Prefatory Note

The attached document represents the most complete and accurate version available based on original copies culled from the files of the FOMC Secretariat at the Board of Governors of the Federal Reserve System. This electronic document was created through a comprehensive digitization process which included identifying the best-preserved paper copies, scanning those copies,[1] and then making the scanned versions text-searchable.[2] Though a stringent quality assurance process was employed, some imperfections may remain.

Please note that this document may contain occasional gaps in the text. These gaps are the result of a redaction process that removed information obtained on a confidential basis. All redacted passages are exempt from disclosure under applicable provisions of the Freedom of Information Act.

[1] In some cases, original copies needed to be photocopied before being scanned into electronic format. All scanned images were deskewed (to remove the effects of printer- and scanner-introduced tilting) and lightly cleaned (to remove dark spots caused by staple holes, hole punches, and other blemishes caused after initial printing).
[2] A two-step process was used. An advanced optimal character recognition computer program (OCR) first created electronic text from the document image. Where the OCR results were inconclusive, staff checked and corrected the text as necessary. Please note that the numbers and text in charts and tables were not reliably recognized by the OCR process and were not checked or corrected by staff.

Confidential (FR) Class III FOMC

September 27, 1989

RECENT DEVELOPMENTS

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

TABLE OF CONTENTS

The economy appears to have continued growing moderately through the summer. Resource utilization rates have been essentially stable in the aggregate, but inflation has abated, owing to a steep decline in energy prices and the effects of this year's higher dollar. Consumer outlays have paced the expansion in spending in the current quarter, although much of the gain has reflected clearance sales of remaining 1989-model cars. Business equipment spending, albeit not so strong as in the first half, has continued to expand at a healthy rate, and nonresidential construction appears to have rebounded after a sharp first-half decline. The July figures on exports suggest smaller gains this quarter than earlier this year.

Labor Markets

Growth in labor demand seems to have tapered off a bit. Abstracting from strike effects, private payroll employment growth measured less than 160,000 per month in July and August, noticeably below the pace of the second quarter.[1] Hiring was brisk in the services industry in August, with further gains in health and business services and a pickup in finance, insurance, and real estate. In contrast, factory hiring remained relatively sluggish; a small gain in August was centered in the auto industry, where shutdowns for model changeover came to an end and most autoworkers returned from temporary layoff.

1. Wildcat stoppages in the coalfields depressed the July payroll count. Workers at four of the seven regional phone companies were on strike during the August survey week. However, the return to work of 20,000 coal miners and 8,000 grocery store workers reduced the net strike effect in August to 108,000. Currently, only workers at NYNEX remain on strike.

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

	1987	1988	1988 Q4	1989 Q1	1989 Q2	1989 June	1989 July	1989 Aug.
	---------------	Average	Monthly	Changes	---------------			
Nonfarm payroll employment[2]	268	276	297	264	240	297	184	110
Private	241	248	279	239	198	261	146	53
Strike-adjusted	238	248	274	250	203	272	155	161
Manufacturing	29	29	53	30	-10	-17	9	11
Durable	16	20	34	13	-12	-27	-13	13
Nondurable	13	9	19	17	2	10	22	-2
Construction	15	14	17	13	10	0	34	8
Trade	61	64	65	77	32	31	41	25
Finance, insurance and real estate	15	11	16	10	11	18	4	24
Services	107	118	114	97	137	220	41	85
Total government	27	27	17	25	42	36	38	57
Private nonfarm production workers	199	197	223	202	151	240	107	37
Manufacturing production workers	25	20	41	19	-14	-26	15	9
Total employment[3]	257	189	213	376	135	326	-82	138
Nonagricultural	252	191	207	371	172	343	-205	50

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 Q4	1989 Q1	1989 Q2	1989 June	1989 July	1989 Aug.
Civilian, 16 years and older	6.2	5.5	5.3	5.2	5.3	5.3	5.2	5.2
Teenagers	16.9	15.3	14.6	15.0	15.1	15.6	14.7	14.5
20-24 years old	9.7	8.7	8.7	8.4	8.3	8.9	8.6	8.8
Men, 25 years and older	4.8	4.2	4.1	4.0	3.9	3.7	3.7	3.7
Women, 25 years and older	4.8	4.3	4.2	4.0	4.3	4.4	4.4	4.2
White	5.3	4.7	4.6	4.4	4.5	4.5	4.6	4.5
Black	13.0	11.7	11.3	11.6	11.2	11.9	10.9	11.1
Fulltime workers	5.8	5.2	5.0	4.9	4.9	4.8	4.9	4.9
Memo:								
Total national[1]	6.1	5.4	5.3	5.1	5.2	5.2	5.2	5.1

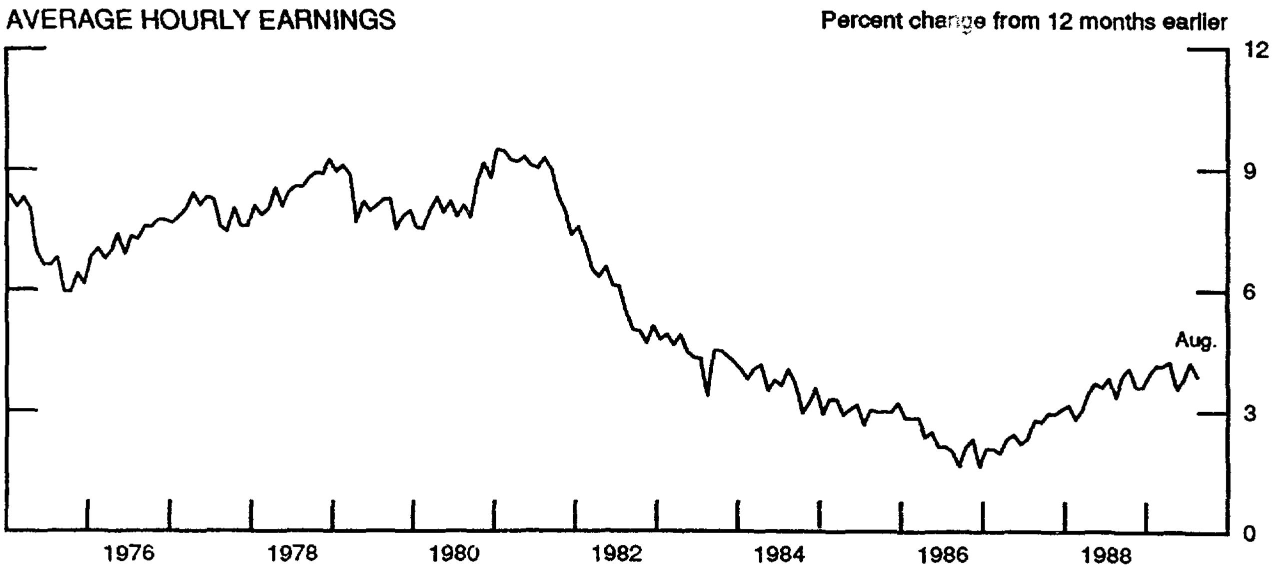
1. Includes resident armed forces as employed.

Average weekly hours of production or nonsupervisory workers fell 0.2 hour in August, reversing the large increase posted in July. This decline pushed the index of aggregate weekly hours down 0.5 percent, after an increase of 0.9 percent in July. Assuming a moderate rise in aggregate hours in September, the increase for the quarter will be about 2-1/4 percent at an annual rate.

Moderate employment gains reported in the household survey have matched increases in the labor force in recent months, and the unemployment rate has remained around 5-1/4 percent, little changed from the rate seen at the beginning of the year. Other measures from the household survey also indicate flatness in the degree of labor utilization; in particular, the number of job losers was unchanged in August, as was the number of individuals involuntarily employed part-time. Initial claims for unemployment insurance through September 9 remained in the relatively low range seen since early this summer.

Average hourly earnings--the only monthly indicator of wage change--edged down 0.1 percent in August, after jumping 0.8 percent in the previous month. The declines occurred largely in industries that had reported large gains in July. If hourly earnings rise a couple of tenths or so in September, the average increase (annualized) for this quarter will be about 4-1/4 percent, a shade above the average pace of recent quarters.

Little other information on wages has become available since the last Greenbook. Revised estimates of second-quarter productivity and labor costs from the BLS did not alter the figures reported earlier on compensation per hour. This measure of hourly compensation has risen 5.5 percent over the year ending in the second quarter, a percentage point above the increase in



AVERAGE HOURLY EARNINGS
(Percent changes based on seasonally adjusted data)

Period		Total private nonfarm	Manufac- turing	Total trade	Services	*Memo:* Hourly Earnings Index [1]
Changes over the year (Q4/Q4)						
1985		3.2	3.4	2.0	4.3	3.1
1986		1.9	1.4	1.4	2.9	2.3
1987		3.0	2.3	2.1	4.7	2.6
1988		3.7	3.0	4.1	4.9	3.5
August 1988 to August 1989		3.9	3.2	4.1	5.4	3.6
Quarterly average changes at compound annual rates						
1988	Q2	4.7	4.2	4.3	5.4	3.8
	Q3	3.5	2.7	3.9	4.9	2.9
	Q4	4.4	3.4	4.6	5.2	4.1
1989	Q1	3.6	2.6	3.6	5.4	3.0
	Q2	4.0	2.2	4.0	6.1	3.8
Monthly changes not at annual rates						
1989	Apr.	.7	.0	.9	.9	.6
	May	-.1	.2	-.5	.1	.0
	June	.2	.3	.5	.1	.2
	July	.8	.4	.5	1.3	.7
	August	-.1	.4	.1	-.3	-.1

1. Values through 1988 were constructed by the BLS. Later values were constructed by FRB staff.

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

	1987	1988	1988 Q3	1988 Q4	1989 Q1	1989 Q2	1989 Aug. Monthly
Employment cost index[1]							
Compensation, all persons	3.3	4.9	3.9	4.8	4.5	4.7	--
By occupation:							
White collar	3.7	5.0	4.3	5.7	5.5	4.8	--
Blue collar	3.1	4.4	2.8	3.8	3.5	4.6	--
Service workers	2.4	5.3	5.3	4.8	3.9	4.2	--
By sector:							
Goods-producing	3.1	4.4	2.9	3.5	3.6	4.3	--
Service-producing	3.7	5.1	4.3	5.9	5.5	5.1	--
By bargaining status:							
Union	2.8	3.9	3.1	2.4	2.6	4.1	--
Nonunion	3.6	5.1	4.2	5.8	5.2	4.7	--
Wages and salaries, all persons	3.3	4.1	3.7	5.0	3.9	3.9	--
Benefits, all persons	3.5	6.8	4.1	4.9	7.0	6.4	--
Labor costs and productivity, all persons[2]							
Nonfarm business sector							
Output per hour	2.5	1.7	3.4	1.9	-1.3	.7	--
Compensation per hour	4.0	4.9	5.5	5.9	4.8	5.6	--
Unit labor costs	1.5	3.1	2.0	3.9	6.2	4.9	--
Manufacturing							
Output per hour	3.8	3.7	5.2	2.3	2.1	2.9	--
Compensation per hour	2.4	5.3	4.9	5.9	3.1	2.4	--
Unit labor costs	-1.4	1.5	-.3	3.5	1.0	-.4	--
Major collective bargaining agreements[3]							
First-year wage adjustments	2.2	2.5	2.5	2.6	3.2	3.7	--
Total effective wage change	3.1	2.6	2.9	2.6	2.7	2.8	--
Average hourly earnings, production workers[2]							
Total private nonfarm	3.0	3.7	3.5	4.4	3.6	4.0	-.1
Manufacturing	2.3	3.0	2.7	3.4	2.6	2.2	.4
Services	4.7	4.9	4.9	5.2	5.4	6.1	-.3
Hourly earnings index, wages of production workers[4]							
Total private nonfarm	2.6	3.5	2.9	4.1	3.0	3.8	-.1

1. Changes are from final month of preceding period to final month of period indicated at a compound annual rate. The data are seasonally adjusted by FRB staff.
2. Changes over periods longer than one quarter are measured final quarter of preceding period to final quarter of period indicated at a compound annual rate. Seasonally adjusted data.
3. Agreements covering 1,000 or more workers; not seasonally adjusted. The numbers reported are cumulative averages from the beginning of the year through the indicated quarter.
4. Values for the HEI after 1988 were produced by FRB staff.

the ECI measure; much of the gap appears to stem from differences in the estimates of wage change for supervisory workers. Productivity growth for the second quarter was revised up, largely because of sizable upward adjustments in the growth of output, and is estimated to have risen 0.7 percent at an annual rate. In the manufacturing sector, productivity grew 2.9 percent at an annual rate.

Industrial Production

Total industrial production rose 0.3 percent in August, slightly above the upward-revised average monthly growth rate for May through July. Much of the August growth was attributable to rebounds in production at auto and truck assembly plants and at coal mines. Although automakers' schedules call for a further rise in assemblies this fall, new orders placed with other manufacturers of durable goods have flattened out this year. Output gains, overall, thus seem likely to be relatively small in coming months.

Output of final products rose 0.3 percent in August; excluding auto and truck assemblies, it was little changed. Output of consumer goods, excluding automotive products, edged down in August with small, widespread declines in nondurable goods. Growth in the output of consumer nondurables has slowed steadily in the last year, and production of home goods, which had been increasing rapidly earlier in the year, has changed little, on balance, during the past two months.

Production of business equipment grew 0.6 percent in August after having edged down slightly, on net, in the previous two months. The increase in equipment output in August resulted principally from the rebound in motor vehicles. Output of manufacturing equipment, which had been climbing steeply since last year, fell in August after increasing only

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

	1987[1]	1988[1]	1989 Q1	1989 Q2[r]	1989 June[r]	1989 July[r]	1989 Aug.[p]
			-Annual rate-		---Monthly rate---		
Total Index	5.8	5.0	2.1	3.2	.2	.1	.3
Previous	*5.8*	*5.0*	*2.6*	*-.1*	*.2*	*.2*	
Ex. motor vehicles	5.9	4.9	2.3	3.9	.3	.3	.2
Products	4.9	5.4	4.3	4.5	.4	-.2	.3
Consumer goods	3.2	6.0	4.1	2.6	.3	-.5	.1
Motor vehicles	4.4	8.8	.0	-6.9	-2.2	-4.3	2.5
Ex. motor vehicles	3.0	5.6	4.6	3.9	.6	-.1	-.2
Durables ex. motor veh.	4.0	3.9	5.0	7.5	1.0	-.7	.6
Nondurable goods	2.8	6.0	4.5	3.2	.5	.1	-.3
Business equipment	7.0	8.3	9.6	9.3	.2	-.3	.6
Motor vehicles	3.9	10.7	-14.1	-12.3	-2.6	-7.7	7.1
Computers	9.8	8.2	28.6	18.8	-1.0	-1.4	.0
Manufacturing equipment	6.2	12.7	3.3	9.9	.8	.1	-.4
Other	5.8	6.2	3.9	5.7	1.2	1.3	.6
Materials	7.2	4.6	-1.3	1.1	-.1	.6	.4
Excluding coal	7.0	4.6	-.7	1.8	.1	.6	.2
Durable	8.0	6.9	-1.7	1.1	.4	.4	.1
Nondurable	8.1	4.1	3.0	2.2	.5	1.2	-.3
Textile	6.5	-2.9	6.2	19.6	2.1	.4	-1.6
Paper	5.9	2.4	-.6	-7.2	-.1	1.8	-.8
Chemical	12.6	6.4	3.5	.8	.6	1.9	.3
Energy	4.5	-.1	-5.2	-.3	-2.1	.1	1.8
Coal	12.1	4.0	-15.2	-15.1	-4.2	-.4	3.2
Excluding coal	2.8	-1.0	-2.6	3.4	-1.7	.2	1.5

1. From the fourth quarter of the previous year to the fourth quarter of the year indicated.
r--revised.
p--preliminary.

slightly in July. Production of office and computing machinery continued in its summer-long slump.

Output of materials increased 0.4 percent in August, with much of the gain resulting from the return to work of most striking coal miners; excluding coal mining, materials production held steady in August after two months of moderate gains. Total materials production has grown less than 1 percent at an annual rate so far this year after rising at more than a 5 percent rate during 1987 and 1988. The slowdown, while widespread, has been especially dramatic among producers of durable goods materials.

Capacity utilization in manufacturing, mining, and utilities was unchanged in August at 83.8 percent. The operating rate for mining jumped 2.0 percentage points as a result of the rebound in coal mining, but this increase was partially offset by a weather-related decline in the operating rate for utilities. Utilization for manufacturing edged down in August to 84.0 percent. Within manufacturing, the operating rate for advanced processing industries was unchanged, while utilization for primary processing edged lower. After having risen steadily from early 1987 into the spring of this year, the operating rate for advanced processing has not increased since April. Utilization for primary processing industries stands at about 1/2 percentage point below its level of a year ago; it has fluctuated between 86 and 87 percent since February.

<u>Personal Income and Consumption</u>

Although the consumption data for the third quarter still are preliminary and incomplete, it appears that the growth of real personal consumption expenditures has significantly exceeded the 1.9 percent annual rate of increase recorded in the second quarter. While much of this pickup

CAPACITY UTILIZATION IN INDUSTRY[1]
(Percent of capacity; seasonally adjusted)

	1967-88 Ave.	1973 Ave.	1978-79 Ave.	1988 Aug.	1989 June	1989 July	1989 Aug.
Total industry	81.6	87.9	85.0	83.8	83.9	83.8	83.8
Manufacturing	80.7	87.0	84.4	84.0	84.3	84.1	84.0
Primary processing	82.0	91.3	86.3	87.4	86.2	87.0	86.8
Advanced processing	80.2	85.1	83.3	82.4	83.4	82.8	82.8
Durable manufacturing	78.8	86.2	83.5	82.3	82.9	82.4	82.6
Primary metals	79.9	96.6	87.8	88.8	84.0	85.6	85.8
Iron and steel	79.0	97.9	88.2	88.2	80.2	82.0	82.7
Nonferrous metals	81.5	94.2	87.1	89.6	89.0	90.3	89.9
Nonelectrical machinery	78.2	86.6	83.2	82.7	86.6	85.9	85.6
Motor vehicles & parts	78.2	94.5	83.6	82.0	80.2	75.8	78.4
Autos	76.1	89.3	81.7	70.7	69.6	61.8	65.8
Aerosp. & misc. trans. eq.	78.1	75.4	77.6	85.8	87.8	89.3	88.4
Nondurable manufacturing	83.6	88.1	85.7	86.4	86.4	86.4	86.1
Textile mill products	85.2	90.1	86.7	89.3	93.3	94.2	92.9
Paper and products	88.8	94.2	89.4	94.8	90.9	91.8	90.8
Chemicals and products	79.3	86.9	81.4	88.6	87.6	87.7	87.3
Mining	86.5	91.4	90.5	82.2	81.2	81.6	83.6
Utilities	86.7	92.8	85.3	83.9	80.6	81.3	80.4
Memo:							
Industrial materials	82.3	91.1	86.7	84.3	83.5	83.8	84.0
Raw steel	80.7	100.4	90.7	98.0	85.4	85.4	86.3
Aluminum	87.8	93.8	94.0	100.5	99.6	101.3	101.4
Paper materials	92.0	96.8	92.1	98.4	92.8	94.1	92.9
Chemical materials	81.3	91.1	85.9	89.0	88.5	89.8	89.7
Energy materials	88.9	93.7	89.4	86.6	83.7	83.8	85.4

1. Data for iron and steel, nonferrous metals, textile mill products, paper and products, chemicals and products, rubber and plastic products, raw steel, aluminum, paper materials, and chemical materials are unpublished estimates for August.

is attributable to higher spending on cars and light trucks, consumption gains outside of motor vehicles also appear to be running somewhat above their relatively sluggish second-quarter pace. In August, consumption of goods excluding motor vehicles is estimated to have risen 0.4 percent, reflecting increased purchases of apparel; these gains were partially offset by estimates of lower consumer expenditures on food and gasoline. Service expenditures rose 0.4 percent last month. Spending on natural gas and electricity moved back up in August, following weather-related declines in June and July, while consumption of nonenergy services rose 0.3 percent, a bit below the average spending increases recorded so far this year.

Real disposable personal income rose 0.5 percent in August, the same pace as recorded in July. For the quarter as a whole, nominal personal income gains are likely to be smaller than on average over the first half of the year, but slower price increases should produce an acceleration of real spendable income. The personal saving rate has remained in the 5-1/2 percent neighborhood observed in the first half.

Recently, the rate of inflation in the prices of consumer goods excluding food and energy has fallen relative to the rate of inflation for nonenergy services. Despite the change in relative prices, the composition of consumer spending has not made a corresponding shift; so far this year, with outlays for goods rising less than service expenditures, the share of services in total real consumption has risen. Such a positive relationship between relative service expenditures and prices represents a continuation of trends that have been present through most of the postwar period. This result suggests that the long-run income-elasticity for services is greater

PERSONAL INCOME
(Average monthly change; billions of dollars)

		1989		1989		
	1988	Q1	Q2[r]	June[r]	July[r]	Aug.[p]
Total personal income	21.8	51.5	18.9	21.2	29.2	19.5
Wages and salaries	13.4	20.9	14.1	18.2	23.5	9.2
Private	11.2	17.3	11.9	16.1	21.2	7.0
Other labor income	1.5	1.6	1.5	1.5	1.6	1.6
Proprietors' income	.1	12.4	-5.3	-9.9	-3.5	.4
Farm	-1.2	11.2	-6.6	-11.1	-6.0	-1.2
Rent, dividends and interest	5.5	10.8	7.2	6.9	7.4	6.7
Transfer payments	3.2	9.5	2.2	5.4	1.4	2.3
Less: Personal contributions for social insurance	1.8	3.7	.8	1.1	1.1	.5
Less: Personal tax and nontax payments	.1	10.3	2.8	-8.9	4.4	2.5
Equals: Disposable personal income	21.6	41.1	16.1	30.0	24.8	17.1
Memo: Real disposable income	8.0	19.7	1.5	20.4	13.4	15.3

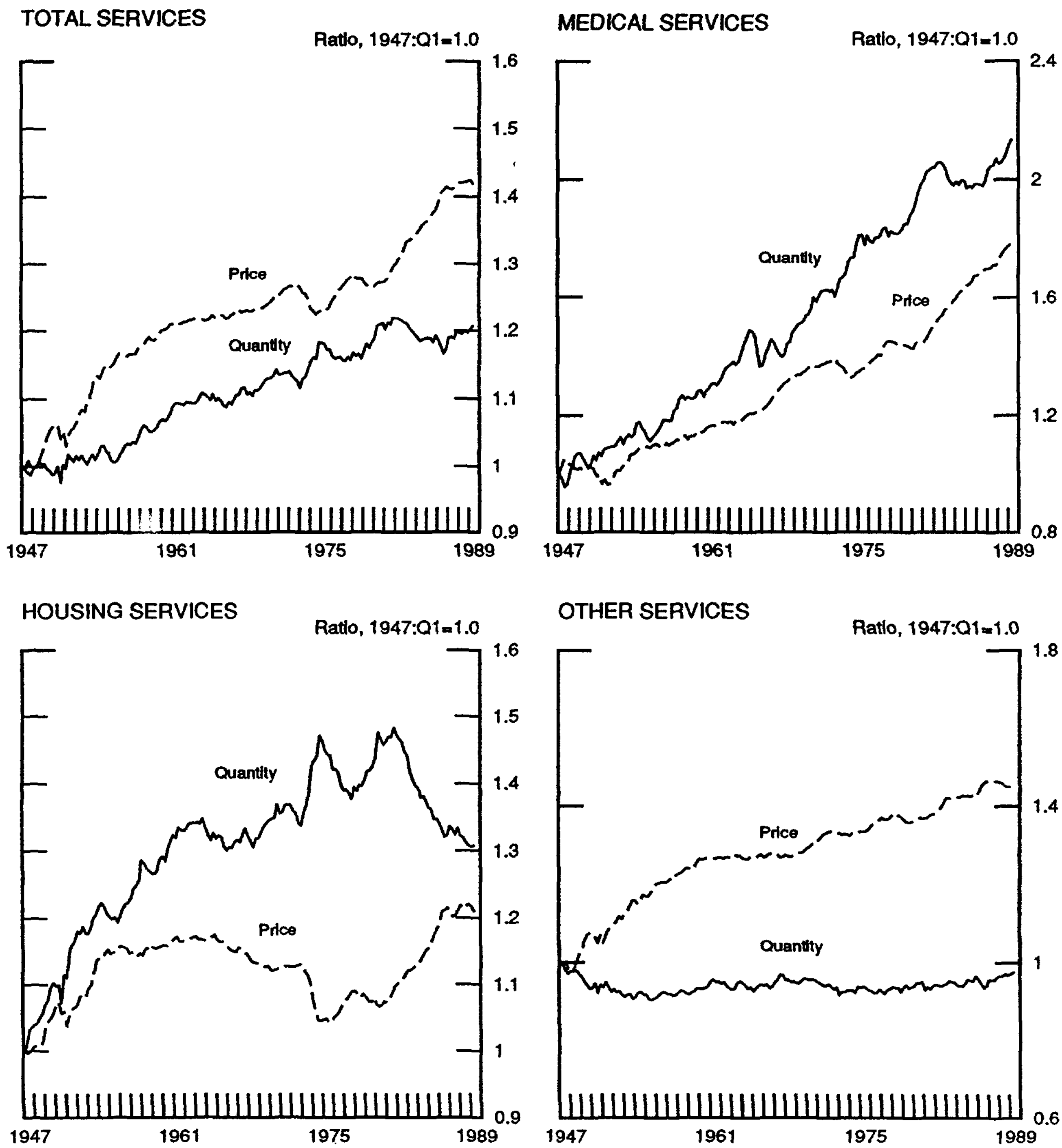
r--Revised.
P--Preliminary.

REAL PERSONAL CONSUMPTION EXPENDITURES
(Percent change from preceding period)

		1989		1989		
	1988	Q1	Q2[r]	June[r]	July[r]	Aug.[p]
	----Annual rate---			----Monthly rate---		
Personal consuption expenditures	3.8	2.0	1.9	.2	.4	1.0
Durable goods	8.0	-1.1	5.5	.4	.4	4.6
Excluding motor vehicles	8.0	5.6	8.0	.1	-1.4	1.5
Nondurable goods	2.1	1.3	-2.3	-.1	.6	.2
Excluding gasoline	2.0	1.8	-2.0	-.2	.7	.5
Services	3.6	3.6	3.8	.3	.3	.4
Excluding energy	3.4	5.0	4.0	.5	.4	.3
Memo:						
Personal saving rate (percent)	4.2	5.6	5.4	5.8	5.8	5.4

r--Revised.
p--Preliminary

Services Relative to Total Consumption Expenditures



Note: "Quantity" measures the real spending on the indicated service divided by total real personal consumption expenditures. "Price" is the PCE deflator for the indicated service divided by the deflator for total PCE.

than for goods, or that there has been some exogenous shift in consumers' tastes in favor of services, or both.[2]

Among the major service groupings, the contemporaneous uptrend in prices and quantity shares seems most pronounced in the medical area. Here, rising incomes and the low price-elasticity of demand likely support the steady common uptrend in the relative price and quantity series. The picture for housing differs: in this area, growth in real income and demographic shifts clearly helped sustain increases in relative expenditures on housing services through the 1970s; but in the 1980s, large increases in the relative rental price of housing services have been accompanied by a downtrend in the share of expenditures on housing services. Although other consumer services reflect the expected negative relationship between expenditure shares and relative prices in the 1950s, over the balance of the postwar period the expenditure share has shown no tendency to fall despite rising relative prices.

Autos and Light Trucks

Sales of domestically produced cars and light trucks picked up from an 11-3/4 million unit pace in July to a 13 million unit annual rate in August. The increase in sales probably was temporary as it came in the wake of some enhancement of incentive programs as well as the announcement of price hikes

2. Of course, measuring quality change is particularly difficult for services, and accounting for any currently unmeasured increases in quality would tend to moderate the reported rise in relative service prices. Such unmeasured quality adjustments also would suggest that increases in the quantity of services consumed may be greater than what is observed in the recorded data. It is possible that proper quality adjustment could lower service prices enough that the relative price of services would fall over the postwar period. However, this is unlikely; as costs determine prices in the long run, relative service prices could fall only if technology had advanced faster in service-producing industries than in goods-producing industries.

on 1990 model-year vehicles. Although sales moderated during the first two selling periods in September, they were still somewhat better than the average so far this year.

SALES OF AUTOMOBILES AND LIGHT TRUCKS[1]
(Millions of units at an annual rate, BEA seasonals)

	1988	1989 Q1	1989 Q2	1989 June	1989 July	1989 Aug.
Autos and light trucks	15.45	14.34	14.93	14.19	14.95	17.01
Autos	10.64	9.82	10.33	9.85	10.24	11.45
Light trucks	4.81	4.52	4.59	4.34	4.70	5.56
Domestically produced[2]	11.74	11.02	11.44	10.85	11.67	13.18
Autos	7.54	6.98	7.33	6.96	7.45	8.33
Light trucks	4.21	4.04	4.11	3.89	4.22	4.85[r]
Imports	3.70	3.32	3.49	3.34	3.28	3.83
Autos	3.10	2.84	3.01	2.89	2.79	3.12
Light trucks[3]	.60	.49	.48	.45	.48	.71[r]

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 and vehicles made in U.S. plants of foreign manufacturers.
3. Based on seasonals for domestic light trucks.
r--revised data, not seasonally adjusted.

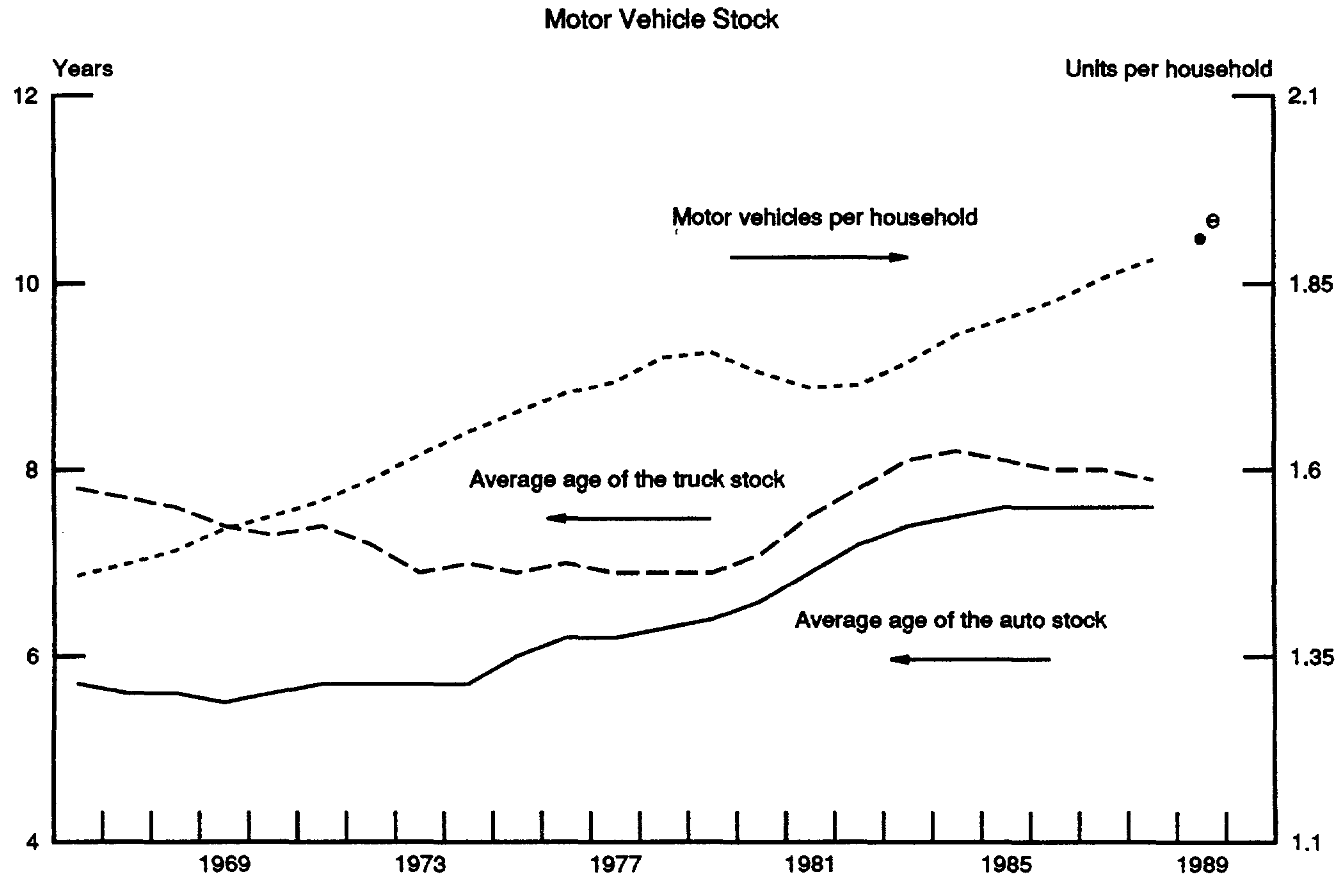
Auto production ran at an average 6-1/2 million unit annual rate in July and August, about a half million units below the average production rate recorded during the first half of the year. The slowdown in production and improvement in sales helped trim inventories of domestically produced cars to 1.6 million units by the end of August, a more comfortable level of stocks than prevailed this past spring. Automakers' current production schedules call for assemblies to run at a moderate 6-3/4 million unit rate in the fourth quarter; thus, even with the prospect of a significant retrenchment in sales this fall, a large overhang in auto inventories looks unlikely to develop in the next few months.

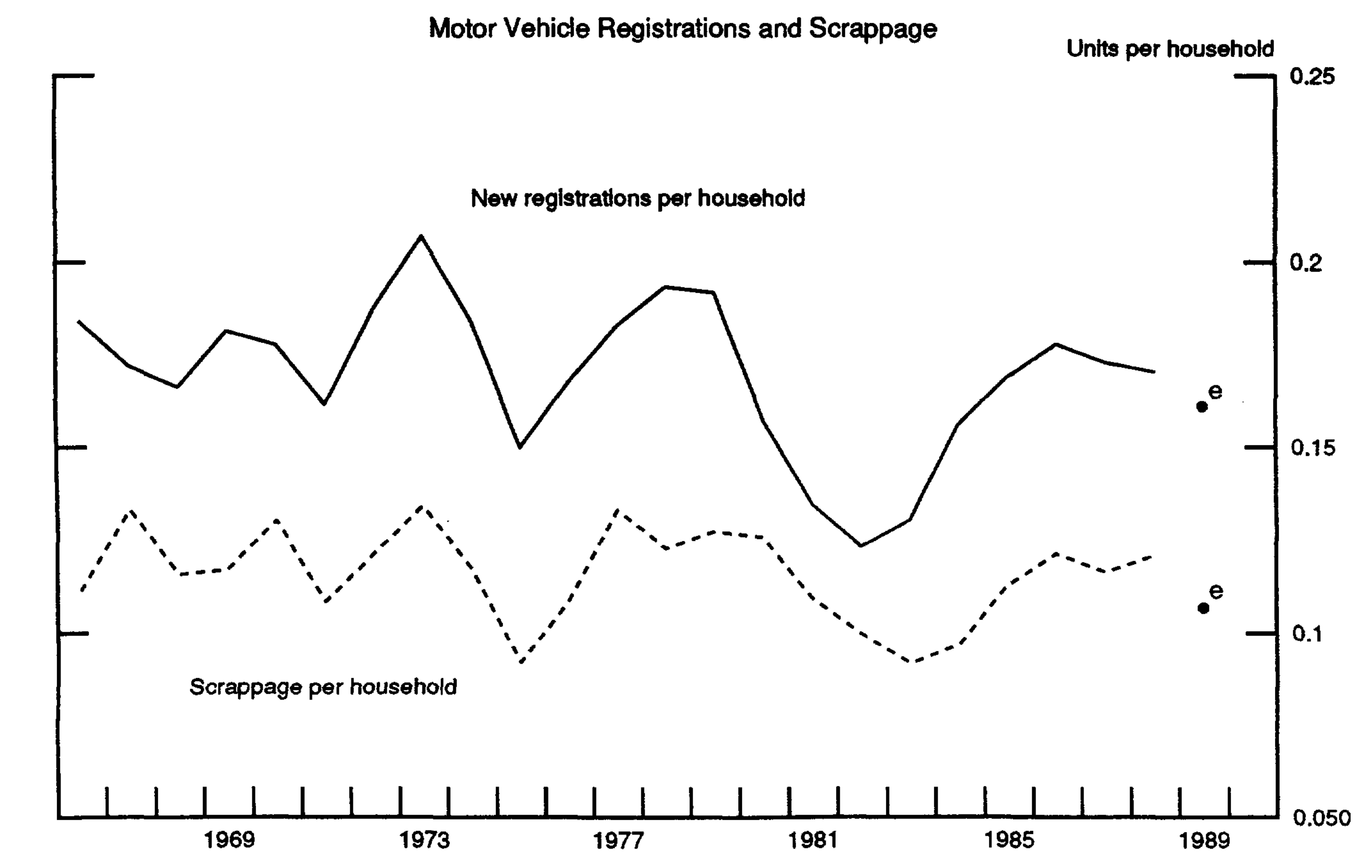
Motor vehicle sales will be influenced not only by the pricing decisions of manufacturers but also by trends in the number and age of vehicles consumers desire to own. When the current expansion began in the early 1980s, for example, the number, in terms of vehicles per household, appeared to be relatively low. This occurred because, over the preceding several years, consumers reacted to the relative increase in energy prices and the downturn in economic activity by reducing the number of vehicles per household from a peak of 1.76 to 1.71 (chart). Furthermore, the average age of the auto stock steadily increased between 1974 and 1985, and the average age of the truck stock moved up noticeably between 1979 and 1983. Consumers reduced the stock of vehicles per household and increased the average age of the stock by cutting back the rate at which they purchased new vehicles and slowing the pace at which they scrapped their existing cars and trucks.[3]

Since 1984, with the help of continued incentive programs and robust gains in income, total registrations of new vehicles have averaged about 15 million units at an annual rate. These gains have exceeded scrappage and household formation rates, and the annual increase in the number of vehicles per household has returned to the trend rate seen before the 1979 downturn. In addition, the average ages of the auto and truck stocks have remained

---

3. The total number of vehicles registered is available on an annual basis and is measured on July 1 of the recording year. Scrappage is calculated as the difference between new registrations and the change in the number of registered vehicles outstanding. Estimates of the number of cars no longer registered, but still in active use, range between 6 and 9 percent of the total number of cars recorded as scrapped. For trucks, this range is about 4 to 6 percent. The 1989 estimates for new registrations and scrappage are based on the historical average ratios of new registrations to sales and scrappage to sales and year-to-date sales of motor vehicles.


Motor Vehicle Stock
Years
Units per household
12
10
8
6
4
2.1
1.85
1.6
1.35
1.1
Motor vehicles per household
e
Average age of the truck stock
Average age of the auto stock
1969
1973
1977
1981
1985
1989


Motor Vehicle Registrations and Scrappage
Units per household
0.25
0.2
0.15
0.1
0.050
New registrations per household
e
e
Scrappage per household
1969
1973
1977
1981
1985
1989

e = estimate.

relatively constant from 1985 to 1988, the last year for which data are available. The rebuilding of the motor vehicle stock and stabilization in its average age suggest that, in the absence of movements in economic fundamentals that would change the desired level or age profile of the motor vehicle stock, stock-adjustment motives should not be exerting a strong influence on auto and truck demand.

Business Fixed Investment

Recent indicators suggest that growth in real outlays for business equipment slowed in July and August from the rapid, 12 percent annual pace during the first half of this year. In nominal terms, during the first two months of the current quarter, average shipments of nondefense capital goods excluding aircraft and computing equipment were 1.0 percent above the second-quarter level, suggesting a moderate rise in real outlays for these items. In addition, for complete aircraft, shipments in July were 1-1/2 percent above the second-quarter average. However, computer shipments probably rose only slowly in real terms. Moreover, sales of heavy trucks have slowed after a two-year boom, as a product cycle in new fuel-efficient models appears to be maturing.

Looking ahead, orders for office and computing equipment as well as for communications equipment now appear to have strengthened a bit over the summer. Moreover, for aircraft, the persistence of a large backlog of unfilled orders should ensure steady increases in future production.[4] However, bookings elsewhere have, on balance, weakened and suggest some further deceleration in spending during the remainder of 1989.

4. Aircraft production is largely capacity-constrained, but steady gains in productivity are being realized as new workers gain experience.

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

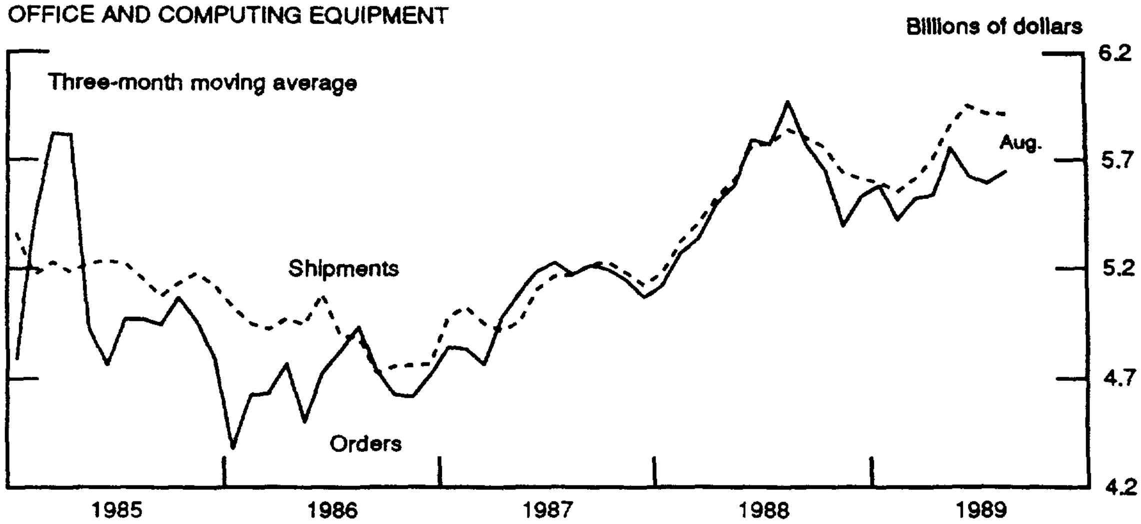
	1988	1989		1989		
	Q4	Q1	Q2	June	July	Aug.
Producers' durable equipment						
Shipments of nondefense capital goods	.9	3.2	3.0	.7	-1.4	6.1
Excluding aircraft and parts	.8	3.2	3.0	.3	-2.1	4.9
Office and computing equipment	-3.3	.0	6.1	5.8	-6.7	1.2
All other categories	1.9	4.0	2.3	-1.0	-.9	5.7
Weighted PDE shipments[1]	.8	3.0	3.1	.3	-1.1	4.8
Shipments of complete aircraft[2]	-8.9	1.2	14.7	23.7	-8.4	--
Sales of heavy-weight trucks	5.9	-3.6	-3.7	-3.3	1.2	-1.8
Orders of nondefense capital goods	.0	5.3	1.0	5.0	5.9	-9.8
Excluding aircraft and parts	-2.3	4.9	2.9	6.4	-10.3	5.3
Office and computing equipment	-4.1	-.1	1.8	-1.3	1.0	3.3
All other categories	-1.8	6.1	3.1	8.2	-12.7	5.8
Weighted PDE orders[1]	-.3	2.4	.8	1.2	-4.0	5.4
Nonresidential structures						
Construction put-in-place	.2	2.1	-.9	1.5	1.0	--
Office	-1.6	4.5	-3.4	-.5	-.8	--
Other commercial	-4.2	2.7	-6.6	2.7	.5	--
Public utilities	2.0	-2.6	2.9	1.9	.6	--
Industrial	2.9	1.6	4.0	2.2	3.1	--
All other	3.6	5.1	.7	1.4	2.6	--
Rotary drilling rigs in use	-16.0	-5.4	18.2	3.9	-.2	-1.5

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.

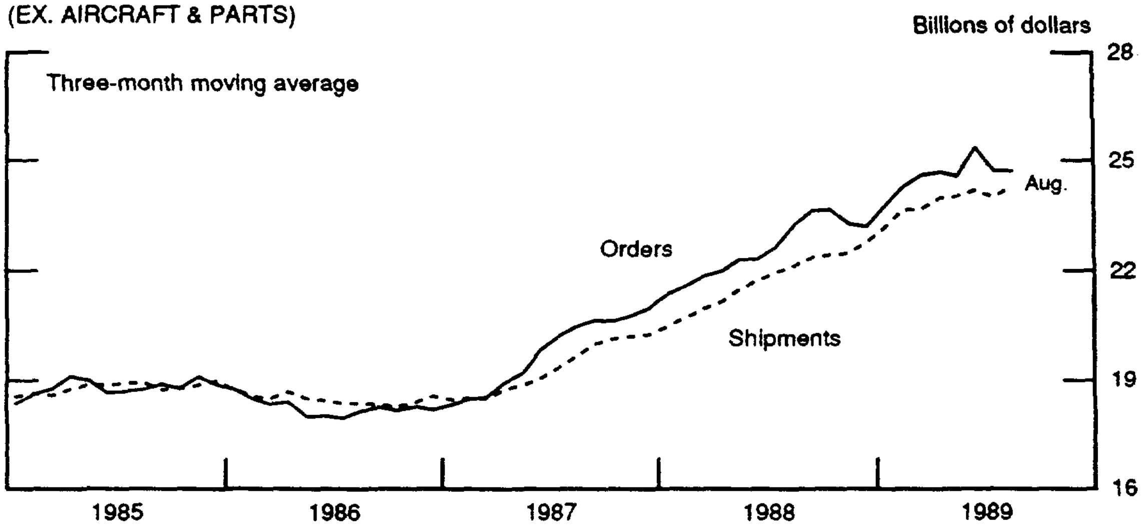
2. From the Current Industrial Report (CIR) titled "Civil Aircraft and Aircraft Engines." Seasonally adjusted with BEA seasonal factors. To estimate PDE spending for aircraft, BEA uses the aircraft shipments shown in that report, not the corresponding Census M-3 series. The CIR does not provide information on aircraft orders.

Indicators of Business Fixed Investment

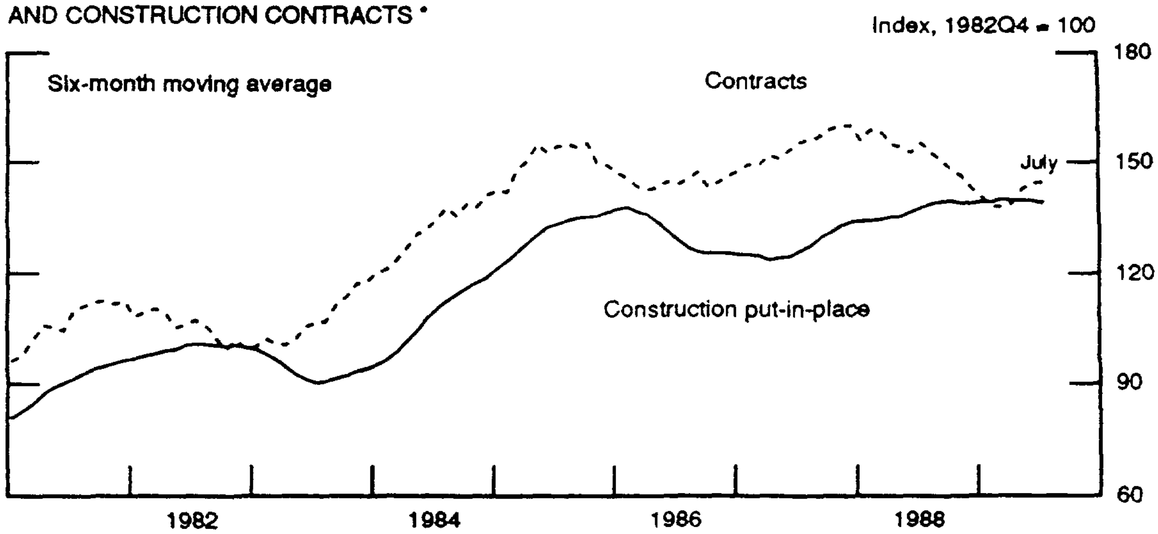
OFFICE AND COMPUTING EQUIPMENT



OTHER NONDEFENSE CAPITAL GOODS
(EX. AIRCRAFT & PARTS)



NONRESIDENTIAL CONSTRUCTION PUT-IN-PLACE
AND CONSTRUCTION CONTRACTS *



* Includes industrial, commercial, and institutional construction; derived from source data that are in current dollars.

After falling at more than a 9-1/2 percent annual rate last quarter, real outlays for nonresidential structures appear to be rebounding somewhat in the current quarter. The nominal value of construction put in place in July was 2.5 percent above the second-quarter level (not at an annual rate). All categories of construction with the exception of office construction have shown recent increases. Nonetheless, the overall trend in construction put-in-place remains fairly flat; only industrial building has posted steady increases this year. The prospects for construction after this quarter are lackluster. The value of new construction contracts has trended up, on average, through midyear, but contracts still have not come close to retracing their 1988 decline; office building remains a notable area of weakness.

The latest Commerce Department survey of business plans for plant and equipment outlays (P&E) indicates a 10 percent rise in nominal outlays this year, with broadly similar increases reported by both manufacturing and nonmanufacturing firms. Among manufacturers, the largest increases are expected by producers of paper, rubber, and aircraft--all industries in which capacity utilization rates are near historic highs. These plans, which were collected in July and August, are little changed from those reported in the spring survey.

At this point in the year, the Commerce survey is a fairly good predictor of the annual growth of P&E; however, the survey plans make larger errors if they are used to forecast nominal business fixed investment (BFI), as indicated in the table.[5] In part, the error from using the survey plans to forecast BFI reflects differences in the sources and definitions of the two series. Most important, estimates of BFI are constructed largely from data on the value of new construction put-in-place, on shipments of nondefense capital goods, and on the net exports of capital goods; the P&E series is estimated from Census surveys of expenditures by firms that purchase these buildings and equipment. Typically, the information obtained from the producers' side of this market (used in BFI) does not line up closely with that from the purchasers (used in P&E). Moreover, the two series differ significantly in coverage, with BFI a somewhat broader measure.[6] A final difference is that movements in BFI typically precede the corresponding changes in P&E because expenditures tend to occur after actual construction and shipment. These differences have led to an unusually wide gap between the two series in recent years, and even if BFI grew at exactly the same rate at which P&E is expected to grow for the remainder of 1989, year-over-year BFI growth in 1989 would be only 6 percent, well below the P&E growth rate. Over time, the historical discrepancies underlying this difference tend to be reduced when benchmark revisions are made.

5. Given the quarterly detail in the Commerce survey, the anticipated increase in nominal P&E spending from the second quarter of this year to the fourth quarter of this year is about 5-1/4 percent at an annual rate. These quarterly anticipations, however, have much wider confidence intervals than the annual ones.

6. BFI includes some industries not covered by P&E--for example, farm, real estate, professional services, forestry, and fishing. In addition, certain outlays not capitalized by businesses (and thus not reported in P&E) are included in BFI--for example, outlays for new motor vehicles held for less than one year.

SURVEYS OF PLANT AND EQUIPMENT EXPENDITURES
(Percent change from previous year, current dollars)

	1988	Planned for 1989 Commerce (Apr.-May)	Planned for 1989 Commerce (July-Aug.)
All business	10.5	9.9	10.0
Manufacturing	14.0	8.2	9.4
Durable	10.3	5.1	5.0
Nondurable	17.5	11.0	13.2
Nonmanufacturing	8.5	10.9	10.3
Memo:[1]			
Prediction of P & E			
Mean error		.2	-.2
Mean absolute error		1.5	.8
Prediction of BFI			
Mean error		-.5	.2
Mean absolute error		2.6	2.4

1. Estimated from 1962 to the present.

Business Inventories

Business inventory investment was dominated in July by large accumulations of stocks at manufacturers of motor vehicles and aircraft, and given the current circumstances in each of these industries, this stockbuilding is likely to be temporary. In aircraft, a delay in the delivery of a sizable number of Boeing 747s apparently led to a runup in both work-in-process and finished inventories in July.[7] In addition, given the large orders backlogs, aircraft production has remained at high levels and, as a result, work-in-process inventories held by aircraft

7. The Census Bureau uses the method of payment as a means of allocating aircraft stocks between the in-process and finished stages of processing. A finished aircraft may appear in work-in-process inventories if it is going to be paid for in one lump sum. Alternatively, if an aircraft is purchased with a series of progress payments, the value of those progress payments is included in stocks of finished goods.

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

	1988	1989		1989		
	Q4	Q1	Q2	May	June	July
Current-cost basis:						
Total	38.7	47.1	61.2	81.0	32.5	60.9
Ex. retail auto	41.3	42.2	47.6	65.4	28.7	60.0
Manufacturing	25.5	27.9	21.4	19.2	17.2	51.7
Ex. M.V. and aircraft	15.1	18.1	13.8	7.6	10.5	32.9
Wholesale	5.4	5.5	11.5	16.7	-.8	.3
Retail	7.8	13.8	28.3	45.2	16.1	8.9
Ex. auto	10.4	8.9	14.7	29.6	12.3	8.0
Constant-dollar basis:						
Total	24.2	10.1	16.2	22.2	18.5	39.2
Ex. retail auto	17.6	1.2	19.2	31.0	16.0	38.5
Manufacturing	12.2	3.8	8.3	5.2	9.5	35.1
Ex. M.V. and aircraft	5.7	-4.1	2.5	-2.4	4.1	20.1
Wholesale	.4	-2.1	5.2	8.1	-.2	-1.9
Retail	11.6	8.4	2.6	8.9	9.2	6.0
Ex. auto	5.1	-.6	5.7	17.7	6.7	5.2

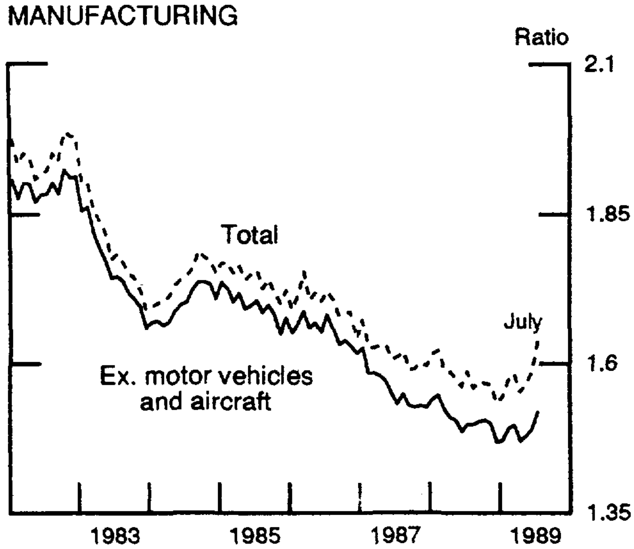
INVENTORIES RELATIVE TO SALES[1]
(Months supply; based on seasonally adjusted data)

	Range in preceding 12 months:[2] Low	High	1988 Q4	1989 Q1	1989 Q2	1989 May	June	July
Current-cost basis:								
Total	1.48	1.51	1.50	1.50	1.51	1.50	1.51	1.54
Ex. retail auto	1.46	1.48	1.48	1.47	1.48	1.47	1.48	1.51
Manufacturing	1.53	1.59	1.57	1.58	1.57	1.57	1.58	1.64
Ex. M.V. and aircraft	1.47	1.51	1.50	1.49	1.48	1.48	1.49	1.52
Wholesale	1.27	1.31	1.30	1.28	1.28	1.28	1.29	1.30
Retail	1.56	1.63	1.59	1.61	1.63	1.62	1.63	1.62
Ex. auto	1.48	1.51	1.51	1.51	1.51	1.50	1.51	1.51
Constant-dollar basis:								
Total	1.48	1.51	1.48	1.50	1.50	1.50	1.50	1.52
Ex. retail auto	1.46	1.48	1.46	1.47	1.47	1.47	1.48	1.50
Manufacturing	1.52	1.58	1.54	1.57	1.57	1.56	1.58	1.62
Ex. M.V. and aircraft	1.45	1.49	1.47	1.48	1.47	1.48	1.48	1.50
Wholesale	1.32	1.36	1.34	1.33	1.33	1.33	1.33	1.34
Retail	1.48	1.56	1.53	1.55	1.55	1.54	1.55	1.54
Ex. auto	1.43	1.45	1.45	1.45	1.46	1.45	1.45	1.46

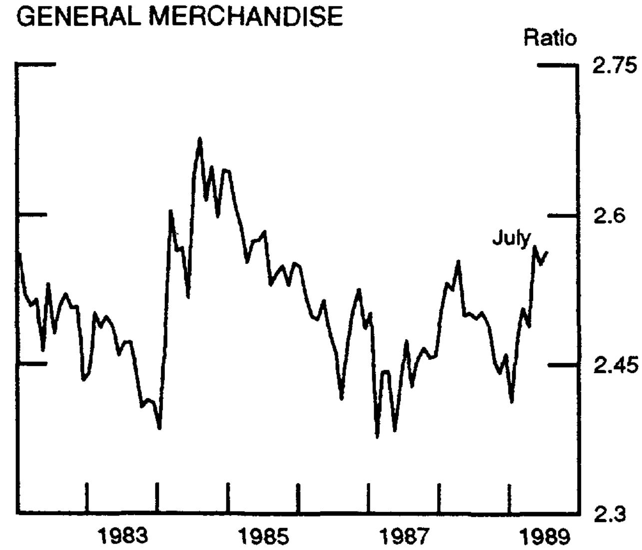
1. Ratio of end-of period inventories to average monthly sales for the period.
2. Highs and lows are specific to each series and are not necessarily coincidental. Range is for the 12-month period preceding the latest month for which data are available.

Ratio of Inventories to Sales
(Based on current-cost data)

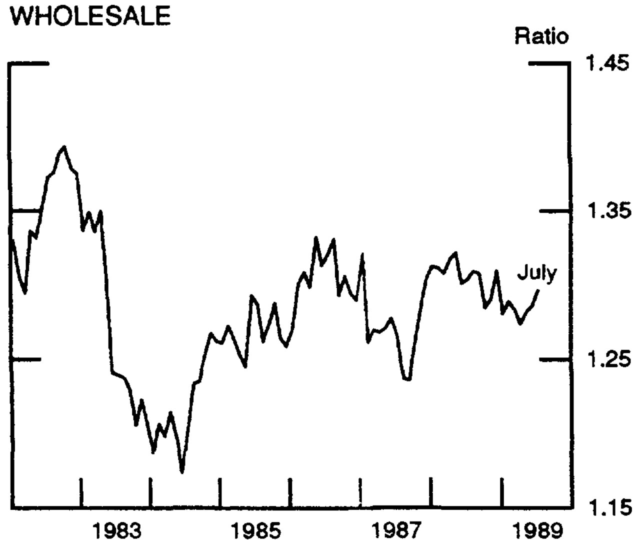
MANUFACTURING



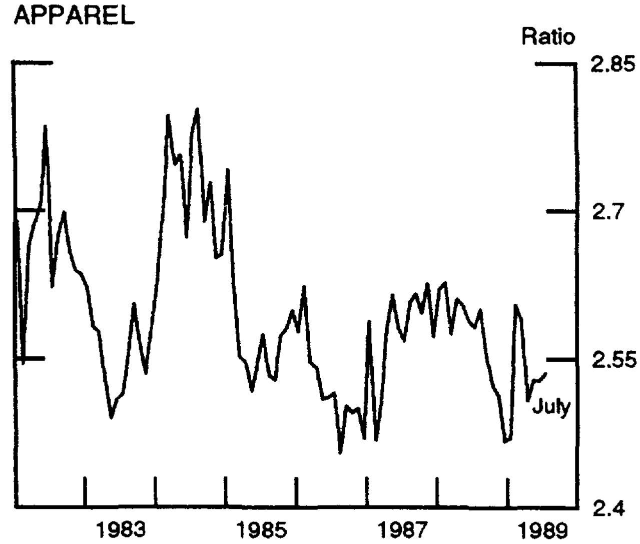
GENERAL MERCHANDISE



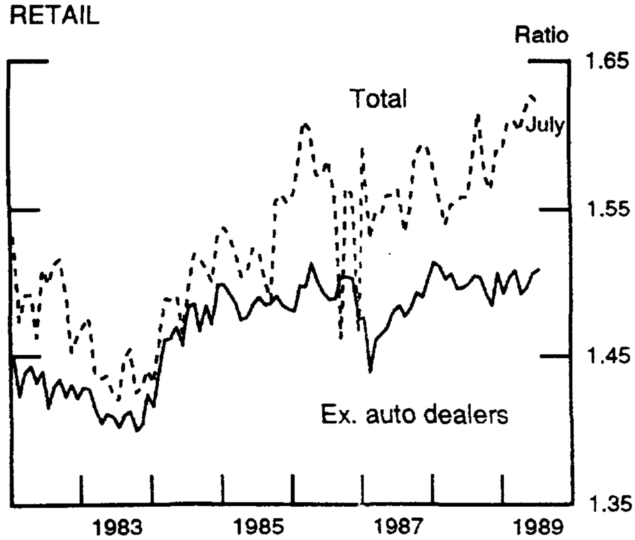
WHOLESALE



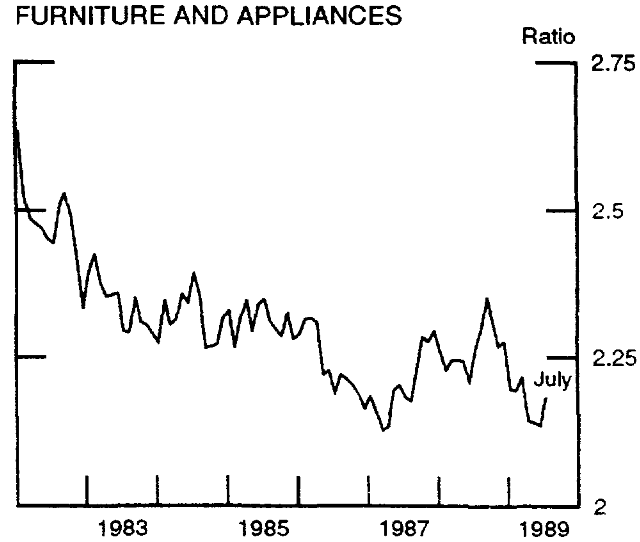
APPAREL



RETAIL



FURNITURE AND APPLIANCES



manufacturers have continued to expand. At domestic automakers, seasonal adjustment problems associated with the earlier-than-usual model changeover may have led to the measured buildup in stocks at the earlier stages of processing. Outside of motor vehicles and aircraft, stocks rose markedly at manufacturers of primary metals and of many types of machinery. However, much of this buildup was at earlier stages of fabrication; accumulations of stocks of finished goods at these industries appear to be moderate.

In the trade sector, inventories held by merchant wholesalers were reduced somewhat in June and July. Over the past year, the overall inventory-sales ratio for non-auto retailers has remained within a narrow range; indeed, the general trend in this ratio has been relatively flat since early 1988 (chart), suggesting that retailers, in the aggregate, have had their inventories under control. However, scattered reports of inventory problems persist. These reports may be consistent with the recent rise in the inventory-sales ratio at general merchandise stores to a level near the high end of the range observed over the past year; this ratio, nonetheless, was still well below the cyclical peak set in 1984. In contrast, the inventory-sales ratio for apparel stores--where sales have been strong of late--was near the mid-range of recent values and the ratio for furniture and appliance outlets is at the low end of the recent range.

Housing Markets

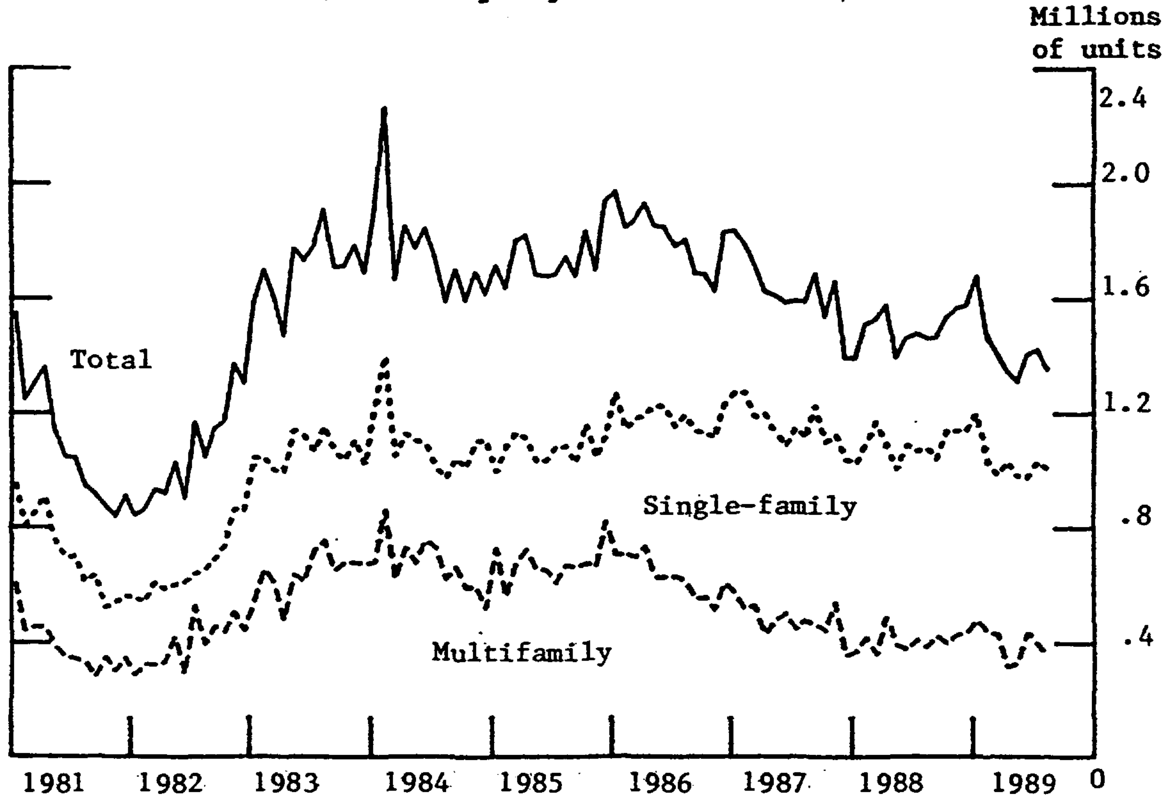
Housing demand appears to have picked up in recent months in response to lower interest rates. But, so far, builders have been cautious about undertaking new construction. Sales of existing homes in August continued to recover from the recent low in May, rising 3 percent to 3.4 million units. New home sales increased a strong 14 percent to 739,000 units in

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

	1988	1988	1989		1989		
	Annual	Q4	Q1	Q2[r]	June[r]	July[r]	Aug.[p]
All units							
Permits	1.46	1.52	1.37	1.33	1.31	1.28	1.33
Starts	1.49	1.56	1.52	1.35	1.41	1.42	1.35
Single-family units							
Permits	.99	1.04	.97	.91	.87	.91	.92
Starts	1.08	1.14	1.07	.99	.97	1.03	1.00
Sales							
New homes	.68	.68	.63	.63	.65	.74	n.a.
Existing homes	3.59	3.77	3.48	3.32	3.36	3.33	3.44
Multifamily units							
Permits	.46	.48	.40	.42	.43	.38	.41
Starts	.41	.42	.45	.36	.43	.40	.35

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

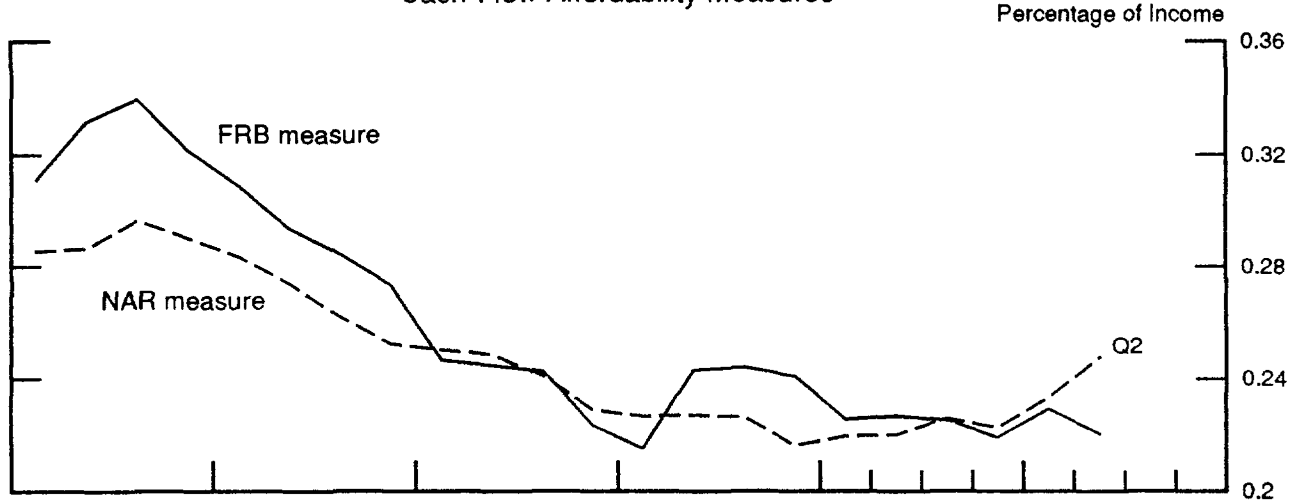
PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



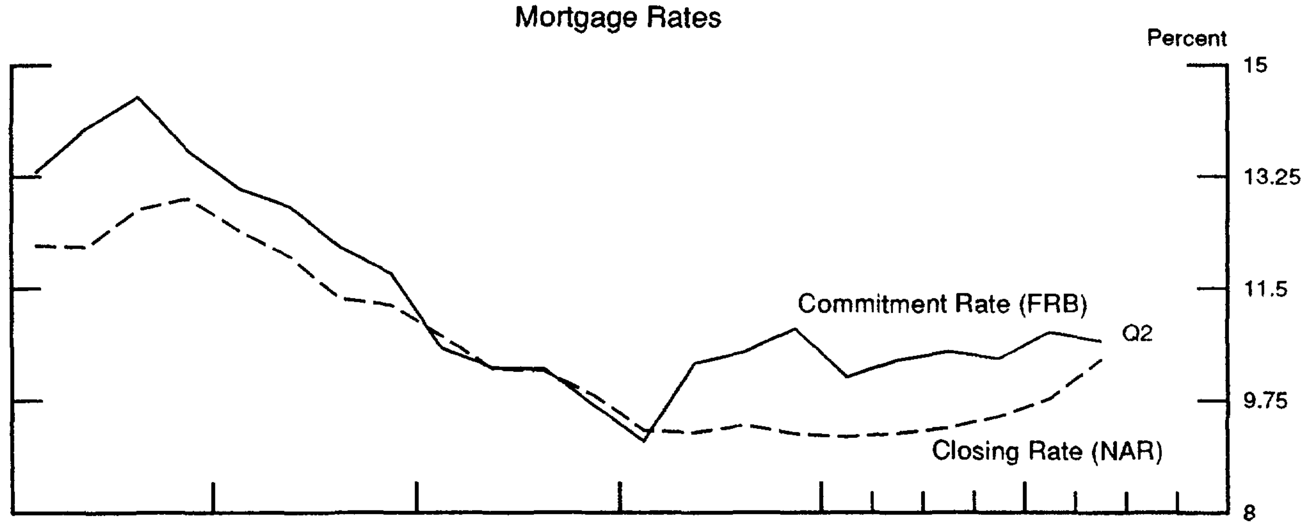
July. However, starts of new houses weakened in August because of a drop in multifamily housing starts accompanied by a small decline in single-family starts. Starts in both sectors were only slightly higher, on average, in July and August than the second-quarter level. On the whole, the increases in home sales and the small improvement in housing starts indicate a moderate response to declines since April in mortgage interest rates.

Housing affordability plays an important role in housing market developments. Cash-flow measures of affordability generally indicate the percentage of a typical household's income that would be required to pay the principal and interest on a mortgage loan to finance the purchase of a specified type of house at current prices and interest rates. However, depending on how such measures are constructed, they can lead to considerably different conclusions about housing affordability. For example, both the cash flow affordability measure calculated by the National Association of Realtors (NAR) and the one maintained by the Board staff show a declining trend since 1984 in mortgage servicing as a percent of income (chart). However, the staff measure indicates that housing affordability has remained about constant since mid-1988, while the NAR index shows an increase in the share of income required to make mortgage payments.

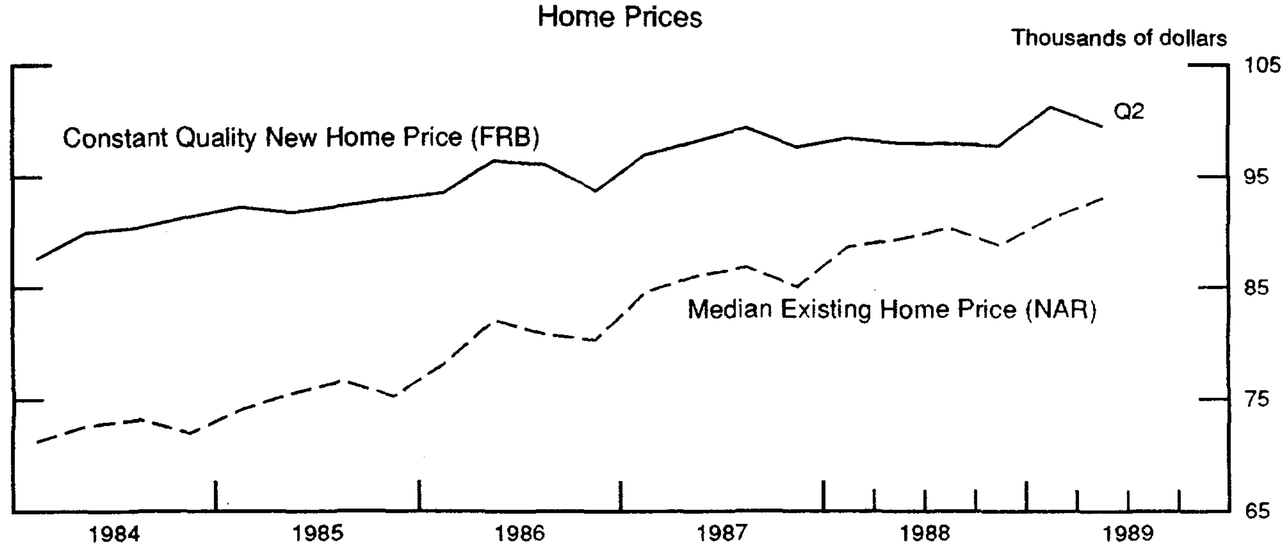
Two factors primarily account for the differences in the relative movements of these two measures. First, the staff affordability measure is constructed using a commitment rate that reflects current mortgage market conditions. By contrast, the NAR series uses a closing rate. Because the mortgage approval and settlement process typically requires several weeks, the closing rate reflects mortgage market conditions in an earlier period, Cash-Flow Affordability Measures



Mortgage Rates



Home Prices



and therefore can introduce an upward bias in the affordability measure in periods such as the recent past when mortgage rates have trended down.

Second, the NAR affordability index is based on sales prices of existing homes. Selling prices can be distorted by changes over time in the structural characteristics and the geographic composition of home sales. The staff affordability measure is based on new home prices that are adjusted to remove the effects of changes in the structural features and geographic composition of homes sold. Accordingly, the price series used in the staff affordability measure rises less rapidly than the price used by the NAR, which is biased upward by the rising quality of the housing stock and by a generally growing proportion of home sales in regions that have relatively high home prices.

Government Purchases

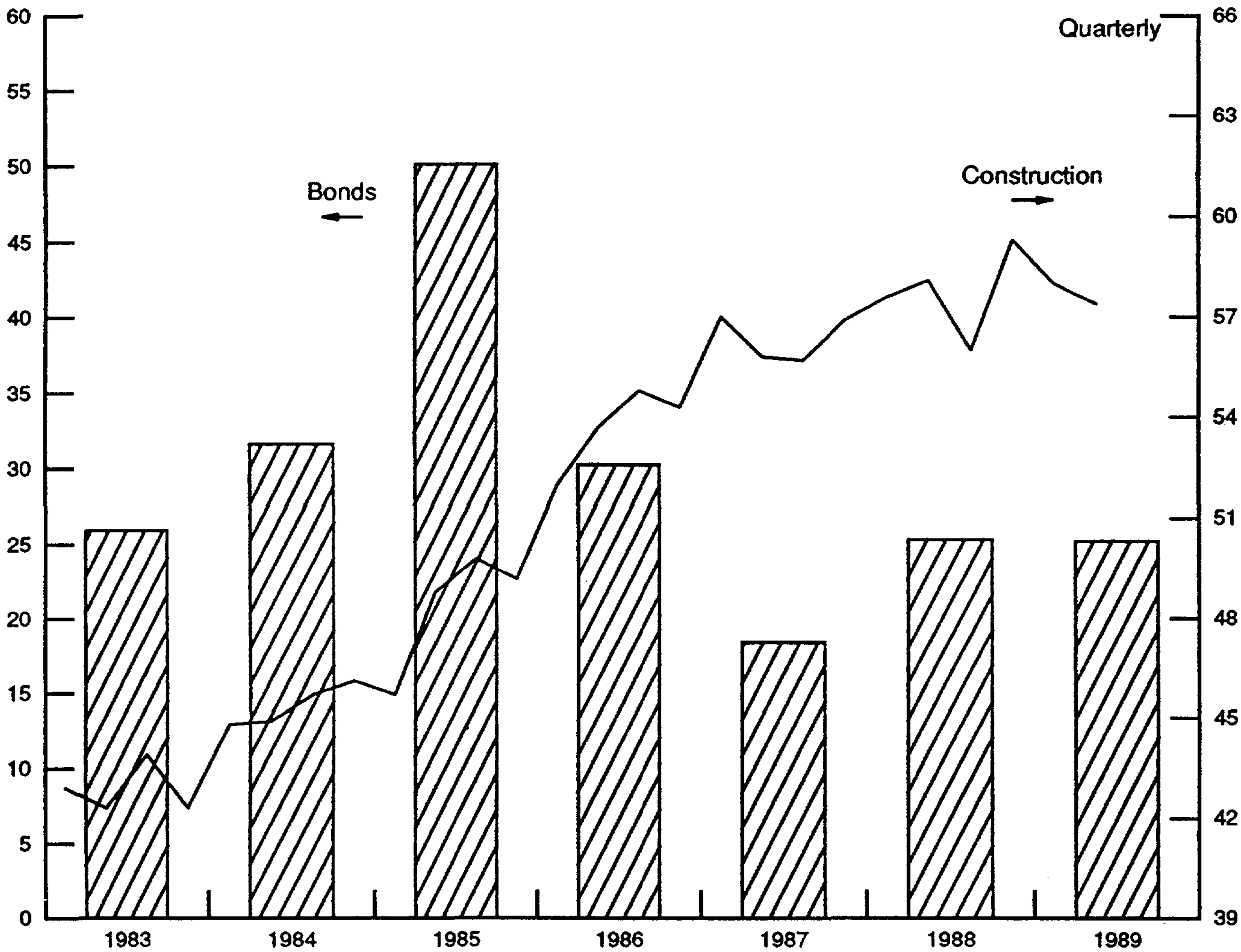
BEA's revised estimates of federal government purchases now show that real nondefense purchases, excluding CCC, rose 2 percent in the second quarter (compared with a 2-1/4 percent drop in the advance estimate), bringing them about in line with the increase expected by the staff over the year. Defense purchases were revised downward slightly, but still showed a small recovery from the plunge in the first quarter. Nonetheless, real defense purchases remain on a general downward trend, as a result of restraint in recent appropriations, and are keeping overall federal purchases excluding CCC from rising.[8]

Purchases by state and local governments appear to be increasing in the third quarter at a fairly moderate pace, after rising at almost a 2 percent

8. A discussion of recent federal budget developments can be found at the end of the nonfinancial section of this Greenbook.

State and Local Public-Purpose Bond Sales and Construction Expenditures

(Billions of 1982 $, Annual Rate)



* - Average of first eight months.

Note: Tax-exempt bonds in real terms calculated using the deflator for state and local construction. Public-purpose bond sales approximated by the sum of transportation, utility and education bonds for new capital.

annual pace over the first half. Employment growth continues to be relatively steady. Real outlays for construction also rose in July; however, the level of real construction spending in July remains slightly below the second-quarter average.

Growth in state and local outlays for infrastructure has slowed in recent years, after an unusual burst of activity in the initial stages of the current expansion. The decline in building activity over the first half of this year has been concentrated in construction of highways and water supply facilities. However, underlying factors--such as overcrowded classrooms and prisons, along with decaying roads and utilities--suggest that further growth in infrastructure spending is likely. Probably reflecting these pressures, offerings of tax-exempt bonds for construction or transportation projects, educational facilities, and utilities remained fairly strong during the first nine months of the year, suggesting plans for a well-maintained pace of construction (chart). In recent years, bond proceeds have financed around half of all state and local construction projects. In addition, state and local officials have been looking toward raising fees and charges both to help balance budgets and to raise funds for future building.

Prices

Recent price reports have been dominated by the movements in energy prices, which dropped this summer after a sharp climb earlier this year. Reflecting this influence, producer prices of finished goods actually declined in each of the past three months, while the consumer price index was flat in August following a 0.2 percent rise in July. A slowing in the prices of food and other goods also contributed to the reduced pace of

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

	Relative importance Dec. 1988	1987	1988	1989 Q1	1989 Q2	1989 July	1989 Aug.
				-Annual rate-		-Monthly rate-	
All items[2]	100.0	4.4	4.4	6.1	5.7	.2	.0
Food	16.2	3.5	5.2	8.2	5.6	.3	.2
Energy	7.3	8.2	.5	10.2	24.8	-.7	-2.0
All items less food and energy	76.5	4.2	4.7	5.2	3.8	.4	.2
Commodities	25.7	3.5	4.0	4.1	2.0	.1	-.3
Services	50.8	4.5	5.0	5.9	4.3	.6	.3
Memorandum:							
CPI-W[3]	100.0	4.5	4.4	6.2	5.7	.2	.0

1. Changes are from final month of preceding period to final month of period indicated.
2. Official index for all urban consumers.
3. Index for urban wage earners and clerical workers.

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

	Relative Importance Dec. 1988	1987	1988	1989 Q1	1989 Q2	1989 July	1989 Aug.
				-Annual rate-		-Monthly rate-	
Finished goods	100.0	2.2	4.0	10.2	5.1	-.4	-.4
Consumer foods	25.8	-.2	5.7	13.1	-2.0	.1	.3
Consumer energy	8.8	11.2	-3.6	41.0	31.0	-3.0	-7.3
Other consumer goods	39.6	2.7	4.8	5.4	5.3	-.3	.5
Capital equipment	25.8	1.3	3.6	4.6	4.1	.0	.3
Intermediate materials[2]	94.8	5.4	5.3	8.7	2.5	-.3	-.3
Excluding energy	83.4	5.2	7.2	5.5	.3	-.2	-.1
Crude food materials	43.8	1.8	14.2	16.9	-18.7	-1.1	1.7
Crude energy	36.9	10.7	-9.5	48.3	22.3	2.1	-6.7
Other crude materials	19.3	22.6	7.5	10.3	-9.8	-1.5	1.2

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

consumer inflation in July and August. So far this year, the CPI excluding food and energy has risen at about a 4-1/4 percent annual rate, somewhat below the pace in 1988.

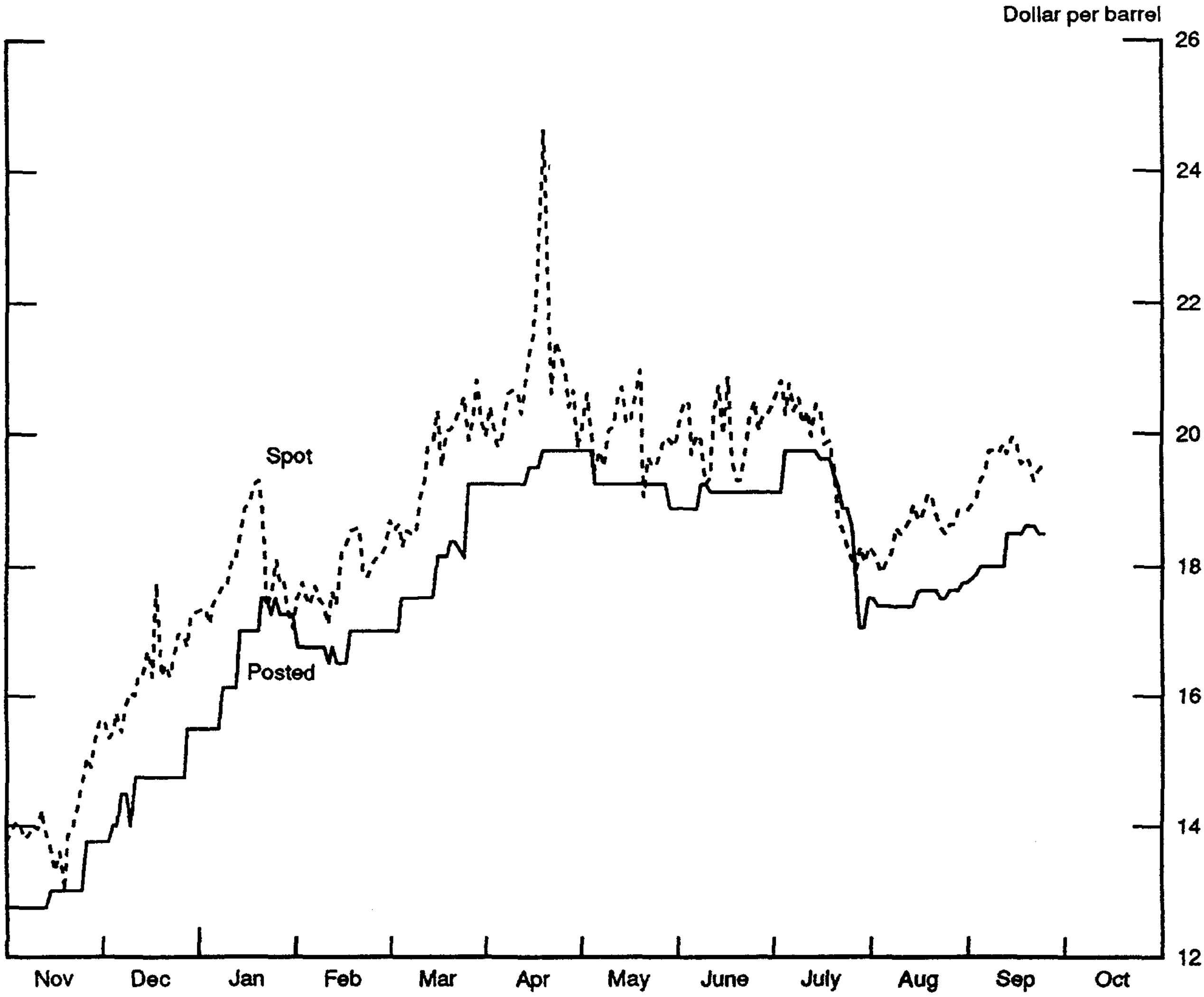
Consumer energy prices fell 2 percent in August. Gasoline prices fell 4.2 percent as the late-July slide in oil prices was passed on to the retail level. The drop in oil prices also contributed to a slight easing of consumer electricity prices, as did the milder-than-normal weather, which eased electricity demand.

Retail gasoline prices continued to decline through mid-September[9] despite a sharp rise in spot prices of both crude oil and gasoline between mid-August and mid-September and a corresponding pickup in wholesale prices of gasoline in early September. Refinery supply disruptions in Venezuela, California, and the Virgin Islands have contributed to recent pressures on spot gasoline prices. Part of the explanation for the continued decline in retail gasoline prices into September may be the normal lags in the response of retail prices to changes in crude oil costs. In addition, the change in regulatory costs at the end of the summer probably was a factor. The tighter environmental standards that increased the cost of producing gasoline over the summer months were eased in August; indeed, that change probably contributed to the 12 percent August decline in the PPI for gasoline.[10]

9. Based on the September 22 Lundberg survey of gasoline retailers.

10. Refiners' margins rose more than 5 cents, on average, in late spring and early summer. Similarly, the total spread between crude oil and retail gasoline prices was about 6 to 10 cents higher over the summer months than in the first quarter. Although it is impossible to determine with any precision, it appears that the staff's earlier estimate that tightened Reid vapor pressure standards would raise margins by about 4 cents a gallon was in the right ballpark.

Daily Spot and Posted Prices of West Texas Intermediate



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

MONTHLY AVERAGE PRICES–WEST TEXAS INTERMEDIATE

Month	Posted	Spot
October	13.29	13.80
November	12.98	13.98
December	14.55	16.27
January	16.68	17.98
February	16.79	17.83
March	17.93	19.45
April	19.46	21.04
May	19.35	20.03
June	19.07	20.01
July	19.25	19.64
August	17.49	18.55
September *	18.27	19.55

* Price through September 26, 1989.

Compiled in the Economic Activity Section, Division of Research and Statistics.

Increases in food prices at the consumer level have been small in recent months, following sharp hikes earlier in the year. In August, consumer food prices rose 0.2 percent as declines for poultry and fruits and vegetables partially offset increases for fish, dairy products, and other more processed foods. Although the August PPI for crude foods turned up 1.7 percent in August, spot prices of farm commodities suggest that this rise will be reversed in the September PPI.

Apart from food and energy, the CPI rose 0.2 percent in August after increasing 0.4 percent in July. In August, the commodities component fell 0.3 percent, held down by continued discounting of apparel and new cars. Since December the CPI for commodities excluding food and energy has risen at an annual rate of only 2 percent, more than accounting for the slowing this year in the CPI less food and energy. This pace is below that in the roughly comparable PPI series, in part reflecting the weakness in import prices. However, this CPI component may reverse some of its recent declines in the next few months when higher-priced fall and winter apparel are introduced into the CPI sample.[11] In contrast to commodities, prices of nonenergy services have risen at a 5-1/4 percent annual rate thus far in 1989--a bit faster than in 1988. In August, the prices of nonenergy services were up 0.3 percent following a large 0.6 percent rise in July. In part, this monthly pattern reflects movements in the prices for lodging while out of town, which rose sharply in July and retraced part of its

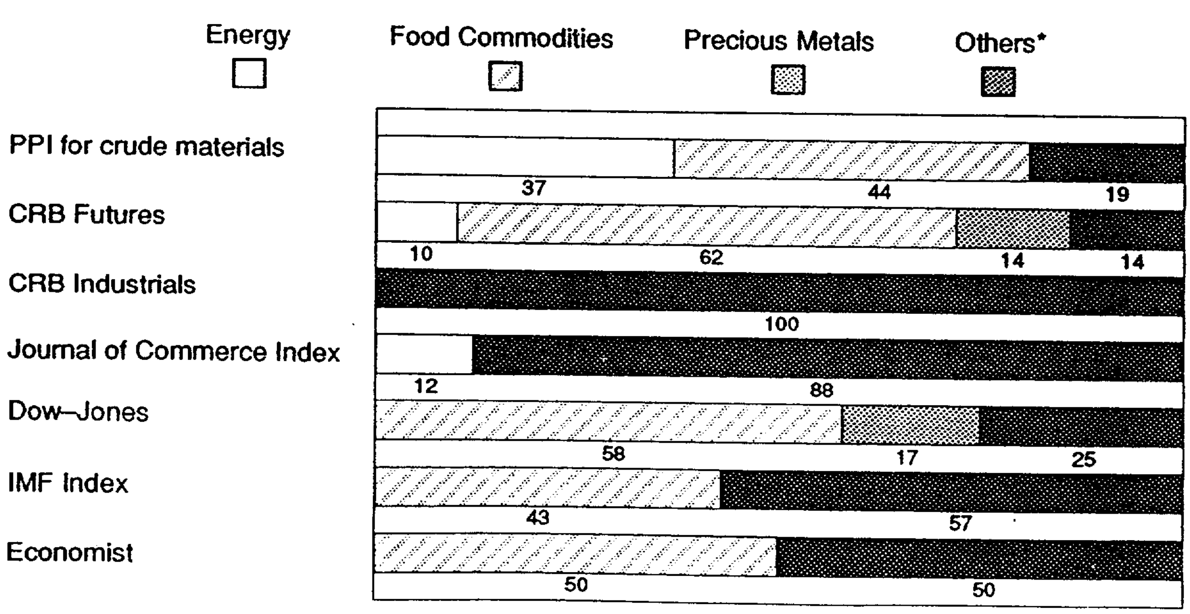
11. Because of changes introduced with the 1987 revision in the BLS pricing procedures for apparel, the BLS seasonal factors for this grouping are not yet consistent with their current sampling methods. The CPI for apparel has posted large increases, even after seasonal adjustment, in September and October of the past two years.

PRICE INDEXES FOR COMMODITIES AND MATERIALS[1]

	Last Obser-vation	Percent change[2] 1987	1988	1989 To Aug. 15*	1989 Aug. 15* To Date	Memo: Year Earlier To Date
1. PPI for crude materials[3]	Aug.	8.9	3.1	3.8	n.a.	4.2
1a. Foods and feeds	Aug.	1.8	14.2	.0	n.a.	-.8
1b. Energy	Aug.	10.7	-9.5	10.5	n.a.	11.3
1c. Ex. food and energy	Aug.	22.6	7.5	-.3	n.a.	1.9
1d. Ex. food and energy, seas. adj.	Aug.	22.8	7.6	-.4	n.a.	2.0
2. Commodity Research Bureau						
2a. Futures prices	Sept. 26	11.7	8.5	-11.5	1.3	-5.0
2b. Industrial spot prices	Sept. 25	19.2	7.3	1.3	1.3	7.1
3. Journal of Commerce industrials	Sept. 26	10.7	3.8	2.3	2.1	6.6
4. Dow-Jones Spot	Sept. 26	17.0	6.9	-9.1	.0	-2.1
5. IMF commodity index[3]	Aug.	30.8	12.6	-9.9	n.a.	-3.1
5a. Metals	Aug.	51.9	33.7	-14.2	n.a.	1.7
5b. Nonfood agric.	Aug.	47.5	-9.4	.6	n.a.	4.5
6. Economist (U.S. dollar index)	Sept. 19	42.5	17.7	-16.2	-1.1	-7.5
6a. Industrials	Sept. 19	62.6	18.9	-16.1	-.9	-4.5

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 August Greenbook.
n.a.--Not available.

Index Weights



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

increase in August. Decreases in auto finance charges also contributed to the moderation in August.

Automobile prices have been a source of considerable volatility in the PPI in the last two months, and they are likely to play a prominent role in September. Passenger car prices in the PPI declined sharply in July as manufacturers instituted substantial dealer liquidation allowances early in the season to reduce inventories.[12] In August, the enhancement of incentive programs was less than the seasonals had expected, and as a result, PPI car prices rose 0.5 percent. A large seasonally adjusted increase is likely in September when these dealer liquidation allowances are not expanded as much as the seasonals expect. On balance, the shifts in dealer liquidation allowances reduced the overall increase in the PPI excluding food and energy by 0.2 percentage point in July and are expected to add a similar, or even larger, amount in September.

At earlier stages of processing, producer prices of intermediate materials less food and energy edged down 0.1 percent further in August and have registered little net change over the last six months. In August, continued price declines in some industries--notably aluminum, fertilizers, and plastics--more than offset increases for copper and other materials. By contrast, the PPI for crude nonfood materials less energy turned up, after four months of declines, mainly reflecting a pickup in prices of copper scrap and ore. Since the midmonth PPI pricing date, spot prices of copper have risen further as supply disruptions in major producing countries have persisted. However, prices have weakened, on net, for aluminum and some

12. The PPI for cars measures reported changes in prices received by domestic manufacturers, net of all types of discounting reported by the manufacturers.

other metals. The domestic commodity price indexes based mainly on industrial materials have registered small increases, on net, since mid-August.

Agriculture

The 1989 crops apparently made it through the summer with only limited damage from weather, and, despite tightness in some markets, the overall supply situation in agriculture looks reasonably satisfactory at the present time.

Based on conditions as of September 1, the Agriculture Department estimates that total crop production will be up about 16 percent this year, reversing most of last year's drought-related decline. Particularly strong production gains are anticipated for feed grains (such as corn) and oilseeds (notably soybeans), while moderate increases are expected for wheat, sugar, and tobacco. The USDA's weekly reports since September 1 suggest that the condition of the crops has changed only slightly over the past month. Crop destruction from Hurricane Hugo was confined mainly to South Carolina, and a late-September cold snap in the Midwest apparently caused only minimal damage.

Because the 1988 crop was so poor, the sharp rebound this year will, in general, merely lift production back in line with consumption, rather than leading to a sizable rebuilding of inventories. Indeed, for corn and wheat, the USDA's current projections for the coming marketing year show demand continuing to run ahead of supply, with the result that stocks are expected to decline a bit further; although corn supplies still are ample, the market for wheat remains very tight. The market for cotton also is expected to

U.S. CROP PRODUCTION AND INVENTORIES[1]

PRODUCTION

	Millions of bushels						
	1980 to 1986					Projected for 1989	
	High	Low	Avg.	1987	1988	as of Aug. 10	as of Sept. 12
Wheat	2785	2092	2495	2107	1811	2044	2064
Corn	8877	4175	7424	7072	4921	7348	7321
Soybeans	2190	1636	1930	1923	1539	1905	1889
Cotton (Millions of bales)	15.4	9.7	11.8	14.8	15.4	11.8	12.3

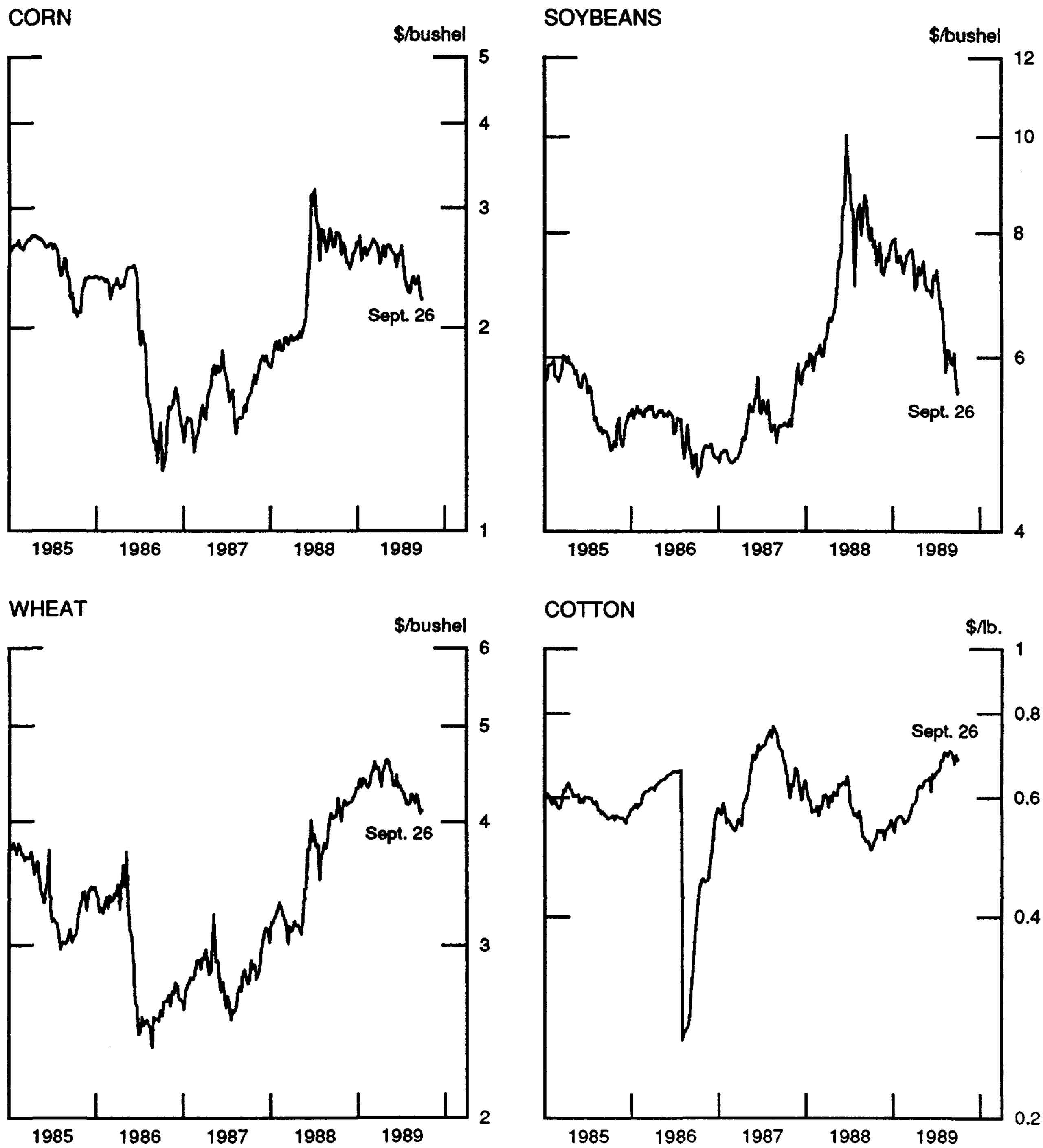
INVENTORIES

	Months' supply at end of marketing year						
				Marketing year beginning			
	1967 to 1986					Projected for 1989	
	High	Low	Avg.	1987	1988	as of Aug. 10	as of Sept. 12
Wheat	11.66	2.07	6.43	5.64	3.47	2.49	2.59
Corn	7.90	.83	2.80	6.64	3.04	2.69	2.69
Soybeans	4.15	.56	1.81	1.76	1.10	1.93	1.87
Cotton[2]	8.89	2.29	4.69	4.88	6.17	3.02	3.02

1. Derived from data in USDA's World Agricultural Supply and Demand Estimates, September 12, 1989. Production, consumption, and stocks are measured on a "marketing year" basis, which differs from crop to crop.

2. The figures for cotton exclude 1985. A pre-announced change in USDA price support policy at the end of that marketing year caused some consumption to be delayed into 1986 and raised the stocks-to-use ratio to an artificially high level of 13.42 months.

Spot Prices for Farm Crops*



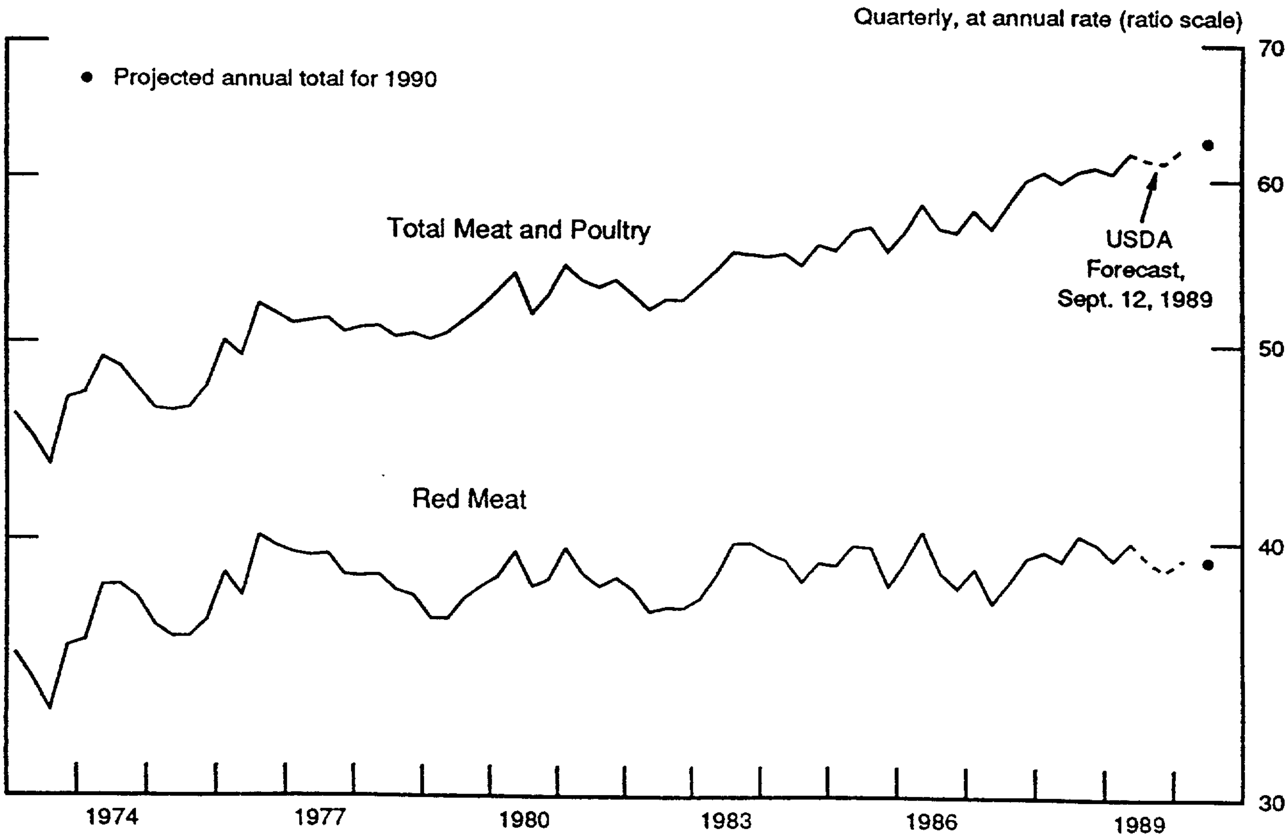
* A ratio scale is used in all panels.

MEAT AND POULTRY PRODUCTION
(Millions of pounds)

		USDA Projections			
		for 1989		for 1990	
	1988	as of Aug. 10	as of Sep. 12	as of Aug. 10	as of Sep. 12
1. Total red meat and poultry	60350	61125	61224	62640	62630
2. Red meat[1]	39763	39313	39303	39215	39205
3. Beef	23424	22706	22756	22825	22825
4 Pork	15623	15915	15865	15700	15700
5. Poultry	20587	21812	21921	23425	23425

1. Includes veal and lamb, in addition to beef and pork.

Meat and Poultry Production
(Billions of pounds, seasonally adjusted)*



*USDA data, seasonally adjusted by the staff of the Federal Reserve Board.

tighten, owing to reduced production this year, while the supply-demand balance for soybeans likely will ease a bit.

Recent price developments have reflected the prospective supply-demand balance. In the soybean market, prices have reversed much of their drought-related advance of a year ago. By contrast, grain prices in both spot and futures markets, while down from their peaks, are holding well above pre-drought levels, and cotton prices have moved up as the supply-demand balance in that market has tightened.

The prospects for livestock supplies continue to look encouraging, although, as with crops, the picture is not uniformly favorable. In September, the USDA boosted further its projection of poultry production for 1989, to a level about 6-1/2 percent above that of 1988. Total meat and poultry production this year now is projected to be up 1-1/2 percent from the 1988 total. For 1990, the agency is projecting a 2-1/4 percent increase in the total, with poultry accounting for all of the gain. As of August, the 12-month changes in the retail prices of meats and poultry were running, on balance, a little below the rate of increase in the overall CPI, and if the USDA's supply projections are realized, the trend in these prices seems likely to hold on a lower trajectory than prices in general. Dairy prices, meanwhile, have been surprisingly firm of late, owing to strong demand and a midsummer dip in production.

Federal Budget

In August, the federal government budget deficit was $22 billion, with outlays of $98 billion and receipts of $76 billion. For the fiscal year to date, the deficit was $146 billion compared with $165 billion a year earlier. Over the first eleven months of the fiscal year, receipts were

COMPOSITION OF FEDERAL GOVERNMENT BUDGET
(Billions of dollars)

Item	First 11 months of fiscal year		Year-to-year change	Memoranda (percent):	
	1988	1989		Share of change	Growth rate
Total receipts	811.2	892.4	81.2	100	10.0
Individual income taxes	359.4	400.7	41.3	51	11.5
Social insurance	305.6	330.2	24.6	30	8.0
Corporate income taxes	73.5	83.2	9.7	12	13.2
Other[1]	72.6	78.4	5.8	7	8.0
Total outlays	976.5	1,038.3	61.8	100	6.3
National defense	268.4	274.9	6.5	11	2.4
Commerce and housing credit[2]	13.0	17.7	4.7	8	31.2
Priority nondefense[3]	87.6	98.6	11.0	18	12.6
Net interest	139.3	155.6	16.3	26	11.7
Medicare	71.8	77.6	5.8	9	8.1
Social security	200.8	213.0	12.2	20	6.1
Other[4]	195.5	200.9	5.4	9	2.8
Deficit	165.3	145.9	-19.4	100	-11.7

1. Includes excise taxes, estate and gift taxes, customs duties, deposits of earnings by Federal Reserve banks, and miscellaneous receipts.
2. Commerce and housing credit includes net payments by FDIC, FSLIC, and their successors under FIRREA.
3. The sum of four functions that include areas of priority initiative spending targeted by President Bush: general science, space and technology; education, training, employment and social services; health; and administration of justice.
4. Includes remaining functions: international affairs; energy; natural resources and environment; agriculture; transportation; community and regional development; income security; veterans benefits and services; general government; and undistributed offsetting receipts (negative).

10 percent above last year's pace, while outlays were 6-1/4 percent higher. About half of the increase in receipts was from individual income taxes, largely reflecting the spring bulge in nonwithheld taxes. Among outlays, net interest, social security, deposit insurance, and medicare continue to provide momentum to spending.

Despite the relatively small deficit through August, the deficit for the full fiscal year is expected to surpass last year's. On the receipts side, following the surprisingly strong tax collections in the spring, year-over-year gains in subsequent months have been smaller. Among spending categories, defense outlays in September likely will include $3 billion of compensation shifted from October. Also, deposit insurance expenditures are being boosted by the thrift bailout legislation passed in August, which authorized $18.8 billion in net expenditures for FY89. About $3 billion was spent in August; however, whether all the available funds will be spent in the current fiscal year is uncertain (any funds not spent in FY89 remain available to be spent subsequently).

OMB's initial sequester report for FY90 showed a Gramm-Rudman-Hollings (GRH) baseline deficit of $116.2 billion, based on legislation enacted by August 15, or $6.2 billion above the $110 billion trigger for FY90 (the $100 billion target plus a $10 billion cushion). Appropriations and reconciliation legislation now before Congress are expected to bring the final GRH deficit below the trigger point, although a number of controversies are pushing the legislation down to the wire.[13] The final

13. In the event that the reconciliation bill is not passed in time to be reflected in the final GRH report, sequestration would become effective on October 16. However, there is precedent for sequestration to be reversed when legislation is passed that is estimated to bring the deficit below the GRH trigger.

GRH deficit estimate will reflect laws enacted and final regulations promulgated by the "latest possible date" before the report is submitted on October 15, but must be based on the same economic and technical assumptions used in the Mid-Session Review and the initial report.

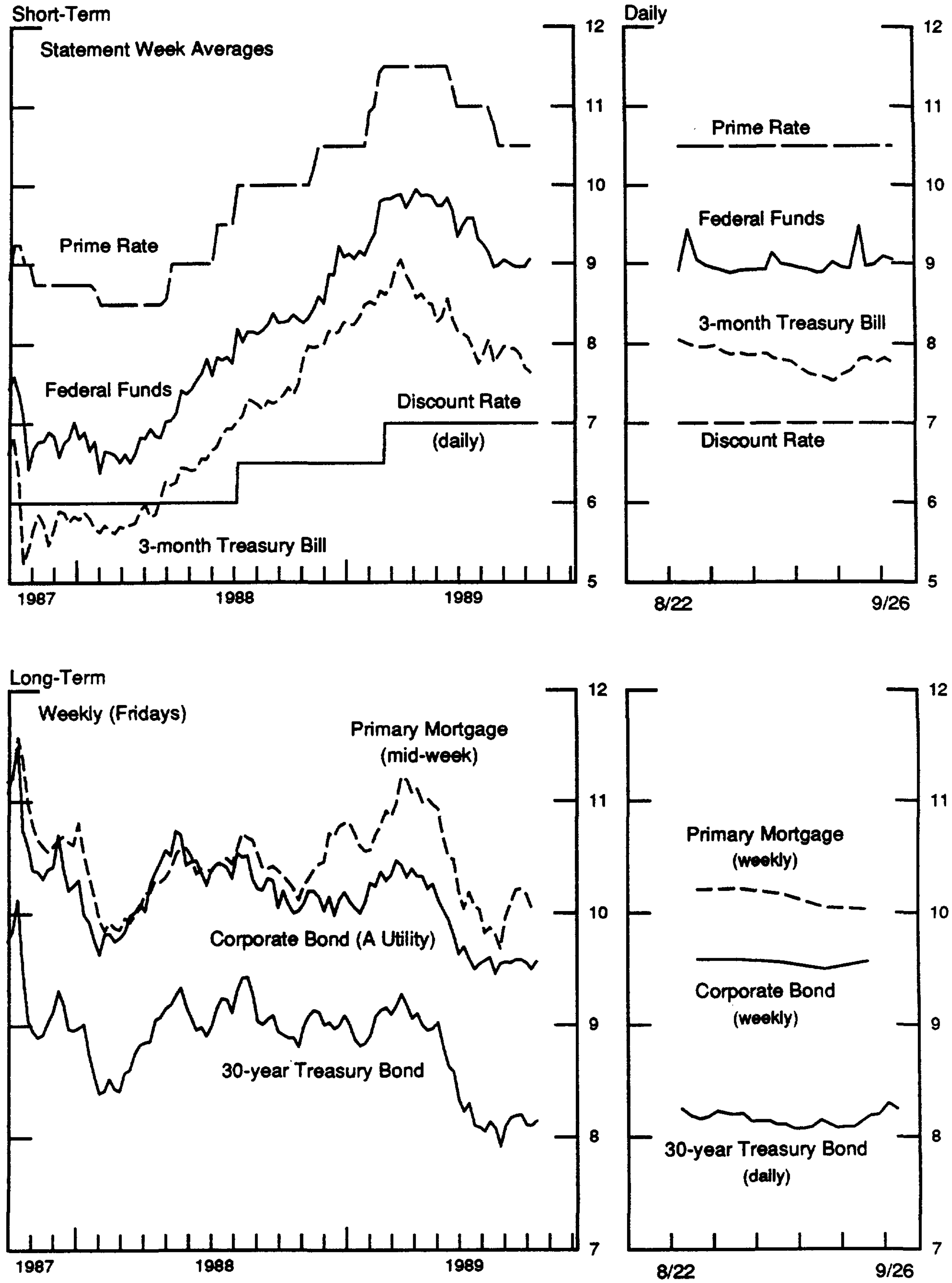
SELECTED FINANCIAL MARKET QUOTATIONS[1]
(Percent)

	1987	1989				Change from:		
	Oct. 16[2]	Mar. highs	Jul-Aug lows	FOMC Aug 22	Sept.26	Mar 89 highs	Jul-Aug lows	FOMC Aug 22
Short-term rates								
Federal funds[3]	7.59	9.85	8.97	8.99	9.01	-.84	.04	.02
Treasury bills[4]								
3-month	6.93	9.09	7.63	8.05	7.76	-1.33	.13	-.29
6-month	7.58	9.11	7.34	8.00	7.83	-1.28	.49	-.17
1-year	7.74	9.05	7.10	7.86	7.74	-1.31	.64	-.12
Commercial paper								
1-month	7.94	10.05	8.52	8.85	8.90	-1.15	.38	.05
3-month	8.65	10.15	8.24	8.66	8.74	-1.41	.50	.08
Large negotiable CDs[4]								
1-month	7.92	10.07	8.45	8.86	8.91	-1.16	.46	.05
3-month	8.90	10.32	8.26	8.80	8.89	-1.43	.63	.09
6-month	9.12	10.08	8.12	8.77	8.87	-1.21	.75	.10
Eurodollar deposits[5]								
1-month	8.00	10.19	8.44	8.88	8.88	-1.31	.44	.00
3-month	9.06	10.50	8.31	8.88	8.88	-1.62	.57	.00
Bank prime rate	9.25	11.50	10.50	10.50	10.50	-1.00	.00	.00
Intermediate- and long-term rates								
U.S. Treasury (constant maturity)								
3-year	9.52	9.88	7.51	8.39	8.39	-1.49	.88	.00
10-year	10.23	9.53	7.74	8.29	8.30	-1.23	.56	.01
30-year	10.24	9.31	7.83	8.25	8.25	-1.06	.42	.00
Municipal revenue[6] (Bond Buyer)	9.59	7.95	7.17	7.39	7.62	-.33	.45	.23
Corporate A utility (recently offered)	11.50	10.47	9.45	9.64	9.59	-.88	.14	-.05
Home mortgage rates[7]								
S&L fixed-rate	11.58	11.22	9.68	10.09	10.03	-1.19	.35	-.06
S&L ARM, 1-yr.	8.45	9.31	8.60	8.69	8.70	-.61	.10	.01

	1987		1989		Percent change from:		
	highs	lows	FOMC Aug 22	Sept.26	1987 highs	1987 lows	FOMC Aug 22
Stock prices							
Dow-Jones Industrial	2722.42	1738.74	2650.99	2663.94	-2.15	53.21	.49
NYSE Composite	187.99	125.91	190.11	191.47	1.85	52.07	.72
AMEX Composite	365.01	231.90	375.86	382.19	4.71	64.81	1.68
NASDAQ (OTC)	455.26	291.88	458.36	467.84	2.76	60.29	2.07

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 reserve maintenance period closest to date shown except Feb. low which is the average for the statement week ended 2/10/88. Last observation is average-to-date for maintenance period ending 10/4/89.
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.

Selected Interest Rates*
(percent)



*--Friday weeks through September 22, Wednesday weeks through September 20.

With federal funds continuing to trade around 9 percent, the general level of market interest rates has changed little since the August FOMC meeting. Fixed-income securities benefited through much of the period from slackening inflation and a strong dollar; however, in the past week, as the dollar weakened, bond prices also receded.

Over the intermeeting period, high quality obligations generally have fared better than other securities, particularly junk bonds, whose spreads over comparable-maturity Treasury issues widened markedly amidst widespread concerns aroused by the debt-servicing difficulties of several prominent issuers. The mortgage-backed securities market may have benefited from heightened concerns about credit quality as spreads of mortgage-backed securities over Treasuries stabilized and, in some cases, declined, despite significant sales of mortgage assets by thrift institutions striving to meet the more stringent capital standards implied by FIRREA.

Changes in thrift behavior prompted by FIRREA have had a significant effect on monetary flows. With thrift deposit rates falling relative to comparable commercial bank yields--reflecting reduced competition from RTC-controlled institutions as well as a growing reluctance on the part of capital-impaired thrifts to bid aggressively for deposits--banks enjoyed the lion's share of core deposit inflows in August and early September. These inflows, boosted by previous declines in opportunity costs associated with earlier policy easings, enabled commercial banks to fund their net credit extensions without tapping managed liabilities. At thrifts, massive runoffs in managed liabilities, owing mainly to efforts by capital-deficient institutions to contract their balance sheets, have significantly weakened the pace of M3. Hence, although healthy advances in M2 pushed this aggregate further above the lower bound of its annual target cone, M3 has drifted close to the lower end of its target cone.

Overall credit demands of nonfinancial sectors appear to have been maintained at about the pace of late spring and early summer. A pickup in Treasury borrowing arising primarily from on-budget financing of the RTC, coupled with a bit stronger growth in mortgage credit associated with a modest increase in home sales, have been roughly offset by a slowdown in business borrowing and consumer installment credit growth.

Monetary Aggregates and Bank Credit

In August, M2 grew at an annual rate of 7-1/2 percent, somewhat slower than in July. Preliminary data for early September suggest that M2 continued to grow at about its August rate, lifting this aggregate a little further above the lower bound of its annual target cone.

The deceleration in M2 was related partly to a weakening in M1--which slowed to less than a 1 percent rate of growth in August, following a demand-deposit-related surge in July--and partly to runoffs in overnight Eurodollars and RPs. Other components of M2, however, continued to display vigor, with growth increasingly concentrated in the more liquid accounts. In response to a narrowing of their yield disadvantage relative to small time deposits, savings deposits plus MMDAs accelerated to a 9-1/4 percent pace, while the rate of small time deposit expansion edged down to 5-1/2 percent. M2-type money funds, which gained from the promotional efforts of a few funds that temporarily waived management fees and absorbed operating expenses, grew at nearly a 50 percent annual rate in August. In recent

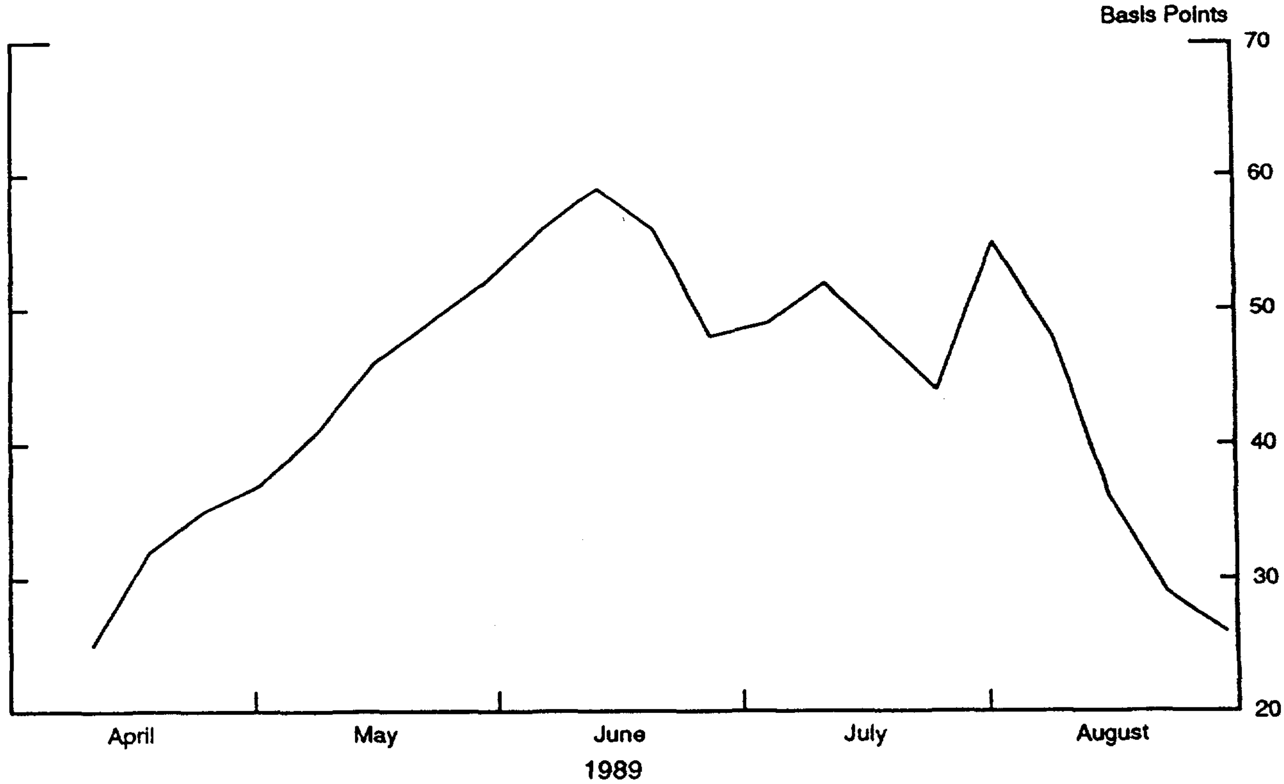
MONETARY AGGREGATES
(based on seasonally adjusted data unless otherwise noted)

	1988[1]	1989 Q1	1989 Q2	1989 Jun	1989 Jul	1989 Aug p	Growth Q4 88- Aug 89p
	Percent change at annual rates						
1. M1	4.3	-0.4	-5.6	-4.7	10.7	0.8	-1.6
2. M2	5.2	1.8	1.2	6.2	11.5	7.4	3.5
3. M3	6.3	3.7	2.9	5.7	9.0	2.0	3.8
	Percent change at annual rates						Levels bil. $ Aug 89p
Selected components							
4. M1-A	2.5	-0.2	-3.3	-5.5	10.6	-2.4	503.0
5. Currency	8.1	7.0	4.1	5.5	3.3	2.8	218.5
6. Demand deposits	-1.2	-5.5	-8.7	-13.8	17.0	-6.9	277.3
7. Other checkable deposits	7.7	-0.7	-9.8	-2.7	11.1	6.6	274.7
8. M2 minus M1[2]	5.5	2.6	3.5	9.9	11.6	9.6	2358.9
9. Overnight RPs and Eurodollars, NSA	-5.7	14.1	-23.7	40.8	22.1	-40.3	74.8
10. General purpose and broker/dealer money market mutual fund shares, NSA	7.4	20.5	20.8	28.7	43.0	47.6	285.5
11. Commercial banks	6.9	5.4	5.4	6.1	7.5	11.3	1027.4
12. Savings deposits, SA, plus MMDAs, NSA[3]	1.4	-8.4	-14.9	0.5	7.5	14.7	519.1
13. Small time deposits	14.7	22.4	29.0	12.1	7.4	7.8	508.3
14. Thrift institutions	4.6	-3.0	-1.1	6.1	4.8	3.1	972.4
15. Savings deposits, SA, plus MMDAs, NSA[3]	-4.3	-14.0	-24.6	-9.5	-3.1	1.7	349.0
16. Small time deposits	11.7	4.3	14.0	15.4	9.1	4.1	623.4
17. M3 minus M2[4]	10.2	10.5	9.2	4.1	0.1	-16.9	873.0
18. Large time deposits	11.0	12.6	14.0	1.9	-0.4	-9.4	568.3
19. At commercial banks, net[5]	12.2	18.0	17.8	1.8	3.0	-3.6	396.2
20. At thrift institutions	8.8	1.2	5.8	2.0	-8.2	-22.6	172.1
21. Institution-only money market mutual fund shares, NSA	-0.8	10.6	12.2	45.9	39.1	29.3	100.6
22. Term RPs, NSA	14.5	7.3	2.5	0.0	-39.0	-51.8	119.7
23. Term Eurodollars, NSA	11.2	-2.3	-6.7	-13.2	7.3	-27.7	97.5
	Average monthly change in billions of dollars						
MEMORANDA:[6]							
24. Managed liabilities at commercial banks (25+26)	5.0	4.8	9.1	19.2	4.0	0.3	690.1
25. Large time deposits, gross	3.3	5.8	4.0	2.0	2.8	-1.1	460.5
26. Nondeposit funds	1.7	-1.1	5.0	17.2	1.2	1.4	229.6
27. Net due to related foreign institutions, SA	-0.4	0.5	-0.1	8.0	3.2	-1.8	9.3
28. Other[7]	2.1	-1.5	5.1	9.2	-2.0	3.2	220.3
29. U.S. government deposits at commercial banks[8]	0.0	-1.5	2.4	0.3	-4.7	0.2	22.9

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 July and August at rates of 3.3 percent and 7.9 percent, respectively. At thrift institutions, savings deposits excluding MMDAs grew during July and August at rates of -5.4 percent and -1.6 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

Rate on Thrift 6-month CDs minus Rate on Commercial Bank 6-month CDs
(simple interest rate)



DEPOSIT PATTERNS AT SAIF-INSURED THRIFT INSTITUTIONS

Capital Ratio[1] June 30, 1989 (percent)	Net Change in Deposits, July 31 - Sept. 11, 1989					
	Core Deposits		Large Time		Total RPs[2]	
	$ mil (nsa)	Percent, annual rate	$ mil (nsa)	Percent, annual rate	$ mil (nsa)	Percent, annual rate
Greater than 6	+1,232	+8.6	+405	+24.4	-344	-150.0
3 to 6	+3,599	+13.4	-352	-5.3	-650	-53.7
0 to 3	+1,799	+6.9	-2,885	-40.1	-4,463	-121.5
Less than 0	-583	-2.7	-893	-27.1	-1,161	-121.9
a) RTC-Controlled	-630	-7.5	-350	-23.6	-810	-236.9
b) Other	+47	+0.4	-543	-29.9	-351	-57.4

1. The capital ratio is the ratio of tangible capital (GAAP capital minus goodwill) to tangible assets, expressed in percent.
2. The RP data are taken from a small sample of thrifts and, consequently, caution should be exercised when drawing inferences from these data.

weeks, growth in liquid deposits and money funds has remained strong, with the latter perhaps bolstered by some shifting out of junk bond mutual funds.

Core deposit growth was heavily skewed toward commercial banks in August--11-1/4 percent versus 3 percent at thrifts--extending a disparity that began in July. This disparity, which apparently continued in September, likely reflects primarily the indirect influence of thrift legislation through downward pressure on thrift offering rates.[1] As shown in the chart, the gap between deposit rates at a broad-based sample of commercial banks and thrifts narrowed in August, perhaps indicating a reluctance on the part of capital-deficient thrifts to bid for funds as well as reduced competition from RTC-controlled thrifts. The accompanying table suggests that core deposit outflows have been concentrated primarily at insolvent thrifts--particularly at RTC-controlled institutions. Among solvent thrifts, the more adequately capitalized institutions have enjoyed healthier inflows of core deposits than the thinly capitalized thrifts. On balance, although the thrift bailout has restrained retail deposit growth at certain categories of thrifts, M2 as a whole appears to have been relatively unaffected, with funds flowing into banks, healthy thrifts, and money funds.

The thrift bailout package has had a much more pronounced effect on M3, whose growth slowed to a mere 2 percent pace in August, restrained by the nearly 40 percent rate of contraction of thrift-managed liabilities. Preliminary data indicate a similar pace for this aggregate in September. As can be seen in the table, the bulk of the runoffs in large time deposits

1. To a limited extent, RTC paydowns of core deposits in late summer restrained retail deposit growth at thrift institutions. Through mid-September, however, the bulk of RTC infusions have been used to pay down M3 managed liabilities.

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

	1987:Q4 to 1988:Q4	1989 Q1	1989 Q2	1989 June	1989 July	1989 Aug p	Levels bil.$ Aug p
	----- Commercial Bank Credit -----						
1. Total loans and securities at banks	7.6	7.9	5.2	5.0	9.9	7.8	2534.4
2. Securities	4.8	2.2	.7	-.9	-1.1	1.1	559.5
3. U.S. government securities	7.3	8.2	5.4	1.0	1.9	7.1	376.6
4. Other securities	.5	-8.9	-8.2	-3.9	-7.8	-11.7	182.8
5. Total loans	8.5	9.6	6.5	6.7	13.1	9.7	1974.9
6. Business loans	6.8	10.6	4.6	-2.7	14.6	9.9	637.3
Security loans	-5.7	53.0	-22.9	97.9	-23.4	-20.8	39.6
8. Real estate loans	14.0	11.8	11.7	11.2	12.6	15.0	729.0
9. Consumer loans	8.5	5.6	6.1	2.0	1.6	7.5	369.3
10. Other loans	-.4	-2.7	1.2	12.5	45.9	-6.0	199.7
	----- Short- and Intermediate-Term Business Credit -----						
11. Business loans net of bankers acceptances	6.9	11.0	4.6	-2.7	14.5	9.2	634.1
12. Loans at foreign branches[2]	30.3	51.9	32.8	32.7	4.5	-72.5	24.9
13. Sum of lines 11 & 12	7.6	12.4	5.6	-1.3	14.1	5.9	659.0
14. Commercial paper issued by nonfinancial firms	15.5	37.5	38.2	27.7	0.0	-9.7	123.0
15. Sum of lines 13 & 14	8.6	16.0	10.5	3.3	11.8	3.5	782.1
16. Bankers acceptances: U.S. trade related[3,4]	-6.8	17.9	8.0	17.0	0.0	-3.4	35.6
17. Line 15 plus bankers acceptances: U.S. trade related	7.8	16.0	10.5	4.0	11.1	3.1	817.6
18. Finance company loans to business[3]	12.3	8.0	14.7	10.8	12.6	n.a.	250.2[5]
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	8.9	14.1	11.5	5.6	11.6	n.a.	1065.8[5]

1. Average of Wednesdays.
2. Loans at foreign branches are loans made to U.S. firms by foreign branches of domestically chartered ba
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 g
5. July data.
p--preliminary.
n.a.--not available

and RPs has been concentrated at the capital-impaired thrifts; runoffs at RTC-controlled institutions comprised a relatively small part of the total. These data suggest that weak M3 growth thus far has been more a result of efforts by marginally solvent thrifts to comply with the new capital standards by paring their balance sheets and less a result of direct RTC disbursements to replace managed liabilities at intervened institutions.

Bank credit grew at a 7-3/4 percent annual rate in August, a little slower than in July, as a moderation in loan expansion more than offset a pickup in holdings of U.S. government securities. Total loan growth at banks eased a bit in August to a 9-3/4 percent annual rate, despite a recovery of consumer loans. Business loans booked at domestic offices of U.S. banks remained strong but credits booked at foreign branches of U.S. banks contracted. This dichotomy likely reflects the sharp narrowing of the prime-LIBOR spread in early August, as prime-based credits are typically booked at domestic offices. Large banks continued to increase their holdings of mortgage-backed securities as well as their share of mortgage lending, presumably filling some of the void caused by the retrenching of capital-impaired thrifts.

Treasury and Sponsored Agency Financing

The staff anticipates that the federal deficit will come in at $53 billion in the third quarter, representing a sharp turnaround from the $23 billion surplus registered last quarter. This quarter-to-quarter swing, large by historical standards, is due in part to the bulge in personal tax payments last spring. The recent thrift legislation, which authorized up to $19 billion of net thrift-related expenditures on budget for fiscal 1989,

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

	1989 Q1	Q2	Q3[p]	Jul.[e]	Aug.[e]	Sept.[p]
Treasury financing						
Total surplus/deficit (-)	-60.8	22.9	-53.3	-18.2	-22.1	-13.0
Means of financing deficit:						
Net cash borrowing from the public	37.9	10.1	38.4	-4.0	35.8	6.5
Marketable borrowings/ repayments (-)	32.0	5.4	33.3	-4.2	32.0	5.5
Bills	3.0	-20.0	9.4	-5.6	17.8	-2.8
Coupons	29.0	25.3	23.9	1.4	14.2	8.3
Nonmarketable	6.0	3.3	5.1	.2	3.8	1.1
Other borrowing[2]	-.2	1.4	.0	.0	.0	.0
Decrease in the cash balance	19.0	-29.1	13.6	21.6	-3.2	-4.8
Memo: Cash balance at end of period	14.7	43.7	30.1	22.1	25.4	30.1
Other[3]	4.0	-3.9	1.3	.6	-10.5	11.2
Federally sponsored credit agencies, net cash borrowing[4]	15.4	5.2	--	--	--	--
FHLBs	14.1	3.9	--	-2.4	-2.2	--
FNMA	-0.8	1.6	--	3.6	.2	--
Farm Credit Banks	-1.1	.3	--	.8	.4	--
FAC	.0	.2	.0	.0	.0	.0
FHLMC	.9	-2.4	--	.4	--	--
FICO	.6	1.1	.7	.0	.0	.7
SLMA	1.7	.5	--	--	--	--

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.
p--projected.
e--staff estimate.
Note: Details may not add to totals due to rounding.

also contributed to the widening of the deficit. Although actual, on-budget, thrift-related outlays were only $3.3 billion in August, the staff expects these outlays to be much larger in September, though they could fall short of the authorized total by as much as $5 billion.

The Treasury met its financing needs largely by raising $33 billion in the market and partly by running down its cash balance. A $15-billion 247-day cash management bill issued in August met much of the extra financing needs resulting from the thrift legislation; the remainder will be raised in the weekly bill auctions, where the gross sizes have been boosted from $13.2 billion to $14.8 billion.

Debt issuance of the federally sponsored credit agencies continues to be driven in large measure by the thrift situation, as Federal Home Loan Bank (FHLB) borrowing has accounted for the bulk of overall agency borrowing in the past year. During the first quarter, net borrowing by the FHLBs soared to $14.1 billion to fund large advances to member thrifts. By the second quarter, FHLB borrowing had ebbed to a net $3.9 billion, and in July and August the FHLBs paid down $4.6 billion as the demand for their advances dropped. More recently, RTC funds have been used to pay down FHLB advances at intervened thrifts. Reflecting the reduced supply, spreads on FHLB securities have become very tight: the latest 1-year issue was priced at a 3 basis-point spread and the 3-year issue at a 12 basis-point spread over comparable-maturity Treasury issues.

The S&L situation also has affected FNMA borrowing, albeit more indirectly. The higher relative yields on mortgage-related securities available since the spring have encouraged FNMA to acquire mortgages for its portfolio in significant volume. To finance these acquisitions, FNMA raised a total of $3.8 billion in new cash in July and August, which increased its debt outstanding almost 4 percent.

Under the provisions of FIRREA, FHLMC will come under the regulatory auspices of HUD and will have an 18-member board of directors (to be in place by February 8, 1990), along the lines of FNMAs. In the past, FHLMC was directed and regulated by the FHLBB. This restructuring has not had a major impact on FHLMC's mortgage market activities, nor is it expected to have a major impact on the scope or conduct of FHLMC's operations in the future.

The Resolution Funding Corporation (REFCORP), which will take over much of the financing of RTC in the future and is currently authorized to raise $30 billion over the next three years, has not yet issued nor announced impending issuance of any securities. FICO, on the other hand, brought a $700 million issue to market in September. Under FIRREA, the proceeds from this issue and from the $2.5 billion of future FICO borrowings will be advanced to the FSLIC Resolution Fund, which is responsible for servicing FSLIC's obligations, including an estimated $40 billion incurred as part of FSLIC's 1988 resolutions of thrift insolvencies.

Business Finance

After remaining unchanged in July, commercial paper of nonfinancial businesses contracted at a 9-3/4 percent pace in August. Growth of commercial paper and business loans combined slowed to a modest 3-3/4 percent annual rate. Since most of this deceleration does not appear to be attributable to merger-related activity, these data, coupled with the relatively sluggish pace of nonfinancial bond issuance, suggest slower non-merger business credit demands through August. Since the last FOMC meeting,

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

	1987	1988	1989				
	Year	Year	Q1[p]	Q2[p]	July[p]	Aug.[p]	Sept.[e]
Corporate securities - total[1]	24.08	22.23	18.82	19.80	15.67	14.35	16.40
Public offerings in U.S.	21.89	20.21	16.25	17.51	14.06	12.93	13.50
Stocks--total[2]	4.45	3.53	1.47	1.80	3.36	1.93	1.50
Nonfinancial	2.32	1.14	.60	.95	1.09	.91	.70
Utility	.57	.24	.16	.29	.17	.27	.40
Industrial	1.75	.90	.44	.66	.92	.63	.30
Financial	2.12	2.39	.87	.85	2.27	1.02	.80
Bonds--total[1]	17.44	16.68	14.78	15.71	10.70	11.00	12.00
Nonfinancial	6.61	6.08	4.57	7.32	5.20	5.00	5.50
Utility	2.02	1.77	.62	2.01	1.50	1.45	1.20
Industrial	4.59	4.31	3.95	5.31	3.70	3.55	4.30
Financial	10.83	10.60	10.21	8.39	5.50	6.00	6.50
By quality[3]							
Aaa and Aa	3.25	2.68	3.46	3.14	2.50	3.13	3.75
A and Baa	5.20	5.57	4.96	6.31	3.95	4.10	5.20
Less than Baa	2.77	2.51	1.91	3.81	2.44	1.80	1.50
No rating (or unknown)	.07	.07	.02	.02	.07	.02	.05
Memo items:							
Equity-based bonds[4]	.87	.28	.12	.59	.11	.77	1.30
Mortgage-backed bonds	5.19	4.69	2.85	.93	1.10	1.20	.50
Other asset-backed	.96	1.26	1.58	1.49	.64	.75	1.00
Variable-rate notes	1.88	1.19	.96	1.82	.28	.30	.05
Bonds sold abroad - total	2.03	1.93	2.55	2.25	1.50	1.00	2.00
Nonfinancial	.94	.69	.89	.48	.40	.20	.85
Financial	1.09	1.24	1.66	1.77	1.10	.80	1.15
Stocks sold abroad - total	.16	.09	.02	.04	.11	.42	.90
Nonfinancial	.12	.08	.02	.04	.11	.42	.25
Financial	.04	.01	.00	.00	.00	.00	.65

1. Securities issued in the private placement market are not included. Total reflects gross proceeds rather than par value of original discount bonds.
2. Excludes equity issues associated with equity for equity swaps that have occured in restructurings. Such swaps totaled $2.2 billion in 1989 Q1 and $4.2 billion in 1989 Q2.
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.

however, nonfinancial commercial paper outstanding has increased about $5 billion and investment-grade bond issuance has picked up.

Prices of junk bonds plunged in mid-September, as the problems of a few large issuers aroused investors' concerns about credit quality. By mid-September, secondary market spreads between junk bonds and Treasury securities had exceeded 575 basis points, a level unseen in more than a decade. More recently, average spreads have narrowed somewhat, reflecting heightened demand for the more highly rated junk issues in an increasingly tiered market. On net, however, average spreads between junk bonds and comparable maturity Treasury issues have risen roughly 30 basis points over the intermeeting period.

Some nervous investors redeemed shares in high-yield mutual funds; but evidently not enough to create the need for fund managers to liquidate bond holdings. Investment banking firms also appear thus far to have weathered the storm; junk bond inventories reportedly were not large, especially relative to dealers' capitalizations. Bridge loan exposures also have received the attention of analysts and regulators, but these, too, have precipitated no major problems to date.

Most major stock market indexes rallied to reach record highs in early September, before falling back somewhat in recent weeks. On net, these indexes have risen 1/2 to 1 percent over the intermeeting period. Despite the high level of equity prices, new issuance of equity by nonfinancial firms apparently slowed in September, following a modest rebound this summer. Although net equity retirements are expected to pick up a bit in the near-term, the successful use of stock financing in Time Inc.'s merger with Warner Communications, coupled with the rising cost of debt financing, may encourage further use of stock-for-stock swaps in mergers, potentially reducing the amount of net equity retirements. A proposed prohibition on the interest deductibility of some payment-in-kind and zero coupon bonds also may slow equity retirements at the margin, as these types of securities commonly have been used to finance mergers.

Municipal Securities

Issuance of long-term municipal securities totaled $8.7 billion in August, continuing the moderate pace set in July. New capital offerings declined, while refunding issuance picked up noticeably to $3.1 billion, with the bulk coming early in the month before municipal bond yields backed up; the uptick in rates caused the postponement of $1.2 billion of refunding issues. Nonetheless, total long-term issuance appears to have picked up in September. Short-term municipal rates rose, on balance, over the

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

	1988	1988		1989		1989		
	Year	Q3	Q4	Q1	Q2	July	Aug.	Sept.[p]
Total offerings[1]	11.74	12.54	12.35	9.20	13.14	10.62	14.14	--
Total tax-exempt	11.41	12.33	11.94	8.92	12.95	10.37	13.92	11.50
Long-term	9.54	9.66	10.68	7.77	9.56	8.74	8.71	10.00
Refundings[2]	2.90	2.16	3.14	2.49	2.20	1.92	3.05	--
New capital	6.64	7.50	7.54	5.28	7.36	6.82	5.66	--
Short-term[3]	1.87	2.67	1.26	1.15	3.39	1.63	5.21	1.50
Total taxable	.33	.21	.41	.28	.19	.25	.22	--

p--preliminary.
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.

intermeeting period, boosted by a surge in issuance related partly to heavy seasonal borrowing by the state of California in August.

Mortgage Markets

The net growth in mortgage debt outstanding appears to have picked up in the third quarter, in line with a modest increase in sales of new and existing homes. Although thrift mortgage lending has dropped off substantially, the slack has been picked up by commercial banks and other investors, working in part through government-sponsored agencies. In July, net holdings of mortgage-related assets by SAIF-insured thrift institutions declined $6.2 billion as the volume of mortgage loans closed at thrifts fell to its lowest level since October 1983. Moreover, data on new commitments suggest little pickup in originations at thrifts over the balance of the quarter. In contrast, as noted above, real estate loan growth at commercial banks has accelerated through August and FNMA has stepped up its acquisitions of mortgages.

The fall in the thrift share of the market for intermediated mortgage credit may have been exacerbated by the decline in borrower preference for adjustable-rate mortgages (ARMs). Historically, thrifts have invested in ARMs more heavily than other lenders, partly because of their desire to match the maturity of their assets more closely with short-term deposit liabilities. By aggressively pricing adjustable-rate products, thrifts have been able to capture a large share of gross loan originations during periods of strong borrower demand for ARMs. In recent months, however, the demand for ARMs has eased, owing in part to the narrow spreads between commitment rates on fixed-rate mortgages (FRMs) and ARMs. According to the Office of Thrift Supervision's survey of major institutional lenders, ARMs accounted

MORTGAGE ACTIVITY AT ALL SAIF-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
1987	21.1	20.0	10.5	6.1	2.4	3.7
1988	19.9	19.4	8.8	4.8	3.8	1.0
1988-Q2	19.6	18.8	9.4	6.1	4.1	2.0
Q3	21.4	20.9	8.5	6.4	5.7	.7
Q4	19.8	19.9	9.5	3.8	2.7	1.1
1989-Q1	20.5	19.3	8.3	4.3	2.6	1.7
Q2	14.7	13.0	7.2	-1.1	1.5	-2.6
1989-Jan.	21.5	19.6	7.7	.8	2.6	-1.8
Feb.	19.6	19.7	8.6	5.8	2.1	3.7
Mar.	20.4	18.6	8.6	6.3	3.0	3.3
Apr.	16.1	13.9	7.0	3.1	4.3	-1.2
May	15.1	12.7	7.1	-.4	.5	-.9
June	12.9	12.3	7.4	-6.1	-.3	-5.8
July	12.1	12.3	7.6	-6.2	-.4	-5.8

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

MORTGAGE-BACKED SECURITY ISSUANCE
(Monthly averages, billions of dollars, NSA unless noted)

	Federally related pass-through securities			Multiclass securities				
	Total (SA)	Total	ARM-backed	Total	Private issues[1]	FNMA REMICs[2]	FHLMC REMICs	Agency strips
1987	20.1	19.6	1.2	5.9	5.0	.1	0	.8
1988	12.4	12.6	2.4	7.1	4.2	.9	1.2	.6
1988-Q2 r	12.2	12.5	3.0	7.7	4.1	1.3	1.2	.5
Q3	13.1	14.9	3.0	6.1	3.7	.7	1.1	.6
Q4 r	14.8	14.5	2.6	8.0	4.3	1.2	1.8	.7
1989-Q1 r	16.0	13.7	3.1	6.9	2.5	1.2	2.8	.4
Q2 r	13.6	13.8	2.8	5.2	.6	2.4	2.1	.1
1989-Jan. r	14.7	12.1	.9	6.6	2.2	.9	3.5	0
Feb. r	16.2	13.7	3.5	4.7	1.7	1.3	1.5	.2
Mar. r	17.1	15.4	4.8	9.4	3.6	1.5	3.4	.9
Apr. r	14.7	13.9	3.0	4.5	.4	2.4	1.5	.2
May r	13.0	12.4	2.2	4.1	.2	1.4	2.4	.0
June r	12.9	15.0	3.2	7.1	1.1	3.5	2.5	.0
July r	13.2	15.5	2.9	10.3	1.0	4.9	3.3	1.1
Aug. p	15.2	17.1	2.3	9.1	0.9	3.3	4.6	0.3

1. Excludes pass-through securities with senior/subordinated structures.
2. FNMA's first REMIC, a $500 million strip security issued in January 1987, is included in the FNMA REMIC category rather than in the strip category.
r--revised p--preliminary

for only 25 percent of conventional home loans closed in early August, the lowest proportion since April 1987.

Despite the increase in the fixed-rate mortgage (FRM) share of conventional home loans closed in recent months, preliminary data for July show that issuance of federally related pass-through securities continues to run behind the average monthly pace of the first part of the year. While pass-through issuance has been flat in recent months, reflecting weak mortgage originations in the second quarter, FNMA and FHLMC have stepped up their issuance of multi-class mortgage-backed securities. Since late spring, FNMA and FHLMC have become the dominant issuers of real estate mortgage investment conduit (REMIC) securities, accounting for over 80 percent of total issuance, far exceeding their 20 percent average share in 1988. Much of the collateral for the new REMIC securities has been purchased in large blocks from thrift institutions.

Consumer Credit

Growth in consumer installment credit appears to have slowed further during the third quarter from the reduced pace of the previous quarter. The stock of installment credit outstanding declined slightly in July compared with a nearly 5 percent annual rate of increase in June. Although caution should be exercised when interpreting one month's data, July's contraction does provide further evidence of a broad slowing in the rate of consumer installment credit growth this year.

A pickup in consumer loans at banks in August suggests that some rebound in aggregate consumer credit growth likely occurred in August. The jump in new-car sales in August associated with expanded incentive programs also points to somewhat faster credit growth.

CONSUMER CREDIT
(Seasonally adjusted)

	Percent change (at annual rate)						Net change (billions of dollars)		Memo: Outstandings (billions of dollars)
			1989		1989		1989		1989
	1987	1988	Q1[1]	Q2[r]	June[r]	July[p]	June[r]	July[p]	July[p]
Total installment[2]	6.2	8.5	8.7	5.6	4.7	-.5	2.71	-.28	700.6
Installment, excluding auto	5.2	10.7	9.8	8.3	9.6	3.5	3.27	1.18	411.8
Selected types									
Auto	7.5	5.7	7.1	1.8	-2.3	-6.0	-.55	-1.46	288.7
Revolving	12.3	13.6	16.1	14.9	20.1	8.0	3.12	1.27	190.9
All other	.1	8.3	4.7	2.8	.8	-.5	.15	-.09	220.9
Selected holders									
Commercial banks	7.6	12.7	3.9	7.8	4.0	-3.3	1.08	-.88	323.6
Finance companies	4.7	3.5	10.0	8.3	4.4	-4.7	.53	-.57	145.5
Credit unions	5.1	7.5	11.1	7.0	2.5	2.9	.18	.22	90.3
Savings institutions[3]	6.6	3.8	4.1	-17.9	-27.2	3.4	-1.39	.17	60.1
Asset pools (NSA)	n.a.	n.a.	65.4	12.8	68.4	24.6	1.87	.71	35.4
Memorandum:									
Total[4]	4.9	7.3	10.0	3.3	1.0	-1.2	.64	-.75	764.0

1. Growth rates are adjusted for discontinuity in data between December 1988 and January 1989.
2. Includes items not shown separately.
3. Savings and loans, mutual savings banks, and federal savings banks.
4. Installment plus noninstallment.
r--revised. p--preliminary.
Note: Details may not add to totals due to rounding.

CONSUMER INTEREST RATES
(Annual percentage rate)

			1988		1989			
	1987	1988	Aug.	Nov.	May	June	July	Aug.
At commercial banks[1]								
New cars (48 mo.)	10.46	10.86	10.93	11.22	12.44	...	...	12.13
Personal (24 mo.)	14.23	14.68	14.81	15.06	15.65	...	...	15.45
Credit cards	17.92	17.79	17.79	17.77	18.11	...	...	18.07
At auto finance cos.[2]								
New cars	10.73	12.60	12.64	13.20	11.80	11.96	11.94	12.22
Used cars	14.61	15.11	15.16	15.75	16.45	16.45	16.37	16.31

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.

Consumers continued to handle their debt obligations in a relatively timely manner during the second quarter, according to delinquency rate statistics from the American Bankers Association. The average delinquency rate for all closed-end types of consumer credit edged downward in the second quarter following a larger drop in the first quarter and, at 2.33 percent, was about in the middle of its range of the past 15 years. Among specific components, delinquencies were up a bit for auto loans. Delinquencies have also been rising on auto loans at the finance company subsidiaries of the auto manufacturers.

U.S. Merchandise Trade

In July, the U.S. merchandise trade deficit was $7.6 billion (seasonally adjusted, Census basis, customs valuation), compared with $8.0 billion revised in June. The improvement in July follows improvements during both the first and second quarters. A significant portion of this improvement appears to be associated with positive J-curve effects associated with the rise in the dollar. Data for August will be released October 17.

Exports in July were 1.8 percent lower than the strong June level, but were little changed from the average in the second quarter and

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

	Exports			Imports			
	Total	Ag.	Nonag.	Total	Oil (nsa)	Non-oil	Balance
1988-May	27.4	3.2	24.3	36.1	3.6	32.5	-8.7
Jun	26.7	2.8	23.9	37.3	3.3	34.0	-10.6
Jul	26.6	3.1	23.5	35.1	3.1	31.9	-8.5
Aug	27.5	3.3	24.2	37.6	3.4	34.2	-10.1
Sep	27.6	3.4	24.2	36.8	3.0	33.7	-9.2
Oct	27.9	3.1	24.8	37.1	2.9	34.2	-9.2
Nov	27.6	3.2	24.3	38.1	2.9	35.2	-10.5
Dec	28.9	3.3	25.6	39.7	3.3	36.4	-10.8
1989-Jan	29.0	3.2	25.7	37.9	3.5	34.4	-8.9
Feb	28.8	3.4	25.4	38.2	3.2	35.0	-9.4
Mar	30.1	3.9	26.2	39.5	3.7	35.9	-9.5
Apr	30.8	3.7	27.1	39.0	4.0	35.0	-8.3
May	30.5	3.5	27.0	40.5	4.7	35.8	-10.1
Jun[r]	31.3	3.3	28.0	39.3	4.2	35.1	-8.0
Jul[p]	30.7	3.4	27.3	38.3	4.3	34.0	-7.6

r--revised p--preliminary

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

	Exports			Imports			
	Total	Ag.	Nonag.	Total	Oil	Non-oil	Balance
- - - - - - - BOP basis (current dollars) - - - - - - -							
1987	250	30	220	410	43	367	-160
1988	319	38	281	447	39	407	-127
1988-1	306	36	270	440	40	399	-134
-2	314	38	276	440	41	399	-126
-3	322	40	283	444	39	405	-121
-4	335	39	296	463	37	426	-128
1989-1	352	43	309	465	43	422	-114
2	364	43	321	474	54	421	-111
- - - - - BOP basis (constant 1982 dollars) [1] - - - -							
1988-1	337	39	297	461	83	377	-124
-2	338	39	300	457	85	372	-119
-3	339	36	303	463	86	377	-124
-4	352	36	316	477	90	388	-125
1989-1	365	40	325	473	88	385	-108
2	378	40	338	482	92	390	-104
Percent Change:							
Q2/Q2	11.7	3.9	12.7	5.6	7.7	5.1	
Q2/Q1 (not AR)	3.5	0.5	3.8	2.0	4.0	1.4	
- - - - - - GNP basis (constant 1982 dollars) - - - - -							
1988-1	336	40	296	460	83	377	-124
-2	339	39	300	457	85	372	-118
-3	344	36	308	468	86	382	-124
-4	359	36	322	483	90	393	-125
1989-1	373	40	332	477	88	390	-105
-2	387	41	346	488	92	396	-101
Percent Change:							
Q2/Q2	14.1	4.9	15.3	6.8	7.9	6.5	
Q2/Q1 (not AR)	3.9	1.5	4.2	2.1	4.2	1.6	

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

5 percent above the average for the first quarter. While most major categories of exports fell in July, shipments of civilian aircraft increased sharply. Deliveries of large jet aircraft are expected to rise substantially further during the remaining months of 1989, as inventories held in the United States are worked down to more normal levels. For the first seven months of 1989, the value of exports was 15.3 percent above that of a year earlier. This increase in exports was largely in volume and was spread among industrial supplies, capital goods (particularly machinery other than computers, and aircraft), and consumer goods (especially durables). Contributing to the strength of exports has been the strong pace of economic growth in foreign industrial countries during the first half of 1989 and the lagged effects of the earlier depreciation of the dollar.

Shipments of agricultural exports during the first half of 1989 were buoyed by purchases of wheat and corn by the Soviet Union; in 1988, Soviet grain purchases were also concentrated in the first half of the year.

Imports declined 2.5 percent in July, with decreases in most categories of trade. During the first seven months of the year, the value of oil imports rose, while the value of non-oil imports was fairly steady at about the average of the fourth quarter of 1988.

The volume of imported oil jumped in July, returning to about its peak recorded in May, and was at a rate well above any quarterly average recorded since the fourth quarter of 1979. The July increase (and weekly data suggest a further rise in the volume of oil imports occurred during August) partly reflected the effects of declining prices, but also may have been in anticipation of planned shutdowns (for maintenance) in October of several refineries in the United States. The average price of oil dropped about 80 cents per barrel from June to a level still well above prices recorded in the first quarter, or at any time last year. Supply disruptions accounted for much of the run-up in price during the second quarter. In recent months, supplies of oil have risen (with OPEC showing little production restraint and North Sea production rising sharply from depressed levels) and prices have declined.

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

	1988			1989			
	Year	Q3	Q4	Q1	Q2	June	July
Value (Bil. $)	39.31	39.10	36.87	43.40	53.71	52.30	53.22
Price ($/BBL)	14.39	14.24	12.85	15.54	18.46	18.23	17.44
Volume (mbd.)	7.49	7.51	7.84	7.65	7.97	7.86	8.36

The value of non-oil imports dropped in July to the lowest monthly level recorded since last September; monthly fluctuations in non-oil imports are often large. Most import categories fell in July, with several notable exceptions. Imports of consumer goods other than automotive, and computers rose for the third consecutive month. The volume of consumer goods has been relatively strong throughout 1989, continuing an upward trend that began in the middle of last year; there was a transitory surge in these imports at the end of last year that was reversed by 1989-Q1. Computer imports have also risen strongly and steadily over the past year. In addition, the volume of imported capital goods other than computers has risen steadily over the past six quarters. Offsetting these increases has been a decline in the volume of imported automotive products (particularly in the second quarter) and an edging off of industrial supplies. Overall, the volume of non-oil imports has been at about the same level in the first and second quarters as in the fourth quarter of last year.

Import and Export Prices

In August, import prices fell 0.3 percent after a revised decline of 0.9 percent in July. The decrease was largely attributable to a drop in oil prices. Prices of non-oil imports edged down just 0.1 percent, after dropping more rapidly in each of the preceding two months. Prices of basic materials and foods continued to slide; during the first eight months of 1989, prices of imported industrial supplies (excluding oil) declined by 2 percent, and prices of imported food dropped 4.6 percent. Prices of imported automotive products declined for the seventh consecutive month, reflecting in part some weakness in automotive markets. The increase in prices of capital goods was the first monthly rise in this component since April. The price of imported consumer goods also turned up in August. Part of the increase in prices of these two categories reflected the depreciation of the dollar in July.

Changes in the exchange value of the dollar significantly affect prices of imports published by BLS. About 15 percent of U.S. imports are priced in foreign currencies. The proportion is higher for manufactured goods. Producers in European countries are more likely to price in their own currencies than producers in Japan, while developing countries tend to price their exports in dollars. Trade categories that move strongly with changes in exchange rates include various types of machinery (metalworking, specialized, general industrial), professional

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

	Year 1989-Q2 / 1988-Q2	Half-Yr 1988-Q4 / 1988-Q2	Quarters 1989 Q1	Quarters 1989 Q2	Months 1989 July	Months 1989 Aug.
		(annual rates)			(monthly rates)	
		- - - - - - - - - BLS Prices - - - - - - - - -				
Imports, Total	2.7	1.4	7.3	0.7	-0.9	-0.3
Foods, Feeds, Bev.	-1.8	-1.8	-1.4	-7.2	-0.9	-1.6
Industrial Supplies	9.2	-2.8	25.8	8.9	-1.9	-1.4
Ind Supp Ex Oil	2.4	5.1	5.0	-5.4	-1.0	-0.9
Capital Goods	0.0	2.0	0.3	-4.2	-0.5	1.0
Automotive Products	2.0	5.5	-0.3	-2.5	-0.7	-0.5
Consumer Goods	2.4	1.7	4.1	1.9	-0.3	0.6
Memo:						
Oil	16.9	-21.7	104.4	48.6	-3.8	-2.5
Non-oil	1.4	3.4	2.2	-3.1	-0.5	-0.1
Exports, Total	3.4	3.9	6.2	-0.4	-0.4	-0.8
Foods, Feeds, Bev.	6.4	13.2	12.1	-11.4	-1.3	-4.5
Industrial Supplies	2.0	0.5	7.3	0.0	-1.3	-0.9
Capital Goods	3.0	2.7	3.8	2.7	0.4	0.2
Automotive Products	3.6	5.6	1.5	1.9	0.1	0.1
Consumer Goods	4.5	4.2	8.8	1.0	0.2	0.3
Memo:						
Agricultural	4.6	5.7	13.6	-5.7	0.2	-3.7
Nonagricultural	3.1	3.5	4.7	0.7	-0.6	-0.2
		- - - - - - - Prices in the GNP Accounts - - - -				
Fixed-Weighted						
Imports, Total	4.8	0.2	11.3	8.0	--	--
Oil	21.5	-28.6	114.9	99.4	--	--
Non-oil	2.6	4.5	2.6	-1.2	--	--
Exports, Total	3.9	6.9	-0.8	2.7	--	--
Ag.	10.0	24.9	-2.9	-3.1	--	--
Nonag.	2.7	3.7	-0.3	3.9	--	--
Deflators						
Imports, Total	2.3	1.5	6.0	0.2	--	--
Oil	21.6	-28.3	113.1	100.2	--	--
Non-oil	0.4	5.1	-1.5	-6.4	--	--
Exports, Total	3.7	5.2	5.2	-0.5	--	--
Ag.	10.0	24.9	-2.9	-3.1	--	--
Nonag.	3.0	3.3	5.6	-0.0	--	--

and scientific apparatus, photographic apparatus, and optical goods. Prices of imported automotive products are largely in dollars.

The decline in export prices in August was due primarily to a decline in prices of exported agricultural commodities and industrial supplies. Over the first eight months of the year, agricultural export prices fell 1.8 percent (there were fairly large declines recorded in prices of meat and soybeans), while nonagricultural export prices rose 0.5 percent. The small change in nonagricultural export prices hides some important compositional differences. Since the beginning of the year, prices of exports of capital goods have risen fairly steadily and have moved in tandem with their counterparts in the Producer Price Index (PPI), which suggests that producers of capital goods allow the foreign-currency price of their products to vary along with the dollar. On the other hand, the export price for industrial supplies appears to respond to changes in the dollar. Export prices of most industrial supplies have fallen steadily since February at rates in excess of the declines in the prices of their domestic counterparts, apparently in response to the appreciation of the dollar.

U.S. Current Account: 1989-Q2

The U.S. current account deficit in 1989-Q2 widened $2.4 billion (SAAR) from the first-quarter level. Excluding volatile direct investment capital gains and losses on foreign currency denominated assets (owing to their revaluation at current exchange rates and shown separately in the table below), the current account improved by $2.6 billion in the second quarter. Improvements in the trade balance, fewer payments by U.S. travelers abroad (part of "other services, net"), and fewer unilateral transfers, more than offset an increase in payments on net private portfolio investments (a result of higher interest rates and a larger stock of liabilities outstanding) and reduced net income on "other direct investments."

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

	1988 Year	1989 Q1-r	1989 Q2-p	$ Change Q2-Q1
Trade Balance	-127.2	-113.5	-110.9	2.6
Exports	319.3	351.7	363.5	11.8
Imports	446.5	465.2	474.3	9.2
Investment Income, net	2.2	-9.7	-20.1	-10.4
Direct Investment, net	31.5	23.9	15.4	-8.5
Capital Gains or Losses[1]	-1.0	-13.9	-18.9	-5.0
Other Direct Investment	32.5	37.8	34.3	-3.5
Portfolio Income, net	-29.3	-33.5	-35.5	-1.9
Military, net	-4.6	-6.0	-6.5	-0.5
Other Services, net	17.7	21.7	25.9	4.1
Unilateral Transfers	-14.7	-14.1	-12.4	1.7
Current Account Balance:				
Published	-126.5	-121.6	-124.0	-2.4
Excluding Capital Gains and Losses	-125.5	-107.7	-105.1	2.6

1. Gains or losses on net financial assets denominated in foreign currencies owing to their revaluation at current exchange rates, and other valuation adjustments.
Plus = gains; minus = losses.

U.S. International Financial Transactions

Recently released balance-of-payments data for 1989-Q2 show continued large capital inflows by direct investors in the United States. (See line 7 in the Summary of U.S. International Transactions table.) The inflow of $12.3 billion for the second quarter was slightly lower than last year's second-quarter level, but, given the upward revisions in the first quarter data, the inflow for the first half of

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

	1987 Year	1988 Year	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2	1989 May	1989 June	1989 July
Private Capital										
Banks										
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	47.5	21.0	15.3	-0.5	9.1	-0.9	0.8	4.0	0.1	-1.8
Securities										
2. Private securities transactions, net[1]	36.4	15.5	10.9	5.8	0.9	5.8	3.7	0.1	1.2	2.1
a) foreign net purchases (+) of U.S. corporate bonds[2]	26.4	26.9	8.9	6.4	9.0	8.8	6.2	0.4	2.2	2.7
b) foreign net purchases (+) of U.S. corporate stocks	16.8	0.4	1.1	1.3	-2.0	0.1	3.6	1.0	2.6	1.6
c) U.S. net purchases (-) of foreign securities	-6.9	-11.8	1.0	-1.9	-6.1	-3.1	-6.2	-1.4	-3.6	-2.2
3. Foreign net purchases (+) of U.S. Treasury obligations	-7.3	20.6	5.6	3.5	5.5	8.7	2.5	8.3	-4.9	-1.8
Official Capital										
4. Changes in foreign official reserves assets in U.S. (+ = increase)	47.7	40.2	6.5	-2.0	10.7	7.8	-5.8	-7.3	-4.6	3.9
a) By area										
G-10 countries (incl. Switz.)	38.8	15.5	-0.8	-6.8	5.3	0.1	-9.3	-3.9	-8.0	-0.2
OPEC	-8.9	-3.4	-1.7	-0.8	0.7	6.8	0.2	-0.4	1.2	0.7
All other countries	17.8	28.0	9.0	5.7	4.6	0.9	3.3	-3.1	2.1	3.4
b) By type										
U.S. Treasury securities	43.2	41.7	5.9	-3.8	11.9	4.6	-9.8	-5.4	-4.3	3.2
Other[3]	4.5	-1.6	0.6	1.8	-1.3	3.1	4.1	-1.9	-0.4	0.7
5. Changes in U.S. official reserve assets (+ = decrease)	9.1	-3.6	*	-7.4	2.3	-4.0	-12.1	-6.5	-5.3	-0.8
Other transactions (Quarterly data)[4]										
6. U.S. direct investment (-) abroad	-44.2	-17.5	2.4	-4.9	-8.9	-5.5	-2.7	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	46.9	58.4	13.8	11.9	23.0	19.2	12.3	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow)[5]	5.7	2.5	-5.4	1.9	5.5	-2.4	5.7	n.a.	n.a.	n.a.
9. U.S. current account balance	-143.7	-126.5	-33.5	-32.3	-28.7	-30.4	-31.0	n.a.	n.a.	n.a.
10. Statistical discrepancy	1.9	-10.6	-15.7	24.0	-19.4	1.7	26.6	n.a.	n.a.	n.a.
MEMO:										
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-159.5	-127.2	-31.4	-30.3	-32.0	-28.4	-27.7	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 all U.S. bonds other than Treasury obligations.
3. Includes deposits in banks, commercial paper, acceptances, borrowing under repurchase agreements, and other securities.
4. Seasonally adjusted.
5. 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.
*--Less than $50 million.
NOTE: Details may not add to total because of rounding.

1989 ($31.5 billion) is running at a marginally higher rate than last year's record pace. The high level of inflows in recent years has not been matched by proportionate increases in reported income payments; the nominal rate of return on the outstanding stock of direct investment in the United States has varied between 2.4 and 5.4 percent since 1985. Such consistently low rates of return, combined with the continuing large direct investment inflows into the United States, are puzzling. Undoubtedly some foreign investors have made costly mistakes; however, there is probably a downward bias to reported income payments introduced both by the distortions of transfer pricing and the temporarily large interest, depreciation, and amortization charges associated with takeovers. In addition, some investors may be anticipating capital gains as a result of future exchange rate changes.

U.S. direct investment capital outflows have increased at a much more modest rate, one that is distorted downward by the effect of large capital losses in the first two quarters of 1989 (the result mainly of the appreciation of the dollar). The seasonally adjusted capital outflow for the second quarter was only $2.7 billion (see line 6); however, because of capital losses of $4.4 billion, the gross outflow was $7.1 billion. The capital outflow for the first half of 1989 ($8.2 billion) is at approximately last year's rate, but the more meaningful rate exclusive of capital gains ($16.1 billion for the first half) is double that for last year.

The statistical discrepancy for the second quarter showed large unrecorded capital inflows of $26.6 billion (line 10). While there are certainly errors and omissions in the reporting of current account transactions, such a wide quarterly swing as this is more likely to be the result of errors and omissions in the reporting of capital flows. For example, the statistical discrepancy will be reduced somewhat when data on U.S. nonbank deposits outside the United States become available; Federal Reserve reports indicate that reductions in such deposits account for a capital inflow of approximately $4.6 billion.

Foreign official reserve assets held in the United States increased by $3.9 billion in July, reversing the decline of the previous two months (line 4 of the Summary table).

. Preliminary data for August from the FRBNY indicate a further increase among G-10 countries in the $3 to $4 billion range.

Private security transactions (line 2) showed a net increase of $2.1 billion, led by continued strong foreign purchases of U.S. corporate bonds and stocks. These purchases were balanced, however, by a moderate sell-off of U.S. Treasury obligations ($1.8 billion) and robust purchases by U.S. residents of foreign securities ($2.2 billion).

A small net outflow was reported by banks in July (line 1). More recent data indicate a small net inflow to banks in August from their own foreign offices and IBFs (line 1 of the International Banking Data table).

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1986	1987	1988				1989				
	Dec.	Dec.	Mar.	June	Sept.	Dec.	Mar.	May	June	July	Aug.
1. Net Claims of U.S. Banking Offices (excluding IBFS) on Own Foreign Offices and IBFS	22.3	-10.9	8.7	-4.8	-4.9	-4.9	-2.9	1.6	-3.9	-3.9	-4.8
(a) U.S.-chartered banks	31.7	15.2	27.8	17.0	16.6	21.6	20.4	22.7	19.2	17.3	16.2
(b) Foreign-chartered banks	-9.4	-26.1	19.0	-21.8	21.5	-26.5	23.3	21.1	-23.1	-21.2	-21.0
2. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	16.8	15.8	13.1	19.7	21.4	21.2	24.0	25.4	26.0	26.2	25.4
3. Eurodollar Holdings of U.S. Nonbank Residents	124.5	132.6	128.9	138.1	141.1	145.3	144.2	141.1	137.8	141.5	140.9

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

Foreign Exchange Markets

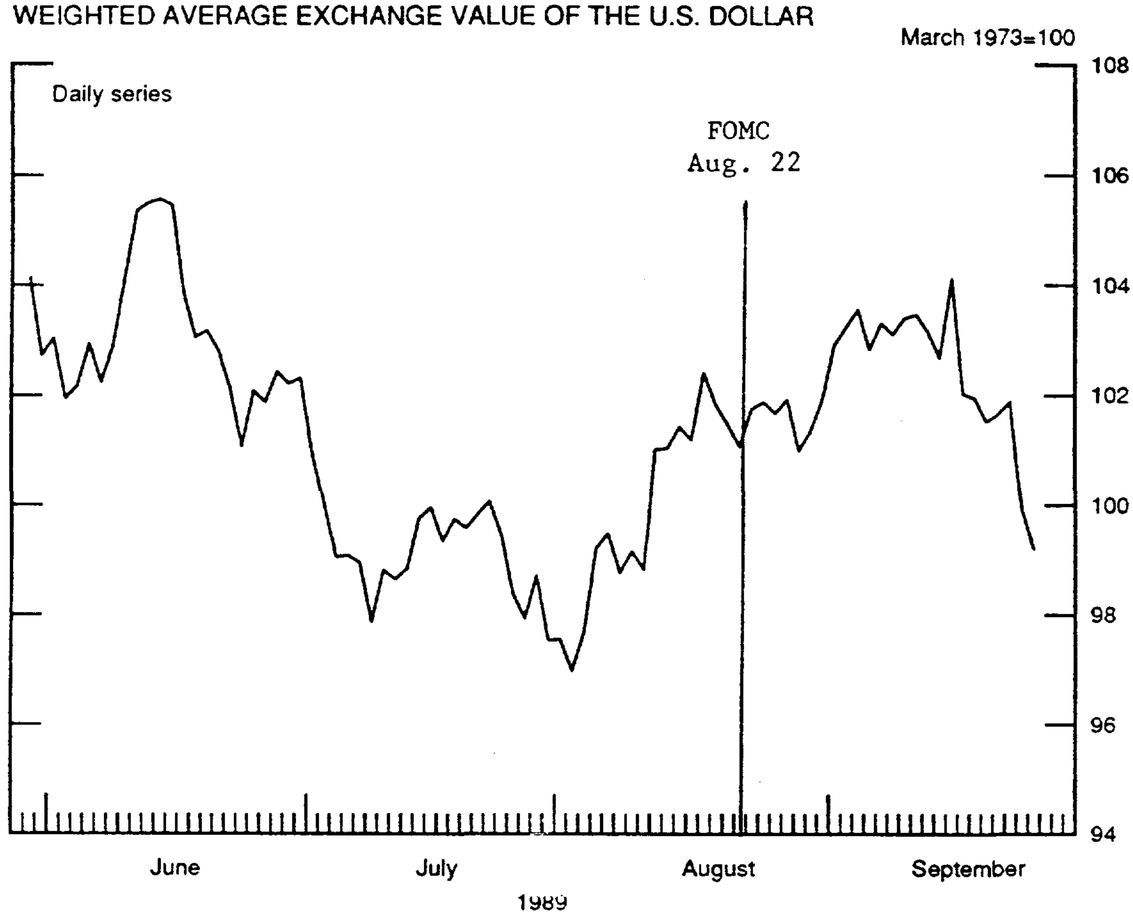
Since the August FOMC meeting, the weighted-average foreign exchange value of the dollar has declined 2-1/4 percent, on balance, as shown in Chart 1. Early in the period, the dollar rose sharply in reaction to data showing unexpectedly robust U.S. job growth in August. After steadying, the dollar climbed to intermeeting highs of DM 2.00 and ¥ 149 on September 15, immediately after the release of better-than-expected U.S. trade data for July. The dollar subsequently eased amid caution ahead of the September 23 G-7 meeting. In the event, the dollar plummeted, reaching lows of about DM 1.8750 and ¥ 140.50 by the end of the intermeeting period. The communique stated that:

> The ministers and governors considered the rise in recent months of the dollar inconsistent with longer run economic fundamentals. They agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy. In this context, they agreed to cooperate closely in exchange markets.

Moreover, this statement was followed by visible concerted intervention by all G-7 central banks and other European central banks, beginning in the Far East Sunday night. Though apparently impressed by the communique and the more aggressive and inclusive intervention operations, market participants nevertheless are uncertain whether these statements and actions will be backed by changes in monetary policies.

Among individual currencies, the dollar fell more than 3-1/4 percent against the mark, but was down only 1-1/4 percent against the yen. Market participants reportedly expect a further tightening of monetary conditions in Germany during the next month or so amid signs of rapid growth, but are somewhat less certain about prospects for

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



INTEREST RATES IN JAPAN AND GERMANY

	Japan		Germany	
	3-month[1]	long-bond[2]	3-month[3]	long-bond[4]
August 22	5.45	5.04	7.00	6.89
September 18	5.69	5.39	7.35	7.11
September 27	5.63	5.19	7.50	7.17

1. CD rate.
2. yield on #111 (bellwether) bond.
3. interbank rate.
4. yield on Federal public authority bond.

tightening in Japan. In addition, the yen was depressed by continued uncertainty about Japanese political leadership in the wake of new revelations about possibly another inside trading scandal.

Desk sales totalled $2.9 billion, about $1.7 billion of which were against yen and the remainder against marks.

With some anticipation of monetary tightening in Germany and Japan, interest rate differentials between dollar-denominated and yen and mark-denominated assets narrowed during the intermeeting period. Interest rates in the United States were little changed. As shown in the table, 3-month CD rates and bond yields in Japan were up 15-20 basis points. In Germany, the minimum rate for accepted bids for funds in the Bundesbank's RP operations rose 30 basis points, 3-month interbank rates increased 50 basis points, and bond yields increased nearly 30 basis points.

Developments in Foreign Industrial Countries

Data on second-quarter GNP growth in the major foreign industrial countries has confirmed a general pattern of a sharp slowing in the pace of activity from the very rapid first-quarter rate. In several countries, notably Japan and Germany, this quarterly pattern appeared to be due to special factors, and did not necessarily indicate a slackening in the underlying pace of activity. Preliminary data for the early part of the third quarter seem to show a return to stronger growth.

After a general increase in inflation in the major foreign economies early in the second quarter, due in several cases to the imposition of indirect taxes and other special factors, inflation rates in recent months have stabilized or declined, reflecting in part lower oil prices and the strength of foreign currencies against the dollar in June and July. However, the weakness of foreign currencies against the dollar in August and early September has heightened concerns about renewed inflationary pressures in several countries.

The trade balances of most major industrial countries have moved toward deficit in recent months. In both Germany and Japan, trade surplus levels have been reduced, while trade deficit rates have increased recently in France, Italy and the United Kingdom.

Individual Country Notes. In Japan, real GNP declined by 3.1 (s.a.a.r.) in the second quarter, after strong 9.6 percent growth in the first quarter. Negative second-quarter growth was due mainly to a decline in consumption (which fell at a 5.2 percent rate) and exports (down at a 12.3 percent rate). Plant and equipment growth, at 11.7 percent, continued strong, but below its very high first-quarter pace. Second-quarter real GNP remained 4.7 percent above its year-earlier level.

The quarterly pattern of real GNP growth in the first half of the year was distorted by the introduction of the 3 percent consumption tax at the beginning of April, which led to a bunching of activity in the

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

	Q4/Q4 1987	Q4/Q4 1988	1988 Q3	1988 Q4	1989 Q1	1989 Q2	1989 Apr.	1989 May	1989 June	1989 July	1989 Aug.	Latest 3 months from year ago 2
Canada												
GDP	6.5	4.0	.8	.7	.8	.2	*	*	*	*	*	2.5
IP	9.6	2.7	1.0	-.7	.2	.6	.5	.1	-.0	n.a.	n.a.	1.1
France												
GDP	2.6	3.1	1.0	.6	1.1	n.a.	*	*	*	*	*	3.0
IP	3.2	4.3	3.2	-.1	1.0	1.8	3.4	-2.1	1.5	n.a.	n.a.	6.1
Germany												
GNP	2.3	3.0	1.1	.5	2.9	.3	*	*	*	*	*	4.9
IP	1.5	4.0	1.8	.6	2.4	-.8	1.0	-4.6	4.2	2.3	n.a.	4.6
Italy												
GDP	3.8	3.3	.7	1.0	.7	n.a.	*	*	*	*	*	3.1
IP	5.7	6.7	.2	4.4	.1	n.a.	.1	-1.7	n.a.	n.a.	n.a.	3.2
Japan												
GNP	5.7	4.8	2.3	.8	2.3	-.8	*	*	*	*	*	4.7
IP	8.1	7.6	2.0	1.8	3.1	.0	-3.8	.5	2.0	-2.6	2.9	6.5
United Kingdom												
GDP	5.1	3.5	1.3	.7	.5	-.3	*	*	*	*	*	2.2
IP	4.1	2.6	1.6	.2	-1.9	-.7	.0	-1.2	.3	1.7	n.a.	-1.1
United States												
GNP	5.4	3.4	.8	.7	.9	.6	*	*	*	*	*	3.0
IP	5.8	5.0	1.7	1.1	.5	.8	.7	-.0	.2	.1	.3	3.2

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	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2	1989 Q3	1989 June	1989 July	1989 Aug.	1989 Sept.	Latest 3 months from year ago
Canada													
CPI	4.2	4.1	1.3	1.1	.8	1.2	1.7	n.a.	.5	.7	.1	n.a.	5.3
WPI	4.3	3.5	.9	1.0	.5	1.1	.4	n.a.	.3	-.2	n.a.	n.a.	2.5
France													
CPI	3.2	3.0	1.0	.9	.6	.8	1.2	n.a.	.1	.3	.2	n.a.	3.5
WPI	3.4	7.2	1.2	2.4	2.5	2.4	.6	n.a.	*	*	*	*	8.1
Germany													
CPI	1.0	1.5	.5	.1	.4	1.6	1.0	.1	.2	-.2	-.1	.2	3.0
WPI	-.7	2.7	1.1	.4	1.2	2.7	1.7	n.a.	-.1	-.9	-.3	n.a.	5.0
Italy													
CPI	5.2	5.2	1.0	1.0	1.9	2.0	1.7	n.a.	.5	.2	.2	n.a.	6.9
WPI	4.6	5.4	1.3	1.2	1.7	2.3	1.4	n.a.	.4	-.2	n.a.	n.a.	6.7
Japan													
CPI	1.1	1.5	.6	.1	1.0	-.1	2.1	n.a.	-.1	-.2	-.3	n.a.	3.2
WPI	-.6	-1.4	-.3	.9	-.8	.5	2.7	n.a.	.7	.0	.0	n.a.	3.3
United Kingdom													
CPI	4.1	6.5	2.4	1.4	2.1	1.6	2.9	n.a.	.3	.1	.3	n.a.	7.9
WPI	4.1	4.9	1.4	1.2	1.1	1.4	1.2	n.a.	.3	.3	.3	n.a.	4.9
United States													
CPI (SA)	4.4	4.3	1.1	1.2	1.1	1.3	1.6	n.a.	.2	.2	.0	n.a.	4.9
WPI (SA)	2.5	3.4	.8	1.1	.9	2.2	1.6	n.a.	-.1	-.4	-.4	n.a.	5.0

1. A[redacted]risk 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	1988 Q1	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2	1989 May	1989 June	1989 July	1989 Aug.
Canada												
Trade	8.6	8.0	1.6	2.5	2.3	1.6	2.0	.6	.5	.1	.9	n.a.
Current account	-8.0	-8.4	-1.4	-1.7	-2.0	-3.2	-3.1	-4.8	*	*	*	*
France												
Trade	-5.2	-5.4	-.9	-.6	-1.9	-2.0	-.6	-2.1	-1.0	-.5	-1.2	n.a.
Current account	-4.1	-4.0	1.4	-.7	-1.1	-3.6	1.0	n.a.	*	*	*	*
Germany												
Trade (NSA)	65.9	72.9	15.0	19.9	17.0	21.0	19.4	17.7	5.4	7.0	5.6	n.a.
Current account (NSA)	45.6	48.7	9.7	14.4	8.7	15.9	15.8	13.7	4.5	5.1	2.7	n.a.
Italy												
Trade	-8.7	-9.9	-3.3	-1.6	-2.5	-2.5	-5.2	-3.3	-1.3	-1.1	-.7	n.a.
Current account (NSA)	-1.6	-5.4	-5.2	1.0	.2	-1.5	-6.6	n.a.	*	*	*	*
Japan												
Trade	79.5	78.1	20.9	16.9	18.4	21.9	21.9	15.4	3.6	5.1	5.0	4.4
Current account 2	87.0	79.6	22.3	17.1	18.1	21.2	21.2	12.5	3.4	2.9	4.0	n.a.
United Kingdom												
Trade	-15.9	-36.0	-7.1	-8.0	-9.7	-11.2	-10.5	-9.4	-2.8	-3.0	-4.0	-3.7
Current account	-5.1	-26.0	-5.4	-5.1	-5.8	-9.8	-8.5	-7.5	-2.2	-2.4	-3.6	-3.2
United States												
Trade 2	-159.5	-127.2	-33.4	-31.4	-30.3	-32.0	-28.4	-27.7	*	*	*	*
Current account	-143.7	-126.5	-32.0	-33.5	-32.3	-28.7	-30.4	-31.0	*	*	*	*

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.

first quarter. As shown in the table below, a similar quarterly pattern was evident in industrial production and retail sales. Abstracting from this distortion, the underlying rate of activity appears to have remained fairly strong. Preliminary indications of activity in the third quarter have been mixed. Industrial production increased by a strong 2.9 percent (s.a.) in August and the unemployment rate remained at 2.2 percent (s.a.) in July, its lowest level in over seven years. However, the capacity utilization rate (s.a.) dropped in July from its near-peak level of the previous month.

JAPANESE ECONOMIC INDICATORS
(percent change from previous period except were noted, s.a.)

	1988	1989						
	Q4	Q1	Q2	Apr.	May	Jun.	Jul.	Aug.
Real GNP	0.8	2.3	-0.8	--	--	--	--	
Industrial Production	1.8	3.1	0.0	-3.8	0.5	2.0	-2.6	
Retail Sales	2.7	6.4	-5.4	-18.0	4.9	2.1	2.7	--
Capacity Utilization	1.6	0.0	0.2	-3.6	1.0	2.6	-3.8	--
Unemployment Rate (percent)	2.4	2.3	2.3	2.3	2.4	2.2	2.2	--

In light of some signs of possible strains on industrial capacity and labor markets, along with the recent weakness of the yen on exchange markets, officials have expressed concerns that underlying inflationary pressures could intensify. Latest monthly data, however, have not indicated any rise in recorded inflation. The 12-month increase in Tokyo consumer prices eased for the second consecutive month in August, moving down to 2.9 percent. Wholesale prices rose 3 percent in the 12 months to August, well below the 3.7 percent peak recorded in June.

The trade balance (s.a.) declined further in August. Through the first eight months of the year, the cumulative trade surplus was $70.1

billion (s.a.a.r.), below the $75 billion surplus rate in the same period last year. The current account surplus has declined even further this year (a $64.7 billion surplus rate through July, compared with $76.3 billion last year), mainly reflecting a sharp increase in tourist expenditures. This decrease in the nominal dollar value of external surpluses mainly reflects J-curve effects from the weaker yen. In real terms, external adjustment has come to a halt. Through the first seven months of this year, the volume of exports was 5.4 percent above its year-earlier level, while import volume rose 7 percent. In the same period last year, in contrast, export volume was up only 2.9 percent while import volume surged by 20 percent.

Economic growth has been strong in Germany throughout the year. However, data in the first half were distorted by the very mild winter weather that acted to boost recorded growth in real GNP to 12 percent (s.a.a.r.) in the first quarter and reduce it to 1.3 percent in the second quarter. From a year earlier, real GNP was up nearly 5 percent in the second quarter, led by a 15 percent rise in exports (while imports rose 9.7 percent) and a 14 percent increase in investment in machinery and equipment. Construction and private consumption also contributed to growth, rising 5.3 percent and 2 percent, respectively, while public consumption was flat.

Monthly series show the continuing strength of the economy in the early months of the third quarter, as shown in the table below. Industrial production (s.a.) rose sharply in July to a level 8.4 percent above its year-earlier level. The volume of manufacturers' new orders (s.a.) increased only slightly in July, but remained a strong 6.7 percent above its year-earlier level.

GERMAN ECONOMIC INDICATORS
(percent change from previous period except where noted, s.a.)

	1988	1989						
	Q4	Q1	Q2	Apr.	May	June	July	Aug.
Industrial Production	0.6	2.4	-0.8	1.0	-4.6	4.2	2.3	--
Vol. of Manufacturing Orders	-0.7	2.3	3.0	1.7	-3.4	2.7	0.1	--
Unemployment Rate (percent)	8.5	7.9	7.9	7.9	8.0	7.9	7.9	7.8
Capacity Utilization	1.5	-0.9	1.1	--	--	--	--	--

The increase in production this year has had relatively little impact on the unemployment rate, which has remained at just under 8 percent (s.a.) in recent months. However, skill shortages and rising vacancies have been reported in numerous industries. Furthermore, capacity utilization in manufacturing rebounded in the second quarter to its highest level since the early 1970s.

Inflation has eased somewhat in recent months. Consumer prices rose 3.7 percent (s.a.a.r.) from January to May, but they advanced at a rate of only 1.7 percent between May and September. However, wage increases have accelerated recently, rising from a 4.9 percent increase (s.a.a.r.) in the first quarter to 5.7 percent in the second quarter.

Although the Bundesbank has not raised its official lending rates since late-June, market interest rates have moved up recently. Growth in M3 rose in August to 5.2 percent (s.a.a.r., from the fourth quarter of 1988), putting M3 growth slightly above the Bundesbank's 1989 target of "about 5 percent."

Germany's external surpluses, after hitting record levels in the first quarter, have moderated. In the period from April through July, the current account and merchandise trade surpluses generally ran slightly below their year-earlier levels. However, on a cumulative basis through July, the current account surplus remained well above its year-earlier level, at $32.3 billion (n.s.a.) versus $26.9 billion in 1988. The trade surplus was slightly above its year-earlier level, at $42.8 billion (n.s.a.) versus $40.9 billion.

Most indicators of French economic activity suggest continued moderate growth. Real marketable GDP grew 2.8 percent (s.a.a.r.) in the second quarter, down from 5.3 percent in the first quarter. The slowing in growth was due entirely to lower net exports. Domestic demand was up by 5.7 percent in the second quarter, after remaining roughly constant in the first quarter. In July, capacity utilization increased to its highest level in nearly two decades, and in August the unemployment rate fell to 9.5 percent (s.a.).

The trade deficit (s.a.) widened sharply in July. The cumulative trade deficit for the first seven months of 1989 was $6.5 billion (s.a.a.r.), up from a deficit rate of $3.9 billion for the same period of 1988. However, in part as a result of the bicentennial of the French Revolution, tourism earnings have surged in 1989 to a total 60 percent above their level in 1988, so that the current account has deteriorated by less than the merchandise trade balance.

Recent data indicate that the pace of economic activity in the United Kingdom has begun to slow. The average measure of real GDP fell by 1 percent (s.a.a.r.) in the second quarter after rising by 2.1 percent in the first quarter. Industrial production grew 1.7 percent (s.a.) in July, due in large part to a rebound in oil production, but was unchanged from its year-earlier level. The unemployment rate resumed its decline in August, falling to 6.1 percent (s.a.) from 6.3 percent registered in the previous two months.

The 12-month rate of consumer price inflation fell sharply to 7.3 percent in August from 8.2 percent in July. The fall was almost entirely due to the removal of the August 1988 rise in home loan interest rates from the calculation of the retail inflation rate. Excluding mortgage interest payments, the 12-month rate of retail price inflation was 5.7 percent in August, down only slightly from 5.8 percent in July and a peak rate of 6 percent in May. Wage pressures continue to be worrisome; the underlying 12-month rate of increase in average earnings rose to 9-1/4 percent in July.

The current account (s.a.) registered its second and third largest deficits ever in July and August, respectively. This raised the cumulative current account deficit so far this year to $34 billion (s.a.a.r.), well above the $22.5 billion deficit rate in the same period last year, and suggesting that the government's official forecast of an unchanged current account deficit this year will be substantially exceeded.

Economic growth in Canada slowed in the second quarter, as real GDP increased 0.6 percent (s.a.a.r.), down from 3.3 percent in the first quarter. The slower growth was due mainly to a sharp decline in net exports. Total domestic demand remained buoyant, expanding 5.6 percent, led by an acceleration in consumption expenditures and inventories and only a slight deceleration in investment. More recent data suggest some weakening in domestic demand, as retail sales declined by 0.3 percent (s.a.) in July and manufacturers' new orders fell 0.3 percent (s.a.) in June. The sharp rise in the rate of consumer price inflation in May and June, due primarily to higher federal and provincial sales taxes, appears to have abated.

Canada's current account deficit increased to $19.2 billion (s.a.a.r.) in the second quarter, a record level. This mainly reflects a drop in the merchandise trade surplus which has been attributed to the strong Canadian dollar and continued high imports of capital goods. However, sharply lower imports in July caused the trade surplus to rebound to its highest level in six months.

The Minister of Finance has announced details of a plan to replace Canada's current manufacturers' sales tax with a lower, but more broadly based, national goods and services tax. The new tax promises to have a less distortionary effect on economic activity than the current tax, but faces opposition in Parliament, from some provinces, and from consumer groups.

In Italy, recent data indicate some slowing in the pace of economic activity. In May, industrial production declined 1.7 percent (s.a.) to a level below the average in the first quarter. Other indicators, such as industrial sales and automobile sales, indicate somewhat stronger activity. Inflation has slowed slightly in recent months, indicating that the rising trend, caused by the introduction of indirect taxes at the end of last year, may have been reversed. The cost of living index rose 6.7 percent in August from its level a year earlier, down from the

7 percent rise registered in June and July. Wholesale prices rose 4.7 percent in July from their level a year ago, down sharply from the 6.8 percent increase in the second quarter.

Recent trade and current account data confirm the trend towards a worsening external position. Preliminary data on the first quarter current account (n.s.a.) show a deficit that is 25 percent larger than the deficit in the first quarter of 1988. The cumulative trade deficit through July is $11 billion (s.a.a.r.), 60 percent above the deficit rate in the same period last year.

Economic Situation in Major Developing Countries

Mexico reached agreement with its Bank Advisory Committee in mid-September on the term sheet for its comprehensive financing package, providing options for principal reduction, interest reduction, and new money, that was agreed to in principle in July. Brazil missed a $1.6 billion interest payment to commercial banks on September 18, citing the need to protect its international reserves. Argentina made progress in implementing the stabilization program initiated in July, and may be close to agreement on an IMF stand-by arrangement. Venezuela reached agreement on an interim financing arrangement with its larger commercial bank creditors to clear about $1 billion in arrears by the end of September; discussions will then resume on a possible package of new money and/or debt and debt-service reduction. In mid-September, the Philippines reached agreement on terms with its Bank Advisory Committee on a financing package providing new money and a debt buy-back. The IMF approved a 17-month stand-by arrangement for Ecuador in September. Final IMF approval of a one-year arrangement for Chile to be drawn from the first credit tranche and involving no performance criteria is expected shortly.

Individual country notes. Mexico and its Bank Advisory Committee reached agreement on September 13 on a detailed term sheet for the commercial bank financing package that was agreed upon in principle in July. This enabled Mexico to begin drawing on an official bridge loan for up to $2 billion from the U.S. monetary authorities, the BIS, acting for the central banks of the other G-10 countries, and Spain. Mexico drew $784 million on its swap line with the Federal Reserve and $384 million on its line with the Treasury's Exchange Stabilization Fund on September 25. The bank package is not expected to be implemented until early 1990, although some of its terms will be retroactive to July 1, 1989.

After declining in July by more than 20 percentage points due to revived confidence and large private capital inflows, the rate for 28-day Treasury bills was 33 percent at the August 29 auction. Since then, it has turned up somewhat. At the September 19 auction, the lowest bid was 35.75 percent, but all bids were rejected. In the next two days, the Bank of Mexico sold in the secondary market at rates averaging 34.25 percent over 80 percent of the bills originally offered at auction on September 19.

The recent upturn in interest rates may reflect a slowing of private capital inflows and rising private demand for credit due to the strong expansion of economic activity. In January-July, industrial production was 5.6 percent higher than in the same period last year. For all of 1989, real GDP is likely to show a 2.5-3 percent increase, compared with a 1.5 percent rise officially forecast last December.

The strength of the economic recovery is stimulating imports, which exceeded $2.1 billion in June, the highest level since October 1981. A current account deficit of more than $4 billion is likely this year, up from $2.9 billion in 1988.

As was expected, Brazil did not pay commercial bank creditors the $1.6 billion in interest due September 18, bringing interest arrears accumulated since early July to about $2.5 billion. In recent weeks, Brazilian officials have been meeting with the Bank Advisory Committee, and have publicly stated that payments would be delayed, citing the need to protect international reserves from speculative attacks before the November presidential elections and the unavailability of financing from commercial banks, the IMF, and the World Bank. Nevertheless, the Brazilian government is still attempting to obtain the release of the third tranche of $600 million from its 1988 financing agreement with commercial banks. Release of the funds is contingent upon an IMF program with Brazil. Brazilian officials and the IMF are considering the possibility of a six-month stand-by arrangement, but Brazil may not be able to produce the economic policies to justify such an agreement.

Brazil's trade surplus remained strong at $1.4 billion in both July and August, bringing the trade surplus through August 1989 to $12.1 billion, compared with $12.6 billion in the same period in 1988. The government has relaxed restrictions on repatriation of capital that it imposed in early July, and has cleared most of the arrears to the Paris Club and multilateral agencies that had accumulated since early July.

Liquid reserves have been rising in recent weeks, and are now estimated to be between $6.5 and $7 billion.

The monthly increase in consumer prices was 29.3 percent in August, only slightly higher than July's increase of 28.8 percent, but preliminary government surveys indicate that consumer prices will rise about 35 percent in September. Industrial production was 7.2 percent higher in July 1989 than a year earlier; this was the third consecutive monthly increase in the year-over-year growth rate.

Financial markets are showing signs of increasing nervousness. The overnight interest rate rose gradually from 34.8 percent (monthly basis) in the third week of August to 37.1 percent on September 18, but surged to 42.9 percent by September 22 due to increased inflation expectations. The parallel market exchange rate has depreciated substantially, driving the spread between the official and parallel exchange rates from 58 percent on September 18 to 83 percent by September 22.

<u>Argentina</u> has made progress in implementing the stabilization program initiated following the inauguration of President Carlos Menem on July 8. The Congress has approved a bill enabling the privatization of state economic enterprises, and specific plans for the sale of parts of the state telephone system and railways have been signed by President Menem. A bill suspending the costly industrial subsidy program has also been approved, and a sweeping reform of the tax system will soon be submitted to Congress.

In parallel with these reform efforts, the authorities have adhered to their commitment to keep the exchange rate and public sector prices unchanged for three months following the initiation of the program in

July. As a result, monthly inflation declined from 197 percent in July to 38 percent in August, and is expected to register about 10 percent in September. The government is considering extending the freeze in public sector prices and the exchange rate through early 1990.

Based on these stabilization efforts, negotiations with the IMF on a new stand-by arrangement have been taking place. Discussions have also taken place with the World Bank that could lead to the resumption of disbursements on policy-based loans that were discontinued in March 1989, or to new policy-based loans; however, neither action is likely until a program with the IMF is agreed. Negotiations on the treatment of more than $4 billion in interest arrears to commercial banks have not yet resumed. However, in response to its desire to extend or renew trade credit lines scheduled to be terminated at the end of September, Argentina has been given informal assurances that credit lines provided by steering committee banks will continue to be made available.

In mid-September, Venezuela and its larger commercial bank creditors reached agreement on a plan to clear interest arrears, which are projected to reach $1 billion, by end-September. The agreement specifies that Venezuela will pay this interest using about $400 million in foreign exchange reserves and about $600 million from a club loan provided by a limited group of banks. After the arrears are cleared, discussions will resume on a restructuring of Venezuela's public sector debt to commercial banks and on a possible package of new money and/or debt and debt-service reduction.

In August, the IMF concluded that Venezuela's economic reform program remained on track, as of June 30, and released the second SDR

247 million disbursement under the three-year Extended Fund Facility arrangement established earlier this year. Monthly inflation has decelerated rapidly in recent months to 2.2 percent in August, compared with a peak of 21.3 percent in March that was due to a sharp devaluation and the removal of price controls. The tight monetary and fiscal policies that have helped to bring down inflation have also depressed real GDP, which is expected to decline about 8 percent this year.

The Philippine government announced on September 17 that it had reached agreement on terms with its Bank Advisory Committee on a debt relief and financing package. The agreement is expected to provide somewhat less than $1 billion through the issuance of new-money bonds that would be excluded from future restructurings. The Philippines plans to use $740 million from reserves and resources to be provided by the IMF, the World Bank, and Japan to buy back, at a discount of about 47 percent reflecting the average price of Philippine bank debt during the past 12 months, about $1.4 billion in commercial bank debt. The formal syndication of the financing package is to commence by the end of September; the government hopes to complete all arrangements by November.

In mid-September, the IMF approved a 17-month, SDR 110 million stand-by arrangement for Ecuador. The arrangement provides that Ecuador will reduce the fiscal deficit, continue monetary restraint, maintain a competitive exchange rate, and pursue structural reform.

In early September, Chile and the IMF management agreed to a one-year, SDR 64 million stand-by arrangement to be drawn from the first credit tranche and thus involving no performance criteria. The stand-by is expected to be approved by the Executive Board in October. Chile hopes to use IMF, World Bank, and Japanese government funds to engage in a $500 million buyback of bank debt at a 40 percent discount.