n.s.a.), compared with the \$24 billion (n.s.a.) recorded during the first nine months of 1986.

The German government has recently formulated plans for financing part of the tax reform planned for 1990. That reform now calls for gross tax reductions that are expected to total 39 billion marks (\$21 billion). German authorities stated at the time the reform was proposed that they would seek measures to offset 19 billion marks of the revenue loss. Details of those revenue measures, made public in mid-October, include a proposal to adopt a 10 percent withholding tax on investment earnings. News of the proposed tax contributed to a decline in bond prices and in stock prices, particularly bank stocks, as market participants feared that the tax would lead to higher German interest rates and to a flow of investment capital out of German banks.

The rate of increase of central bank money (CBM) rose again in September. Growth of CBM from the target base was 7.8 percent (s.a.a.r.), up from the 7.5 percent (s.a.a.r.) experienced in August. Continued growth of CBM above the current target range of 3-6 percent was a factor in the Bundesbank decision to raise its repo rate, used in transactions with German banks, from 3.6 percent in early September to 3.85 percent in mid-October. However, following the recent asset market developments, a rate of 3.8 percent was announced on October 20.

In France, Finance Minister Balladur presented in September the government's 1988 budget that calls for a reduction in the central government's deficit to 2.1 percent of GDP from a projected 2.5 percent

deficit in 1987. The budget also includes income tax cuts for companies and individuals, as well as lower value added tax rates on automobiles and other items.

In the United Kingdom, the unemployment rate declined to 10 percent (s.a.) in September, the 15th consecutive monthly decline and the largest on record.

On October 5, 1987, Canada reached a tentative Free Trade Agreement with the United States, meeting the Congressional deadline for a "fast-track" agreement. The Administration now has 90 days to resolve a few remaining details as Congress analyzes the current agreement. Under the agreement between the Administration and Congress, Congress cannot amend the agreement when it comes up for a final vote by January 2, 1988.

In Italy, the 1988 budget was introduced in Parliament on September 30. The budget proposed increases in corporate income taxes and in the value added tax. Approximately two thirds of this additional revenue is to be used to finance higher interest payments on the public debt. Noticeably absent were measures to restrain public spending, suggesting that the government will find it necessary to increase taxes during the course of the year, as it did in 1987, in order to achieve its deficit/GDP target of 10.5 percent.

Economic Situation in Major Developing Countries

The Paris Club decided not to reschedule Brazil's first-half 1987 amortization payments in September. Discussions continue between Brazilian officials and commercial banks aimed at normalizing relations and forging an agreement on a financing package. On November 4, Mexico will draw about \$870 million from the \$7.7 billion commercial bank loan

signed last March. In mid-October, Argentina devalued the austral and announced new economic reform measures. The U.S. Treasury recently agreed to participate in a \$500 million multilateral bridge loan for Argentina. Venezuelan Central Bank President Hernan Anzola and Finance Minister Manuel Azpurua resigned in October. After a six-month hiatus, Ecuador is making considerable progress in arranging a new external financing package.

Individual Country Notes. In mid-September, the Paris Club decided not to reschedule Brazil's first-half 1987 amortization payments to official creditors or those that are officially guaranteed. Although Brazil continues to make interest payments to the Paris Club, it is in arrears on all 1987 principal payments. The Paris Club has stated that an IMF program is a prerequisite to future reschedulings. To date, the Brazilian government has declined to seek an accord with the IMF, at least until after an agreement with bank creditors is reached; Brazilian negotiators do not want bank disbursements linked to performance under an IMF program. Meanwhile, meetings continue between Brazilian officials and creditor banks aimed at normalizing relations and forging an agreement on a financing package. Brazil has requested \$10.4 billion in new bank loans to help meet interest payments on its debt through the end of 1989.

The official inflation estimate for September was 5.7 percent (on a monthly basis). With the end of the wage and price freeze in mid-September, a return to double-digit monthly inflation rates, as experienced earlier this year, is likely. The trade surplus for September was

\$1.5 billion, the best monthly figure so far this year. For the first nine months of 1987, Brazil's trade surplus totaled \$7.9 billion.

On November 4, Mexico will draw about \$870 million on the \$7.7 billion commercial bank loan signed last March. This drawing represents two tranches that were initially scheduled to be \$500 million each, but were reduced under a formula in the loan agreement due to improvement in world oil prices. The first drawing on the loan took place last April and amounted to \$3.5 billion. In accordance with the loan agreement, at least \$1.5 billion will not be drawn because of the improved external account performance, and another \$250 million will be withheld because of Mexican savings on interest payments resulting from the lowering of spreads under the debt restructuring.

Economic activity in Mexico began to recover in the second quarter after declining or remaining flat for nearly 18 months. In June and July, industrial production averaged over 4 percent more than in the same months of 1986. Imports exceeded year-earlier levels for two consecutive months for the first time since December 1985. The trade surplus, which totaled \$6.3 billion in January-July 1987, is likely to grow more slowly in August-December, although it could still exceed \$10 billion for the full year, the highest level since 1984. The peso continued to appreciate in real terms in September, even though consumer prices showed a smaller rise (6.6 percent) than in any month since March 1987. Inflation is likely to rise in October; the minimum wage was raised by 25 percent on October 1 and contractual wages normally rise with the minimum wage.

Monthly CPI inflation in Argentina dropped from 13.7 percent in August to 11.7 percent in September, while WPI inflation increased from 14.6 percent in August to 16.6 percent in September. The austral was devalued by nearly 21 percent in two devaluations in mid-October. Also in mid-October, a new package of economic measures was announced including a 15 percent average hike of public sector prices, a 12 percent increase in public and private sector wages followed by a new freeze of wages and prices, a freeing of the exchange rate for financial transactions, the deregulation of interest rates on some bank deposits and loans, measures to encourage debt-equity swaps, and new tax measures to be submitted to the Argentine Congress. The exchange rate system now consists of two official exchange rates: a commercial rate for trade and public sector transactions and payment of interest on foreign debt, and a liberalized financial rate for all other transactions including dividend and profit remittances, capital repatriation, and tourism. A parallel or "black" market for foreign exchange still exists that services unregistered capital flows.

The first \$750 million disbursement from Argentina's \$1.95 billion new money package with commercial banks was made in early October. Argentina will require a waiver of performance criteria or a modification of its stand-by arrangement with the IMF to draw the next \$210 million tranche now expected in November. The U.S. Treasury agreed to participate in a \$500 million multilateral bridge loan that is being assembled for Argentina in support of its economic reform efforts; the loan will be bridged to upcoming IMF and World Bank disbursements.

In October, Venezuelan Central Bank President Hernan Anzola and Finance Minister Manuel Azpurua resigned. Hector Hurtado, currently head of the state-owned Venezuelan Investment Fund, will be the new Finance Minister. Mauricio Garcia Araujo will be the new Central Bank head. A World Bank team is now in Caracas to begin negotiations on a \$400-500 million trade policy loan. Consumer prices rose 1.4 percent in September (on a monthly basis), up from 0.8 percent in August, but down from 4-5 percent average monthly increases registered in May through July.

After a six-month hiatus, Ecuador is making considerable progress in arranging a new external financing package that would lead to the resumption of debt-servicing that was interrupted earlier this year. However, political tensions have risen. President Febres Cordero declared a state of emergency in anticipation of a general strike organized by opposition groups for October 28.

Negotiations with commercial banks follow the reopening of the oil pipeline in mid-August, upon completion of repairs made necessary by the March earthquake. In mid-October, preliminary agreement was reached with leading banks on a package consisting of \$350 million in new money and a \$4.9 billion debt restructuring, the terms of which must still be approved by all members of the bank advisory committee. A \$220 million oil export financing facility, obtained from a group of banks a year ago, was extended to the end of 1987, with permission for Ecuador to utilize fully the facility. Interest arrears to the banks are estimated at about \$350 million. An IMF staff mission visited Ecuador in October

to negotiate the terms of a stand-by arrangement. Preliminary discussions on a Paris Club rescheduling were held in September and another meeting is scheduled for November.

In Peru, legislation nationalizing 10 domestic private banks and 23 finance and insurance houses was signed into law on October 9. Commitments to a voluntary \$1.06 billion commercial bank loan to Columbia (about the same magnitude as scheduled amortization payments over the period from fourth quarter 1987 through year-end 1988) were about 70 percent subscribed as of October 26. On September 23, Morocco and its commercial bank creditors signed an agreement rescheduling \$1.6 billion of principal payments due between January 1985 and December 1988 over a ten-year period including four years of grace at 1-3/16 over LIBOR; in addition, \$450 million of bankers' acceptances and \$80 million of trade credit arrears were converted into six-year facilities.