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March 22, 1989

RECENT DEVELOPMENTS

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

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DOMESTIC NONFINANCIAL DEVELOPMENTS

Economic activity appears to have remained fairly robust in early 1989. While the fragmentary information on expenditures is ambiguous, gains in jobs and personal income clearly were sizable in the January-February period. Inflation picked up in the past few months; in part this reflected large increases in food and energy prices, but prices of other goods and services accelerated too. Wage increases also appear to be trending upward against a backdrop of tightening labor markets and increasingly numerous reports of labor shortages.

Labor Market Developments

The demand for labor remained strong in the first two months of 1989. Nonfarm payroll employment grew 290,000 in February, after a weather-boosted increase of 415,000 in January, and these employment gains raised the aggregate hours of production workers in January and February to a level about 3 percent (annual rate) higher than in the fourth quarter of 1988.

The rise in employment was paced by further steady increases in the service-producing sector, most notably in retail and wholesale trade and in services. Employment in the goods-producing sector also rose on net over the two months, but the increase was concentrated in January. In particular, jobs at construction sites declined 20,000 last month after a large January rise; unusually mild weather in January probably accounted for part of this up-and-down pattern. Manufacturing employment also dipped in February after four months of sizable increases. The February decline was more than accounted for by layoffs in the automobile industry and followed a

CHANGES IN EMPLOYMENT¹
(Thousands of employees; based on seasonally adjusted data)

	1987	1988	1988			1988	1989	
			Q2	Q3	Q4	Dec.	Jan.	Feb.
-----Average Monthly Changes-----								
Nonfarm payroll employment ²	286	303	346	227	301	222	415	289
Strike-adjusted	283	303	345	229	296	222	417	292
Manufacturing	38	32	46	2	64	26	53	-8
Durable	21	22	35	7	38	14	37	-14
Nondurable	16	11	12	-6	26	12	16	6
Construction	21	27	39	19	22	17	105	-22
Trade	68	80	81	52	73	54	159	104
Finance and services	114	122	141	93	127	139	60	140
Total government	28	28	20	51	3	-23	0	65
Private nonfarm production workers	208	216	258	124	242	207	346	162
Manufacturing production workers	30	22	30	-3	50	16	43	0
Total employment ³	257	189	291	123	213	62	702	142
Nonagricultural	252	191	311	105	207	107	595	219

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

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

	1987	1988	1988			1988	1989	
			Q2	Q3	Q4	Dec.	Jan.	Feb.
Civilian, 16 years and older	6.2	5.5	5.5	5.5	5.3	5.3	5.4	5.1
Teenagers	16.9	15.3	15.2	15.3	14.6	14.8	16.4	14.8
20-24 years old	9.7	8.7	8.7	8.5	8.7	8.7	9.3	8.1
Men, 25 years and older	4.8	4.2	4.2	4.1	4.1	4.1	4.0	4.0
Women, 25 years and older	4.8	4.3	4.3	4.4	4.2	4.1	4.1	3.9
White	5.3	4.7	4.7	4.8	4.6	4.6	4.6	4.3
Black	13.0	11.7	11.9	11.2	11.3	11.6	12.0	11.9
Hispanics	8.8	8.2	8.8	8.0	7.8	7.6	8.4	6.8
Fulltime workers	5.8	5.2	5.1	5.1	5.0	5.1	5.0	4.8
Memo:								
Total National ¹	6.1	5.4	5.4	5.4	5.3	5.3	5.4	5.1

1. Includes resident armed forces as employed.

similar increase in January. Elsewhere in manufacturing, producers of nonelectrical machinery and fabricated metal products continued to add workers.

In the household survey, the unemployment rate fell to 5.1 percent in February from 5.4 percent in January and a 5.3 percent average in the fourth quarter. The drop in the unemployment rate last month may have been exaggerated by large declines in the rates for teenagers, young adults (ages 20-24), and Hispanics--groups whose unemployment rates typically exhibit much month-to-month variability. Nonetheless, smoothing through these fluctuations, joblessness in these groups appears to be on the decline. The unemployment rate for adults 25 years old and up, at about 4 percent in February, has continued to trend downward and is at its lowest level since 1979.

Quantitative data on labor costs in the first quarter are limited to the readings on average hourly earnings, which were little changed in February after a large increase in January. On average, the increase so far this year was about in line with the pace over the past 12 months. Qualitative reports--such as those in the March "Beigebook"--suggest that upward pressures on wages are widespread across the country.

Revised data for the fourth quarter show unit labor costs in the nonfarm business sector up 5-1/2 percent at an annual rate; this rise brought the increase over 1988 as a whole to about 4 percent. The pickup in unit labor costs last year reflected both an acceleration in compensation and a slowing of productivity growth. Output per hour was virtually unchanged in the fourth quarter and up only about 3/4 percent over the year as a whole, below the staff's estimate of the 1-1/4 percent trend. The

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

	Annual ¹		1988		1989	
	1987	1988	Q3	Q4	Jan.	Feb.
	-Monthly Rate-					
<u>Average hourly earnings</u>						
Total private nonfarm	3.0	3.7	3.5	4.2	.5	.1
Manufacturing	2.3	2.9	2.5	3.3	.1	.3
Contract construction	.7	2.2	3.0	.7	.3	.3
Transportation and public utilities	2.8	2.0	1.7	.3	1.1	-.6
Trade	2.1	4.0	4.1	5.0	.5	.1
Services	4.6	4.9	4.4	5.3	.5	.4
<u>Hourly earnings index²</u>	2.6	3.5	2.9	4.1	.5	.1
<u>Employment cost index³</u>						
Compensation, all persons	3.3	4.9	3.8	4.8	--	--
By occupation:						
White collar	3.7	5.0	4.1	5.7	--	--
Blue collar	3.1	4.4	2.7	3.6	--	--
Service workers	2.4	5.3	5.5	4.3	--	--
By sector:						
Goods-producing	3.1	4.4	2.7	3.6	--	--
Service-producing	3.7	5.1	4.2	5.8	--	--
By bargaining status:						
Union	2.8	3.9	3.1	2.1	--	--
Nonunion	3.6	5.1	3.8	5.9	--	--
Manufacturing	3.1	4.5	3.1	3.3	--	--
Wages and salaries, all persons	3.3	4.1	3.4	5.0	--	--
Benefits, all persons	3.5	6.8	4.8	4.8	--	--
<u>Labor costs and productivity, all persons</u>						
Compensation per hour	4.1	4.8	5.7	5.6	--	--
Output per hour	1.9	.7	2.0	.1	--	--
Unit labor costs	2.1	4.0	3.7	5.6	--	--
<u>Manufacturing</u>						
Compensation per hour	1.6	4.6	4.8	5.5	--	--
Output per hour	3.4	3.5	5.2	1.8	--	--
Unit labor costs	-1.8	1.1	-.5	3.5	--	--

1. Changes are from final quarter of preceding period to final quarter of period indicated. Seasonally adjusted data.

2. The values for the hourly earnings index for 1989 were constructed by the Federal Reserve staff.

3. Percentage change at an annual rate, measured from the final month of preceding period to final month of period indicated; seasonally adjusted by the Federal Reserve staff.

slowing of productivity last year may be a manifestation of the relative scarcity of labor and high capacity utilization rates, which probably have forced some businesses to employ workers and facilities that are less productive than those already in use.

Industrial Production and Capacity Utilization

Activity in the industrial sector leveled off in February, after rising at about a 5 percent annual rate since October of last year. A reduced rate of auto assemblies held down the increase in total output 0.1 percentage point in both January and February. Assemblies of trucks were little changed, on balance, over the past two months, although at a level that was well above their fourth-quarter average. In addition to the decline in auto assemblies, output of materials fell 0.4 percent in February. Much of the weakness in recent months has occurred in energy materials, particularly coal. However, in February, output of durable materials fell, with declines in consumer durable parts and in basic metal materials, particularly steel.

Outside of these areas, production gains have been well maintained. Home goods output, including appliances, is still strong, and consumer nondurables, although up only 0.2 percent in February, are likely to post another solid gain for the quarter as a whole. The output of business equipment, after slowing in the fourth quarter of last year, has risen rapidly in recent months. Production of office and computing equipment has been exceptionally robust, and output of manufacturing equipment has strengthened as well. A significant portion of this recent surge in domestic equipment production likely resulted from continued strong foreign demand. At this point, there is little hard information on the sources of demand in the first quarter. However, for the past few years, exports have

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

	1987 ¹	1988 ¹	1988			1988	1989	
			H1 ¹	Q3	Q4 ^r	Dec. ^r	Jan. ^r	Feb. ^e
			---Annual rate---			---Monthly rate---		
Total Index	5.8	5.1	4.2	7.1	4.7	.4	.4	.0
Previous	5.8	5.1	4.2	7.1	4.7	.5	.3	
Products	4.9	5.4	5.3	6.4	4.4	.6	.6	.2
Consumer goods	3.2	6.0	4.9	6.6	7.6	1.0	.4	.1
Motor vehicles	4.4	8.8	8.5	-1.1	20.5	3.9	-1.4	-.8
Autos	-6.2	13.7	14.2	-5.9	36.3	4.0	-5.2	-3.7
Ex. motor vehicles	3.0	5.6	4.5	7.2	6.0	.6	.6	.3
Home goods	4.0	3.9	-.8	7.0	10.6	.8	.5	.5
Nondurable goods	2.8	6.0	5.5	7.7	5.3	.6	.7	.2
Business equipment	7.0	8.3	10.5	9.4	2.9	.7	1.0	.8
Motor vehicles	3.9	10.7	4.3	1.3	35.9	4.9	-4.7	-1.6
Computers	9.4	8.7	18.0	.1	.1	3.7	2.2	2.2
Others	6.4	7.9	8.3	14.0	1.3	-.8	1.2	.5
Defense & space	1.9	-3.6	-3.5	-2.6	-5.0	-.7	-.1	-.2
Construction supplies	4.7	5.1	6.4	.9	6.9	.4	1.8	-.7
Business supplies	6.7	5.4	3.3	10.1	4.9	.7	.4	.4
Materials	7.2	4.6	2.5	8.3	5.2	.1	.0	-.4
Durable	8.0	6.9	6.0	9.0	6.6	-.5	.8	-.3
Consumer durable parts	1.8	9.0	11.0	5.5	8.7	-1.1	.5	-1.3
Equipment parts	6.3	6.8	8.6	8.3	2.0	-.4	.5	.4
Basic metals	21.3	3.6	-7.8	24.7	8.6	-1.7	1.9	-1.6
Nondurable	8.1	4.1	.6	7.6	8.1	1.0	.1	-.1
Textile	6.5	-3.1	-7.2	1.1	1.3	-.7	1.2	.0
Paper	5.9	2.4	1.0	8.5	-0.7	2.1	-.7	-1.6
Chemical	12.6	6.6	.3	11.4	15.4	1.3	-.1	.3
Energy	4.5	.1	-3.0	7.7	-1.2	.7	-2.0	-1.0
Memo:								
Manufacturing	5.9	5.6	5.1	7.2	5.1	.4	.7	.0

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

r -- revised

e -- estimated

accounted for a steadily growing share of domestically produced capital goods, and that trend extended through the fourth quarter (chart). On the import side, domestic producers of noncomputer equipment appear to have slowed--although not reversed--their loss of market share in the United States; imports of computers, however, have continued to grow rapidly.

The operating rate for all industries edged down in February, as did capacity utilization in manufacturing, particularly at primary processors. Despite drops in utilization of more than 1 percentage point in February for primary metals, petroleum products, and paper, these basic industries continue to operate at relatively high rates. And the operating rate for chemicals and products, which also edged off, still is above past cyclical peaks. For primary processing as a whole, capacity utilization is more than 1-1/2 percentage points above the average of 1978-79--a period of accelerating materials prices. Moreover, operating rates in advanced processing industries are nearly at their 1978-79 average.

Personal Consumption Expenditures

Consumer spending appears to have slowed somewhat in the first quarter, after rising more than 3-1/2 percent in real terms last year. The slowing has been concentrated in spending on goods and on energy services. Outlays for non-energy services, which had increased steadily over the course of 1988, posted another sizable rise in January.

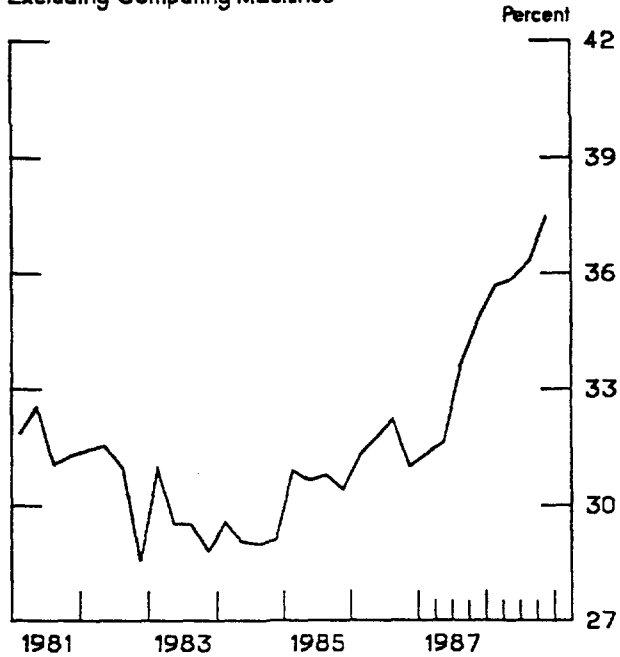
Revised figures indicate that sales at the PCE control grouping of retail stores¹ increased sharply in nominal terms around the turn of the year. And while advance estimates showed little change in these outlays in

1. The PCE control category excludes sales at automotive dealers and building material and supply stores, and gasoline sales at gasoline stations.

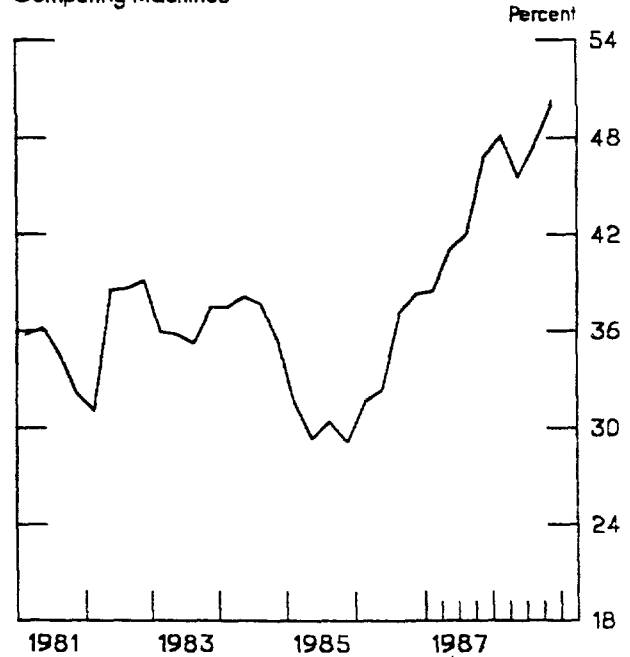
Real Export and Import Shares for Capital Goods
(Excluding automotive products)

Exports as a Share of Domestic Production*

Excluding Computing Machines

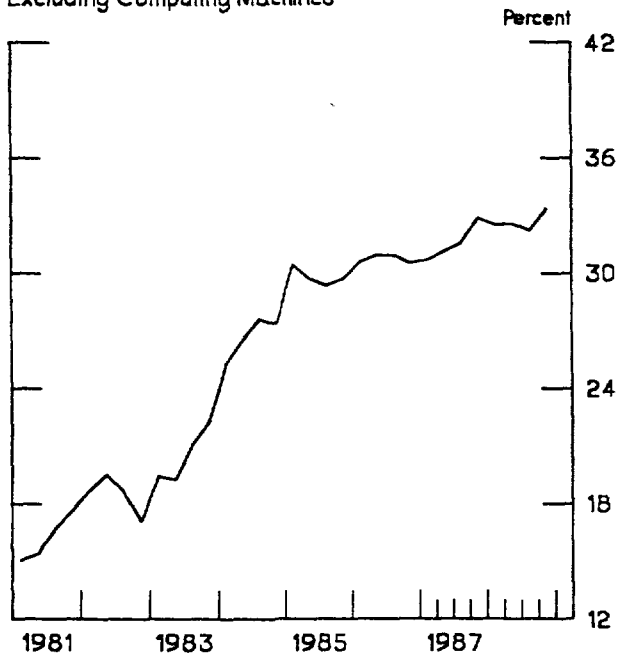


Computing Machines**

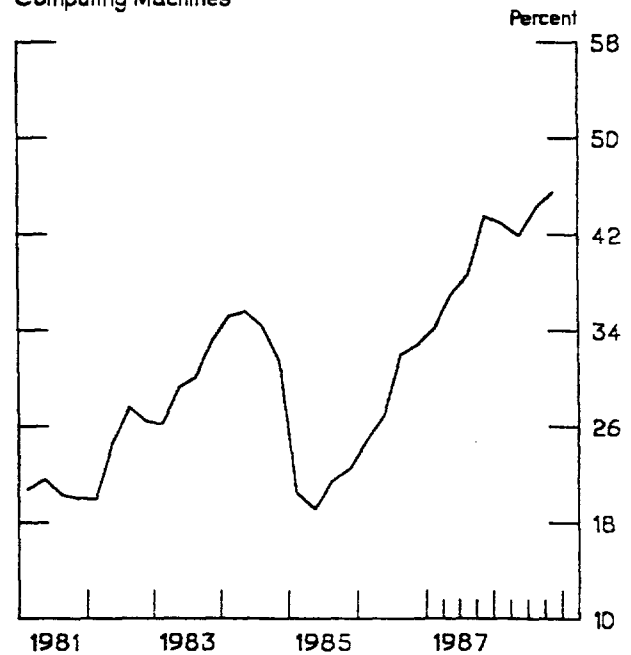


Imports as a Share of Domestic PDE Outlays

Excluding Computing Machines



Computing Machines**



* Production is measured as the sum of outlays for producers' durable equipment plus exports minus imports of capital goods.

** Includes staff adjustment to ensure consistency between export and import data and domestic PDE outlays.

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

	<u>1967-88</u>	<u>1973</u>	<u>1978-79</u>	<u>1988</u>	<u>1988</u>	<u>1989</u>	
	Ave.	Ave.	Ave.	Feb.	Dec.	Jan.	Feb.
Total industry	81.6	87.9	85.0	82.4	84.3	84.5	84.3
Manufacturing	80.7	87.0	84.4	82.6	84.5	84.8	84.6
Primary processing	82.0	91.3	86.3	86.6	88.0	88.4	88.0
Advanced processing	80.2	85.1	83.3	80.7	82.8	83.1	83.0
Durable manufacturing	78.8	86.2	83.5	80.5	83.1	83.5	83.4
Iron and steel	79.0	97.9	88.2	86.8	86.6	92.5	89.8 ^e
Nonferrous metals	81.5	94.2	87.1	82.7	89.1	89.5	90.5 ^e
Fabricated metal products	78.0	84.0	84.6	81.8	84.8	84.6	84.4
Nonelectrical machinery	78.2	86.6	83.2	78.7	83.8	84.4	85.1
Motor vehicles & parts	78.2	94.5	83.6	76.8	87.2	86.1	84.9
Nondurable manufacturing	83.6	88.1	85.7	85.7	86.5	86.7	86.3
Paper and products	88.8	94.2	89.4	94.7	94.1	94.0	92.5 ^e
Chemicals and products	79.3	86.9	81.4	84.7	89.7	89.4	89.0 ^e
Petroleum products	86.9	97.1	87.8	86.3	87.6	89.0	87.5
Mining	86.5	91.4	90.5	79.5	84.0	82.5	81.1
Utilities	86.7	92.8	85.3	82.6	82.0	81.5	82.9
femo:							
Industrial materials	82.3	91.1	86.7	82.3	85.1	84.9	84.4
Raw steel	80.7	100.4	90.7	85.7	87.7	93.3	86.8 ^e
Aluminum	87.8	93.8	94.0	97.9	99.4	100.2	100.4 ^e
Paper materials	92.0	96.8	92.1	97.8	98.4	97.3	95.4 ^e
Chemical materials	81.3	91.1	85.9	85.7	91.3	90.9	90.7 ^e

e--estimate

RETAIL SALES
(Seasonally adjusted percentage change)

	1988			1988	1989	
	Q2	Q3	Q4	Dec.	Jan.	Feb.
Total sales	1.6	1.3	2.2	-.2	.7	-.4
Automotive dealers	.1	-.4	4.2	.0	-1.7	-1.7
PCE control ¹	2.0	2.0	1.5	-.5	1.6	.1
Furniture and appliances	5.0	-.8	2.6	-.5	4.6	-.3
Other durables	2.3	.7	-.9	1.2	-.1	.7
Apparel	1.8	3.9	2.7	1.1	2.5	.8
Food	2.4	2.3	.9	-1.4	2.4	.2
General merchandise	.6	1.4	3.4	.2	1.7	-.6
Memo:						
Real PCE control	0.4	1.1	.7	-.6	.5	-.2 ^e

1. PCE control excludes sales at automotive dealers, building material and supply stores, and gasoline sales at gasoline stations.

e--Staff estimate

PERSONAL INCOME
(Average monthly change at an annual rate; billions of dollars)

	1988	1988		1988		1989
		Q3	Q4	Nov.	Dec. ^r	Jan. ^p
Total personal income	22.4	23.3	31.1	-7.9	37.6	74.0
Wages and salaries	14.9	15.8	19.0	8.0	16.0	30.3
Private	12.8	13.7	16.9	5.7	13.9	24.4
Other labor income	.9	1.0	1.0	1.0	1.0	1.0
Proprietors' income	.2	-2.6	1.4	-26.2	12.1	25.5
Farm	-1.5	-4.4	-1.4	-27.8	9.4	22.7
Rent, dividends and interest	5.2	8.0	8.1	8.0	8.2	10.9
Transfer payments	3.3	2.0	2.7	1.8	1.2	15.2
Less: Personal contributions for social insurance	2.0	.9	1.2	.5	.9	8.9
Less: Personal tax and nontax payments	.2	3.2	4.1	1.9	3.9	12.7
Equals: Disposable personal income	22.3	20.1	27.0	-9.8	33.7	61.3
Memo: Real disposable income	8.0	4.5	13.1	-11.9	18.2	30.2
Personal saving rate (percent)	4.2	4.2	4.5	4.2	4.3	5.8

r--Revised.

P--Preliminary.

February, spending levels were well above the fourth-quarter average. However, prices for these items also have risen sharply in recent months, and when measured in real terms, the average level of the PCE control in January and February probably was only about 1-1/2 percent at an annual rate above the fourth-quarter level.

Consumption this quarter also is being damped by the effects of January's unseasonably warm weather on spending for fuel oil, electricity, and natural gas. Assuming that heating bills returned to more normal levels in February and March, lower energy consumption in the first quarter still is expected to cut roughly 3/4 percentage point at an annual rate from growth in total PCE spending.

Gains in consumer spending continue to be buttressed by sizable increases in income. Real disposable income rose nearly 4 percent last year and was up another 1 percent in January. The magnitude of the January advance reflects both the strong employment and wage gains and some non-recurring special factors, notably a step-up in farm proprietors' income associated with BEA's assumption of a January 1 rebound in farm output and an increase in transfer payments resulting from cost-of-living adjustments in social security and other federal transfer programs. In addition, the sharp rise in wages and salaries probably was exaggerated by the effects on payrolls of the mild weather. Nonetheless, even abstracting from these transitory factors, underlying income growth remains strong.

The jump in disposable income in January, coupled with relatively weak growth in consumer outlays, pushed the personal saving rate to 5.8 percent, compared with an average of 4.5 percent in the fourth quarter of 1988.

Taking a longer perspective, the saving rate has been moving up since mid-1987. Among other things, this rise in the saving rate probably reflects some reversal of the stimulus to consumption that was provided by the booming stock market earlier in the expansion. Stock prices, of course, have recovered some since the crash. Nonetheless, overall household net worth has not kept pace with the growth in income, and the wealth-to-income ratio currently is no higher than its 1985-86 average value.

Autos and Trucks

Sales of domestically produced cars have averaged about 7 million units at an annual rate since the turn of the year. However, adding in the strong sales at the end of 1988, the underlying sales pace still looks to be on the order of 7-1/4 to 7-1/2 million units annually. Meanwhile, light truck sales have held steady at about a 4 million unit pace since September, while imported cars have continued to trend down. The decline in foreign car sales over the past year and a half likely reflects a combination of higher prices for many models and increased production in the United States of Japanese makes.

Inventories of domestically produced automobiles remained a bit hefty at the end of February, at roughly 1.65 million units. Domestic automakers apparently expect inventory burdens to be eased by a pickup in sales, perhaps induced by more generous incentives this spring. They lowered production 700,000 units in February to a 6.9 million unit annual rate (BEA seasonals), and current schedules call for assemblies in March at about the same rate. However, assemblies are scheduled to move up to a 7.3 million unit average pace during the second quarter.

AUTOMOBILES AND LIGHT TRUCKS¹
(Millions of units at an annual rate, BEA seasonals)

	1988	1988		1988	1989		
		Q3	Q4	Dec.	Jan.	Feb.	Mar.
Sales							
Autos and light trucks	15.45	15.70	15.15	16.07	14.44	14.38	
Autos	10.64	10.66	10.49	11.53	9.79	9.85	
Light trucks	4.81	5.04	4.65	4.54	4.65	4.53r	
Domestically produced ²	11.74	11.96	11.59	12.38	11.18	11.13	
Autos	7.54	7.60	7.47	8.39	7.04	7.07	6.24*
Light trucks	4.21	4.35	4.12	3.99	4.14	4.06r	
Imports	3.70	3.74	3.55	3.69	3.27	3.25	
Autos	3.10	3.06	3.02	3.14	2.75r	2.78	
Light trucks ³	.60	.69	.53	.55	.51	.47	
Memo:							
Domestic production	7.15	7.15	7.79	8.21	7.61	6.87	
Inventories of domesti-							
cally produced autos ⁴	1.61	1.52	1.61	1.61	1.61	1.65 ^e	

Note: Data on sales of trucks and imported autos for the current month are preliminary and subject to revision.

1. Components may not add to totals due to rounding.
2. Includes vehicles produced in Canada and Mexico for General Motors, Ford, and Chrysler.

3. Based on seasonals for domestic light trucks.

*Data for first ten days of March.

4. Inventories are as of end of the period.

r-revised.

e--staff estimate.

Business Fixed Investment

[Unpublished detail on orders and shipments are provided to the Board on a confidential basis. The information from Boeing also should be treated as proprietary.]

After a moderate decline in the fourth quarter, business capital spending appears to have rebounded in the current quarter with healthy increases in outlays for both equipment and structures.² Weighted shipments of nondefense capital goods rose 1.1 percent in February to a level 3 percent above their fourth-quarter average.³ Shipments of machinery have been strong in recent months, but sales of office and computing machinery have remained soft (chart). As for motor vehicles, business purchases of automobiles have been sluggish after a strong fourth quarter, while purchases of heavy-weight trucks have remained robust. Looking ahead, moderate increases in equipment spending appear to be in the offing, as the January/February average of weighted PDE new orders, excluding the aircraft group, was 2 percent above the fourth-quarter level.

2. Some analysts have suggested that seasonally adjusted fourth-quarter spending on PDE was artificially weak, and first-quarter spending will be artificially strong, because seasonal factors have been distorted by earlier tax-induced bulges for end-of-year equipment spending. An examination of the evolution of the seasonal factors does not reveal any support for this hypothesis.

3. This series is the weighted sum of shipments in 25 individual industries and approximates the procedure used by BEA to construct its current-quarter estimate of equipment spending (excluding aircraft). The weights are equal to the fraction of domestic shipments (shipments less exports) in a given industry that are allocated to investment spending; the weights are significantly less than 1 in industries such as engines and turbines whose output consists largely of intermediate inputs. Weights for individual industries also are reduced to the extent that their output is purchased by consumers or the government. The unweighted shipments series (excluding aircraft) increased 0.5 percent in February to a level 3.0 percent above the fourth-quarter average.

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

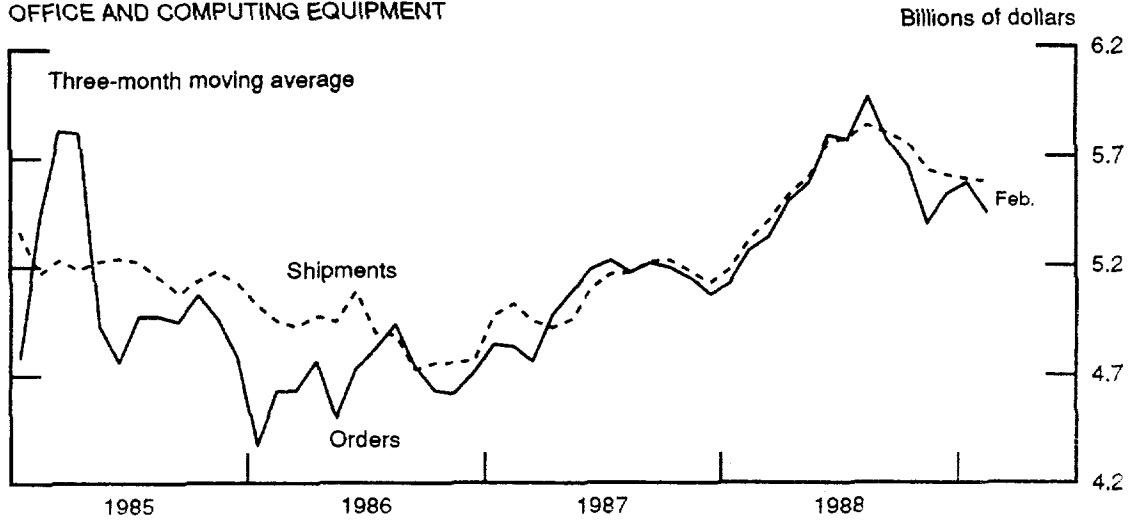
	1988			1988	1989	
	Q2	Q3	Q4	Dec.	Jan.	Feb.
<u>Producers' durable equipment</u>						
Shipments of nondefense capital goods	3.8	2.6	.1	.5	1.9	-.4
Excluding aircraft and parts	4.3	2.4	.8	3.6	-.1	.5
Office and computing equipment	6.6	.7	-3.3	4.0	-1.7	-2.8
All other categories	3.7	2.8	1.9	3.5	.3	1.3
Weighted PDE shipments¹	4.3	2.2	.8	4.3	-1.3	1.1
Shipments of complete aircraft ²	12.1	-8.8	-14.8	-28.9	93.6	--
Sales of heavy-weight trucks	-.8	-2.3	7.7	-10.0	8.2	--
Orders of nondefense capital goods	1.1	9.1	.0	10.1	2.2	-8.9
Excluding aircraft and parts	3.4	4.5	-2.3	.8	5.9	-3.2
Office and computing equipment	8.6	-.4	-4.1	3.6	.5	-11.1
All other categories	2.1	5.8	-1.8	.2	7.2	-1.4
Weighted PDE orders¹	3.8	4.1	-.3	4.0	.1	-1.7
<u>Nonresidential structures</u>						
Construction put-in-place	1.4	1.6	1.1	2.0	2.7	--
Office	4.1	1.0	-1.2	1.8	2.0	--
Other commercial	6.0	-2.4	-4.0	5.9	5.0	--
Public utilities	-.2	10.1	.8	1.5	-1.1	--
Industrial	-.2	.1	11.4	-5.3	7.8	--
All other	-3.5	-3.4	4.3	3.2	3.4	--
Rotary drilling rigs in use	6.2	-8.5	-16.0	-4.2	-6.8	6.0

1. Computed as a weighted sum of 25 individual equipment series (excluding aircraft) from the Census M-3 report with weights equal to the fraction of final business spending for each type of equipment.

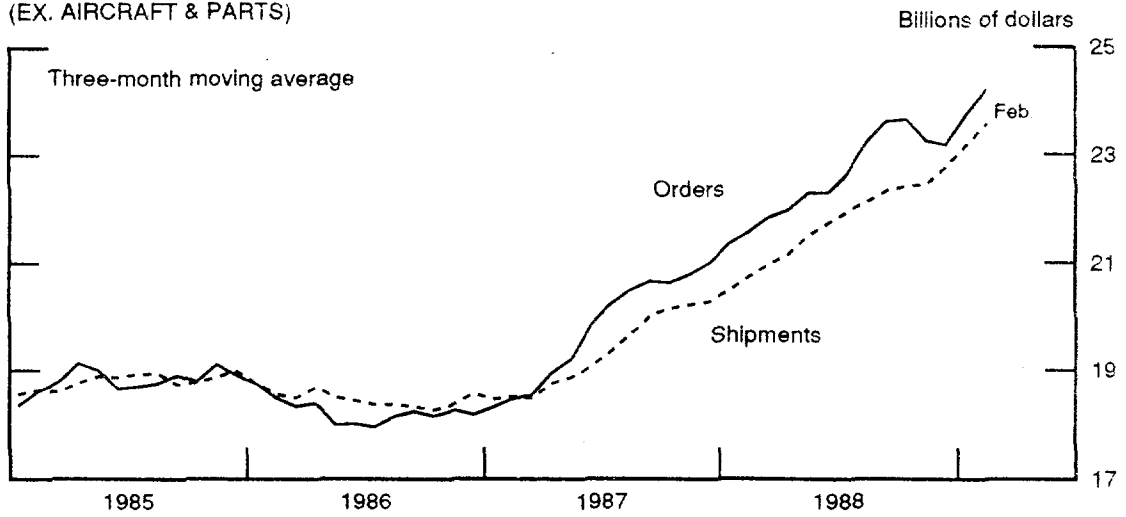
2. From the Current Industrial Report (CIR) titled "Civil Aircraft and Aircraft Engines." Seasonally adjusted with BEA seasonal factors. To estimate PDE spending for aircraft, BEA uses the aircraft shipments shown in that report, not the corresponding Census series. The CIR does not provide information on aircraft orders.

Indicators of Business Fixed Investment

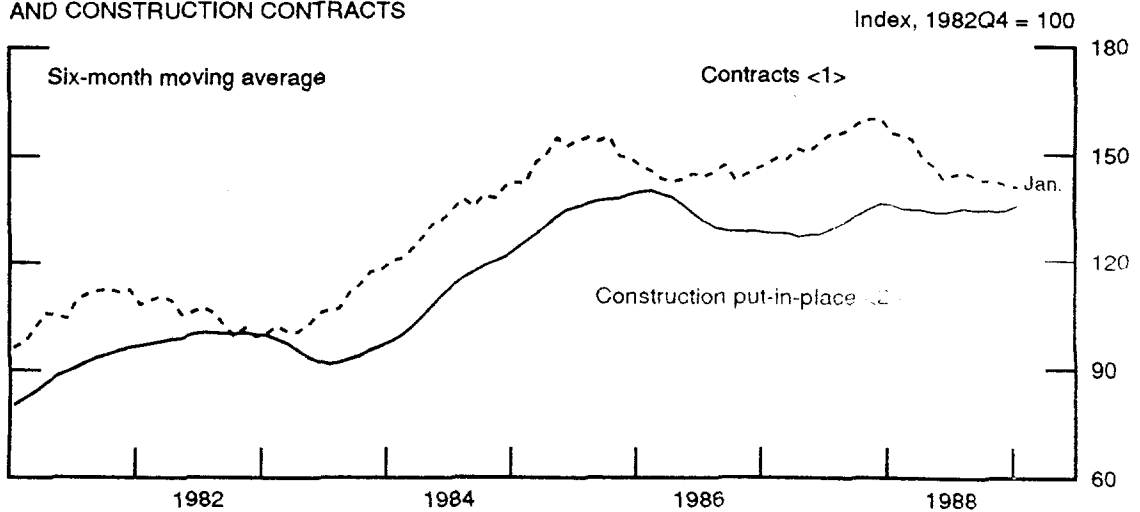
OFFICE AND COMPUTING EQUIPMENT



OTHER NONDEFENSE CAPITAL GOODS
(EX. AIRCRAFT & PARTS)



NONRESIDENTIAL CONSTRUCTION PUT-IN-PLACE
AND CONSTRUCTION CONTRACTS



<1> From F.W.Dodge. Includes industrial, commercial, and institutional construction.

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

Moving beyond the near term, deliveries of aircraft are expected to provide considerable support to equipment outlays, as well as to exports, in coming years. Backlogs of orders for aircraft, which were largely unchanged from 1980 to the start of 1987, have doubled over the past two years. Most notably, the Boeing Company, which supplies 60 percent of the world market, has a current backlog of over 1,100 orders for new commercial jets.⁴ Although Boeing currently is operating at full tilt, they plan to increase production over the next year by 25 percent--from the current rate of about 26 jets per month to 32 per month. This will be accomplished, in part, through improvements in productivity and borrowing workers from other aircraft manufacturers. Boeing already has brought a small contingent of Lockheed employees to Washington.

In the area of nonresidential structures, construction put-in-place rose sharply for a second month in January to a level 4-1/4 percent above the fourth-quarter average. Gains were recorded in almost all categories of building. The size of these increases is somewhat surprising in light of the downtrend in contracts (except for industrial buildings) over the past year and may have been exaggerated by the unusually mild weather around the turn of the year. Petroleum drilling, which declined through much of 1988, appears to be firming as the number of drilling rigs in use rose 6 percent in February.

Business Inventories

Inventories generally appear to be in line with sales, although there are some exceptions--notably auto dealers and computer makers.

4. Between one-third and one-half of the current backlog of orders is from domestic airlines and thus will be reflected in equipment outlays; the remainder will be exported.

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

	1988			1988		1989
	Q2	Q3	Q4	Nov.	Dec.	Jan.
Current-cost basis:						
Total	54.2	78.3	37.9	34.1	81.6	66.3
Total ex. auto	42.4	55.1	40.5	27.8	66.8	53.7
Manufacturing	21.1	23.3	25.5	26.3	30.7	39.5
Wholesale	13.1	21.1	4.6	-8.7	13.1	4.5
Retail	20.0	33.9	7.8	16.4	37.8	22.3
Automotive	11.7	23.2	-2.6	6.3	14.9	12.6
Ex. auto	8.3	10.7	10.5	10.2	22.9	9.6
Constant-dollar basis:						
Total	19.4	25.5	25.1	26.3	25.3	--
Total ex. auto	8.4	16.8	16.8	8.7	36.4	--
Manufacturing	5.8	5.7	9.6	8.9	16.0	--
Wholesale	.0	8.1	2.1	-7.4	6.9	--
Retail	13.7	11.7	13.4	24.9	2.4	--
Automotive	11.0	8.7	8.3	17.6	-11.1	--
Ex. auto	2.7	3.0	5.1	7.2	13.6	--

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

	1988			1988		1989
	Q2	Q3	Q4	Nov.	Dec.	Jan.
	Range in ² preceding 12 months:					
	Low	High				
Current-cost basis:						
Total	1.48	1.52	1.50	1.51	1.50	1.48
Total ex. auto	1.46	1.50	1.48	1.48	1.47	1.46
Manufacturing	1.53	1.62	1.58	1.58	1.57	1.53
Wholesale	1.26	1.30	1.30	1.30	1.28	1.29
Retail	1.54	1.62	1.57	1.61	1.59	1.59
Automotive	1.67	2.01	1.78	1.98	1.88	1.83
Ex. auto	1.48	1.51	1.51	1.51	1.51	1.49
Constant-dollar basis:						
Total	1.50	1.53	1.51	1.52	1.52	1.51
Total ex. auto	1.48	1.51	1.50	1.50	1.49	1.48
Manufacturing	1.58	1.62	1.59	1.59	1.58	1.58
Wholesale	1.30	1.33	1.32	1.33	1.32	1.31
Retail	1.55	1.62	1.59	1.61	1.62	1.61
Automotive	1.70	1.97	1.83	1.93	1.95	1.97
Ex. auto	1.51	1.53	1.52	1.52	1.52	1.52

1. Ratio of end-of period inventories to average monthly sales for the period.
2. Highs and lows are specific to each series and are not necessarily coincidental. Range is for the 12-month period preceding the latest month for which data are available.

Manufacturing inventories rose \$9-1/2 billion (1982 prices) at an annual rate in the fourth quarter, following average increases of about \$6 billion in the preceding two quarters. Separate current-cost data show that factory inventories posted a sharp rise in January, with more than half of the accumulation in the aircraft and nonelectrical machinery industries.

The concentration of manufacturing inventory investment in aircraft and nonelectrical machinery has been evident for some time. In the aircraft industry, the stockbuilding has coincided with booming orders and consists largely of parts and components awaiting final assembly. In the case of nonelectrical machinery, the accumulation has been concentrated in office and computing equipment and has taken place primarily at the finished goods level. Although output of computers slowed somewhat in the second half of last year, the softening in demand apparently was not fully anticipated by the manufacturers. Their inventory-to-shipments ratio has been increasing steadily since mid-1988, and in January reached its highest level in two years (chart). Inventories of other types of nonelectrical machinery have remained in line with shipments.

The inventory situation at nonauto trade establishments has been relatively stable. Recent revisions to retail inventory data, together with the concurrent revision to retail sales data, generally lowered inventory-sales ratios in this sector. In particular, the revisions eliminated the upward drift that emerged in 1988 in the ratio for nonauto retail establishments; it now is little different than in previous years.

Housing Markets

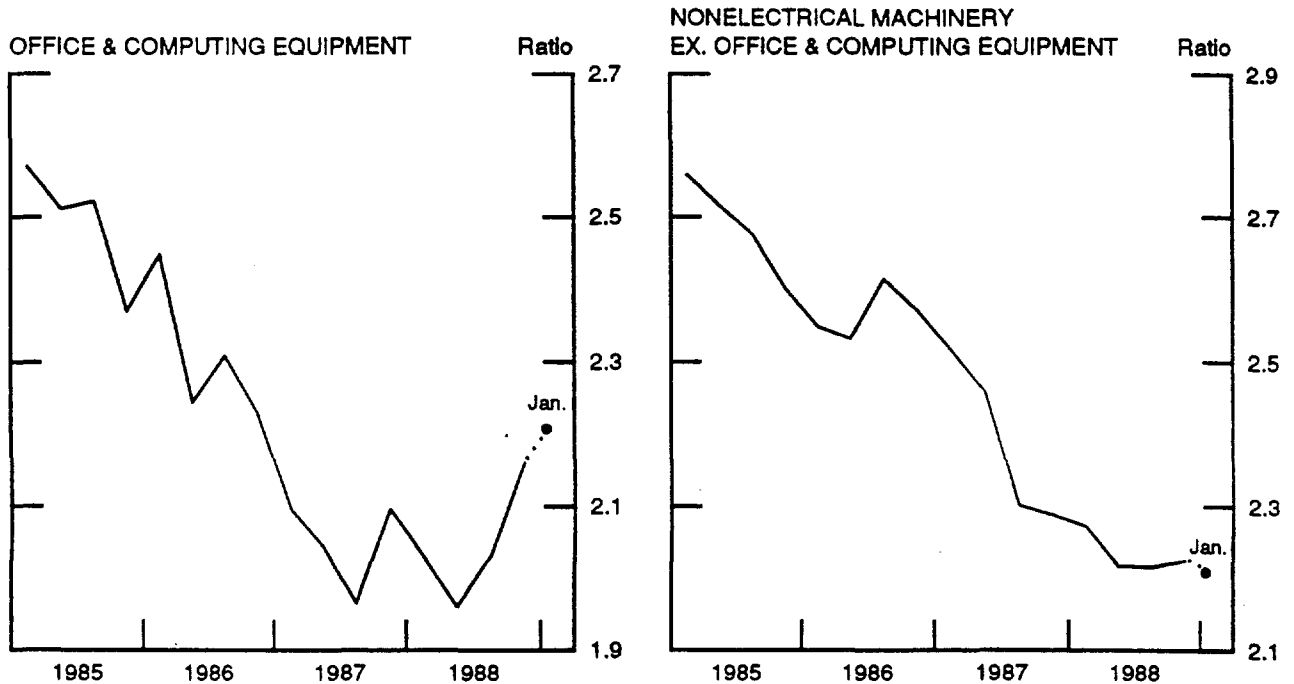
Housing activity has fluctuated appreciably in recent months. Starts in January surged to nearly 1.7 million units at an annual rate, boosted by

MANUFACTURERS' INVENTORY CHANGES IN RECENT YEARS
(In billions of 1982 dollars at an annual rate)

	1986	1987	1988		
			H1	Q3	Q4
Total manufacturing	-3.5	5.2	10.8	5.7	9.6
Materials	-1.3	.5	3.3	3.5	-5.9
Work-in-process	-2.1	3.4	5.3	-2.2	10.0
Finished goods	-.1	1.3	2.2	4.4	5.4
Transportation equipment, except motor vehicles¹	.4	2.9	5.5	-1.6	5.6
Materials	.6	-.7	.8	.3	-.2
Work-in-process	-.4	3.4	4.5	-2.2	6.7
Finished goods	.1	.2	.3	.3	-.9
Nonelectrical machinery	-1.8	-.3	3.6	5.7	1.5
Materials	-.7	-.1	.1	2.3	-2.1
Work-in-process	-1.0	-.5	1.8	.4	.6
Finished goods	-.1	.3	1.7	3.1	3.0

1. This category consists of aircraft, aircraft parts, shipbuilding and tanks, railroad cars and equipment. Aircraft and parts account for the bulk of the stocks in this category.

Ratio of Inventories to Sales in Nonelectrical Machinery
(Current cost basis)

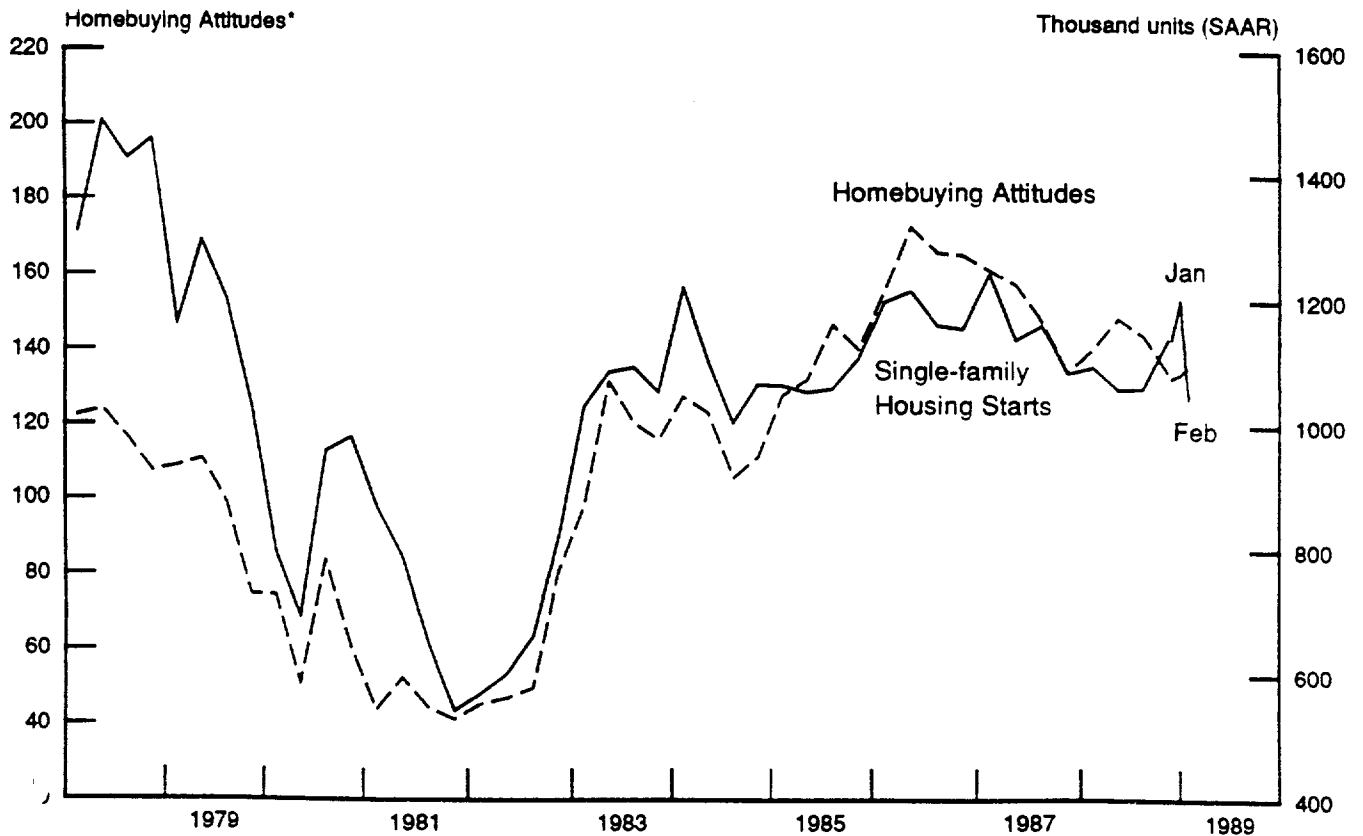


PRIVATE HOUSING ACTIVITY
(Seasonally adjusted annual rates; millions of units)

	1988	1988			1988	1989	
	Annual	Q2	Q3	Q4 ^r	Dec. ^r	Jan. ^r	Feb. ^p
All units							
Permits	1.45	1.46	1.43	1.53	1.57	1.51	1.40
Starts	1.49	1.48	1.47	1.56	1.58	1.69	1.50
Single-family units							
Permits	1.00	.98	.99	1.05	1.08	1.06	.99
Starts	1.08	1.06	1.06	1.14	1.14	1.20	1.05
Sales							
New homes	.68	.69	.70	.68	.67	.70	n.a.
Existing homes	3.59	3.64	3.66	3.77	3.92	3.63	n.a.
Multifamily units							
Permits	.45	.48	.43	.48	.48	.44	.42
Starts	.41	.42	.41	.42	.44	.49	.45

p--preliminary estimates.
r--revised.
n.a.--not available.

Single-family Housing Starts and Consumer Homebuying Attitudes



* Homebuying attitudes calculated by the Survey of Consumers (University of Michigan) as the proportion of respondents viewing current homebuying conditions favorably minus those holding a negative view plus 100. Quarterly values plotted through 1988.

a combination of temperatures that were nationally 5 degrees higher than usual on a construction-weighted basis and below-normal amounts of precipitation. With the return of more typical weather conditions in February, starts dropped to a 1.5 million unit rate. The average pace of starts so far this year is a bit above that in the fourth quarter, but the less volatile permits series has shown a decline, perhaps signaling the beginning of a response to tightening mortgage market conditions.

Consumer assessments of the homebuying climate apparently have changed little, on balance, in recent months (chart). In February, about two-thirds of the respondents to the Michigan Survey described these conditions as favorable, fewer than in the first half of 1988, but about the same as in the latter half. However, the impetus to homebuying for some now appears to be coming from fears of future increases in mortgage rates. Throughout most of 1988, respondents typically cited low mortgage interest rates and the availability of good buys as the chief reasons for their favorable assessments.

Federal Government

In February, the federal government recorded a budget deficit of \$27.9 billion with outlays of \$89.9 billion and revenues of \$62.0 billion. For the first five months of the fiscal year, the budget deficit was \$92.7 billion compared with \$90.3 billion over the same period of the previous year. Revenues in FY1989 are 7-1/2 percent above a year earlier, reflecting continued increases in nominal income and employment, as well as strength in corporate income tax receipts stemming, at least in part, from tax reform.

Outlays so far in FY1989 are 6-1/2 percent, or \$29 billion, higher than a year earlier. Increases in net outlays by FSLIC have accounted for \$10

billion of the total rise. Excluding FSLIC, outlays have risen 4-1/4 percent. The other major sources of growth have been social security, net interest, and defense. These three functions account for 60 percent of total budget expenditures and 65 percent of the non-FSLIC growth. Among other programs, agriculture expenditures have remained below last year's levels because of drought-induced reductions in Commodity Credit Corporation net outlays.

GROWTH IN FEDERAL OUTLAYS
(First five months of FY1989 from year-earlier)

	Growth (percent)	Contribution to growth (percentage points)
Total outlays	6.5	--
FSLIC	n.a ¹	2.6
National defense	3.4	.9
Social security	5.9	1.2
Interest	7.9	1.3
Agriculture	-21.6	-.7
Other	4.0	1.4

1. Net FSLIC outlays rose from -\$0.4 billion in the first five months of FY1988 to \$9.4 billion this year.

The February projections for the FY1989 budget by the Office of Management and Budget and the Congressional Budget Office point to a deficit of about \$160 billion, slightly higher than in the past two years, but relatively constant in real terms and slowly shrinking as a share of GNP.

For FY1990, the Bush Administration has proposed to reduce the budget deficit to \$91 billion, or \$95 billion excluding asset sales. These results are premised on achievement of 3-1/2 percent growth in real GNP this year and a sharp decline in interest rates. Policy initiatives include measures to raise \$5-1/2 billion in revenues, on net, relative to current law. Most

of the increase is expected to result from higher realizations of capital gains induced by a proposed tax rate reduction for selected assets. The President's budget also calls for outlay reductions of \$27 billion relative to those estimated to result from current laws and policies. The plan would hold growth in total outlays between FY1989 and FY1990 to \$11 billion (excluding the effects of asset sales) or only 0.9 percent. The CBO, using less optimistic economic assumptions, projects a budget deficit of \$109 billion (without asset sales) assuming full enactment of the Bush Administration program. The estimate by the Administration (which will be the relevant one for the Gramm-Rudman sequestration process) is below the Gramm-Rudman target of \$100 billion; both estimates are below the \$110 billion trigger that would cause a sequester.

State and Local Government Sector

Recent data on the activities of state and local governments are mixed; employment has strengthened, but spending on construction has dropped. In February, employment rose further to a level 0.6 percent above the fourth-quarter average. However, real outlays for construction fell nearly 3 percent in January, after a substantial jump in the closing months of last year. Variation in spending for streets and highways accounted for much of the December-January movement. Over 1988 as a whole, revised NIPA data show that total building outlays rose 2-3/4 percent, a percentage point more than in 1987, but still below the pace of the mid-1980s.

Widespread fiscal woes apparently have continued to restrain spending by state governments. On the revenue side, only a few governors have submitted proposals for major sales or income tax increases this year. However, other revenue-raising measures are being sought, including

increases in gasoline taxes--some quite large--and in cigarette and alcohol taxes. In addition, many states are looking to user fees as a source of revenue; for example, increases in highway user charges are being discussed in California and Florida, and some states are considering larger fees for automobile registrations and drivers' licenses. Some local governments face prospects of reduced state aid, but many recently have been--or expect to be--granted broader taxing powers, notably the authority to impose local income taxes.

Prices

Prices accelerated further in early 1989. Much of this pickup reflected larger price increases for food and energy, but price increases also accelerated for a broad range of nonfood, nonenergy goods and services. The uptrend in inflation at the finished goods level likely has reflected the passthrough of increases in labor and materials costs.

Excluding food and energy, the CPI increased about 1/2 percent per month in January and February, a bit more than in 1988. Prices of nonenergy services, up 0.5 percent in both months, have been rising more rapidly than last year; in February, they were boosted by a large increase in the cost of out-of-town lodging and a further sharp rise in the price of medical services. Meanwhile, the prices of goods advanced only 0.2 percent last month; tobacco prices, which had surged in January, were up another 1 percent, while apparel prices were down. The decline in apparel prices, however, is likely to be followed by substantial increases in the next two months as spring merchandise is introduced into the CPI sample. On balance, prices of other nonfood, nonenergy goods advanced moderately last month. In the PPI, capital equipment prices have posted sizable advances in recent

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

	Relative importance		1988	1988		1989	
	Dec. 1988	1987		Q3	Q4	Jan.	Feb.
				-Annual rate-		-Monthly rate-	
All items ²	100.0	4.4	4.4	4.8	4.1	.6	.4
Food	16.2	3.5	5.2	8.8	3.0	.7	.4
Energy	7.3	8.2	.5	2.7	-.4	.8	.6
All items less food and energy	76.5	4.2	4.7	4.3	4.9	.5	.4
Commodities	25.7	3.5	4.0	3.1	4.2	.5	.2
Services	50.8	4.5	5.0	4.8	5.4	.5	.5
Memorandum:							
CPI-W ³	100.0	4.5	4.4	4.9	4.1	.6	.4

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		1988	1988		1989	
	Dec. 1988	1987		Q3	Q4	Jan.	Feb.
				-Annual rate-		-Monthly rate-	
Finished goods	100.0	2.2	4.0	5.7	3.0	1.0	1.0
Consumer foods	25.8	-.2	5.7	9.2	2.1	1.1	1.2
Consumer energy	8.8	11.2	-3.4	-2.7	2.1	4.9	2.4
Other consumer goods	39.6	2.7	4.8	5.9	4.4	.4	.7
Capital equipment	25.8	1.3	3.5	6.1	1.4	.6	.4
Intermediate materials ²	94.8	5.4	5.4	4.6	4.5	.9	.6
Excluding energy	83.4	5.2	7.2	7.2	6.7	.6	.5
Crude food materials	43.8	1.8	14.2	29.1	-7.9	2.2	-1.3
Crude energy	36.9	10.7	-9.4	-27.0	12.9	6.7	1.1
Other crude materials	19.3	22.6	6.0	8.5	5.8	2.2	.0

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

2. Excludes materials for food manufacturing and animal feeds.

months, with higher prices for many types of machinery and for motor vehicles.

Producers continued to face rising costs for raw and intermediate materials in early 1989, although the pace of those increases may be ebbing a bit. The PPI for intermediate materials excluding food and energy increased 0.5 percent on average in January and February, down slightly from its average monthly pace in 1988. At earlier stages of processing, the PPI for crude nonfood, nonenergy materials was flat in February, held down by falling prices for raw cotton and scrap. However, on spot commodity markets, prices have firmed a bit recently. Since the end of January, the Journal of Commerce index of industrial prices has risen 2 percent, boosted by sizable increases in the prices of oil and industrial metals, particularly tin and zinc.

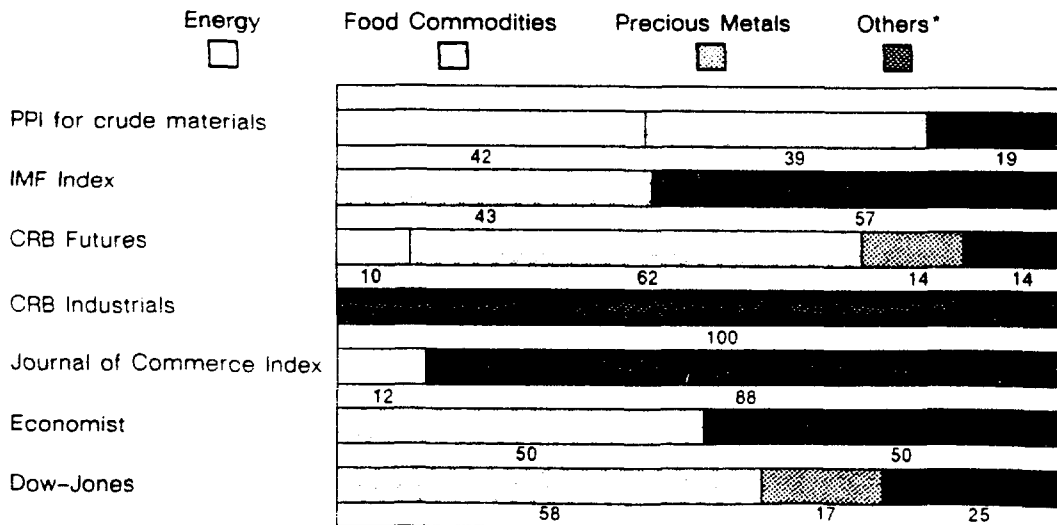
Food Prices. The CPI for food rose 0.6 percent per month, on average, over the first two months of 1989, slightly higher than the average pace over the last three quarters of 1988. The persistence of price pressures in the food area partly reflects lagged effects of the drought, but there also are indications of inflationary pressures similar to those at work in other sectors. For example, the price increases of recent months have encompassed not only those food items that are most sensitive to farm supply conditions, but also many items that are more heavily keyed to the cost of labor and other nonfarm inputs. According to USDA data, the costs of packaging and advertising have been trending up rapidly in the food sector, and data on average hourly earnings show that wage trends in food marketing have moved up a notch or so from the very subdued pace of the 1984-87 period.

PRICE INDEXES FOR COMMODITIES AND MATERIALS¹

	Last Observation	Percent change ²			
		1987	1988	1989	
				To Jan. 31*	Jan. 31 to date
1. PPI for crude materials ³	Feb.	8.9	2.8	4.1	.0
1a. Foods and feeds	Feb.	1.8	14.2	2.6	-1.2
1b. Energy	Feb.	10.7	-9.4	6.7	1.1
1c. Ex. food and energy	Feb.	22.6	6.0	2.1	.6
1d. Ex. food and energy, seasonally adjusted	Feb.	22.8	5.9	2.2	.0
2. IMF commodity index ³	Feb.	30.8	12.6	-.2	-1.2
2a. Metals	Feb.	51.9	33.7	1.1	-2.5
2b. Nonfood agric.	Feb.	47.5	-9.4	-1.2	1.1
3. Commodity Research Bureau					
3a. Futures prices	Mar. 21	11.7	8.5	-4.0	2.1
3b. Industrial spot prices	Mar. 20	19.2	7.3	4.2	.7
4. <u>Journal of Commerce</u> Industrials	Mar. 21	10.7	3.8	.6	2.0
5. <u>Economist</u> (U.S.\$ index)	Mar. 14	42.5	17.7	-3.6	-1.4
5a. Industrials	Mar. 14	62.6	18.9	-2.7	-4.2
6. Dow-Jones Spot	Mar. 21	17.0	6.9	-4.0	.7

- 1. Not seasonally adjusted.
- 2. Change is measured to end of period, from last observation of previous period.
- 3. Monthly observations. IMF index includes items not shown separately.
- * Week of the February Greenbook.

Index Weights



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

The risk of food price pressures persisting into the spring is growing. The producer prices of finished foods registered a second month of steep advance in February, and a drop in the prices of crude foods last month is likely to be followed by a big rise in March. Egg prices have increased especially rapidly since mid-February, and this surge probably has been passed to consumers with virtually no lag at all.

Taking a somewhat longer view, most indicators of food price prospects still provide reason for expecting a significant easing of price pressures later on in 1989. In contrast to the recent increases in the current prices of farm products, futures prices generally have shown relatively little movement in recent weeks, although the continued drought in the Central Plains has caused noticeable skittishness in the market for wheat. In livestock markets, concerns about a sharp drop in meat supplies in 1989 seem to have eased a bit, owing to a recent Agriculture Department report that showed a larger inventory of cattle than most observers had been expecting; in its March forecast of supply-demand conditions for 1989, the USDA projected that the total production of meat and poultry this year, in fact, will be fractionally higher than in 1988. The prospects for the supplies and prices of both crops and livestock will be sensitive, of course, to weather conditions as the spring planting season gets under way in coming weeks.

Energy Prices. Consumer energy prices increased 0.8 percent in January and 0.6 percent in February, as higher crude oil prices were passed through to the prices of gasoline and fuel oil. Posted prices for West Texas Intermediate crude oil rose \$5 per barrel from mid-November to mid-January, and have since held at about \$17.50 per barrel. Given the typical lags

between movements in crude oil prices and the retail prices of refined energy products, prices for gasoline and fuel oil in the February CPI seem to embody almost all of the run-up in crude costs. After advancing sharply in the fourth quarter, electricity prices receded slightly in January and February, while natural gas prices have risen significantly during the past half year.

Gasoline prices are expected to rise somewhat this summer in response to government action designed to curb air pollution. New EPA limits are being placed on the "volatility" of gasoline--the tendency of gas to evaporate--and several states are requesting waivers so they can impose a stricter standard. Lower volatility gasoline requires higher crude oil inputs. With domestic refineries currently handling nearly as much crude as they can, the staff estimates that tighter gas supplies will probably push prices up about 3 cents per gallon this summer; outside estimates range from 1/2 to 10 cents per gallon. Because the new volatility standards apply only in the summer, gas prices should retrace their rise during the winter.

SELECTED FINANCIAL MARKET QUOTATIONS¹
(Percent)

	1987		1988			Change from:
	Jan.-Feb. lows	Oct. 16 ²	Feb lows	FOMC Feb.8	Mar.21	FOMC Feb.8
Short-term rates						
Federal funds ³	5.95	7.59	6.38	9.13	9.82	.69
Treasury bills ⁴						
3-month	5.30	6.93	5.59	8.53	9.09	.56
6-month	5.31	7.58	5.77	8.47	9.11	.64
1-year	5.35	7.74	6.10	8.44	9.05	.61
Commercial paper						
1-month	5.81	7.94	6.41	9.11	10.05	.94
3-month	5.73	8.65	6.45	9.17	10.15	.98
Large negotiable CDs⁴						
1-month	5.85	7.92	6.44	9.15	10.06	.91
3-month	5.80	8.90	6.49	9.29	10.28	.99
6-month	5.78	9.12	6.55	9.44	10.67	1.23
Eurodollar deposits⁵						
1-month	6.00	8.00	6.44	9.25	10.19	.94
3-month	6.00	9.06	6.50	9.38	10.50	1.12
Bank prime rate	7.50	9.25	8.50	10.50	11.50	1.00
Intermediate- and long-term rates						
U.S. Treasury (constant maturity)						
3-year	6.34	9.52	7.28	9.19	9.88	.69
10-year	7.01	10.23	8.11	8.95	9.53	.58
30-year	7.29	10.24	8.32	8.82	9.30	.48
Municipal revenue⁶						
(Bond Buyer)	6.92	9.59	7.76	7.58	7.93	.35
Corporate A utility						
(recently offered)	8.78	11.50	9.63	10.05e	10.46e	.41
Home mortgage rates⁷						
S&L fixed-rate	9.10	11.58	9.84	10.55	10.98	.43
S&L ARM, 1-yr.	7.52	8.45	7.59	8.56	9.02	.46

	1986	1987		1988		Percent change from:
	Year-end	Record highs	Lows	FOMC Feb.8	Mar.21	FOMC Feb.8
Stock prices						
Dow-Jones Industrial	1895.95	2722.42	1738.74	2343.21	2266.25	-3.28
NYSE Composite	138.58	187.99	125.91	167.69	163.80	-2.32
AMEX Composite	263.27	365.01	231.90	327.23	326.49	-.23
NASDAQ (OTC)	348.83	455.26	291.88	407.97	401.77	-1.52

1. One-day quotes except as noted.

2. Last business day prior to stock market decline on Monday, October 19, 1987.

3. Average for two-week maintenance period closest to date shown except lows shown which are one-week averages ending Feb. 25 and Feb. 10, respectively. Last observation is average to date for maintenance period ending 3/22/89.

4. Secondary market.

5. Bid rates for Eurodollar deposits at 11 a.m. London time.

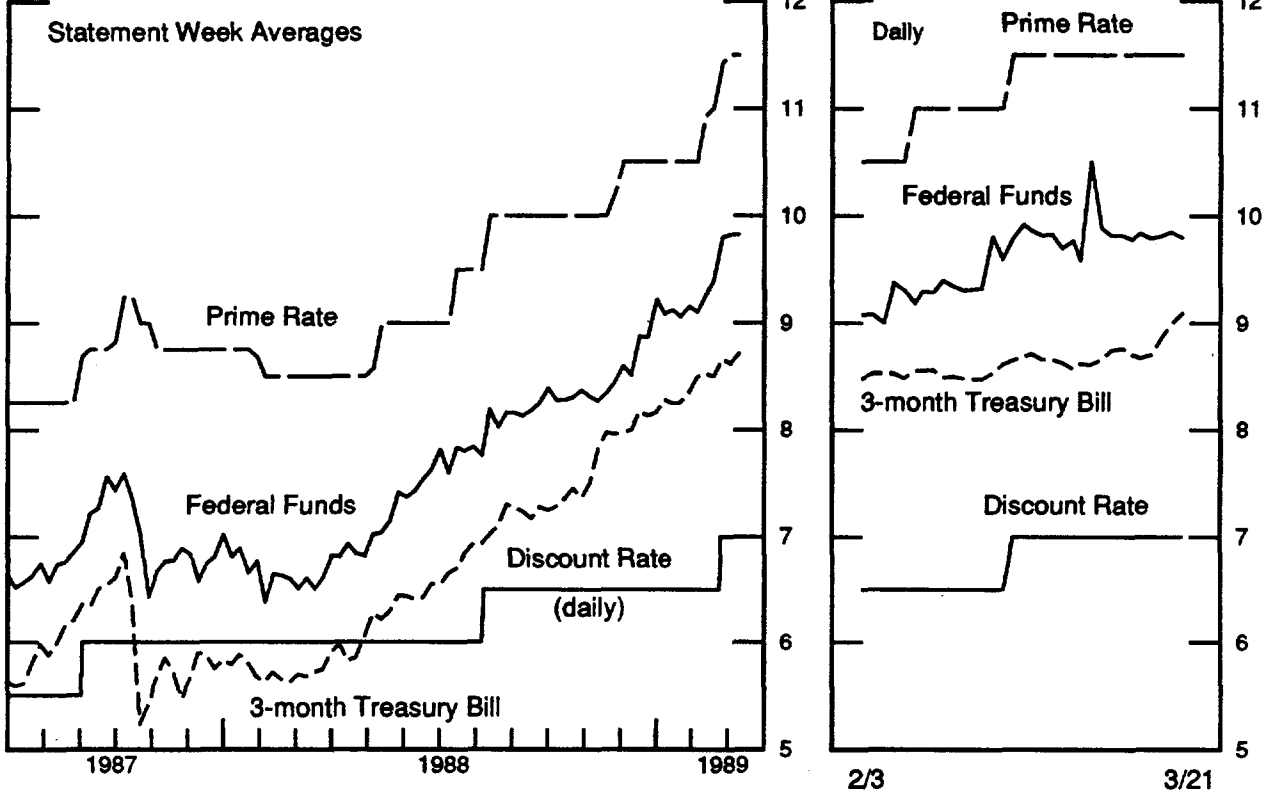
6. Based on one-day Thursday quotes and futures-market index changes.

7. Quotes for week ending Friday closest to date shown.

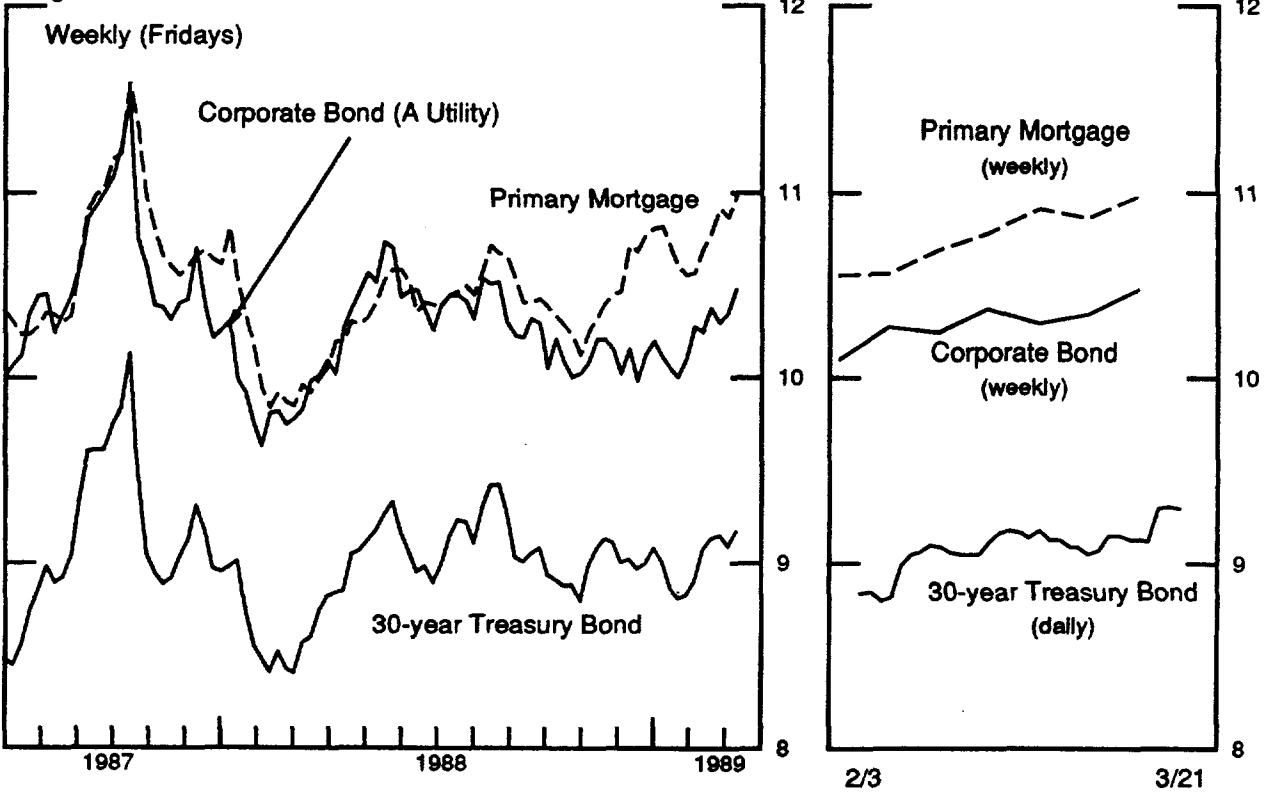
e--estimate

Selected Interest Rates* (percent)

Short-Term



Long-Term



*--Friday weeks through March 17, Wednesday weeks through March 15.

DOMESTIC FINANCIAL DEVELOPMENTS

Under the influence of System tightening actions, short-term interest rates have risen considerably since the February FOMC meeting. In contrast to some other recent periods of firming money market conditions, the latest has seen long-term interest rates rise noticeably as well, owing largely to heightened concerns about inflation. In addition, share price indexes are down, on balance, over the intermeeting period, having slumped along with the bond market in recent days.

Growth in the monetary aggregates has been sluggish. M2 has remained below its annual target cone, as deposit rates have continued to lag behind rising market yields. M3 has grown somewhat more rapidly than M2, tracking along the bottom of its annual range; banks have been heavy issuers of managed liabilities, partly to fund the huge RJR-Nabisco transaction.

Bolstered by the surge in bank loans to business, private debt growth appears to have picked up considerably from January's pace. Commercial paper of nonfinancial firms has continued to grow rapidly and bond issuance has recovered somewhat. While consumer credit expansion remains moderate, growth in home mortgage debt appears to have picked up from its relatively sluggish fourth-quarter pace.

In the current quarter, federal borrowing has declined, although much less than seasonally. State and local debt issuance also is expected to remain somewhat below the pace of last quarter, in part reflecting a falloff in advance refunding issues.

Interest Rate Developments

The federal funds rate has risen almost 3/4 percentage point since the last FOMC meeting, mainly in response to the 1/2 percentage point increase in the discount rate on February 24. Other private short-term rates have risen even more, around one percentage point, with CD and commercial paper rates perhaps reflecting supply pressures associated with the surge in business financings. Banks have implemented two half-point increases in the prime rate; the rate seems at present to be in a reasonably normal alignment with money market yields.

Treasury bill rates have risen only 50 to 60 basis points over the intermeeting period. The pressure on bill yields as well as on other Treasury rates has been diminished a bit by continued strong retail demand reflected in noncompetitive tenders. Intermediate- and long-term Treasury rates have moved up by comparable amounts, reacting to the rise in short-term rates and to heightened concerns about inflationary pressures and attendant risks of further tightening by the System. Increases in Treasury note and bond yields came on the heels of the strong February employment data and the much larger-than-expected February jump in the producer price index. Yields on corporate and municipal bonds, and conventional mortgage rates, have moved up along with those on Treasuries. Secondary market yields on fixed-rate mortgage instruments, however, have risen more than Treasuries, reflecting increased interest rate uncertainty and, reportedly, concerns about large sales of mortgage securities by thrift institutions.

Monetary Aggregates and Bank Credit

Expansion in the monetary aggregates remained subdued in February. For M1, the 1-3/4 percent growth registered last month primarily reflected some

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

	1988 ¹	1988 Q3	1988 Q4	1988 Dec	1989 Jan	1989 Feb p	Growth Q4 88- Feb 89p
-----Percent change at annual rates-----							
1. M1	4.3	5.2	2.3	5.5	-6.1	1.8	0.0
2. M2	5.2	3.8	3.6	4.0	-1.2	1.7	1.8
3. M3	6.3	5.7	5.0	5.4	1.8	3.4	3.6
							Levels bil. \$ Feb 89p
-----Percent change at annual rates-----							
<u>Selected components</u>							
4. M1-A	2.5	3.3	1.7	5.2	-6.9	3.8	506.6
5. Currency	8.1	7.5	6.6	7.4	9.1	5.1	214.3
6. Demand deposits	-1.2	0.4	-1.8	3.8	-19.1	3.4	284.8
7. Other checkable deposits	7.7	8.7	3.3	6.0	-4.7	-1.7	280.8
8. M2 minus M1 ²	5.5	3.3	4.1	3.5	0.4	1.7	2283.3
9. Overnight RPs and Eurodollars, NSA	-5.9	-3.0	-9.2	44.6	56.8	-32.2	79.7
10. General purpose and broker/dealer money market mutual fund shares, NSA	7.5	-2.9	9.7	11.1	12.0	29.3	247.9
11. Commercial banks	6.9	5.5	6.8	5.7	2.8	4.4	993.8
12. Savings deposits, SA, plus MMDAs, NSA ³	1.4	1.0	-1.8	-4.2	-12.8	-14.2	532.7
13. Small time deposits	14.7	11.6	18.0	18.1	21.9	26.6	461.1
14. Thrift institutions	4.6	2.3	0.3	-2.1	-3.3	-5.2	964.4
15. Savings deposits, SA, plus MMDAs, NSA ³	-4.3	-2.0	-8.6	-7.7	-16.3	-20.9	377.1
16. Small time deposits	11.7	5.4	6.6	1.7	5.4	5.3	587.4
17. M3 minus M2 ⁴	10.6	13.1	10.2	10.3	12.6	9.1	863.9
18. Large time deposits	11.0	13.4	11.3	7.4	13.4	15.0	550.5
19. At commercial banks, net ⁵	12.2	18.1	13.0	12.3	16.8	23.4	377.2
20. At thrift institutions	8.8	4.1	8.0	-2.1	5.6	-2.1	173.4
21. Institution-only money market mutual fund shares, NSA	-0.8	-23.3	10.9	2.7	23.3	4.0	89.6
22. Term RPs, NSA	15.0	13.0	8.4	-33.5	9.6	24.7	128.9
23. Term Eurodollars, NSA	13.3	45.6	11.0	40.5	-44.7	1.2	103.4

-----Average monthly change in billions of dollars-----

MEMORANDA:⁶

24. Managed liabilities at commercial banks (25+26)	4.9	4.5	4.6	0.8	0.3	10.3	653.3
25. Large time deposits, gross	3.3	5.5	3.1	4.6	5.8	5.5	440.4
26. Nondeposit funds	1.7	-1.0	1.4	-3.8	-5.5	4.8	212.9
27. Net due to related foreign institutions, SA	-0.4	0.0	-0.5	-2.5	1.2	2.7	10.6
28. Other ⁷	2.1	-1.0	1.9	-1.3	-6.8	2.1	202.2
29. U.S. government deposits at commercial banks ⁸	0.0	0.5	0.5	1.9	-4.6	0.0	20.3

1. Amounts shown are from fourth quarter to fourth quarter.
 2. Nontransactions M2 is seasonally adjusted as a whole.
 3. Commercial bank savings deposits excluding MMDAs grew during January and February at rates of -10.6 percent and -2.5 percent, respectively. At thrift institutions, savings deposits excluding MMDAs grew during January and February at rates of -9 percent and -13.7 percent, respectively.
 4. The non-M2 component of M3 is seasonally adjusted as a whole.
 5. Net of large denomination time deposits held by money market mutual funds and thrift institutions.
 6. Dollar amounts shown under memoranda are calculated on an end-month-of-quarter basis.
 7. Consists of borrowing from other than commercial banks in the form of federal funds purchased, securities sold under agreements to repurchase, and other liabilities for borrowed money (including borrowing from the Federal Reserve and unaffiliated foreign banks, loan RPs and other minor items). Data are partially estimated.
 8. Consists of Treasury demand deposits and note balances at commercial banks.
- p - preliminary

recovery in demand deposits after January's sharp runoff. M2 increased at a similar pace, as deposit inflows at commercial banks and general purpose/broker-dealer MMMFs partially offset continued outflows experienced by FSLIC-insured thrifts. Since the fourth quarter of 1988, M2 has grown at about February's 1-3/4 percent annual rate, leaving it below the 3 percent lower bound of its 1989 growth cone. Data through mid-March suggest some strengthening of M2.

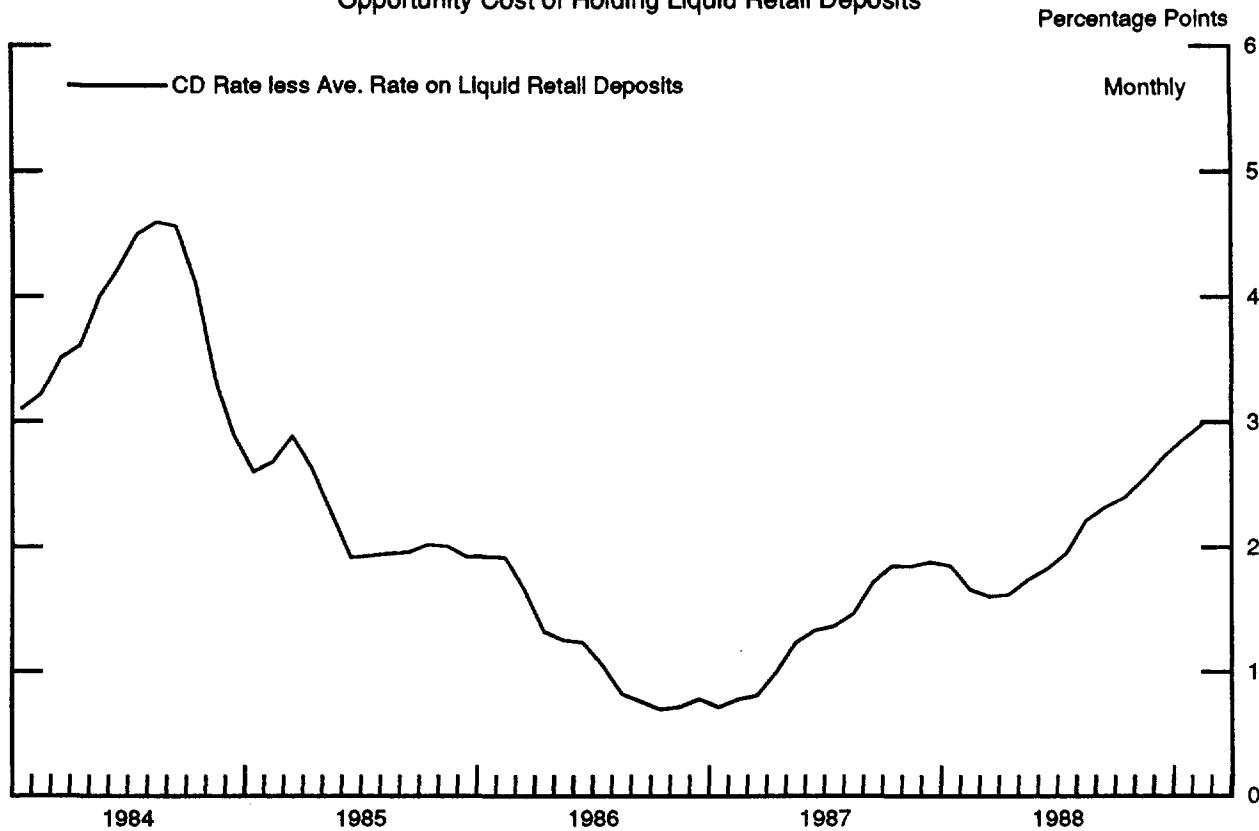
The continued weakness in core deposits probably is attributable to the rising opportunity cost of holding these balances, perhaps together with depositors' concerns occasioned by the thrift crisis. The weak demand for retail deposits over the past few months has been mirrored by a surge in noncompetitive tenders for Treasury bills and notes. From last quarter's sizable \$1.5 billion monthly average, these tenders surged to \$5.6 billion in January and \$4.3 billion in February.

A brisk runoff in savings and MMDA deposits was more than offset by a pickup in retail CDs and M2-type MMMFs, evidently reflecting depositors' reactions to yield spreads that greatly favor these instruments. In February, for example, the 3 percentage point spread between average rates paid on six-month retail CDs and average rates on liquid retail deposits was more than one point above the 1988 average (top panel of chart 1). The bottom panel of the chart shows the shifting toward retail CDs that has accompanied this wider spread.

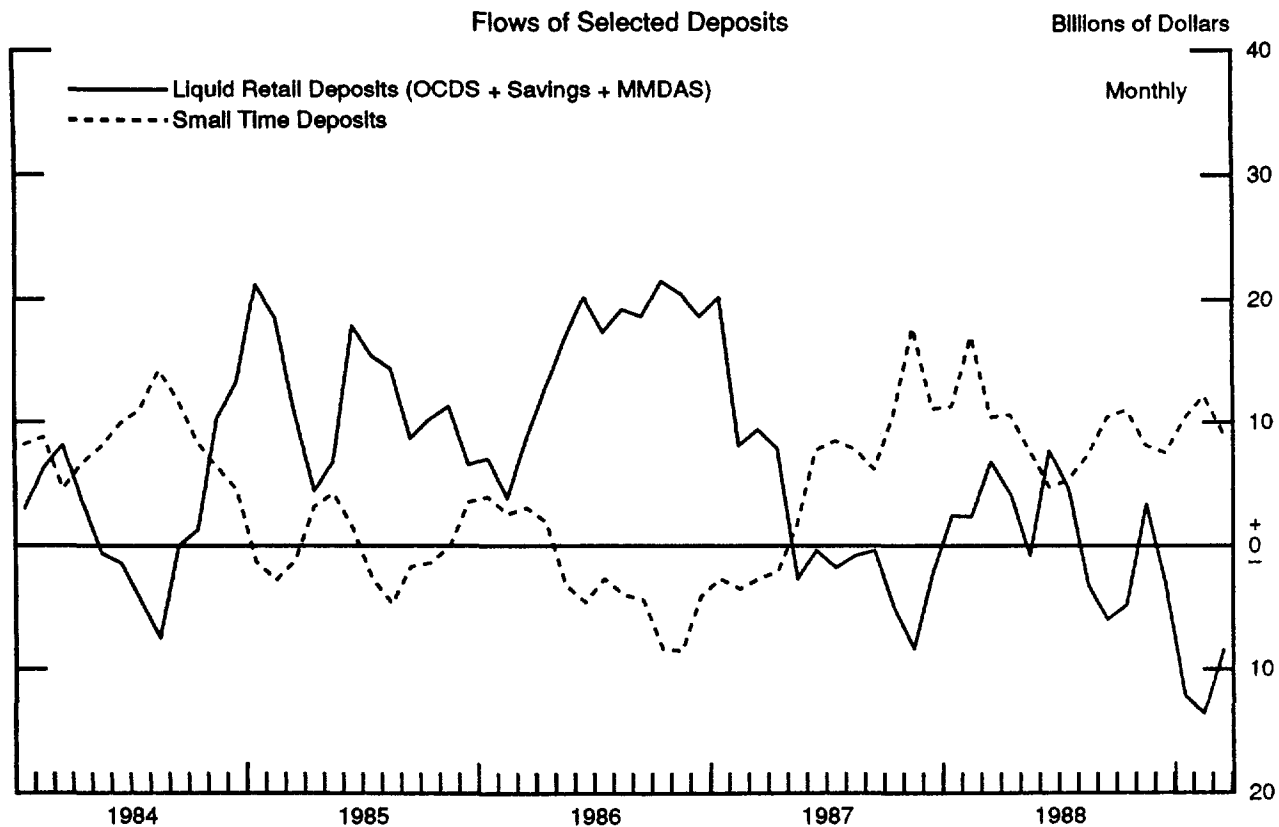
At thrifts, only about a third of the runoff in liquid retail deposits in February was offset by inflows to small CDs.¹ Instead, apparently with

1. Among thrifts, runoffs have been concentrated at FSLIC-insured institutions, as opposed to those that are FDIC-insured or credit unions.

Opportunity Cost of Holding Liquid Retail Deposits



Flows of Selected Deposits



regulatory encouragement, thrifts have been using FHLB advances to replace funds lost in part through greater restraint on their deposit rates. During February, advances are estimated to have grown about \$5 billion on a month-end basis (seasonally adjusted). Since the middle of 1988, the less aggressive pricing of retail deposits by thrifts has been reflected in a declining margin of thrift deposit rates over bank rates. The share of household deposits held at thrifts has declined over the same period, with the shift perhaps accentuated recently by public concerns about the thrift situation.

Inflows to M2-type money funds surged in February from the already strong pace of the preceding two months. Taxable money funds recently have been yielding about 2-1/2 percentage points more than MMDAs--or about a quarter point less than 3-month Treasury bills. Retail depositors appear to be shifting balances from thrifts to money funds, as well as to banks and Treasury securities.

M3 grew at a 3-1/2 percent rate in February, a bit above January's pace, accounted for largely by the turnaround in M2 growth. Partial data for March suggest a further strengthening in M3 growth. Since the fourth quarter of last year, M3 has grown at a 3-1/2 percent annual rate, the lower bound of its 1989 range. Net large time deposits accelerated to a 15 percent pace in February as banks, faced with a surge in credit demand, increased their use of managed liabilities; at thrifts, large CDs declined.

Bank credit grew at a 14-1/2 percent annual rate last month, paced by a pickup in business and security loans. Business loans, which were boosted by the \$8 billion extended to KKR for the purchase of RJR-Nabisco shares, soared to a 24 percent annual pace. Security loans jumped nearly \$7 billion

COMMERCIAL BANK CREDIT AND SHORT- AND INTERMEDIATE-TERM BUSINESS CREDIT¹
 (Percentage changes at annual rates, based on seasonally adjusted data)¹

	1987:Q4	1988			1989		Levels
	to	Q3	Q4	Dec.	Jan.	Feb. ^P	bil.\$ P Feb.
	1988:Q4						
----- Commercial Bank Credit -----							
1. Total loans and securities at banks	7.3	5.1	6.1	3.7	2.4	14.4	2441.8
2. Securities	4.7	2.2	5.0	3.3	-11.9	4.6	551.9
3. U.S. government securities	7.4	5.0	10.4	13.1	-2.0	5.3	363.4
4. Other securities	.2	-2.6	-5.1	-14.7	-30.5	3.2	188.5
5. Total loans	8.1	6.0	6.4	3.8	6.7	17.3	1889.9
6. Business loans	6.3	3.5	4.0	1.6	9.6	23.8	616.5
Security loans	-6.2	-28.4	13.1	.0	-28.5	227.0	44.0
8. Real estate loans	13.4	12.8	11.0	10.0	11.6	12.9	678.4
9. Consumer loans	8.6	6.4	8.3	9.5	5.7	3.0	357.9
10. Other loans	.2	-1.8	-5.9	-20.6	-16.0	-1.2	193.1
----- Short- and Intermediate-Term Business Credit -----							
11. Business loans net of bankers acceptances	6.4	3.6	4.1	2.0	9.7	24.5	613.7
12. Loans at foreign branches ²	30.3	20.1	13.4	11.2	-38.9	28.7	21.4
13. Sum of lines 11 & 12	7.1	4.2	4.4	2.3	8.0	24.5	635.0
14. Commercial paper issued by nonfinancial firms	15.6	-.9	50.1	82.7	57.4	22.4	109.3
15. Sum of lines 13 & 14	8.2	3.5	10.3	13.1	15.0	24.3	744.4
16. Bankers acceptances: U.S. trade related ^{3,4}	-6.8	-6.0	11.0	36.9	17.9	n.a.	33.9 ⁵
17. Line 15 plus bankers acceptances: U.S. trade related	7.4	3.0	10.3	14.0	15.4	n.a.	763.5 ⁵
18. Finance company loans to business ³	12.4	10.9	12.7	7.7	4.6	n.a.	235.3 ⁵
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	8.5	4.9	10.9	12.6	12.6	n.a.	998.8 ⁵

1. Average of Wednesdays.

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

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

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

5. January data.

p--preliminary.

n.a.--not available.

*Data reflect benchmarking to the June 1988 call report and new seasonal adjustments.

during the month, possibly due to primary dealers' need to finance larger Treasury positions.

Real estate loan growth--at 13 percent--was a little faster in February, as home equity loans picked up. A slowing in consumer lending at banks, to just a 3 percent rate, mainly reflected heavy securitization; when adjusted for issuance of loan-backed securities, consumer loans expanded at a 6-1/2 percent annual rate, down only slightly from the 7-1/2 percent rate in January.

Business Finance

Total net borrowing by nonfinancial businesses appears to have strengthened considerably since the last FOMC meeting owing mainly, but not entirely, to the RJR-Nabisco deal. This buyout is expected to boost net equity retirements to a record annual rate of more than \$200 billion in the current quarter. Growth of bank loans plus commercial paper surged to a 25 percent pace in February as the current rate environment encouraged firms to finance large merger and nonmerger needs with shorter-term sources of funds. Bond financing, however, was buoyed by an increase in private placements associated with the RJR-Nabisco deal.

Although public bond offerings by nonfinancial firms jumped in March, the new issues were concentrated in the one- to five-year maturity range. Borrowers generally have combined these shorter-term fixed-rate issues with interest rate swaps, creating synthetic floating-rate liabilities at a cost lower than the LIBOR benchmark. The proceeds from many of these issues apparently are being used to pay down other forms of short-term debt; business borrowing from large banks did, in fact, slow substantially in early March, though commercial paper issuance continued to surge.

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

	1987	1988		1989			
	Year	Year ^P	Q3	Q4 ^P	Jan. ^P	Feb. ^P	Mar. ^e
Corporate securities - total ¹	24.08	22.15	20.51	19.52	17.50	14.62	26.01
Public offerings in U.S.	21.89	20.13	18.42	17.47	14.80	12.60	24.00
Stocks--total ²	4.45	3.53	3.83	2.76	3.30	2.60	2.00
Nonfinancial	2.32	1.14	1.50	.67	2.35	1.15	1.00
Utility	.57	.24	.16	.17	2.20	.05	.00
Industrial	1.75	.90	1.34	.50	.15	1.10	1.00
Financial	2.12	2.39	2.33	2.09	.95	1.45	1.00
Bonds--total ¹	17.44	16.60	14.59	14.71	11.50	10.00	22.00
Nonfinancial	6.61	6.09	5.14	4.68	3.45	2.40	7.00
Utility	2.02	1.76	1.17	3.60	.65	.95	.50
Industrial	4.59	4.33	3.97	1.08	2.80	1.45	6.50
Financial	10.83	10.50	9.45	10.03	8.05	7.60	15.00
By quality ³							
Aaa and Aa	3.25	2.68	1.90	1.85	2.17	2.32	7.00
A and Baa	5.20	5.45	4.12	3.36	2.65	3.30	8.00
Less than Baa	2.77	2.51	2.69	3.17	2.17	1.35	1.00
No rating (or unknown)	.07	.07	.04	.03	.00	.00	.00
Memo items:							
Equity-based bonds ⁴	.87	.28	.32	.31	.00	.30	.20
Mortgage-backed bonds	5.19	4.64	4.17	4.77	2.71	1.85	4.00
Other asset-backed	.96	1.26	1.67	1.53	1.80	1.18	2.00
Variable-rate notes	1.88	1.13	.88	.85	.88	.43	1.30
Bonds sold abroad - total	2.03	1.93	2.01	1.98	2.70	2.00	2.00
Nonfinancial	.94	.65	.81	.69	.80	.85	1.00
Financial	1.09	1.24	1.20	1.29	1.90	1.15	1.00
Stocks sold abroad - total	.16	.09	.08	.05	.00	.02	.01
Nonfinancial	.12	.08	.07	.05	.00	.02	.01
Financial	.04	.01	.01	.00	.00	.00	.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.

Apart from these shorter-term swap-driven issues, overall public bond issuance remains relatively weak; many firms reportedly are anticipating lower interest rates later this year. For investment grade industrial firms, in addition, investors' concerns about "event risk" continue to deter long-term issuance. Only two such firms have issued debt with maturities of twenty years or longer in the four months since the RJR buyout announcement.

Issuance of junk bonds also has been relatively light since the last FOMC meeting, but volume is expected to increase soon. In particular, RJR shareholders are slated to receive \$1.8 billion in junk bonds in the second phase of the buyout sometime in the second quarter. Low-grade bond issuance in the public market also is expected to be bolstered when the \$5 billion in notes placed privately for RJR are replaced before midyear.

The early-year rally in stock prices fizzled out in February and a rebound in March was ended by the disappointing PPI report. Small investors, however, may have shown some renewed interest in stocks, for equity mutual funds registered positive net inflows during January and February, the first two consecutive monthly inflows since the 1987 crash.

Municipal Securities

New issues of long-term municipal securities totaled about \$8 billion in February, up from January's modest volume of \$6-1/2 billion; in March, long-term issues are expected to total about \$9 billion, close to the average monthly pace of last year. February's increase was accounted for by issues for new capital; refunding issues, which tend to be more interest-sensitive, were down.

Yields on long-term municipal securities drifted up about 35 basis points in the intermeeting period, roughly in line with yields on taxable

securities. The ratio of tax-exempt to taxable yields has hovered near the current level since its substantial decline in August.

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

	1987	1988	1988			1989		
	Year	Year	Q2	Q3	Q4	Jan.	Feb. ^p	Mar. ^f
Total offerings ¹	10.44	10.88	11.73	11.55	11.58	7.63	9.29	--
Total tax-exempt	10.05	10.60	11.41	11.32	11.21	7.43	9.09	10.00
Long-term ²	8.53	9.01	9.20	8.80	10.09	6.64	7.96	9.00
Refundings ²	3.80	2.75	3.18	1.87	2.91	2.50	1.79	--
New capital	4.73	6.26	6.02	6.93	7.18	4.14	6.17	--
Short-term ³	1.52	1.59	2.21	2.52	1.12	.79	1.13	1.00
Total taxable	.39	.28	.32	.23	.37	.20	.20	--
Memo item:								
Bank-qualified ⁴	n.a.	n.a.	n.a.	n.a.	n.a.	.39	.37	--

1. Includes issues for public and private purposes; also includes taxable issues.

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

3. Does not include tax-exempt commercial paper.

4. No data prior to January 1989.

p--preliminary.

f--forecast.

Commercial banks have, since 1986, been trimming their holdings of tax-exempt securities. Because their ability to deduct 80 percent of the carrying costs on newly acquired tax-exempt bonds is restricted to instruments issued by units that do not expect to issue more than \$10 million of bonds during the year, bank holdings have been largely determined by the pace at which pre-tax reform acquisitions are maturing. Thus far in 1989 "bank-qualified" municipal issues have accounted for about five percent of total long-term municipal volume.

Treasury and Sponsored Agency Financing

The staff forecast for the first-quarter federal budget deficit is \$60 billion on a not seasonally adjusted basis, down about \$7 billion from the deficit posted last quarter. A portion of the deficit is expected to be financed by an \$18 billion decline in the Treasury's cash balance, in advance of the large seasonal inflow of funds from tax payments in April. Marketable borrowing is expected to fall about \$7 billion from the fourth-quarter level, the reduction being more than accounted for by an expected \$13 billion decrease in new cash raised in bill auctions. Gross auction sizes of most coupon issues have been boosted; stripping activity remained at a surprisingly robust \$3-1/4 billion pace in both January and February following December's \$4-1/2 billion volume. "Other borrowing" is expected to fall off sharply in the first quarter, after being boosted in the fourth quarter by heavy issuance of FSLIC notes.

Borrowing by federally sponsored credit agencies continues to be dominated by the Federal Home Loan Banks. Over the past four months, FHLB borrowing has averaged more than \$4 billion per month, accounting for more than 80 percent of all borrowing by sponsored agencies. This heavy issuance of debt, reflecting FSLIC-insured thrifts' increased reliance on advances, has markedly increased yield differentials between FHLB and Treasury securities in recent weeks. For example, in the mid-March offering, the spread on the FHLB 3-month note was 74 basis points, up from February's spread of 25 basis points. The recent widening in spreads also reflects expectations that FHLB credit demands will continue to be large over the near term.

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

	1988	1989	1989		
	Q4	Q1 ^e	Jan.	Feb.	Mar. ^e
<u>Treasury financing</u>					
Total surplus/deficit (-)	-67.6	-60.2	2.8	-27.9	-35.2
Means of financing deficit:					
Net cash borrowing from the public	53.7	35.3	7.2	17.3	10.9
Marketable borrowings/ repayments (-)	36.9	29.7	6.5	13.7	9.5
Bills	15.5	2.8	2.3	-.1	.6
Coupons	21.4	27.0	4.2	13.8	8.9
Nonmarketable ²	6.3	5.8	.8	3.7	1.4
Other borrowing ²	10.5	-.2	-.1	-.1	.0
Decrease in the cash balance	10.8	17.5	-8.1	16.9	8.7
Memo: Cash balance at end of period	33.7	16.1	41.8	24.8	16.1
Other ³	3.1	7.4	-1.9	-6.4	15.6
<u>Federally sponsored credit agencies, net cash borrowing⁴</u>					
	13.4 ^P	-	3.0 ^P	5.4 ^P	-
FHLBs	10.8	-	4.0	4.1 ^P	-
FNMA	-.6	-	-.6	.4	-
Farm Credit Banks	-.6	-	-.8	.1	-
FAC ⁵	.2	-	.0	.0	-
FHLMC	.4 ^P	-	.3 ^P	.3 ^P	-
FICO	2.1	-	.0	.0	-
SLMA	2.0	-	.1 ^P	.5 ^P	-

1. Data reported on a not seasonally adjusted, payment basis.

2. Securities issued by federal agencies under special financing authorities (primarily FSLIC).

3. Includes checks issued less checks paid, accrued items and other transactions.

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

5. Financial Assistance Corporation, an institution within Farm Credit System, was created in January 1988 by Congress to provide financial assistance to Farm Credit Banks. It first issued bonds in July 1988.

e--staff estimate.

p--preliminary.

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

Spreads between FICO issues and 30-year Treasury bonds, in contrast, fell after the announcement of the savings and loan resolution plan, as investors apparently assumed that the proposal strengthened the government's implicit commitment to back FICO debt. At the most recent public offering of these bonds in March, the spread was a record low of 47 basis points, down from 69 basis points in late December. The \$600 million of securities issued in March brought FICO's total borrowing since its creation in 1987 to \$6.5 billion, placing it \$4.3 billion below its authorized limit of \$10.8 billion.

Thrift Institutions

Retail deposits at FSLIC-insured institutions, on the month-end basis reported by the FHLBB, ran off at a 7 percent seasonally adjusted rate in January, considerably exceeding December's 4 percent outflow. Moreover, large time deposits declined at nearly an 11 percent pace in January. In contrast to December, the January deposit outflows were widespread, with four out of five thrifts reporting withdrawals. Federal Reserve deposit reports from large thrifts indicate that sizable outflows continued at these institutions in February.

As noted above, many institutions partially substituted advances and other borrowings for deposits, as reflected by the strong growth in these liabilities. The Dallas and San Francisco FHLB districts accounted for the bulk of new advances. While the strong demand in the Dallas district was attributable to troubled institutions using FSLIC notes to collateralize their advances, borrowers in the San Francisco district were primarily healthy institutions engaged in liability management.

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

	Mortgage transactions			Net change in mortgage assets ¹		
	Origina- tions	Commit- ments	Sales	Total	Mortgage loans	Mortgage- backed securities
1985	16.4	15.0	8.2	4.1	4.2	-.2
1986	21.9	19.8	14.2	4.7	1.3	3.4
1987	21.1	20.0	10.6	6.1	2.4	3.7
1988 ^r	19.9	19.4	8.9	4.8	3.9	.9
1988-Q1	18.6	17.8	7.7	2.6	3.6	-.9
Q2	19.7	19.1	10.1	5.8	3.3	2.5
Q3	21.5	20.8	8.7	6.0	5.1	.9
Q4 ^r	19.8	19.9	9.1	4.9	3.6	1.3
1988-Oct. ^r	19.0	19.0	8.5	5.5	5.3	.2
Nov. ^r	21.1	20.7	10.9	3.8	1.6	2.2
Dec. ^r	19.3	20.0	7.8	5.5	4.0	1.5
1989-Jan. ^P	20.4	19.3	7.2	1.3	4.4	-3.1

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

r--revised.

p--preliminary.

NEW ISSUES OF MORTGAGE-BACKED PASS-THROUGH SECURITIES
BY FEDERALLY RELATED AGENCIES
(Monthly averages, billions of dollars)

Period	Seasonally adjusted				Not seasonally adjusted	
	Total	GNMAs	FHLMCs	FNMA's	Total	ARM-backed
1985	9.0	3.8	3.2	2.0	9.0	.3
1986	21.3	8.1	8.2	5.0	21.6	.7
1987	20.2	8.2	6.7	5.3	19.6	1.2
1988	12.4	4.6	3.3	4.6	12.6	2.4
1988-Q1	9.8	3.8	2.6	3.4	8.5	.9
Q2	12.1	4.5	2.8	4.8	12.5	3.0
Q3	13.3	5.5	3.4	4.4	14.9	3.0
Q4 ^r	14.6	4.8	4.2	5.6	14.5	2.6
1988-Oct. ^r	14.2	5.3	3.8	5.0	14.3	2.2
Nov. ^r	14.8	4.3	4.4	6.1	13.5	2.4
Dec. ^r	14.7	4.7	4.4	5.6	15.6	3.2
1989-Jan. ^P	14.1	4.6	4.8	4.7	12.1	.9

r--revised.

p--preliminary.

Reflecting heavy deposit runoffs, the assets of FSLIC-insured institutions contracted at a 3-1/2 percent pace in January, following December's strong gains.² By concentrating much of the asset adjustment in relatively liquid asset categories such as investment securities and mortgage-backed instruments, thrifts were able to continue moderate expansion of their mortgage and consumer loan holdings. January's 7 percent increase in mortgage loans was close to December's pace, while the 14-1/2 percent growth in consumer loans was the strongest since last May.

Under the Administration's reform plan for the thrift industry, thrifts must meet the current commercial bank primary capital standards of 5.5 percent of total assets by June 1991. Based on quarterly data through September 1988, GAAP solvent institutions would need an additional \$20 billion of capital--that is, retained earnings plus equity investments--to meet this standard. However, banks currently are in the process of phasing in a risk-based capital standard. Using this benchmark, which assigns a risk weight of 50 percent to residential mortgages, the shortfall is reduced to \$15 billion. Insolvent thrift institutions would need about \$17 billion of primary capital and \$14 billion of risk-adjusted capital to match these standards.³

The thrift industry as a whole may have difficulty raising new capital at the roughly \$12 billion per year needed to make up this risk-adjusted

2. About one-third of January's decline was attributable to the phase-in of generally accepted accounting standards, which required the write-down of certain asset categories, primarily those reflecting appraisal value of buildings and other fixed assets.

3. These figures are based on the assumption that funds from the Resolution Trust Corporation will be employed to bring GAAP tangible net worth of insolvent thrifts to zero.

capital shortfall by mid-1991. Retained earnings can be expected to make only a minor contribution over the near future. Capital generated externally through equity issuance would have to pick up greatly to cover the difference. Between 1983 and 1988, equity offerings by thrifts averaged less than \$2 billion per year, while in the first two months of 1989, these institutions raised only \$113 million in equity capital. However, new capital is likely to be forthcoming from those institutions acquiring thrifts, and following reform, these institutions may find the capital markets more receptive.

Equity prices of selected thrift institutions had risen by somewhat more than the market from the beginning of the year to the announcement of the Administration's plan on February 6. The day after this announcement, thrift equity prices increased more than 2 percent. Since that time, thrift equity prices have been considerably weaker than market indexes.

Mortgage Markets

Available data suggest that net mortgage debt growth has picked up in the first quarter from last quarter's sluggish pace, perhaps reflecting the surge in home sales at the end of 1988. Growth of real estate loans at commercial banks strengthened in the first two months of the year, while the volume of mortgage loans closed at FSLIC-insured institutions rose 5-1/2 percent in January.

January's recovery in lending activity helped to buoy issues of federally related mortgage-backed pass-throughs, with a seasonally adjusted volume of \$14.1 billion. Although pass-through volume climbed throughout 1988, it remained well below the levels attained in the prior two years. In

ARM DISCOUNTS
(January 1989)

Size of discount (basis points)	Average initial rate (percent)	Average base rate (percent) ¹	Percent of total
0	8.89	8.89	38
100 or fewer	8.52	8.96	6
101 - 200	8.66	10.46	16
201 - 300	8.25	10.67	30
301 or more	7.88	11.77	11
All discounted loans	8.32	10.65	62

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

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

AVERAGE ARM INDEX VALUES AND INITIAL RATE SPREADS
(Percent)

Period (1)	Initial ARM rate (2)	One-year Treasury (3)	FHLB 11th District cost of funds (4)	ARM spreads	
				Treasury (2) - (3)	11th District (2) - (4)
1985	10.04	8.43	9.52	1.61	.52
1986	8.42	6.46	8.24	1.96	.18
1987	7.82	6.76	7.38	1.06	.44
1988	7.90	7.65	7.69	.25	.21
1988-Q1	7.66	6.78	7.59	.88	.07
Q2	7.71	7.30	7.55	.41	.17
Q3	8.00	8.00	7.70	0	.30
Q4	8.22	8.53	7.92	-.31	.30
1988-July	7.84	7.75	7.59	.09	.25
Aug.	8.01	8.17	7.66	-.16	.35
Sept.	8.14	8.09	7.85	.05	.29
Oct.	8.12	8.11	7.83	.01	.29
Nov.	8.15	8.48	7.91	-.33	.24
Dec.	8.39	8.99	8.02	-.60	.37
1989-Jan.	8.55	9.05	8.13	-.50	.42
Feb.	8.65	9.25	n.a.	-.60	n.a.

n.a.--not available.

contrast to the sustained pace of pass-throughs in recent months, the market for private issues of multiclass mortgage securities--CMOs--has slowed substantially, in part because of difficulty in marketing residual tranches as investors have been concerned about further losses should rates move higher.

Since the last FOMC meeting, increases in primary market rates on mortgages have lagged the rise in secondary market yields, with the contract rate on new commitments for 30-year fixed-rate conventional home loans up 50 basis points to 10.98 percent as of last week. The initial rate on ARMs rose by a similar amount, to 9.02 percent, maintaining the spread between the initial rate on FRMs and ARMs at almost 2 percentage points.

Relatively low initial rates on ARM loans spurred an increase in the ARM share of conventional home mortgages closed at major lenders to 58 percent in early February. Aggressive pricing is evidenced by the declining spread between the initial rate on ARMs and the one-year constant-maturity Treasury yield, to a negative 60 basis points in February. In addition, recent reports indicate that ARMs tied to the 11th FHLB District cost of funds index (COFI) have increased in popularity among borrowers, since the sluggish behavior of this index allows ARM rates tied to it to adjust more slowly to changes in market conditions.

Consumer Installment Credit

Consumer installment credit increased at close to an 8 percent annual rate in both December and January, staying within the 7- to 10-percent growth range that it maintained most of last year. This expansion has been squarely in line with the growth of personal consumption, as typically has

III-20
CONSUMER CREDIT
(Seasonally adjusted)

			Percent change (at annual rate)				Net change (billions of dollars)		Memo: Outstanding (billions of dollars)
	1987	1988 ^r	1988		1988	1989	1988	1989	1989
			H1	H2 ^r	Dec. ^r	Jan. ^p	Dec. ^r	Jan. ^p	Jan. ^p
Total installment ¹	7.2	8.7	10.2	6.8	7.8	7.9	4.30	4.36	670.6
Installment, excluding auto	6.2	8.8	9.4	7.9	6.3	6.8	2.35	2.14	378.5
Selected types									
Auto	8.6	8.5	11.3	5.4	9.8	9.2	2.35	2.22	292.0
Revolving	16.8	16.6	17.0	15.0	8.4	5.3	1.29	.82	186.6
All other	-1.5	2.2	3.0	1.4	4.2	8.3	.67	1.32	191.9
Selected holders									
Commercial banks	7.4	13.3	13.3	12.6	7.6	5.5	2.00	1.47	320.6
Finance companies	4.8	2.5	6.7	-1.7	10.9	13.9	1.30	1.66	145.2
Credit unions	6.4	6.4	9.5	3.1	1.5	9.1	.11	.65	86.9
Savings institutions ²	12.4	6.8	10.4	3.0	2.8	15.0	.16	.85	69.2
Memorandum:									
Total ³	6.1	7.0	8.0	5.8	8.8	3.2	5.36	1.96	735.7

1. Includes items not shown separately.

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

3. Installment plus noninstallment.

r--revised.

p--preliminary.

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

CONSUMER INTEREST RATES
(Annual percentage rate)

	1986	1987	1988	1988			1989	
				May	Aug.	Nov.	Jan.	Feb.
At commercial banks ¹								
New cars (48 mo.)	11.33	10.46	10.86	10.55	10.93	11.22	...	11.76
Personal (24 mo.)	14.83	14.23	14.68	14.40	14.81	15.06	...	15.22
Credit cards	18.26	17.92	17.79	17.78	17.79	17.77	...	17.83
At auto finance cos. ²								
New cars	9.44	10.73	12.60	12.29	12.64	13.20	13.27	n.a.
Used cars	15.95	14.61	15.11	14.81	15.16	15.75	15.57	n.a.

1. Average of "most common" rate charged for specified type and maturity during the first week of the mid-month of each quarter.

2. Average rate for all loans of each type made during the month regardless of maturity.

been the case after the second or third year of economic upswings. In the present case, however, changes in tax laws have been a special factor encouraging reduced consumer debt use. Auto loan growth held steady at about a 9 percent rate in January, while credit card debt--by far the strongest component in 1988 decelerated noticeably further, to a rather low 5 percent pace. The sizable "all other" category--which includes personal cash loans--showed stepped-up growth in January.

Interest rates on consumer loans at banks have been rising since last spring. The largest rate increases have been recorded for new-car loans. By early February, the average new-car finance rate had risen 1/2 percentage point above the November level and was about 1-1/4 points above the average for the May 1988 survey. Personal loan rates advanced 3/4 percentage point between last May and February, but credit card rates, which normally are sticky, were up only 5 basis points. The effects of such rate increases on expenditures are likely to be small: on a \$10,000, 4-year new-car loan, a 1-1/4 percentage point increase in interest rate (holding other loan terms constant) would boost scheduled monthly payments by only \$6 on a base payment of more than \$250.

Recent data on delinquent loans present mixed evidence on the ability of consumers to meet loan payment obligations during the fourth quarter. The average delinquency rate on closed-end consumer loans at banks increased for the second consecutive quarter after two quarters of decline; however, at 2.53 percent in the fourth quarter, it is still well below the cyclical peak of 2.80 percent reached in 1980. Among its components, auto loans showed relatively sharp increases and were near historically high levels.

Auto finance companies have also recorded rather large increases in past-due loans in recent months. On the other hand, delinquency rates on credit card accounts and home equity lines of credit at banks edged down last quarter.

INTERNATIONAL DEVELOPMENTS

INTERNATIONAL DEVELOPMENTS

U.S. Merchandise Trade

In January, the seasonally adjusted U.S. merchandise trade deficit was \$9.5 billion (Census basis, customs valuation), compared with an \$11.0 billion revised deficit in December. Beginning with the January 1989 data, only customs valuation imports and f.a.s. exports appear in the press release.

Recorded exports declined 4 percent in January, with decreases recorded in almost all major trade categories. The value of imports declined 7 percent. Increases in imports of oil (entirely because the average price rose more than 10 percent) and industrial supplies (primarily associated with chemicals and paper), were more than offset by declines in all other major import categories. Part of the sharp

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

	Exports			Imports			Balance
	Total	Ag.	Nonag.	Total	Oil	Non-oil	
					(nsa)		
1988-Apr	26.0	3.3	22.7	34.8	3.1	31.7	-8.8
May	27.5	3.1	24.3	35.7	3.6	32.1	-8.3
Jun	26.3	3.0	23.3	37.9	3.3	34.6	-11.7
Jul	26.5	3.1	23.4	34.5	3.1	31.4	-8.0
Aug	27.5	3.4	24.1	38.1	3.4	34.7	-10.6
Sep	28.0	3.6	24.4	37.2	3.0	34.1	-9.2
Oct	27.8	3.0	24.8	36.6	2.9	33.7	-8.8
Nov	27.5	3.0	24.5	38.2	2.9	35.3	-10.7
Dec ^r	29.1	3.3	25.8	40.1	3.3	36.8	-11.0
1989-Jan ^P	27.8	3.1	24.7	37.3	3.5	33.8	-9.5

r--revised.

p--preliminary.

decrease in imports of consumer durables, computer accessories, and other electronic components in January, followed strong increases in those categories during the final months of 1988, and may reflect in part the effects of the termination of GSP status on December 31, 1988 for Korea, Hong Kong, Singapore, and Taiwan.

The trade figures for January may be subject to larger revisions than usual. Beginning with the January figures, in compliance with the Trade Act of 1988, the data are based on two new commodity classification systems: the International Harmonized System (HS) and Revision 3 of the Standard International Trade Classification (SITC). With the adoption of these systems, the United States joins most other countries in reporting trade using common commodity classifications for merchandise exports and imports. Because of this massive change in the way each trader must identify products and the fact that many duty rate classifications were changed to be consistent with the new system, the amount of carry-over from month to month (documents tabulated in later months for transactions occurring in an earlier month) during the first few months of 1989 will probably be increased. As a result, the levels of exports and imports may be understated in January for this reason alone.

In the fourth quarter of 1988, the merchandise trade deficit on a balance-of-payments basis was \$128 billion (s.a.a.r.), \$11 billion larger than in the third quarter (revised). (See the table on the next page.) Both exports and imports reached record levels. For the year 1988, the deficit was \$126.5 billion, \$34 billion smaller than in 1987.

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

	Exports			Imports			Balance
	Total	Ag.	Nonag.	Total	Oil	Non-oil	
- - - - - BOP basis (current dollars) - - - - -							
1987	250	30	220	410	43	367	-160
1988	320	38	281	446	39	407	-127
1987-4	272	31	242	437	45	392	-165
1988-1	301	36	265	441	40	401	-141
-2	318	38	280	438	41	397	-121
-3	327	41	286	443	39	404	-117
-4	335	38	296	462	37	426	-128
- - - - - BOP basis (constant 1982 dollars) ¹ - - - - -							
1987-4	300	35	264	460	81	379	-160
1988-1	329	39	290	463	82	381	-134
-2	340	40	301	458	85	373	-118
-3	341	37	304	465	87	379	-124
-4	348	35	313	479	90	389	-131
Percent Change:							
Q4/Q4	16.3	0.3	18.4	4.2	10.7	2.9	
Q4/Q3	2.0	-5.1	2.8	2.9	3.4	2.8	
(not AR)							
- - - - - GNP basis (constant 1982 dollars) - - - - -							
1987-4	305	35	269	461	81	380	-156
1988-1	329	39	290	463	82	381	-134
-2	339	40	299	459	85	374	-120
-3	346	38	308	471	87	384	-125
-4	354	36	318	484	90	394	-130
Percent Change:							
Q4/Q4	16.1	2.3	17.9	5.0	10.7	3.8	
Q4/Q3	2.2	-5.0	3.1	2.8	3.4	2.6	
(not AR)							

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

Exports rose 2 percent in both current and constant dollars from the third to the fourth quarter. The increase in nonagricultural exports (4 percent in value and 3 percent in volume) was largely in capital goods (other than aircraft) and automotive products. By area, the value of nonagricultural exports increased to all areas of the world with the exception of Japan and the Asian newly industrialized economies.

Agricultural exports declined 6 percent in value and 5 percent in volume in the fourth quarter, largely in soybeans and corn. The decrease in soybeans, by 22 percent in volume and 11 percent in price, was largely due to reduced shipments to Japan and Mexico. Exports of corn declined 18 percent, all in volume, as decreases in shipments to Japan and Western Europe outweighed an increase in shipments to the Soviet Union. Partly offsetting these declines was an increase in exports of wheat, by 11 percent in volume and 12 percent in price.

Non-oil imports rose 5 percent in nominal terms and 3 percent in volume in the fourth quarter. The largest increases in volume were in consumer goods and automotive products (particularly passenger cars from Japan and Germany, which rose from somewhat depressed third-quarter levels). Non-oil imports from industrial countries increased sharply. There was also an increase in non-oil imports from Mexico (importantly consumer goods and also automotive products).

The value of oil imports declined 6 percent in the fourth quarter as higher volumes were more than offset by a drop in the average price. (See the table on the next page.) The volume of oil imports rose

sharply in December and continued at roughly that strong level in January in reaction to the decline in prices last autumn brought about by an increase in OPEC production. Since the OPEC accord in mid-November, and accidents in the North Sea that restricted U.K. production, spot prices and import prices have risen significantly. OPEC production has been reduced roughly 2-1/2 to 3 mbd so far this year from the rate in late 1988.

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

	1988						1989
	Year	Q1	Q2	Q3	Q4	Dec	Jan
Value (Bil. \$)	39.29	39.84	41.03	39.35	36.94	39.71	43.56 ^e
Price (\$/BBL)	14.34	15.24	15.16	14.21	12.89	13.28	14.82 ^e
Volume (mbd.)	7.49	7.15	7.39	7.57	7.83	8.17	8.05 ^e

e--Estimated.

Import and Export Prices

In January, prices for imports and exports rose substantially (see the table on the next page) paced by significant rises in both import and export prices for foods, feeds, and beverages and petroleum. Non-oil import prices increased 0.9 percent (at a monthly rate) and non-agricultural export prices also rose 0.9 percent.

The data for January mark the first publication of a limited set of import and export prices on a monthly basis. These data are not seasonally adjusted and may be subject to significant measurement errors. The new series supplement the more detailed data that are currently published on a quarterly basis. While the quarterly figures

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

	1988-04		Quarters (AR)			Months
	1987-04		1988			1989
			Q2	Q3	Q4	Jan
	(monthly rate)					
- - - - - BLS Prices - - - - -						
<u>Imports, Total</u>	4.1	11.0	-5.0	6.4		1.3
Foods, Feeds, Bev.	1.6	0.0	-3.5	4.3		3.4
Industrial Supplies	12.2	23.9	-10.2	-1.3		1.9
Capital Goods	4.4	7.7	-6.0	10.3		0.3
Automotive Products	7.0	7.0	0.6	10.2		0.9
Consumer Goods	5.0	6.9	-4.1	8.2		1.1
Memo:						
Oil	-21.9	23.0	-32.8	-28.9		n.a.
Non-oil	6.9	10.1	-1.9	9.9		0.9
<u>Exports, Total</u>	6.3	11.8	8.3	-0.7		1.3
Foods, Feeds, Bev.	21.4	56.1	63.5	-21.2		4.6
Industrial Supplies	6.3	15.2	1.2	0.4		1.3
Capital Goods	3.5	3.9	2.3	3.1		0.6
Automotive Products	2.2	1.9	1.9	5.8		0.0
Consumer Goods	4.5	1.8	2.6	5.9		0.9
Memo:						
Agricultural	21.9	63.7	68.5	-22.5		3.8
Nonagricultural	4.6	7.6	3.3	1.8		0.9
- - - - - Prices in the GNP Accounts - - - - -						
<u>Fixed-Weighted</u>						
Imports, Total	2.7	6.3	-0.8	2.4		--
Oil	-26.1	-2.4	-22.0	-32.3		--
Non-oil	7.5	7.5	2.4	7.6		--
Exports, Total	8.0	8.1	13.8	1.5		--
Ag.	25.3	23.0	65.8	-4.1		--
Nonag.	4.9	5.5	5.4	2.7		--
<u>Deflators</u>						
Imports, Total	1.7	1.4	-1.8	5.7		--
Oil	-26.0	-2.4	-21.9	-32.1		--
Non-oil	5.6	4.1	0.1	10.5		--
Exports, Total	5.8	9.2	9.9	1.7		--
Ag.	25.3	23.0	65.8	-4.1		--
Nonag.	3.6	7.4	4.1	3.1		--

are based on a sample of approximately 22,000 products collected from over 8,300 companies, data for the monthly indexes are collected for approximately 4,300 products from over 1,900 companies. Monthly price indexes will be revised at the time of the quarterly press release. For example, with the release of the March 1989 data, revision will be made in the December 1988, January 1989, and February 1989 figures.

In the fourth quarter, prices of non-oil imports (n.s.a.) rose on average 10 percent at an annual rate. This was the same rate of increase as prevailed in the first two quarters of 1988 and followed a price decline on average in the third quarter. Over the four quarters of 1988, the increase in non-oil import prices was 7 percent. All the major categories of imports shown in the table on the previous page posted higher rates of price increase in the fourth quarter than in the third. An important influence on these price movements was the exchange value of the dollar, which declined during the fourth quarter after appreciating during the third quarter.

Prices of exports on average declined at an annual rate of less than 1 percent in the fourth quarter, led by a 21 percent decline in the price of foods, feeds, and beverages, and a 4 percent drop in the price of computers, peripherals, and parts. However, with the exception of industrial supplies, prices of other exports rose at a faster pace in the fourth quarter than in the third quarter. Despite the large fourth-quarter decline, the index for prices of exports of foods, feeds, and beverages closed the year 21 percent higher than a year ago, due in part to the summer drought. Prices for industrial supplies, capital

goods (excluding computers), and consumer goods all showed increases throughout each quarter of the year. For the year, prices of exports rose by more than 6 percent on average (Q4/Q4).

U.S. Current Account: 1988-Q4

The U.S. current account deficit in 1988-Q4 narrowed \$2.8 billion (s.a.a.r.) from third-quarter levels. The reduction occurred because of a large swing in capital gains on direct investment. This swing reflected the impact of the dollar depreciation in 1988-Q4 on the dollar value of foreign-currency denominated assets, liabilities, depreciation, and inventory charges on the books of the foreign affiliates of U.S. firms.

U.S. CURRENT ACCOUNT
(Billions of dollars, annual rates, seasonally adjusted)

	1988			
	Year	Q2 ^r	Q3 ^r	Q4 ^p
Trade balance	-126.5	-120.6	-116.7	-128.1
Exports	319.9	317.8	326.7	334.6
Imports	446.4	438.4	443.4	462.7
Investment income, net	2.6	-7.9	-4.9	18.8
Direct investment, net	30.9	21.7	24.6	48.8
Capital gains or losses ¹	-2.3	-10.4	-12.0	11.3
Other direct investment	33.2	32.1	36.6	37.4
Portfolio income, net	-28.3	-29.6	-29.6	-30.0
Military, net	-4.2	-3.7	-3.4	-5.7
Other services, net	6.4	8.1	7.5	5.1
Unilateral transfers	-13.6	-11.1	-12.9	-17.8
Current account balance:				
Published	-135.3	-135.3	-130.4	-127.7
Excluding capital gains	-133.1	-124.8	-118.5	-139.0

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

Excluding capital gains, the current account deteriorated \$20.5 billion in the fourth quarter.

Roughly half of the \$20.5 billion deterioration in the current account deficit resulted from a worsening in the trade balance, and the remainder was split between an increase in unilateral transfer payments and a decline in military sales and other net services. The \$4.9 billion increase in unilateral transfers abroad occurred as Israel drew nearly all of the grant funds provided by the U.S. Government in the first quarter of the fiscal year. The reduction in military sales (by 20 percent) occurred as deliveries under several programs were completed. Receipts from foreigners for both travel and passenger-fare services increased for the ninth consecutive quarter. However, payments to foreigners for travel services also rose and, as a result, there was little net change in this sector during the quarter. Net income on private portfolio investment was little changed, though the gross flows were boosted by higher U.S. interest rates and a step-up in bank activity.

U.S. International Financial Transactions

Foreign official reserve assets in the United States increased net by \$1.7 billion in January, despite net intervention sales of dollars by the G-10 countries and declines in their reserves in the United States. (See line 4 of the Summary of U.S. International Transactions table.) The composition of reserve assets held in the United States also shifted, as several G-10 countries sold Treasury bills and acquired bank deposits. Partial information for February indicates that the G-10

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

	1987	1988	1987	1988					1989	
	Year	Year	Q4	Q1	Q2	Q3	Q4	Nov.	Dec.	Jan.
<u>Private Capital</u>										
Banks										
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	47.5	23.2	10.9	-3.0	17.0	-1.1	10.4	1.2	8.4	-17.0
Securities										
2. Private securities transactions, net ¹	35.4	15.8	-7.0	-2.2	10.9	6.2	0.9	3.0	-0.4	0.6
a) foreign net purchases (+) of U.S. corporate bonds	26.4	27.4	2.8	2.6	8.9	7.0	9.0	2.7	3.9	1.5
b) foreign net purchases (+) of U.S. corporate stocks	16.8	.3	-7.4	*	1.0	1.2	-2.0	*	-1.2	0.2
c) U.S. net purchases (-) of foreign securities	-6.9	-11.9	-2.4	-4.9	1.0	-2.0	-6.1	0.3	-2.8	-1.1
3. Foreign net purchases (+) of U.S. Treasury obligations	-7.3	20.3	0.5	7.0	5.6	3.5	4.2	8.0	-3.8	2.4
<u>Official Capital</u>										
4. Changes in foreign official reserves assets in U.S. (+ = increase)	47.7	40.1	19.8	24.8	6.5	-2.2	11.1	5.9	-1.2	1.7
a) By area										
G-10 countries (incl. Switz.)	38.8	15.5	15.6	17.7	-0.8	-7.0	5.5	3.1	-2.1	-1.2
OPEC	-8.9	-3.4	-2.8	-1.6	-1.6	-0.8	0.7	1.3	0.8	0.4
All other countries	17.8	28.0	7.1	8.7	9.0	5.6	4.8	1.5	0.1	2.6
b) By type										
U.S. Treasury securities	43.2	41.7	19.1	27.7	5.9	-3.8	11.9	5.2	2.1	-3.3
Other ²	4.5	-1.6	0.7	-2.9	0.7	1.5	-0.8	0.7	-3.3	5.0
5. Changes in U.S. official reserve assets (+ = decrease)	9.1	-3.6	3.7	1.5	*	-7.4	2.3	2.4	0.5	-1.9
<u>Other transactions</u> (Quarterly data)										
6. U.S. direct investment (-) abroad ⁴	-44.5	-20.4	-19.7	-6.5	0.5	-5.2	-9.2	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S. ⁴	42.0	42.2	11.7	7.3	13.1	8.4	13.4	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) ^{3,4}	4.6	1.2	-2.7	3.7	-7.2	6.7	-2.2	n.a.	n.a.	n.a.
9. U.S. current account balance ⁴	-154.0	-135.3	-33.5	-37.0	-33.8	-32.6	-31.9	n.a.	n.a.	n.a.
10. Statistical discrepancy ⁴	18.5	16.5	16.3	4.4	-12.6	23.7	1.0	n.a.	n.a.	n.a.

MEMO:

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

-160.3 -126.5 -41.2 -35.2 -30.2 -29.2 -32.0 n.a. n.a. n.a.

1. These data have not been adjusted to exclude commissions on securities transactions and, therefore, do not match exactly the data on U.S. international transactions as published by the Department of Commerce.

2. Includes deposits in banks, commercial paper, acceptances, borrowing under repurchase agreements, and other securities.

3. Includes U.S. government assets other than official reserves, transactions by nonbanking concerns, and other banking and official transactions not shown elsewhere. In addition, it includes amounts resulting from adjustments to the data made by the Department of Commerce and revisions to the data in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.

4. Includes seasonal adjustment for quarterly data.

*--Less than \$50 million.

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

countries added about \$0.8 billion net to their reserves held at the FRBNY in that month.

Private foreign net purchases of U.S. Treasury securities amounted to \$2.4 billion in January, above the monthly average rate of purchases in 1988 (line 3). About one-third of this total was accounted for by the World Bank, while the rest of the purchasers were concentrated in Europe and Japan. Private foreign net purchases of U.S. corporate bonds (line 2a) were \$1.5 billion, below the monthly average in 1988. Issuance of Eurobonds by U.S. corporations, which had been very weak in December, picked up substantially in the first quarter of 1989. Foreign net purchases of U.S. stocks remained depressed in January (line 2b), but U.S. net purchases of Japanese stocks (included in line 2c) rebounded to more than \$0.8 billion.

Banks reported substantial net outflows in January (line 1). The bulk of the outflows involved transactions with own foreign offices, and more than reversed the inflows that occurred in the last days of December. As shown on the International Banking Data table on line 1 (see next page), on a monthly average basis, there was little change in net claims of banks in the United States on their own foreign offices and IBFs in the first two months of 1989.

The Department of Commerce recently released data for the fourth quarter of 1988 on other international transactions. (See lines 6 through 10 of the Summary of U.S. International Transactions table.) For the year 1988, U.S. direct investment abroad fell substantially. Apart from a \$17 billion swing from capital gains to losses associated

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1986	1987				1988				1989	
	Dec.	Mar.	June	Sept.	Dec.	Mar.	June	Sept.	Dec.	Jan.	Feb.
1. Net Claims of U.S. Banking Offices (excluding IBFS) on Own Foreign Offices and IBFS	22.3	9.1	5.0	-8.7	-10.9	8.7	-4.8	-4.9	-4.9	-3.4	-6.2
(a) U.S.-chartered banks	31.7	21.5	16.3	12.6	15.2	27.8	17.0	16.6	21.6	21.1	18.6
(b) Foreign-chartered banks	-9.4	-12.4	-11.3	-20.3	-26.1	-19.0	-21.8	-21.5	-26.5	-24.5	-24.8
2. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	16.8	16.0	15.6	17.1	15.8	19.1	19.7	21.4	21.2	19.8	21.0
3. Eurodollar Holdings of U.S. Nonbank Residents ¹	124.5	34.0	135.7	141.1	132.6	128.9	138.1	141.1	145.3	143.9	142.0

IV-12

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.

with currency translation effects, the major explanation was the sale of assets by a financially pressed U.S. petroleum company. Foreign direct investment in the United States (line 7) continued at very high levels in 1988.

Other capital flows (line 8) showed a net inflow of \$1 billion in 1988. Included in this total is the change in banks' claims and liabilities denominated in foreign currencies. Between the end of 1987 and the end of 1988 foreign currency claims increased by \$15 billion (or almost 30 percent) while liabilities increased by \$16 billion (also almost 30 percent). Since the dollar did not depreciate against most currencies during this period, these increases were not the result of converting foreign currencies to dollar values. The bulk of these changes were reported by the IBFs of Japanese-based banks vis-a-vis Japan. One possible explanation for these developments is that essentially domestic Japanese transactions are being booked at IBFs of Japanese banks. Window guidance discouraging lending in Japan for real estate investments has increased borrowing from offshore for this purpose. Efforts preventing domestic interbank rates from rising as rapidly as Euroyen rates have stimulated deposit growth offshore, and regulations limiting direct inflows from the Japan offshore market have encouraged round-tripping through financial centers outside Japan.

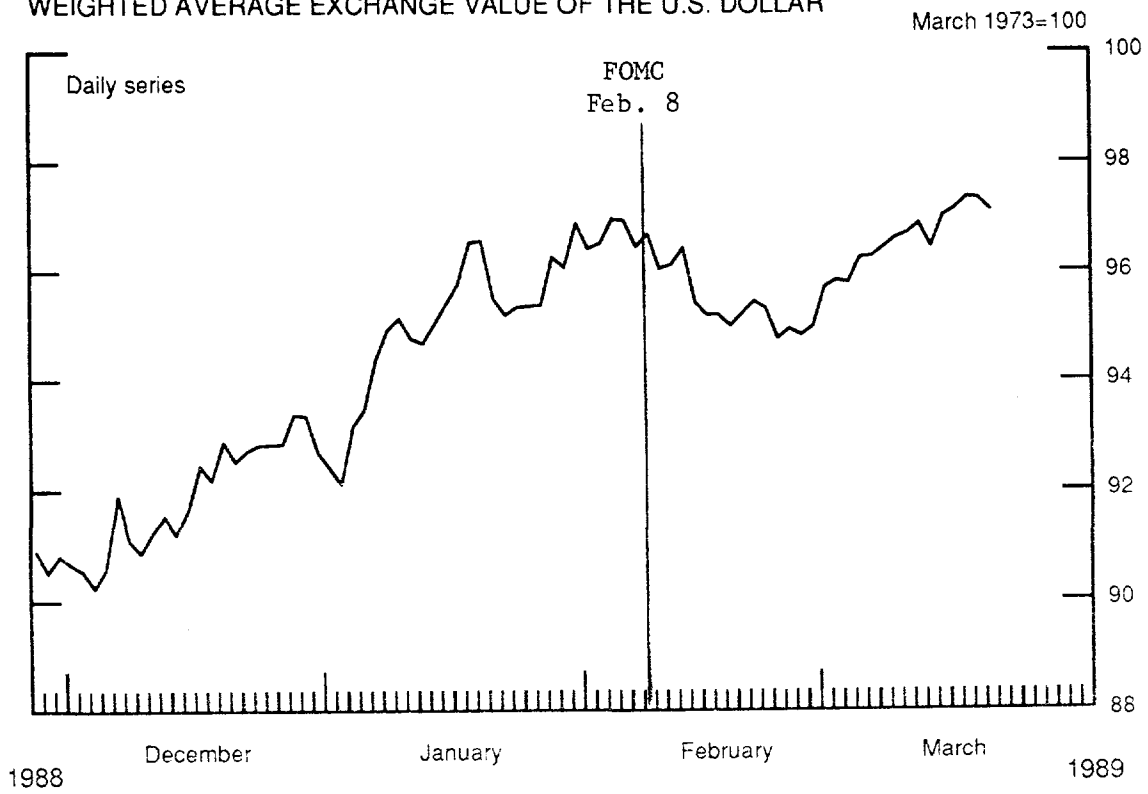
The statistical discrepancy in the U.S. international transactions accounts was \$16.5 billion in 1988, slightly smaller than 1987 (line 10). However, this decline should not be interpreted as reflecting an improvement in data accuracy. The wide swings from quarter to quarter

in the discrepancy, combined with the relatively stable movement in the current account balance, suggest that there are substantial errors and omissions in the recording of data on capital flows. This impression is reinforced by examination of data for January; despite the current account deficit, data for the month (admittedly incomplete) show a net capital outflow of over \$12 billion. In addition, with increasing frequency, those responsible for producing the capital flows data have failed to catch large errors in the data.

Foreign Exchange Markets

After weakening considerably during February, the dollar recovered in March; overall, the trade-weighted foreign-exchange value of the dollar rose 0.4 percent during the intermeeting period, as shown in Chart 1. Movements in the dollar were dominated primarily by changing perceptions of the relative tightness of monetary policies in the United States and abroad. The dollar declined through most of February, as market participants were disappointed by a perceived lack of action by the Federal Reserve in the wake of data showing larger than expected increases in U.S. price indices. Meanwhile, another round of official interest rate increases in Europe was anticipated. After the Federal Reserve increased its discount rate on February 24 and foreign authorities signaled an unwillingness to tighten further at the time, the dollar rebounded. The dollar strengthened still further after the release of the U.S. PPI for February. The dollar rose particularly strongly against the mark, exceeding DM 1.87; on several occasions in

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



March, the Desk,

intervened to purchase marks.

Expectations of official European interest rate increases focused on a rise in the Bundesbank's Lombard rate. Early in the period, increases in measures of German inflation and capacity utilization were announced, and, throughout February, the German call money rate hovered around the 6 percent Lombard rate, occasionally exceeding it. The 3-month interbank rate increased by almost a full percentage point to a high of 7 percent shortly after the rise in the U.S. discount rate, and the range of interest rates in Bundesbank repurchase operations rose steadily. However, the Bundesbank council met twice after the Federal Reserve increased its discount rate and, in both meetings, refrained from increasing the Lombard rate. In addition, subsequent RP allocations were made at fixed rates, the first of which was announced at a rate below the call money rate. Since the end of February, 3-month interest rates have retreated about 1/2 percentage point, and the mark has weakened considerably.

Expectations of further monetary tightening in the United Kingdom also have diminished. After signs of slowing in the British economy began to emerge, the Bank of England avoided increasing its intervention rates. The pound strengthened somewhat following Chancellor Lawson's budget address which indicated that monetary policy would not be eased and fiscal policy would remain restrained. On balance, sterling declined about 1 percent over the intermeeting period.

Japanese monetary authorities also have not followed the recent tightening in the United States. While Bank of Japan officials have expressed some concern over possible inflationary pressures, Ministry of Finance officials have indicated there is little likelihood of monetary tightening. Recently, the Bank of Japan has injected liquidity to offset fiscal year-end pressures on short-term interest rates.

With these foreign authorities showing little inclination towards additional monetary restraint, short-term interest rate differentials moved in favor of dollar assets during the intermeeting period. Rates on 3-month CDs in the United States moved up about 90 basis points compared with increases of only about 40 basis points, overall, in comparable German rates and little change in the Japanese Gensaki rates.

The Australian dollar has fallen about 8 percent since the last FOMC meeting, with much of the decline occurring in a two-day period. The sudden fall coincided with news of a much larger than expected current account deficit and statements by both the Prime Minister and the Treasurer indicating that they favored a decline in the Australian dollar.

the Desk sold \$600 million, all
against marks.

Developments in Foreign Industrial Countries

Economic growth slackened in most of the major foreign industrial nations in the fourth quarter of last year, but data available so far for 1989 do not indicate further slowing. Japanese GNP grew by 3 percent (s.a.a.r.) in the fourth quarter after a surge of 9.1 percent in the third quarter. In Germany, real GNP grew 1.1 percent (s.a.a.r.) last quarter, down from the 4.5 percent growth of the third quarter. Real GDP growth slowed considerably in France in the fourth quarter, while it remained roughly constant in Canada and the United Kingdom. In the early months of 1989, unemployment rates have declined further in most of the major foreign industrial nations, while data on industrial production, retail sales, and orders have been mixed.

Inflation abroad has stepped up in recent months. In Japan, consumer price inflation was 1.4 percent in the year to February, up slightly from the 1.2 percent rate at the end of last year. German consumer prices were 2.6 percent above year-ago levels in February, well above the 12-month inflation rate of 1.6 percent in December. While much of the increase was accounted for by a hike in German excise taxes in January, there is evidence that the underlying rate of inflation has risen as well. CPI inflation on a 12-month basis has risen in all of the other major foreign industrial countries in early 1989.

Individual country notes. In Japan, real GNP rose 3 percent (s.a.a.r.) in the fourth quarter and domestic demand grew 3.1 percent.

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

	Q4/Q4 1987	Q4/Q4 1988	1988				1988			1989		Latest 3 months from year ago 2
			Q1	Q2	Q3	Q4	Oct.	Nov.	Dec.	Jan.	Feb.	
Canada												
GDP	6.1	3.4	.8	1.1	.8	.6	*	*	*	*	*	3.4
IP	8.5	2.9	1.2	1.1	.6	-.0	-.5	-.3	.6	n. a.	n. a.	2.9
France												
GDP	2.7	2.8	1.0	.4	1.0	.4	*	*	*	*	*	2.8
IP	3.2	4.2	.9	.8	2.7	-.2	-3.3	4.0	-.7	.5	n. a.	5.1
Germany												
GNP	2.4	2.7	1.4	-.1	1.1	.3	*	*	*	*	*	2.7
IP	1.5	3.8	1.1	.3	1.8	.6	-1.0	.5	1.7	1.5	n. a.	4.8
Italy												
GDP	2.7	n. a.	1.3	.8	1.5	n. a.	*	*	*	*	*	3.9
IP	5.7	6.8	2.7	-.7	.1	4.5	3.2	1.4	.5	n. a.	n. a.	6.8
Japan												
GNP	5.7	4.7	2.4	-.8	2.3	.7	*	*	*	*	*	4.7
IP	8.1	8.0	3.2	-.2	2.5	2.4	-1.0	2.8	.9	.9	n. a.	9.0
United Kingdom												
GDP	4.0	3.0	2.0	.2	.3	.5	*	*	*	*	*	3.0
IP	4.1	2.6	-.7	2.4	.7	.2	-.3	.0	-.8	-1.2	n. a.	1.9
United States												
GNP	5.0	2.7	.8	.7	.6	.5	*	*	*	*	*	2.7
IP	5.8	5.1	1.0	1.1	1.7	1.1	.6	.4	.4	.4	.0	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 1987	Q4/Q4 1988	1987		1988				1988		1989		Latest 3 months from year ago
			Q3	Q4	Q1	Q2	Q3	Q4	Nov.	Dec.	Jan.	Feb.	
Canada													
CPI	4.2	4.1	1.2	.7	.8	1.3	1.1	.8	.3	.0	.5	.7	4.3
WPI	4.3	3.5	1.4	1.1	1.1	.9	1.0	.5	.5	.0	.6	n. a.	3.3
France													
CPI	3.2	3.0	.6	.5	.5	1.0	.9	.6	.1	.2	.4	.3	3.3
WPI	2.6	n. a.	.5	1.0	1.1	.8	2.4	n. a.	*	*	*	*	5.4
Germany													
CPI	1.0	1.5	.0	.0	.5	.5	.1	.4	.2	.2	1.1	.3	2.3
WPI	-.7	2.7	-.4	-.2	.1	1.1	.4	1.2	.5	.8	1.7	.2	4.7
Italy													
CPI	5.2	5.2	1.1	1.7	1.1	1.0	1.0	1.9	.8	.3	.8	.8	5.8
WPI	4.6	5.4	.8	1.2	1.1	1.3	1.2	1.7	.9	.7	.8	n. a.	5.9
Japan													
CPI	1.1	1.5	-.2	-.4	-.2	.6	.0	1.0	-.3	-.4	.1	-.2	1.3
WPI	-.6	-1.4	1.3	-.4	-1.2	-.3	.9	-.8	-.6	.0	.3	.3	-.3
United Kingdom													
CPI	4.1	6.5	.2	1.1	.5	2.4	1.4	2.1	.5	.3	.6	n. a.	6.9
WPI	3.9	4.9	.5	1.1	1.3	1.5	.8	1.2	.4	.3	1.0	.3	5.1
United States													
CPI (SA)	4.4	4.3	.9	.9	.9	1.1	1.2	1.1	.2	.3	.6	.4	4.6
WPI (SA)	2.5	3.4	.5	.1	.6	.8	1.1	.8	.2	.5	1.0	1.0	4.6

1. Asterisk indicates that monthly data are not available.

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

	1987	1988	1987		1988				1988		1989	
			Q3	Q4	Q1	Q2	Q3	Q4	Nov.	Dec.	Jan.	Feb.
<u>Canada</u>												
Trade	8.3	7.4	2.3	1.6	1.7	2.1	2.6	1.0	.3	.5	.7	n. a.
Current account	-8.0	n. a.	-2.1	-2.6	-1.2	-1.9	-1.6	n. a.	*	*	*	*
<u>France</u>												
Trade	-5.2	-6.0	-1.0	-1.0	-.9	-1.0	-1.9	-2.1	-.6	-.8	-.4	n. a.
Current account	-4.1	n. a.	-.9	-2.3	1.5	-.7	-1.1	n. a.	*	*	*	*
<u>Germany</u>												
Trade (NSA)	65.9	72.8	15.2	20.1	15.0	19.9	17.0	21.0	7.5	7.7 ^a	6.4	n. a.
Current account (NSA)	45.4	48.5	7.8	15.3	8.6	15.0	8.7	16.1	6.1	5.7	5.9	n. a.
<u>Italy</u>												
Trade	-9.3	-7.4	-2.9	-2.4	-1.0	-1.1	-3.1	-2.3	-.7	-1.4	-2.0	n. a.
Current account (NSA)	-1.1	-4.4	1.6	-1.6	-5.1	1.1	.4	-.8	*	*	*	*
<u>Japan</u>												
Trade	79.5	77.6	17.8	18.3	20.8	16.7	17.8	22.2	7.6	7.4	7.6	8.8
Current account 2	87.0	79.5	19.9	20.5	23.1	17.6	17.8	20.8	7.4	6.6	6.7	n. a.
<u>United Kingdom</u>												
Trade	-15.9	-36.2	-5.0	-5.3	-7.1	-8.2	-9.4	-11.5	-3.4	-3.0	-3.7	n. a.
Current account	-5.1	-26.1	-1.9	-3.9	-5.1	-5.4	-6.1	-9.6	-2.8	-2.5	-3.0	n. a.
<u>United States</u>												
Trade 2	-160.3	-126.5	-39.7	-41.2	-35.2	-30.2	-29.2	-32.0	*	*	*	*
Current account	-154.0	-135.3	-42.0	-33.5	-37.0	-33.8	-32.6	-31.9	*	*	*	*

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.

While plant and equipment spending rose a strong 24.4 percent and residential investment was up 12.6 percent, consumption was virtually unchanged, rising only 0.1 percent. Both exports and imports were essentially flat in the fourth quarter, after strong increases in the third quarter, and net exports had a neutral impact on growth.

Most indicators suggest that activity was strong early in the first quarter of this year. Industrial production rose 0.9 percent (s.a.) in January, to a level 2.5 percent above the fourth-quarter average. Retail sales increased by 1.4 percent (s.a.) in January after declining in the previous two months. The unemployment rate declined to 2.3 percent (s.a.) in December, its lowest level since 1982, and remained unchanged in January. Capacity utilization declined slightly (s.a.) in December, following its largest monthly increase in over 20 years in November. New machinery orders were up sharply (s.a.) in December. However, this increase was due entirely to a jump in orders placed by the public sector; orders placed by both overseas customers and the domestic private sector declined.

The 12-month increase in the consumer price index for Tokyo was 1.4 percent in February, up slightly from the end of last year. Wholesale prices rose 0.3 percent (n.s.a.) in both January and February owing to higher prices of oil and of other internationally traded goods as the yen depreciated slightly. Wholesale prices rose 0.3 percent in the year to February, the first 12-month increase since October 1987. The 12-month growth rate of M2+CDs was 10.4 percent in February, near the

middle of the 10 to 11 percent range for first-quarter growth forecast by the Bank of Japan.

The trade surplus increased in January and rose further in February. In the two months combined, the surplus was \$98.4 billion (s.a.a.r.), a higher rate than the \$77.6 billion surplus for all of last year. The current account surplus rate in January was \$80.8 billion, compared with a surplus of \$79.5 for all of 1988.

Economic growth slowed in Germany in the fourth quarter, as real GNP rose 1.1 percent (s.a.a.r.). The quarter was marked by a large decline in net exports and a modest decline in public consumption, but sharp increases in both inventory investment and investment in machinery and equipment. Monthly data indicate that the slowing of growth in the fourth quarter occurred largely in October. Industrial production recovered in November and December, and advanced 0.6 percent (s.a.) in the fourth quarter as a whole, led by strength in the capital goods sector. In January, industrial production advanced by 1.5 percent. However, the volume of new orders, which had rebounded strongly in November and December, declined 2.5 percent in January as domestic orders leveled off and foreign orders fell back to October's level. Partly in response to the mild winter, the German unemployment rate continued to decline to 7.9 percent (s.a.) in February. In the fourth quarter, manufacturing capacity utilization attained its highest rate since 1973, 88.7 percent, up 3.7 points from its year-ago rate.

Concern about inflation has risen in recent months. Consumer prices increased 1.1 percent (n.s.a.) in January and 0.3 percent in

February, to a level 2.6 percent above their year-earlier level. A significant part of the increase in January reflected one-time increases in excise taxes; rising import prices, due to firming oil prices and a weak mark, accounted for most of the rest. Import prices rose 2.2 percent (n.s.a.) in January, to a level 5.9 percent above their year-earlier level. Wholesale prices also have accelerated in recent months, with February's 0.2 percent (n.s.a.) increase placing them 5.4 percent above their year-earlier level. Wages moved up 6 percent (s.a.a.r.) between the second and fourth quarters of 1988, after rising 3.6 percent over the preceding four quarters. In January, M3 growth was 6.4 percent (s.a.a.r., from the fourth quarter of 1988), exceeding the Bundesbank's 5 percent M3 growth target for 1989, but slower than the 6.8 percent growth recorded in 1988.

The German trade surplus narrowed in January to \$6.4 billion (n.s.a.), while the current account surplus widened to \$5.9 billion (n.s.a.). In 1988, the trade surplus reached a record \$72.8 billion. Between 1987 and 1988, Germany's trade surplus with the United States declined from \$13.5 billion to \$9.5 billion, while its surplus with other EEC countries rose by nearly \$12 billion. In 1988, the current account surplus registered a record \$48.5 billion.

In France, real GDP grew by 1.6 percent (s.a.a.r.) in the fourth quarter after expanding at a 4.5 percent rate in the previous quarter. Consumption rose only slightly, and gross fixed capital formation stagnated after several quarters of vigorous growth. Inventories rose strongly, especially in the manufactured goods sector. Retail prices

rose 0.3 percent (n.s.a.) in February, bringing the 12-month inflation rate to 3.4 percent compared with a 3.1 percent rate in December.

On March 9, Finance Minister Beregovoy announced further easing of French exchange controls. Limitations on franc and foreign currency loans to non-residents were ended and individuals were allowed to hold bank accounts in ECUs. The only significant remaining exchange controls restrict private individuals from opening foreign currency accounts in France or accounts abroad. Beregovoy said these remaining limits would be lifted by June 30, 1990, the deadline for full liberalization of EC capital flows.

In the United Kingdom, recent data on the strength of economic activity have been mixed. The average measure of real GDP grew only 2 percent (s.a.a.r.) in the fourth quarter of last year. Industrial production fell by 0.8 percent (s.a.) in December and by 1.2 percent in January as a result of lower oil output. The volume of retail sales was down 2.4 percent (s.a.) in January, but then rose 2.5 percent in February. The unemployment rate fell to 6.8 percent (s.a.) in January, the 31st consecutive monthly decline and an eight-year low.

The 12-month rate of retail price inflation rose to 7.5 percent in January, more than double the 3.3 percent rate recorded in January of last year. Excluding mortgage interest payments, the rate was 5.6 percent. Wholesale prices increased by 5.2 percent in the 12 months to February. The underlying 12-month rate of increase of average earnings rose to 9 percent in January.

U.K. trade and current account deficits, after declining in recent months, increased to their third-highest levels ever in January. In 1988 as a whole, the current account deficit was a record \$26.1 billion, surpassing by far the \$5.1 billion deficit of the previous year.

The British budget, released on March 14, contained no significant policy initiatives. Major tax rates were not reduced despite the record budget surplus projected for the current fiscal year. The target for growth of M0 was kept at its 1 to 5 percent range for 1989. In 1988, M0 growth exceeded this range by more than 2 percentage points. The government expressed confidence that its policy of maintaining high short-term interest rates would soon slow spending and reduce inflation.

Canadian real GDP rose 2.3 percent (s.a.a.r.) in the fourth quarter, down from 3.4 percent in the third quarter. Consumer spending increased 6.3 percent (s.a.a.r.) and business investment in fixed capital increased 8.4 percent while external demand dropped sharply. A substantial positive swing in the rate of inventory accumulation also contributed to growth. Industrial production increased 0.6 percent (s.a.) in December while retail sales surged 1.9 percent (s.a.). Canada's unemployment rate remained at 7.6 percent (s.a.) in February, the same as in January and December, but slightly below the average rate of 7.8 percent in 1988. Inflation has edged up recently. Consumer prices increased 0.7 percent (s.a.) in February to a level 4.6 percent above that of a year ago.

In Italy, growth was strong in 1988. Third-quarter GDP grew 6.3 percent (s.a.a.r.), resulting in a cumulative rise of 5 percent during

the first three quarters of 1988. The pace of activity appears to have been sustained in the fourth quarter; in December, industrial production was 10.9 percent above its year-earlier level. Recent price increases have heightened concerns about inflation. In February, 12-month consumer price inflation was 6.3 percent, compared with a rate of 5.5 percent in December. About half of this increase reflects higher value added taxes.

Economic Situation in Major Developing Countries

Treasury Secretary Brady, in a March 10 speech, suggested some possible modifications of the debt strategy. His ideas represent an evolution of the Baker Initiative, and include such innovations as generalized waivers of sharing and negative pledge clauses in international loan contracts and voluntary debt reduction operations implemented through negotiations between commercial banks and debtor countries and supported by international financial institutions. Venezuela's new president introduced a far-reaching economic program in February. In mid-March, the U.S. Treasury disbursed to Venezuela a \$450 million short-term loan bridged to a first credit tranche purchase from the IMF. Mexican authorities are preparing for debt negotiations with commercial banks in which they will request debt reduction, coupled with new money and a restructuring of principal payments. Wage and price controls introduced in January have slowed Brazil's inflation rate. In Argentina, a surge in the demand for dollars in February led the government to float the exchange rate for financial transactions. In early March, the World Bank announced that it was discontinuing

disbursements on two sector loans to Argentina. The Philippines reached agreement with an IMF mission this month on a three-year economic program totaling \$1.2 billion.

Individual country notes. On February 16, Venezuela's new president Carlos Andres Perez announced a far-reaching economic adjustment program. The program is designed to reduce the current account deficit, encourage capital repatriation and domestic saving, rationalize public and private sector prices, and cut the fiscal deficit. Measures already implemented include: a unified and floating exchange rate (representing an average devaluation of about 60 percent), liberalized domestic interest rates, a public sector hiring freeze, a 30 percent increase in public sector wages, a 54 percent rise in the minimum wage to compensate partially for past inflation, decontrol of private sector prices except for a basket of about two dozen basic consumer goods, and hikes in fuel prices averaging 85 percent. Higher gasoline prices and bus fares sparked widespread rioting at the end of February that left more than 250 dead.

The government has indicated its commitment to continued economic adjustment. Measures to be implemented in the future include: tariff and tax reform, privatization of some public enterprises, and further increases in public sector prices.

Venezuela is seeking substantial financing in support of this program from the IMF and the IBRD. It has requested a first credit tranche purchase of \$453 million from the IMF, expected to be approved by the IMF Executive Board on March 29, to be followed by a three-year

program supported by the IMF. In mid-March, the U.S. Treasury disbursed a \$450 million loan bridged to the drawing of the first credit tranche. The government has asked for \$600 million in interim financing from commercial banks, which is unlikely to be forthcoming, and plans to request new money and a new rescheduling of its bank debt.

The Mexican authorities are preparing for debt negotiations with commercial banks in which they will ask for a reduction in principal and/or interest rates, coupled with new money and/or a restructuring of principal payments due soon. Their aim is to reduce scheduled debt service and to reach a multi-year financing arrangement that would obviate the need for annual negotiations and facilitate longer-range financial planning.

The CPI rose by 2.4 percent in January and by 1.4 percent in February. Larger increases had been anticipated in the wake of the January 1 increase in many administered prices and in minimum wages. In February, the CPI was 26 percent higher than a year earlier.

In 1988, imports were 55 percent higher than in 1987, reflecting the trade liberalization measures put into effect at the end of 1987 and the real appreciation of the peso during the year. Over the same period, oil exports were 22 percent lower, but non-oil exports were 19 percent higher. The trade surplus, including in-bond industries, fell to \$4 billion in 1988 from \$10 billion in 1987. A \$3 billion current account deficit was recorded in 1988, after a surplus of nearly \$4 billion in 1987.

In February and early March, interest rates in Mexico continued to ease. At the March 14 auction, the 28-day Treasury bill rate was 47 percent, compared with the recent peak of 52 percent in late-December 1988.

Brazil's Summer Plan measures, introduced on January 15, were effective in reducing measured consumer price inflation from 35.5 percent in January to 3.6 percent in February. However, this decline is mainly due to the imposition of wage and price controls. It is not yet clear how effective the plan has been in reducing the underlying rate of inflation. President Sarney has not been able to move forward to any significant degree with promised reductions in the public sector work force or privatization of state enterprises.

The Brazilian Congress passed legislation March 20 concerning the credit portion of the government's central budget, about 20 percent of the overall budget, that restores most of the expenditures that had been vetoed by President Sarney in a previous version of the budget. Sarney signed the legislation as part of a budget compromise. Legislation concerning the remaining 80 percent of the budget should be addressed in upcoming weeks.

In mid-March, the Brazilian Congress authorized the executive branch to pay \$200 million in arrears to external bank creditors. This payment, along with a \$450 million interest payment to banks that was originally scheduled for March 15, should be completed soon. Commercial banks have signed waivers of covenants that will allow disbursement of \$600 million in new money from the 1988 financing agreement. These

funds were originally conditional on disbursement from the \$500 million World Bank Power Sector II loan that is now unlikely to go forward. Up to \$1 billion in environmental and power sector project loans are being considered in part to replace this loan. An IMF mission will visit Brazil in early April mainly to analyze the prospects for fiscal adjustment in 1989.

In Argentina, a surge in the demand for dollars at the beginning of February led the government to fix the exchange rate for imports and cease to intervene in the market for foreign exchange used for financial transactions; the exchange rate applicable to most exports has remained fixed by the authorities. Since then, the free market rate used for financial transactions has depreciated by more than 100 percent. The exchange rate has stabilized somewhat in recent weeks, in part due to the resumption of some intervention. As a result of reduced demand for austral-denominated assets and tight monetary policy, calculated real interest rates on short-term instruments now exceed 10 percent per month.

Inflation rose from 6.8 percent on a monthly basis in December 1988 to 8.9 percent in January 1989 and 9.6 percent in February. At the end of February, key business groups withdrew support from the voluntary price guidelines that had helped reduce inflation from last August's peak levels. March inflation is projected at 15 percent.

On March 2, the World Bank announced it was discontinuing disbursements on its trade and banking sector loans approved last October due to Argentina's failure to achieve sufficient progress in

implementing macroeconomic reforms. Half of the \$300 million trade sector loan has already been disbursed, while the \$400 million banking sector loan never became effective.

The Philippines reached agreement with an IMF mission on March 8 on a new three-year IMF economic program totaling \$1.2 billion. Of this amount, \$870 million would be provided from the Extended Fund Facility and \$375 million from the Compensatory and Contingency Financing Facility. A signed letter of intent has been sent to the Fund and its Executive Board is likely to consider the program in early May. Philippine officials are likely to request new loans from commercial banks in early April.

The impact of the interruption in fruit exports from Chile on its overall trade balance is not expected to be severe.