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January 25, 1995

RECENT DEVELOPMENTS

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

DOMESTIC NONFINANCIAL DEVELOPMENTS

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Economic activity was robust in late 1994, with real GDP evidently posting its best quarterly gain of the year. Although rates of unemployment and capacity utilization pierced levels that in the past had been associated with accelerating wages and prices, inflation at the retail level had not yet picked up at year-end.

Employment and Unemployment

Job growth evidently remained strong at the turn of the year. In December, hiring continued at the brisk pace that has prevailed since early last year; total nonfarm payroll employment rose 256,000, and private payroll employment was up 286,000. Production-worker hours rose 0.3 percent in December, and for the fourth quarter as a whole increased 5.3 percent at an annual rate. Initial claims for unemployment insurance in mid-January were at about the same level that prevailed during the second half of last year, suggesting that employment growth has continued to be substantial.

Job gains were very broadly based in December. The three-month diffusion index rose to 68.5 percent--the highest reading since December 1988.¹ In the goods-producing sector, manufacturing added 54,000 jobs. The increase marked the third consecutive month of brisk hiring in the manufacturing sector, with demand for labor particularly strong in metals, capital goods, electronic equipment, motor vehicles, and related areas. For the year as a whole, manufacturers added nearly 300,000 workers to their payrolls.

Construction payrolls slipped 6,000 last month after having risen more than 70,000 in November. In part, the November increase

1. The diffusion index is based on payrolls in 356 private industries. A reading of 50 percent indicates a balance between industries with increasing employment and those with decreasing employment.

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

	1993	1994	1994			1994		
			Q2	Q3	Q4	Oct.	Nov.	Dec.
-----Average monthly changes-----								
Nonfarm payroll employment ²	194	290	345	284	302	162	488	256
Private	179	270	320	240	298	193	414	286
Manufacturing	-11	24	21	17	46	46	39	54
Durable	-7	21	21	18	33	29	38	32
Nondurable	-4	3	0	0	13	17	1	22
Construction	19	25	40	15	23	2	73	-6
Trade	42	78	96	79	91	64	106	102
Finance, insurance, real estate	10	2	6	-1	0	-8	4	3
Services	116	133	146	124	128	93	180	110
Health services	23	21	22	20	20	22	8	31
Business services	46	60	57	59	64	33	104	54
Total government	15	21	26	44	4	-31	74	-30
Private nonfarm production workers	164	238	300	199	244	168	344	219
Manufacturing production workers	-1	28	24	19	48	42	43	60
Total employment ³	209	326	158	336	309	497	262	167
Nonagricultural	219	289	192	297	268	414	256	135
Memo:								
Aggregate hours of private production workers (percent change)	.3	.3	.4	.2	.4	1.1	-.3	.3
Average workweek (hours)	34.5	34.6	34.7	34.5	34.7	34.9	34.6	34.6
Manufacturing (hours)	41.5	42.0	42.1	42.0	42.2	42.1	42.2	42.2

1. Average change from final month of preceding period to final month of period indicated.
2. Survey of establishments.
3. Survey of households. Data for 1994 are not directly comparable with earlier years because of a redesign of the CPS in January 1994.

SELECTED UNEMPLOYMENT AND LABOR FORCE PARTICIPATION RATES¹
(Percent; based on seasonally adjusted data)

	1993	1994	1994			1994		
			Q2	Q3	Q4	Oct.	Nov.	Dec.
Civilian unemployment rate (16 years and older)	6.8	6.1	6.2	6.0	5.6	5.7	5.6	5.4
Teenagers	19.0	17.6	18.1	17.5	16.7	17.1	15.8	17.2
20-24 years old	10.5	9.7	9.7	9.7	8.9	9.0	9.1	8.6
Men, 25 years and older	5.8	4.8	4.8	4.7	4.4	4.5	4.4	4.3
Women, 25 years and older	5.4	4.9	5.0	4.8	4.5	4.6	4.6	4.3
Full-time workers	6.8	6.1	6.2	6.0	5.6	5.8	5.6	5.3
Labor force participation rate	66.2	66.6	66.5	66.5	66.6	66.7	66.7	66.6
Teenagers	51.5	52.7	53.2	52.3	52.5	52.7	51.8	52.9
20-24 years old	77.1	77.0	76.9	76.9	77.2	77.3	77.3	77.1
Men, 25 years and older	76.2	76.0	75.8	75.9	76.2	76.1	76.2	76.3
Women, 25 years and older	57.1	58.1	57.9	58.2	58.2	58.2	58.3	58.0

1. Data for 1994 are not directly comparable with earlier years because of a redesign of the CPS in January 1994.

and the December decline reflected the timing of the survey: The November survey reference week was relatively early in the month whereas the December survey was relatively late. Because construction employment declines as weather conditions deteriorate, the early November survey likely picked up fewer seasonal layoffs than usual, whereas the late December survey picked up more.²

In the private service-producing sector, substantial gains in services and retail trade helped boost payrolls 240,000 in December. Transportation added 24,000 jobs, apparently because demands for trucking and passenger transportation exceeded seasonal norms. Federal government employment was boosted by a larger-than-usual addition of postal workers for the holiday rush. However, local government employment fell 50,000 as the jobs ended for temporary election workers hired in November.

The December levels for the total workweek (34.6 hours) and the manufacturing workweek (42.2 hours) were unchanged from November. However, factory overtime hours edged back up to 4.8 hours, matching the highest level in the forty-year history of this series.

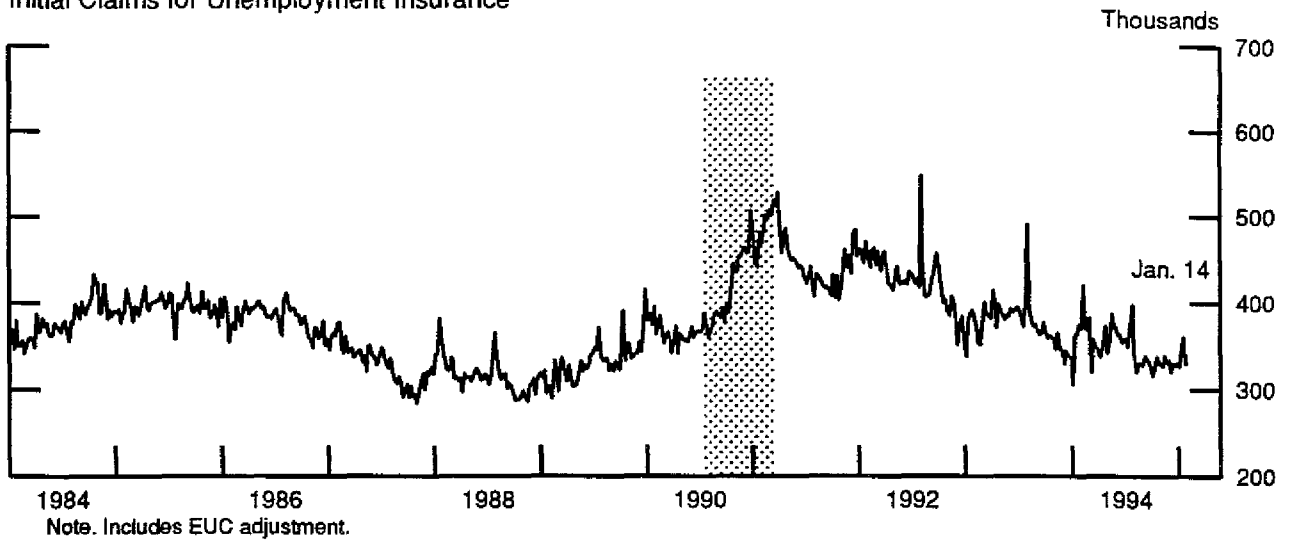
In December, the civilian unemployment rate dropped another 0.2 percentage point, to 5.4 percent. The January-to-December decline in the unemployment rate was 1.3 percentage points--the largest such decline since 1983. The December drop in joblessness reflected lower rates for both men and women aged 20 and over; rates rose for teenagers. The labor force was little changed in December, and the participation rate held at 66.6 percent. Total household employment rose 167,000, and the employment-to-population ratio remained at 63 percent.

The table below shows the readings on several series from the household survey for December 1994 and compares them with those for

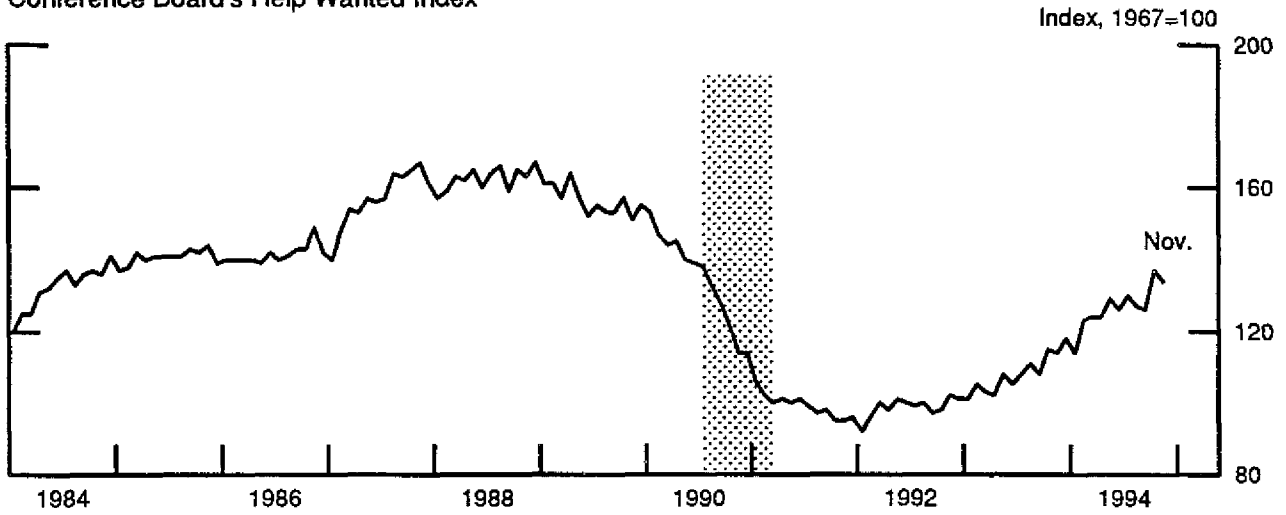
2. Precipitation during the December survey week does not appear to have exceeded seasonal norms.

Labor Market Indicators

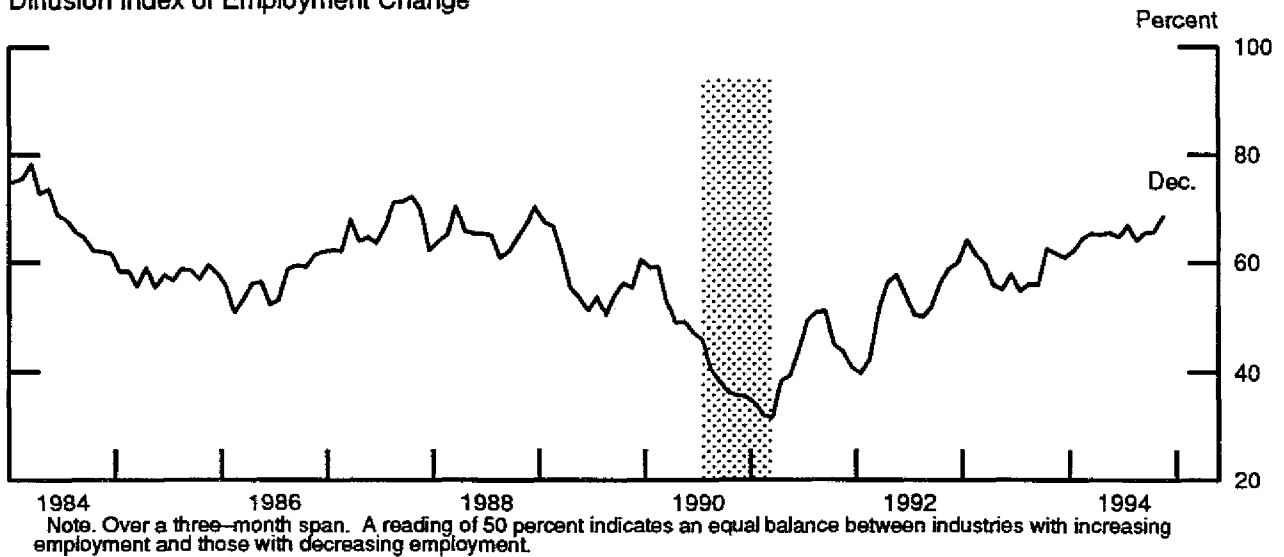
Initial Claims for Unemployment Insurance



Conference Board's Help Wanted Index



Diffusion Index of Employment Change



December 1993 and the annual averages for 1989, when, as measured by the overall jobless figure, the labor market was as tight as it was last month. The pre-1994 data have been adjusted to be comparable with data from the new Current Population Survey (CPS).³ As shown in the table, jobless rates for adults declined substantially during 1994, reaching levels by December quite comparable to those that prevailed in 1989. The rate for teenagers also moved down last year, but it remained higher at year-end than in 1989. Nonetheless, despite the sharp drop in unemployment, the employment-to-population ratio in December stood slightly below its 1989 level.

INDICATORS OF LABOR MARKET SLACK FROM THE HOUSEHOLD SURVEY¹
(Seasonally adjusted data)

	1989	1993 Dec.	1994 Dec.
Total unemployment rate (percent)	5.4	6.5	5.4
Teenagers	15.6	18.4	17.2
Men, aged 20 and over	4.6	6.0	4.7
Women, aged 20 and over	4.8	5.8	4.7
Employment-to-population ratio	63.4	62.5	63.0
Involuntary part-time workers (percent of household employment)	3.2	4.2	3.5
Permanent job losers (percent of unemployed)	31.1	39.3	34.8
Labor force participation rate	67.1	66.9	66.6
Teenagers	54.7	51.8	52.9
Men, aged 20 and over	78.3	77.0	77.0
Women, aged 20 and over	57.8	59.9	59.2
Discouraged workers (percent not in the labor force)	.69	.69 ²	.67

1. Data for 1989 and 1993 have been adjusted, using factors developed by the BLS, to be comparable with data in 1994.

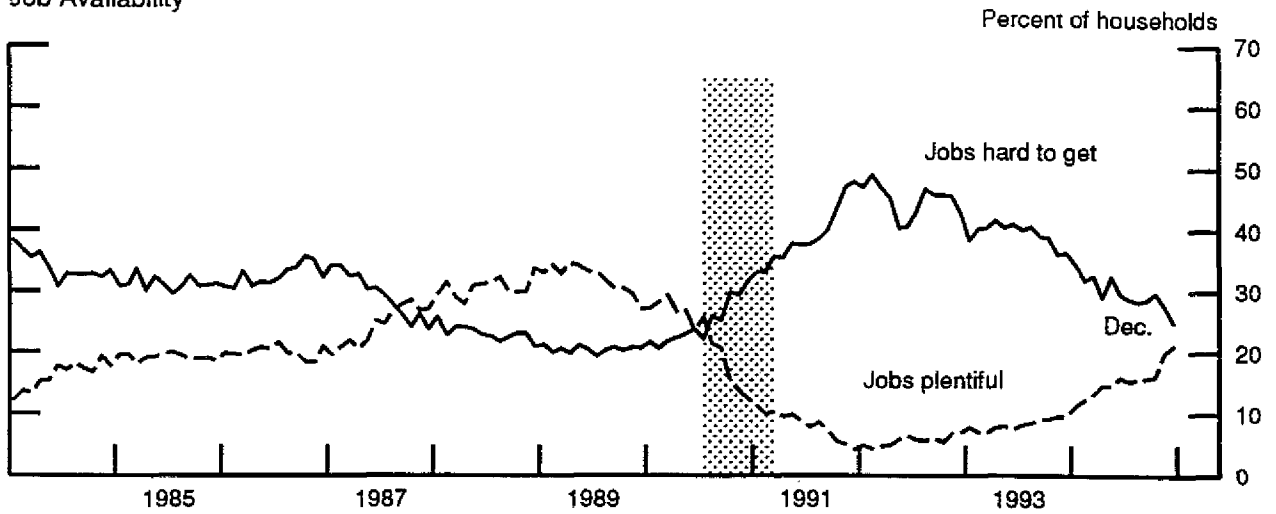
2. Data are for 1993:Q4.

3. The adjustment factors were developed by the research staff at the Bureau of Labor Statistics (BLS). The estimates are the result of analysis of data from the CPS and the parallel survey from October 1992 through May 1994. Although the BLS made this research public in December, the adjustment factors are not regarded as official and should be interpreted with care.

Labor Market Survey Indicators

Conference Board Survey

Job Availability

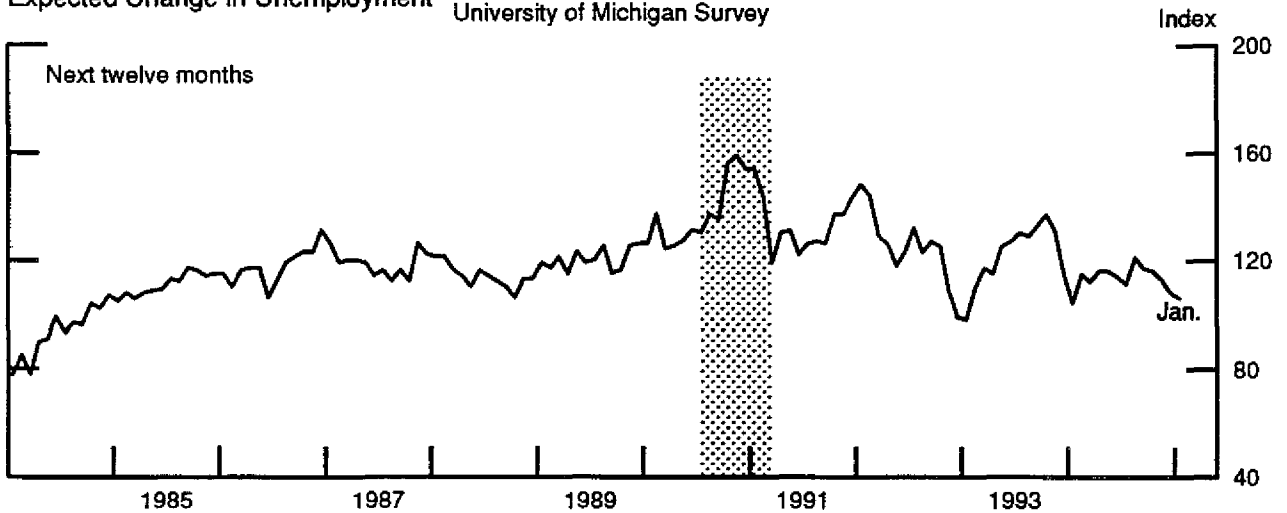


Employment Expectations



Note. Percentage of households responding "more jobs" minus percentage responding "fewer jobs" plus 100.

Expected Change in Unemployment University of Michigan Survey



Note. Percentage expecting "more" minus percentage expecting "less" plus 100.

Among the series for which adjustment factors are available are a few others frequently used as supplemental gauges of labor market tightness. These include the percentages of involuntary part-time workers and of the unemployed who are permanent job losers. As of December, both measures had improved markedly from year-earlier levels but were still somewhat higher than their 1989 averages. This tilt in the composition of employment and unemployment may explain why households seem less ebullient about labor market conditions than during 1989.

Another possible signal that labor markets are not as tight as during 1989 is the lag in labor force participation rates, particularly for adult men and teenagers. However, the weakness in participation is not readily attributed to a higher level of worker discouragement over job market prospects or their personal deficiencies⁴--a series for which comparable data exist.

Indeed, survey data indicate that although household appraisals of the current and future labor market became increasingly upbeat during 1994, households still felt somewhat less positive than they had in 1989 (chart). This can be seen in responses to the Conference Board survey's questions on the proportion of households indicating that jobs were plentiful, the proportion viewing jobs as hard to get, and expectations of employment opportunities six months hence. The index for expected unemployment over the next twelve months from the Michigan Survey of Consumer Attitudes, which drifted

4. Individuals not in the labor force may offer a variety of explanations for nonparticipation, including retirement, school enrollment, and household responsibilities. The small category of discouraged workers represents those available for work who say that they think they cannot get a job because of discouragement over job prospects or that they believe that they lack education or training or are being discriminated against by employers because of age or other factors.

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

	Proportion in total IP 1994:Q4	1994			1994		
		Q2	Q3	Q4	Oct.	Nov.	Dec.
		----Annual rate----			----Monthly rate----		
Total index	100.0	6.0	4.9	5.4	.4	.7	1.0
Previous		6.0	5.0		.5	.5	
Major Market Groups:							
Products, total	60.1	4.9	3.9	4.2	.4	.7	.7
Consumer goods	27.4	2.1	1.9	.8	-.4	.9	.9
Business equipment	15.4	8.2	11.4	11.1	1.3	-.4	1.1
Defense and space equipment	2.4	-7.9	-16.1	-1.8	-.1	.3	.4
Construction supplies	5.5	11.4	9.7	7.0	1.0	.5	.2
Materials	39.9	7.7	6.5	7.3	.3	.8	1.3
Major Industry Groups:							
Manufacturing	86.8	7.3	5.5	7.3	.4	1.0	1.0
Manufacturing excluding motor vehicles and parts	81.1	9.3	5.5	6.4	.4	.9	.9
Motor vehicles and parts	5.7	-17.8	5.1	21.2	.8	2.2	2.5
Mining	6.1	5.7	-2.3	-3.3	-.9	-.5	1.2
Utilities	7.1	-6.7	3.1	-7.0	.6	-1.3	-.8

CAPACITY UTILIZATION
(Percent of capacity; seasonally adjusted)

	1988-89	1967-94	1994	1994		1994		
	High	Avg.	Avg.	Q3	Q4	Oct.	Nov.	Dec.
Total industry	84.9	82.0	84.0	84.3	84.8	84.3	84.7	85.4
Manufacturing	85.2	81.3	83.4	83.6	84.4	83.8	84.4	85.1
Primary processing	89.0	82.5	87.8	88.1	89.2	88.3	89.3	90.0
Advanced processing	83.5	80.7	81.6	81.8	82.5	82.0	82.5	83.1

lower in January's preliminary report, is more in line with readings for the late 1980s.

On balance, the strength in labor demand has absorbed a significant proportion of jobless workers over the past year-- including a sizable share of those on permanent layoff. As a result the measured margin of slack has dropped from well above to noticeably below our notion of where pressures on wage and price inflation are likely to begin to surface. Nonetheless, despite the acceleration in job creation last year, households may still be uncertain about job security, given continued announcements about corporate restructuring and downsizing. These lingering concerns may be giving the labor market less of an "overheated" tone than it had in 1989.

Industrial Production

Industrial production expanded rapidly at year-end; a 1.0 percent gain in December followed an upward-revised 0.7 percent increase in November. Growth was widespread across manufacturing industries, while a decline in utilities output was offset by an upturn in mining. The December surge in manufacturing output boosted the factory operating rate to 85.1 percent, just below the last cyclical peak in early 1989.

Output of motor vehicles and parts rose sharply in the fourth quarter, as the production problems that had held down assemblies in the third quarter were mostly resolved.⁵ In addition, production of Chrysler's popular minivans has been boosted to build up inventories in anticipation of a lengthy changeover in the second

5. According to industry sources, production difficulties remain only for the Cavalier/Sunbird and Cirrus/Stratus models, where output still has not returned to the levels seen before last summer's lengthy model changeover. Production of Ford's Explorer underwent model changeover in late November and will not be back to full production until next month at the earliest.

CAPACITY UTILIZATION RELATIVE TO PREVIOUS PERIODS
OF HIGH UTILIZATION

	Capacity utilization Dec. 1994	Difference between current utilization and		
		1967-94 Average	1979:Q1	1989:Q1
Manufacturing	85.1	3.8	-1.7	0.4
Primary processing	90.0	7.7	2.5	2.1
Textile mill products	92.6	6.6	4.8	2.8
Lumber and products	93.3	10.2	8.8	4.2
Pulp and paper	95.7	3.4	4.7	0.7
Chemicals ¹	85.8	2.6	-1.6	-6.1
Petroleum products	92.9	7.5	6.3	6.2
Stone, clay, and glass	83.0	5.1	-2.8	-0.3
Primary metals	96.4	16.4	5.7	7.9
Fabricated metal products	85.2	7.9	1.8	3.5
Advanced processing	83.1	2.4	-3.0	-0.1
Furniture and fixtures	81.8	0.1	-3.1	-2.2
Chemicals ²	78.6	1.2	-1.7	-0.8
Industrial machinery	91.7	10.8	0.3	8.9
Electrical machinery	91.4	11.1	3.7	7.7
Motor vehicles and parts	89.1	13.4	-0.7	6.0
Aerospace and misc. transportation equipment	64.2	-11.6	-10.8	-20.3
Instruments	76.3	-5.9	-15.7	-3.9
Miscellaneous manufactures	75.3	-0.2	-2.7	-4.1

1. Includes industrial organic and inorganic chemicals, synthetic materials, plastics resins, and fertilizers.

2. Includes drugs and toiletries, soaps and detergents, paints and allied products, pesticides, and other miscellaneous chemical products.

quarter.⁶ By December, assemblies reached 12.7 million units (annual rate), compared with 11.8 million units in the third quarter.

Current assembly schedules show a further step-up to a 13.0 million unit annual rate in the first quarter of 1995. In January, production is scheduled to remain at the high December pace as firms seek to replenish dealer stocks from a relatively low December level.⁷

PRODUCTION OF DOMESTIC AUTOS AND TRUCKS
(Millions of units at an annual rate; FRB seasonal basis)¹

	1994			1995	
	Nov.	Dec.	Q4	Jan.	Q1
U.S. production	12.3	12.7	12.3	12.7	13.0
Autos	6.5	7.0	6.6	7.1	7.3
Trucks	5.8	5.8	5.7	5.6	5.7
Days' supply				-scheduled-	
Autos	60.0	62.2			
Light trucks	62.6	64.3			

1. Components may not sum to totals because of rounding.

In contrast to other major areas of industrial production, utilities output continued to be depressed in December by unseasonably warm weather; the index of utilities output stood 2.7 percent below its average for the year. Thus, with a return to normal temperatures, utilities could contribute significantly to IP growth in coming months.

6. This spring, plants producing Chrysler's popular minivans are scheduled for a lengthy changeover to the production of a newly designed van. Sources at Chrysler indicate that additional production in the fourth quarter and output scheduled for the first quarter should cover some of the 40,000 units (not annual rate) that they expect to lose during down time at these plants.

7. Current schedules are 0.8 million units below those at the beginning of January. The brief UAW strike last week at a key parts facility disrupted production at several assembly plants, reducing schedules by 0.1 million units. The remainder of the drop likely reflects some production adjustments by firms in response to softening sales as well as the correction of an error in Wards' reporting which had overstated GM's assembly plans for January.

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

	1993	1994	1994			1994		
			Q2	Q3	Q4	Oct.	Nov.	Dec.
Total	13.9	15.1	14.8	15.1	15.3	15.4	15.2	15.3
(BEA seasonals)	13.9	15.1	14.8	14.6	15.4	15.3	15.4	15.6
Autos	8.7	9.2	9.1	9.3	9.2	9.1	9.1	9.3
Light trucks	5.2	5.8	5.7	5.8	6.1	6.2	6.1	6.0
North American²	11.7	12.9	12.6	12.8	13.2	13.2	13.3	13.3
Autos	6.7	7.3	7.2	7.2	7.3	7.2	7.3	7.5
Big Three	5.5	5.7	5.7	5.6	5.8	5.6	5.8	5.9
Transplants	1.3	1.5	1.5	1.6	1.6	1.6	1.6	1.6
Light trucks	5.0	5.7	5.5	5.6	5.9	6.0	5.9	5.8
Foreign produced	2.1	2.1	2.1	2.2	2.0	2.2	1.9	2.0
Autos	2.0	2.0	2.0	2.0	1.8	1.9	1.8	1.8
Light trucks	.2	.2	.2	.2	.2	.2	.2	.2
Memo: Domestic name-plate market share								
Total	.74	.73	.73	.71	.74	.73	.75	.74
Autos	.65	.63	.63	.61	.64	.62	.64	.64

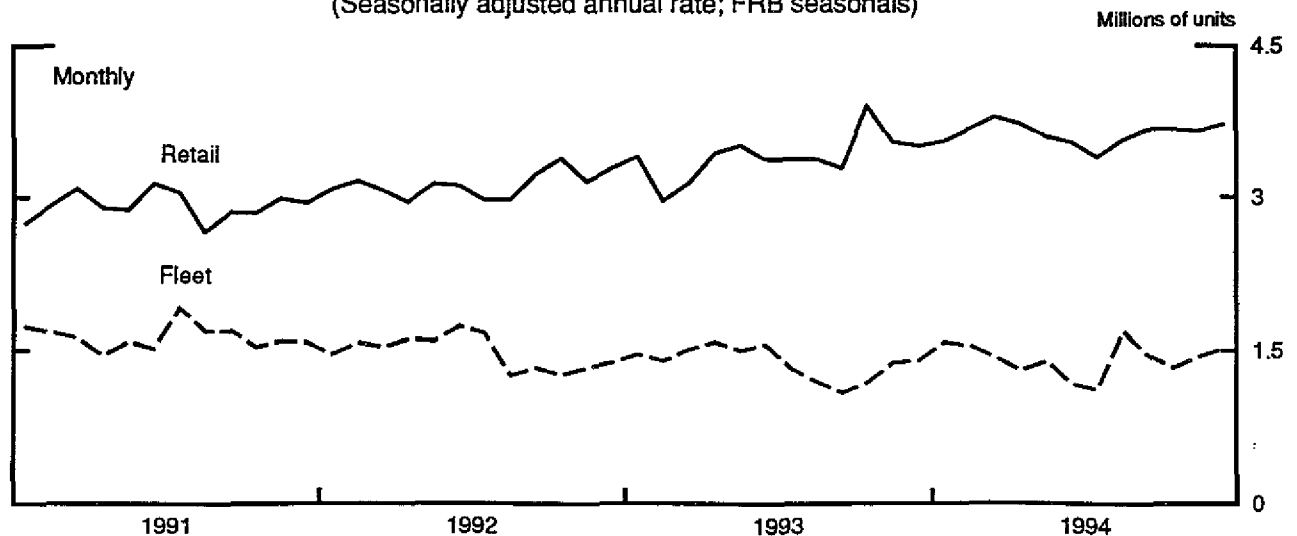
Note. Data on sales of trucks and imported autos for the most recent month are preliminary and subject to revision.

1. Components may not add to totals because of rounding.

2. Excludes some vehicles produced in Canada that are classified as imports by the industry; before January 1994, some vehicles produced in Mexico were also excluded.

GM and Ford Domestic Auto Sales

(Seasonally adjusted annual rate; FRB seasonals)



Note. Data are confidential. Retail includes consumer leasing.

The output of consumer goods other than motor vehicles increased 0.7 percent in December, with solid gains in both the durables and nondurables categories. Producers of business equipment posted a 1.2 percent increase in output last month. Materials output moved up more than 1 percent--led by iron and steel, metal stampings, and semiconductors--while construction supplies edged up following faster rates of increase in the previous two months.

The 6.7 percent rise in manufacturing output over the year has pushed utilization rates to high levels, particularly in primary processing, motor vehicles, and machinery-producing industries. Manufacturing capacity utilization is 3.8 percentage points above the 1967-94 average, 1.7 percentage points below its peak in 1979, and 0.4 percentage point above its peak in 1989.

All primary-processing industries are operating at utilization rates substantially in excess of their long-run averages. Furthermore, most of these industries are operating above the utilization rates they reached during the 1979 and 1989 peaks. Advanced-processing industries display considerably more variation in their utilization rates: The machinery industries and the motor vehicles and parts industry are operating well above their average utilization rates, but the aerospace and miscellaneous transportation equipment industry and instruments are operating at rates notably below the 1967-94 average.

Motor Vehicles

Sales of new light vehicles in December were 15.3 million units at an annual rate (FRB seasonals), about the same pace as has prevailed since August. To some extent, the recent strength in sales has likely been sustained by a catch-up in purchases that were postponed earlier in the year because of limited supplies. As

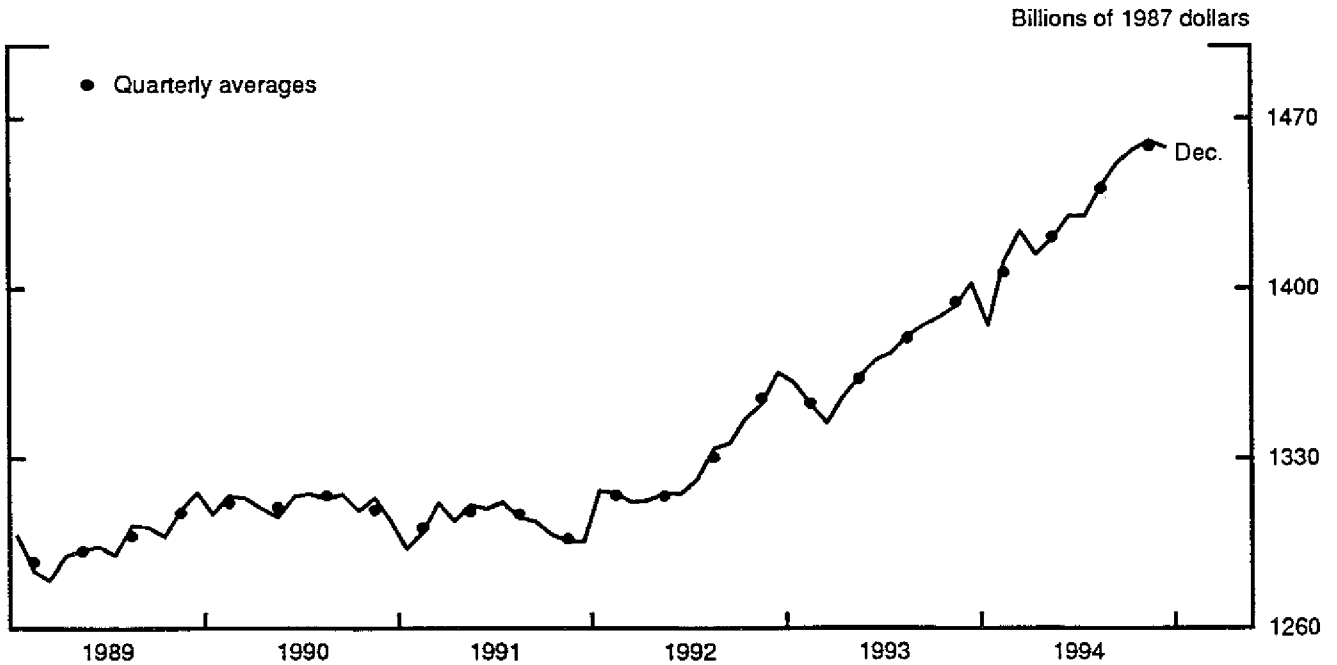
RETAIL SALES
(Percent change from preceding period; seasonally adjusted)

	1994					
	Q3	Q4	Sept.	Oct.	Nov.	Dec.
Total sales	2.0	2.3	.8	1.2	.2	-.1
(Previous)	2.0		.8	1.3	1.2	
Retail control ¹	1.9	1.1	.6	.2	.2	.1
(Previous)	1.9		.6	.3	.7	
Nondurables	1.6	.7	.5	.1	.1	-.1
General merchandise	1.9	.3	.8	-.1	-.2	-.2
Apparel	.9	2.8	-.6	2.6	.7	-.3
Other ²	1.6	.6	.5	-.1	.1	.0
Durables	4.0	2.8	1.3	.8	.1	1.1
Furniture and appliances	4.6	5.1	2.1	1.9	.8	.0
Other	3.1	.2	.3	-.5	-.7	2.5

1. Total excluding auto dealers and building material and supply stores.

2. Includes sales at food stores, gasoline stations, and other nondurable goods stores.

Real PCE Goods Excluding Motor Vehicles



Note. October, November, and December figures are staff estimates.

availability has improved for several of these vehicles, sales have picked up.

However, signs of some slackening in demand are emerging. Despite an uptick in January, the Michigan survey indicates that consumer attitudes toward buying conditions for motor vehicles remain well below the average level in the first half of 1994. Apparently, any boost to consumer attitudes from the recent strength in job growth and income has been damped by the cumulative effects of interest rate hikes over 1994 and higher sticker prices. Ford reports an unanticipated weakening in dealer orders at the turn of the year, and has cut its assembly schedules for January by 100,000 units (annual rate).⁸ GM has also cut January schedules by 0.7 million units, and special factors cannot explain all of the cut. Finally, stocks of Chrysler's minivans are currently above the level targeted by the firm, even after incentives that had been removed last fall were reinstated.

Personal Income and Consumption

Consumer spending posted another sizable increase in the fourth quarter; the data in hand suggest that the average level of real spending on goods other than motor vehicles was almost 5 percent (annual rate) above the level in the third quarter. However, that quarterly-average gain occurred, in large part, on the strength of the sharp rise in spending in September, which provided a high jumping-off point as the fourth quarter began. The current estimates of modest month-to-month changes in outlays for non-auto consumer goods during the October to December period suggest that spending decelerated abruptly.

The flattening in sales was a surprise to most analysts and has raised questions about the accuracy of the retail sales report. An

⁸. Our conversations with the motor vehicle manufacturers are confidential.

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

	1993	1994				
		Q1	Q2	Q3	Oct.	Nov.
Total personal income	.1	30.3	22.5	31.2	81.2	-8.0
Wages and salaries	-8.8	19.8	15.6	14.4	46.2	-5.7
Private	-10.2	17.0	14.0	13.1	44.2	-7.3
Other labor income	2.5	1.8	1.7	1.8	1.9	1.7
Proprietors' income	2.9	.5	-4.0	1.2	19.8	-15.1
Farm	.7	-1.7	-5.5	-.8	16.5	-17.1
Rent	1.9	2.3	-1.9	.0	-1.0	-1.2
Dividend	.8	.9	2.1	1.8	2.0	2.0
Interest	-2.7	3.2	7.5	8.9	9.9	7.1
Transfer payments	4.6	4.9	2.8	4.1	5.6	2.7
Less: Personal contributions for social insurance	1.1	3.1	1.3	1.1	3.1	-.3
Less: Personal tax and nontax payments	-.1	5.2	4.1	2.8	11.1	1.4
Equals: Disposable personal income	.0	25.1	18.4	28.3	70.0	-9.4
Memo: Real disposable income	-6.4	11.8	5.9	12.2	50.3	-11.5

REAL PCE SERVICES
(Percent change from the preceding period)

	1993	1994				
		Q1	Q2	Q3	Oct.	Nov.
		-----Annual rate-----			Monthly rate	
PCE services	2.5	4.0	1.1	2.2	.3	.1
Energy	2.2	5.9	-3.4	-11.6	2.8	-1.7
Non-energy	2.5	3.9	1.3	3.0	.2	.2
Housing	1.6	1.9	1.9	2.1	.1	.1
Household operation	1.1	1.2	4.1	6.5	.2	.2
Transportation	4.8	3.4	2.8	1.8	.7	.4
Medical	2.5	2.4	3.6	3.1	.2	.2
Personal business	3.5	8.1	-6.7	-1.5	.2	-.0
Other	3.1	7.4	2.5	7.3	.3	.6

examination of the revision history of the retail sales series reveals no systematic biases in the advance and preliminary estimates; so, from that vantage point, we have no basis for anticipating an upward revision. Moreover, the anecdotal reports that one hears are often year-over-year comparisons of sales, and the Census report did show December sales well above those in late 1993.

Spending on services advanced only moderately in October and November; real PCE services increased 0.3 percent in October and edged up 0.1 percent in November. Expenditures for non-energy services grew moderately in November, with healthy gains in expenditures for recreation and transportation services and modest increases elsewhere. However, total outlays for services in November were held down by a decline in energy spending owing to the unusually mild weather; that weather-related softness may well have extended into December.

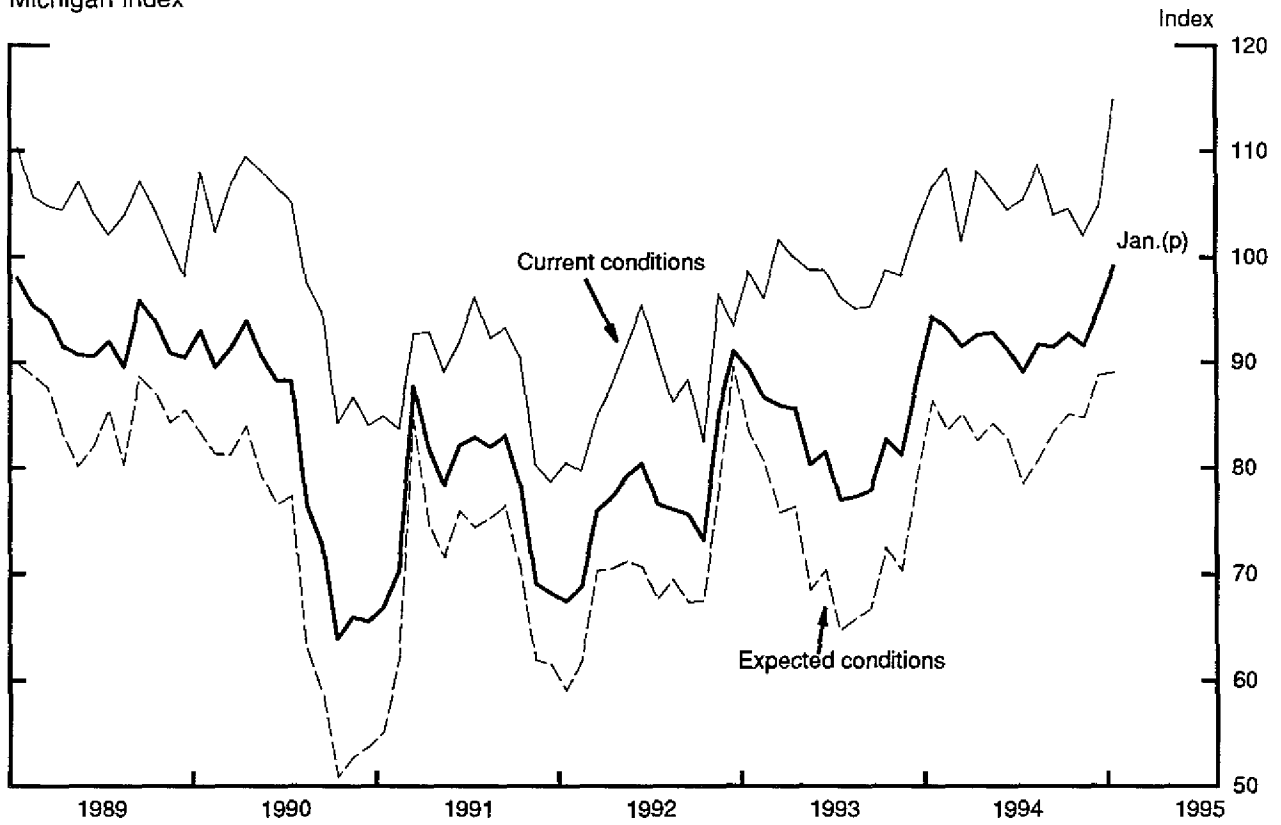
Conceivably, some of the moderation in spending toward year-end may have occurred because consumers wanted a breather in order to rebuild household wealth. The rapid expansion of credit in 1994 pushed the ratio of total household debt to disposable income to a historically high level, while household assets declined slightly relative to income. As a result, the ratio of net worth to disposable income fell somewhat.

Nonetheless, many of the fundamental factors influencing consumer demand remain very positive. Real disposable personal income accelerated over the October-November period, paced by a strong increase in wage and salary income.⁹ The level of real

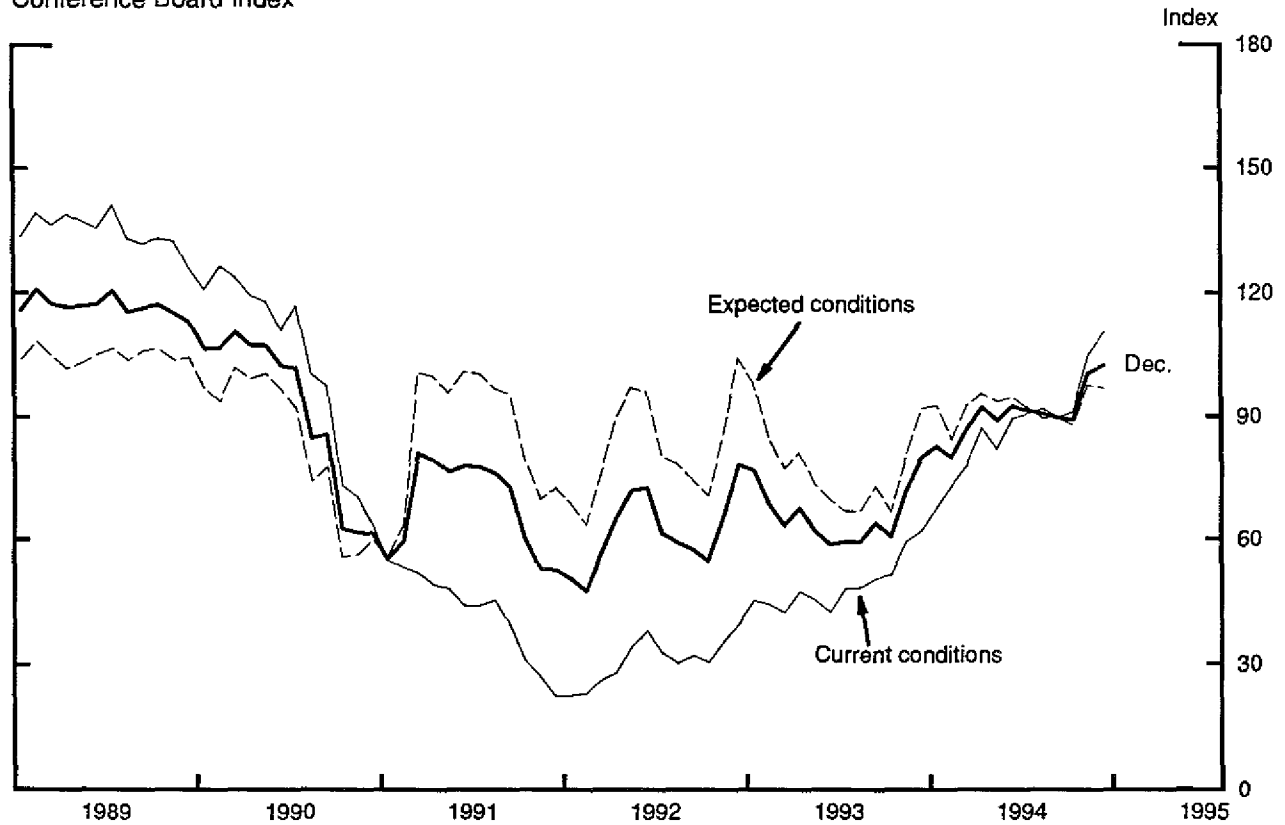
9. The uneven monthly pattern of income growth in October and November largely reflected fluctuations in hourly earnings and the average workweek. In addition, two factors temporarily boosted income in October: payments to farmers under the government's Conservation Reserve program and large bonus payments to workers in the motor vehicles industry.

Consumer Sentiment

Michigan Index



Conference Board Index



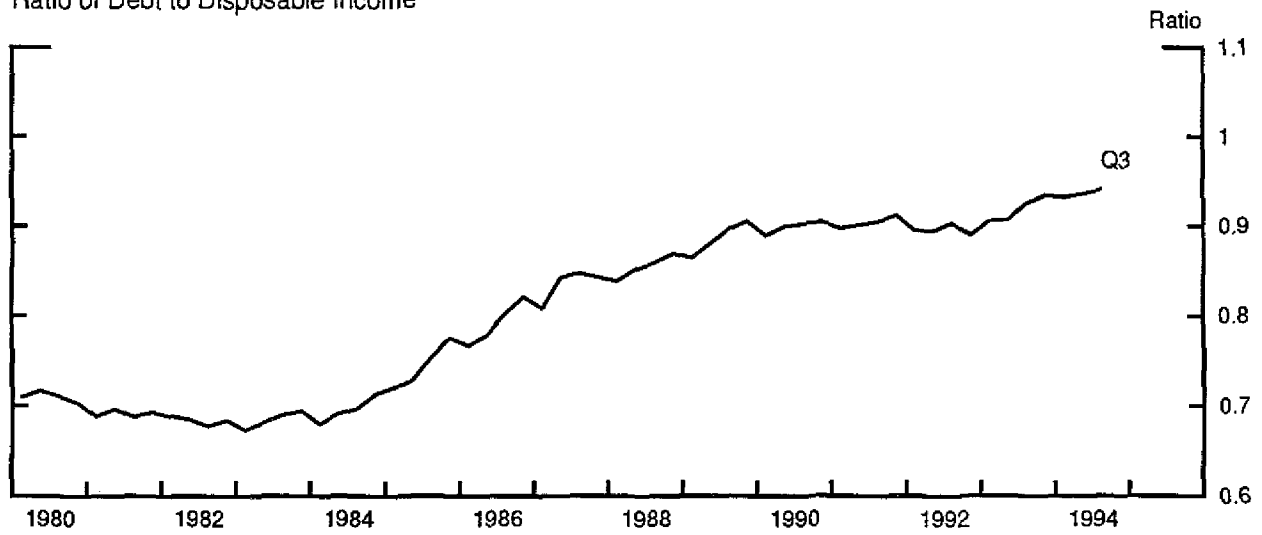
DPI in November was 1.4 percent (not an annual rate) above the third-quarter average. Furthermore, the December labor market report indicated that wages and salaries rose moderately last month. All told, given the available income and spending data, the personal saving rate apparently increased considerably--perhaps about 1/2 percentage point--during the fourth quarter. This implied spurt could be interpreted as an indication that spending might actually have been better than reported, or it may point to the possibility that spending will pick up again early this year. On the latter score, sales reports for January have been positive overall.

Indeed, the recent information on consumer sentiment does not suggest that households would be turning cautious in spending their income. The Michigan SRC index of consumer sentiment climbed another 4 points in early January because of a marked improvement in households' assessments of current conditions. The respondents' evaluation of the change in their personal financial situation over the past year was the most positive since 1988. The Conference Board survey also showed a surge at the end of last year.

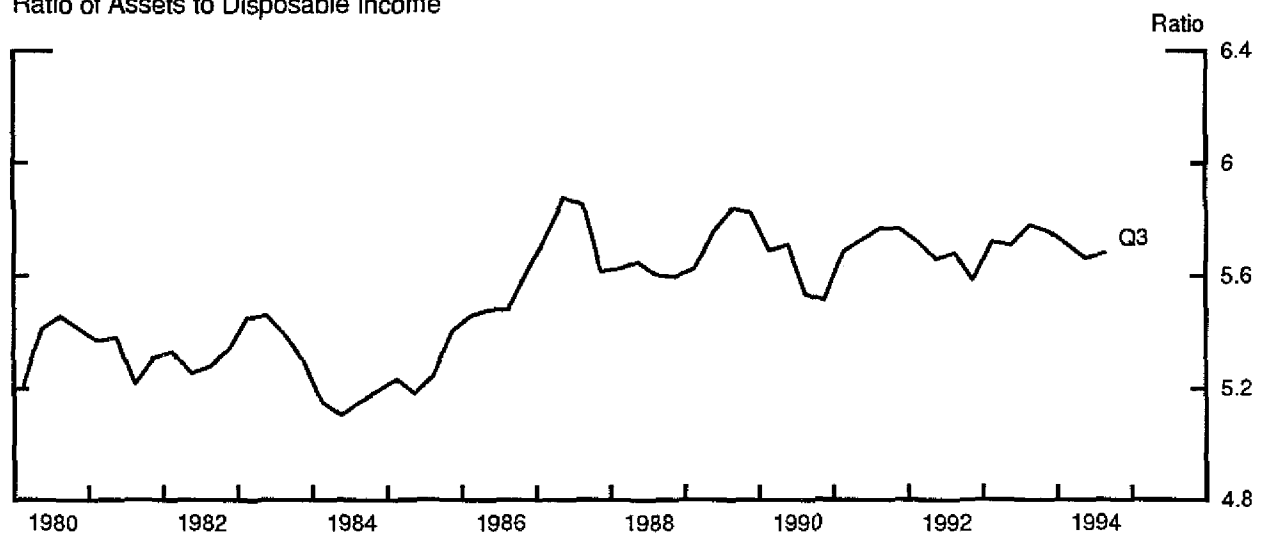
Many analysts have pointed to the record levels of household indebtedness as a source of vulnerability for consumer spending. One way to evaluate the likely effect of growing indebtedness on consumer spending is to consider the effect on debt service payments. All else equal, a household with a high percentage of income committed to debt service has less flexibility to absorb adverse shocks to income. Thus, households would tend to establish comfort levels for debt service beyond which they would hesitate to go; those levels would probably be influenced to some extent by their perceptions of the security of their income flows as well as by the size and degree of liquidity of their wealth.

Household Balance Sheet Indicators

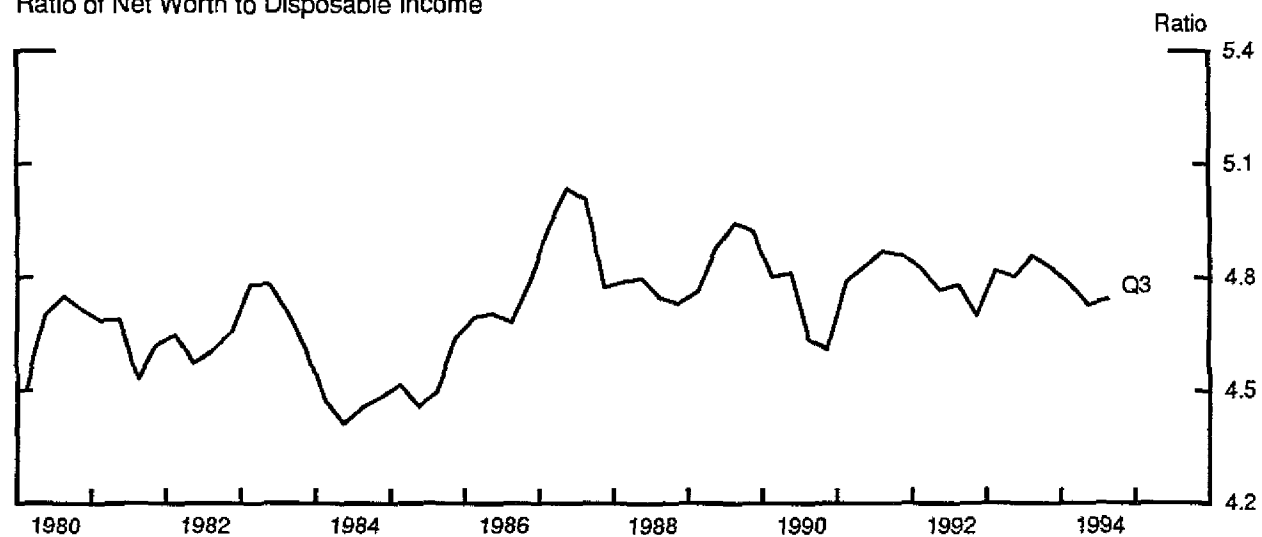
Ratio of Debt to Disposable Income



Ratio of Assets to Disposable Income

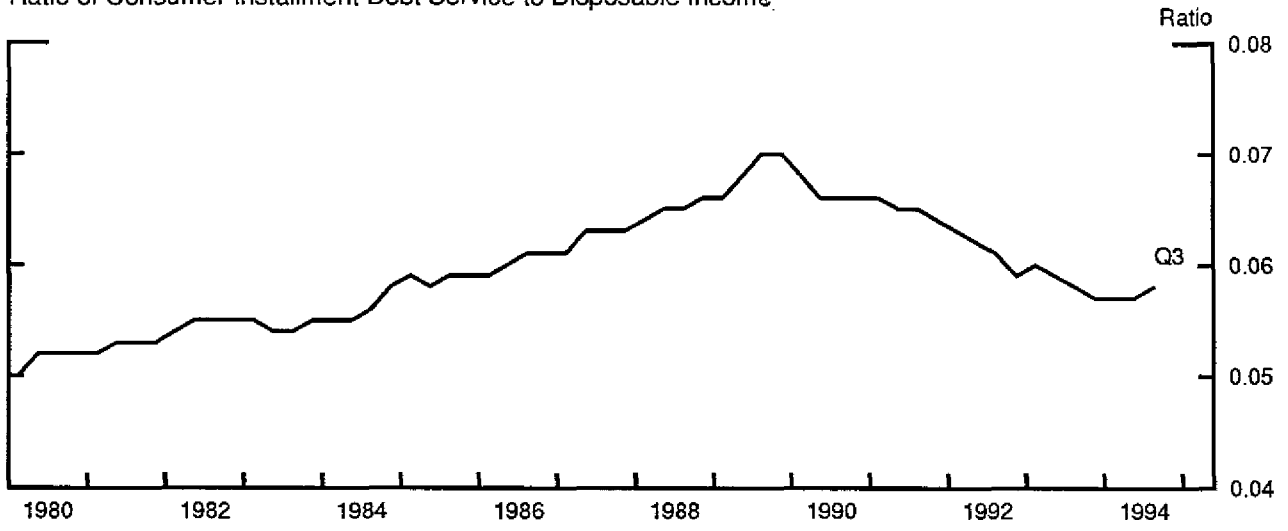


Ratio of Net Worth to Disposable Income

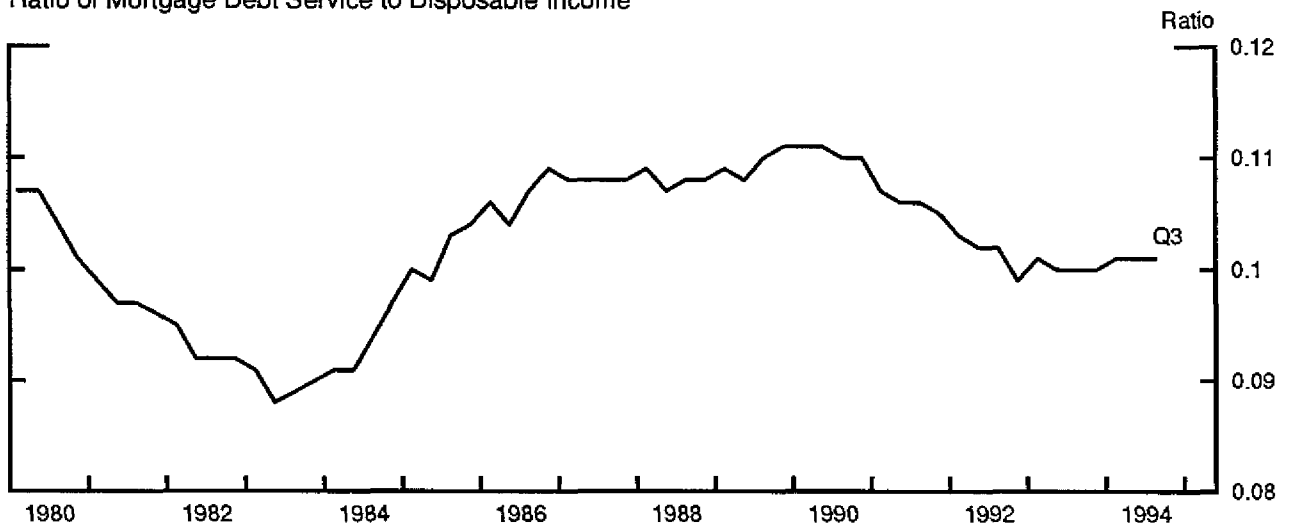


Debt Service Burdens

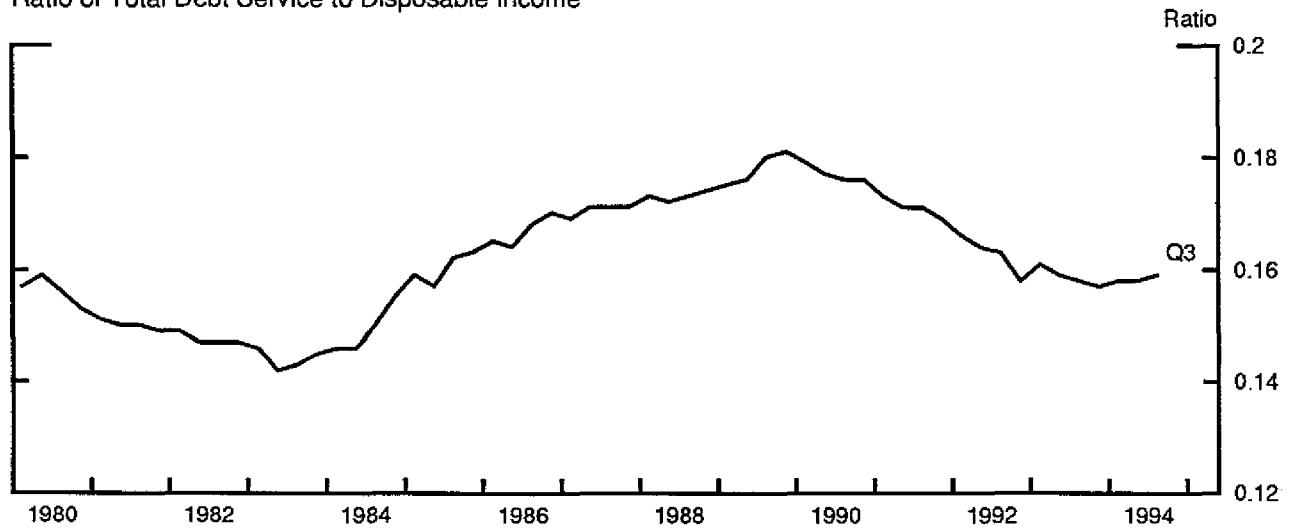
Ratio of Consumer Installment Debt Service to Disposable Income



Ratio of Mortgage Debt Service to Disposable Income

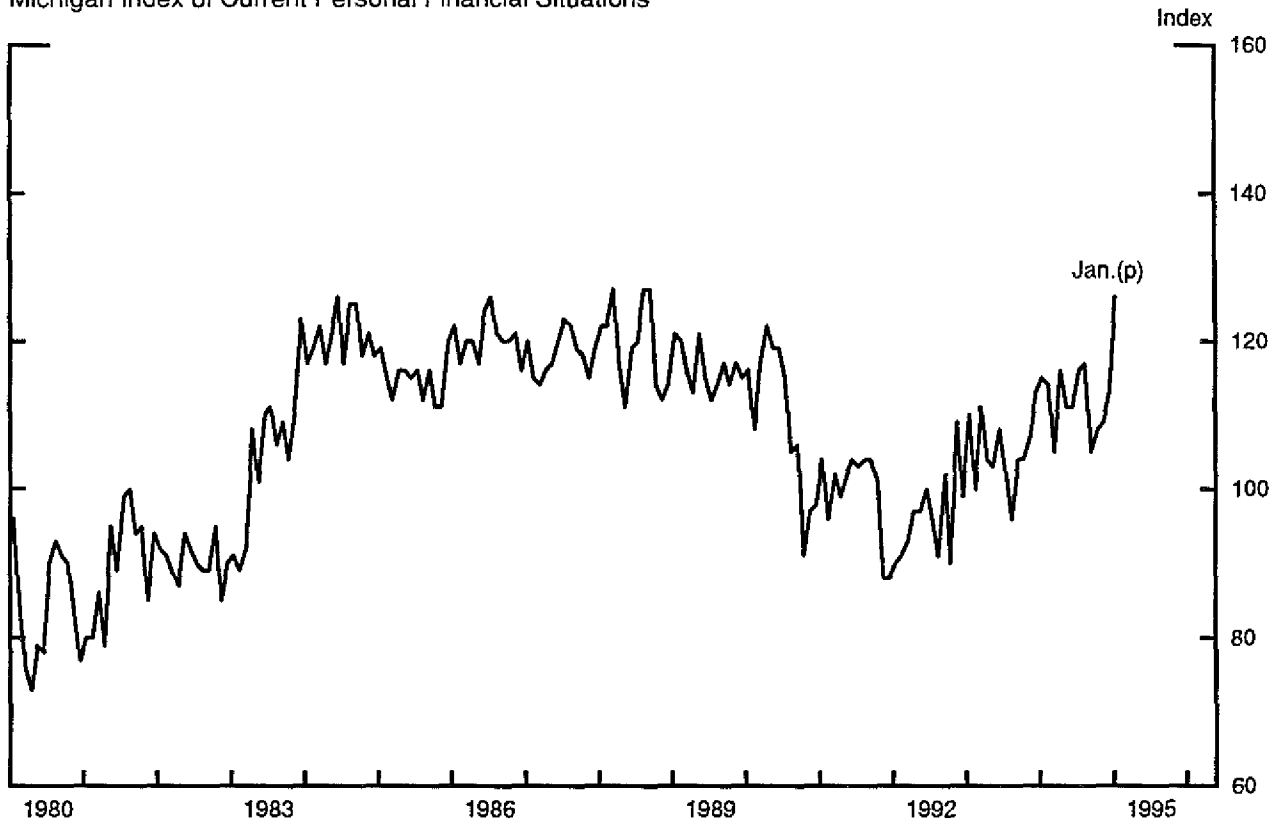


Ratio of Total Debt Service to Disposable Income

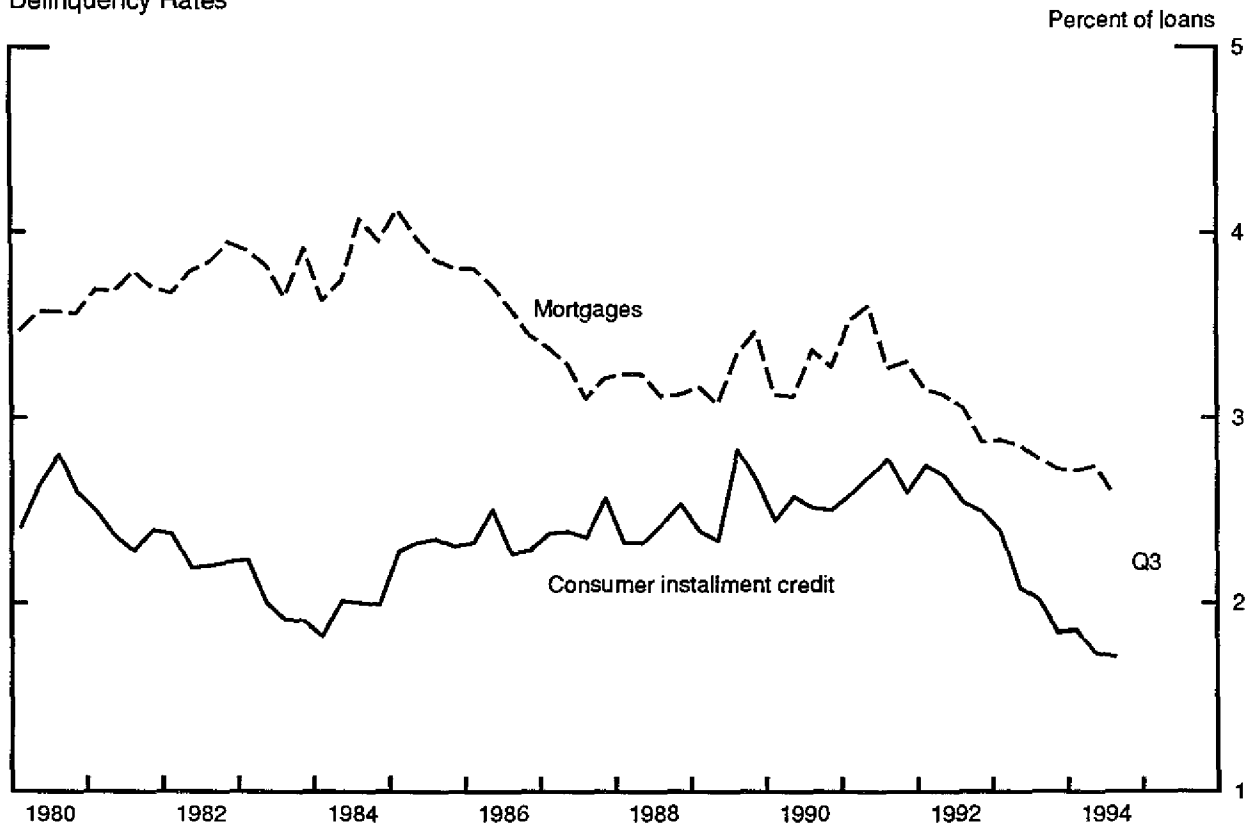


Other Potential Indicators of Financial Distress

Michigan Index of Current Personal Financial Situations



Delinquency Rates



In the current situation, although the downward trends in the ratio of installment debt service to disposable income and the ratio of mortgage debt service to disposable income have come to an end, neither ratio has increased appreciably in recent quarters. As a result, the ratio of total debt service to disposable income stands well below its 1989 peak. At the same time, consumer confidence in job and income prospects appears to have improved and households' appraisals of their current financial situations are very positive. These attitudes suggest that consumers are comfortable with their current debt burden and do not feel a need to reduce that burden by curtailing spending. Thus, household indebtedness currently does not appear likely to be cramping consumer spending.

Certainly, we see no signs of actual household financial distress. The delinquency rates on consumer installment credit and mortgages continued to decline in 1994, reaching their lowest levels in more than ten years. Given that fact and the generally upbeat view of the economy, there is no prospect of a tightening of credit by lenders.

Housing Markets

Although some indicators of housing demand have softened, single-family starts and existing home sales both rose in December. For the fourth quarter overall, the continuing recovery in multifamily construction and resilient single-family homebuilding lifted total starts to their highest quarterly level in six years.

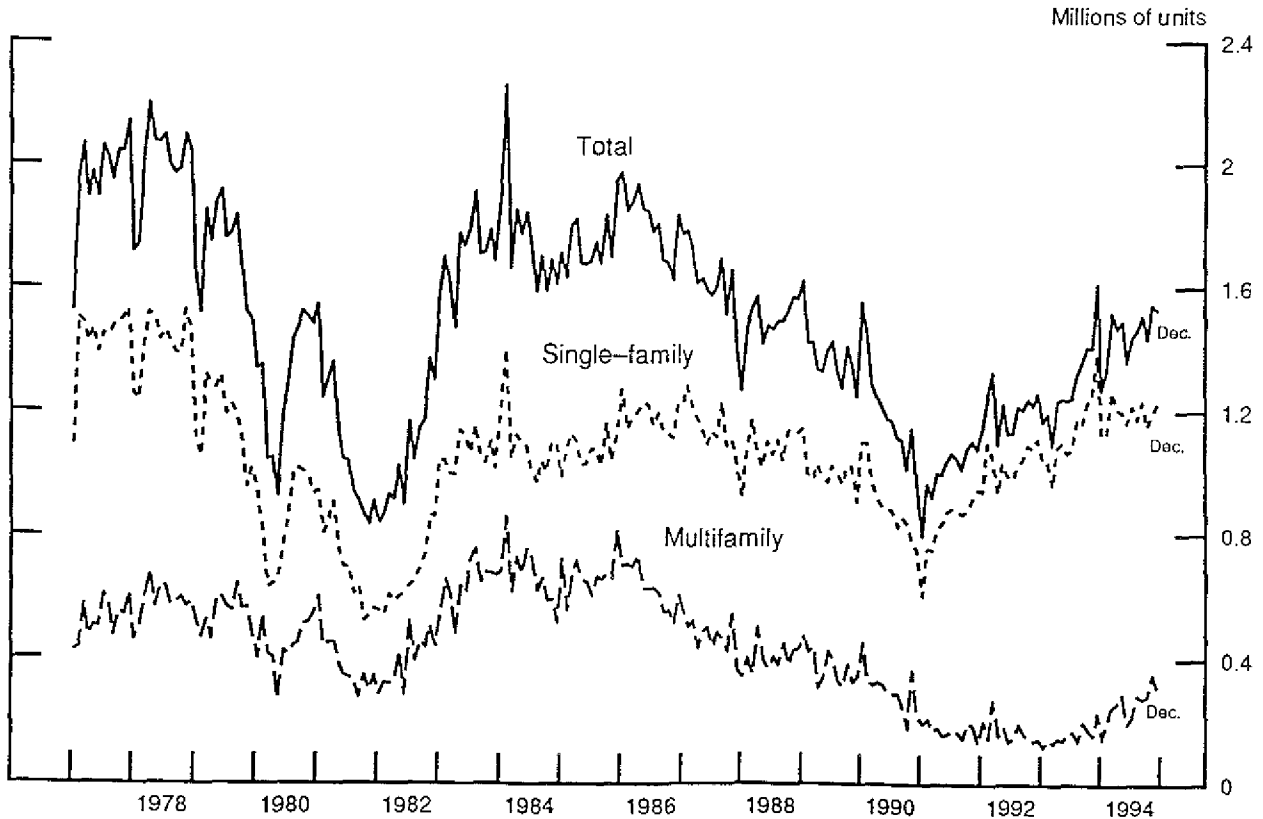
Single-family starts rose 3 percent in December, to a 1.23 million unit annual rate; the level of permit issuance was in line with starts. Although December was unusually warm, the regional pattern of starts suggests that favorable weather accounted for little of last month's strength in construction.

PRIVATE HOUSING ACTIVITY
(Millions of units; seasonally adjusted annual rates)

	1994							
	Annual	Q1	Q2	Q3	Q4 ^P	Oct. ^r	Nov. ^r	Dec. ^P
<u>All units</u>								
Starts	1.45	1.37	1.44	1.47	1.50	1.44	1.55	1.53
Permits	1.36	1.29	1.35	1.37	1.39	1.40	1.39	1.40
<u>Single-family units</u>								
Starts	1.20	1.17	1.19	1.21	1.19	1.15	1.19	1.23
Permits	1.06	1.06	1.07	1.04	1.06	1.05	1.04	1.09
New-home sales	n.a.	.69	.66	.67	n.a.	.71	.69	n.a.
Existing-home sales	3.97	4.05	4.06	3.93	3.87	3.91	3.82	3.89
<u>Multifamily units</u>								
Starts	.26	.20	.25	.26	.31	.28	.35	.30
Permits	.30	.23	.29	.33	.34	.35	.35	.31

Note. p Preliminary. r Revised. n.a. Not available.

Private Housing Starts
(Seasonally adjusted annual rate)



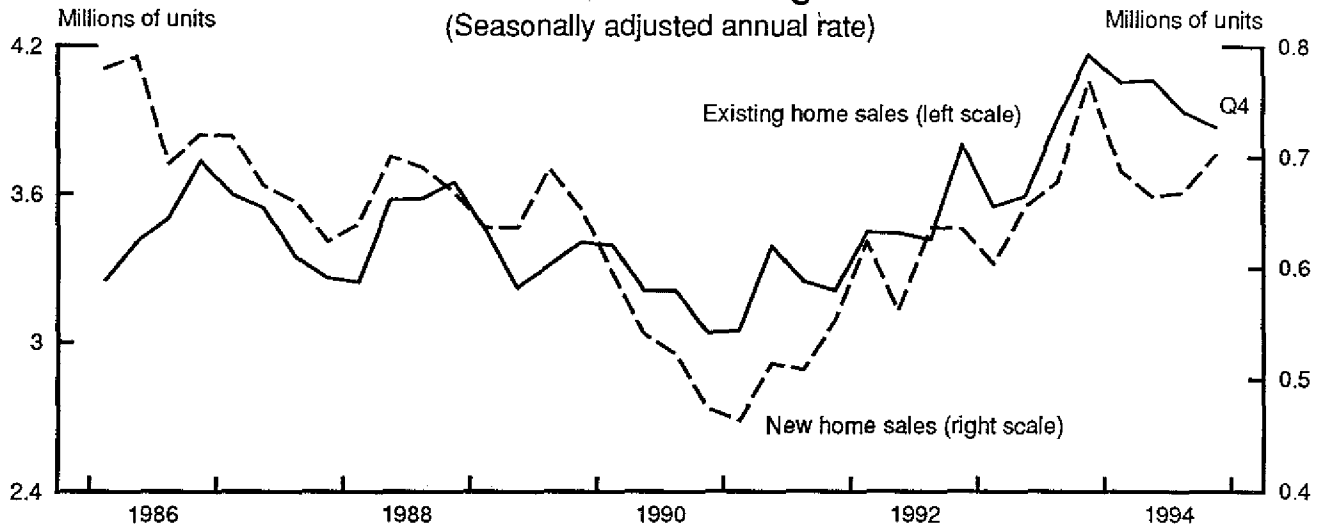
The most recent data on home sales are mixed. New home sales were off 2.5 percent in November and are at a level consistent with a lower level of construction than was reported at year-end. The inventory of unsold new homes has risen steadily over the past two years, but relative to sales, stocks are not especially high by historical standards (chart). Sales of existing homes rose 1.8 percent in December, retracing most of the previous month's decline. Nonetheless, these sales, on a quarterly average basis, have trended lower since midyear. The year-over-year increases in transactions prices of new and existing homes sold in November/December were 2 percent or less. Constant-quality price indexes--which control for the mix of homes sold--suggest that prices in the third quarter were about 4 percent higher than a year earlier.

Interest rates on both fixed- and adjustable-rate mortgages rose more than 200 basis points during 1994. However, by past standards the responses of single-family starts and home sales were mild. In 1987, for example, housing's reaction to that year's mortgage rate increases was at least twice as large. Clearly, other factors have worked to offset the effect of interest rates this time. Income and job growth have boosted consumer sentiment much more than in 1987. In addition, underwriting standards for home mortgages appear to have eased slightly during the past year, and market participants report that the availability of a widened variety of fixed- and adjustable-rate mortgages has also sustained activity.

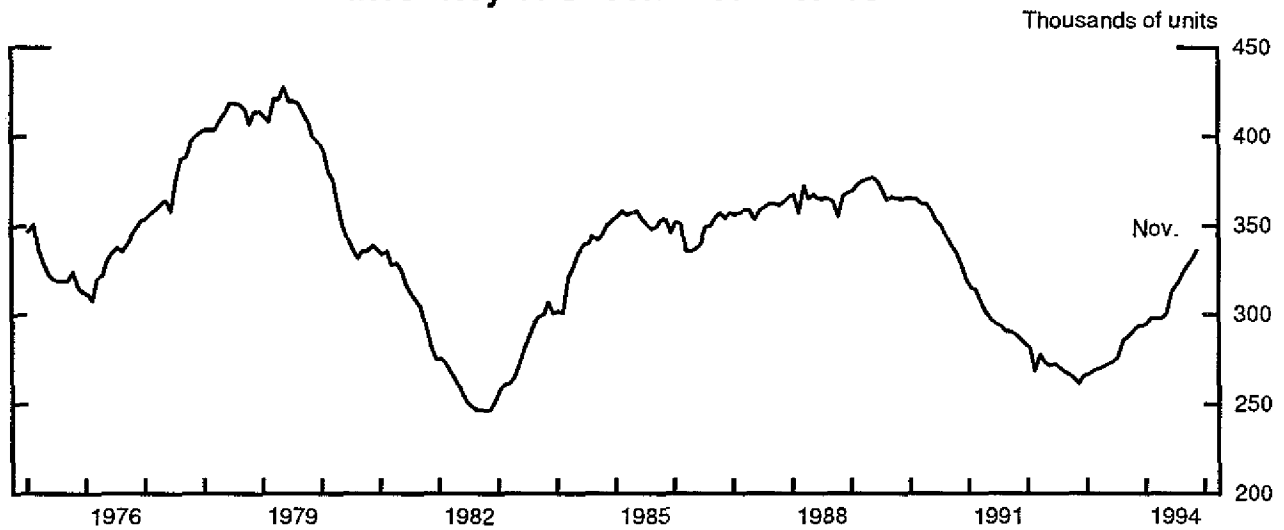
Anecdotal reports since Thanksgiving, when FRM rates first reached 9-1/4 percent and ARMs approached 6-1/2 percent, have indicated further slowing in many local housing markets. In evaluating these reports, distinguishing a true slowing from

Sales of New and Existing Homes

(Seasonally adjusted annual rate)

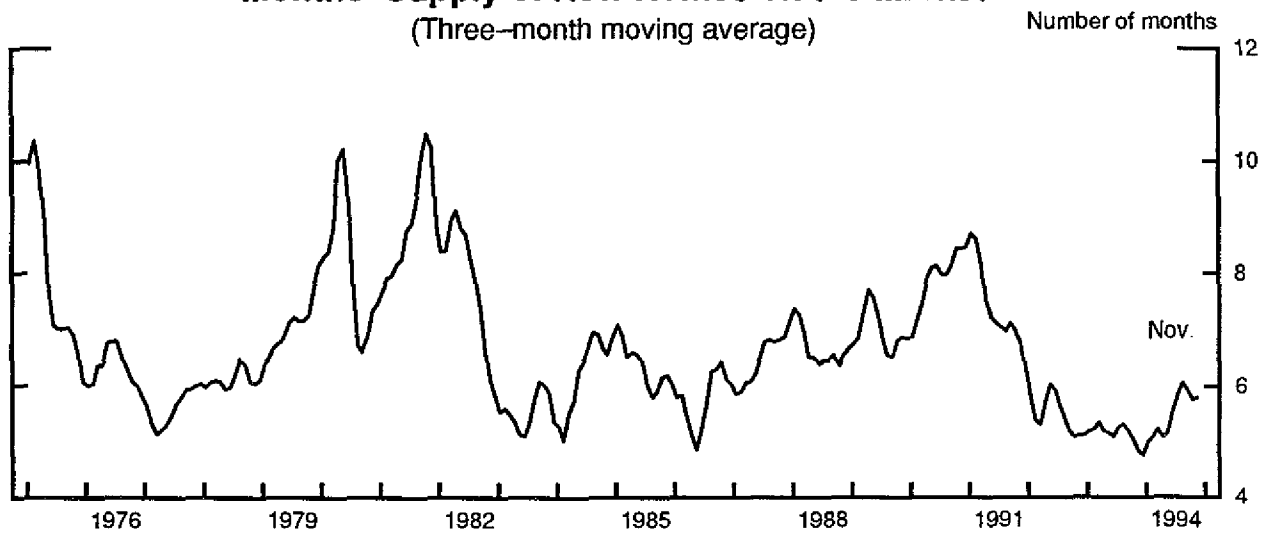


Inventory of Unsold New Homes



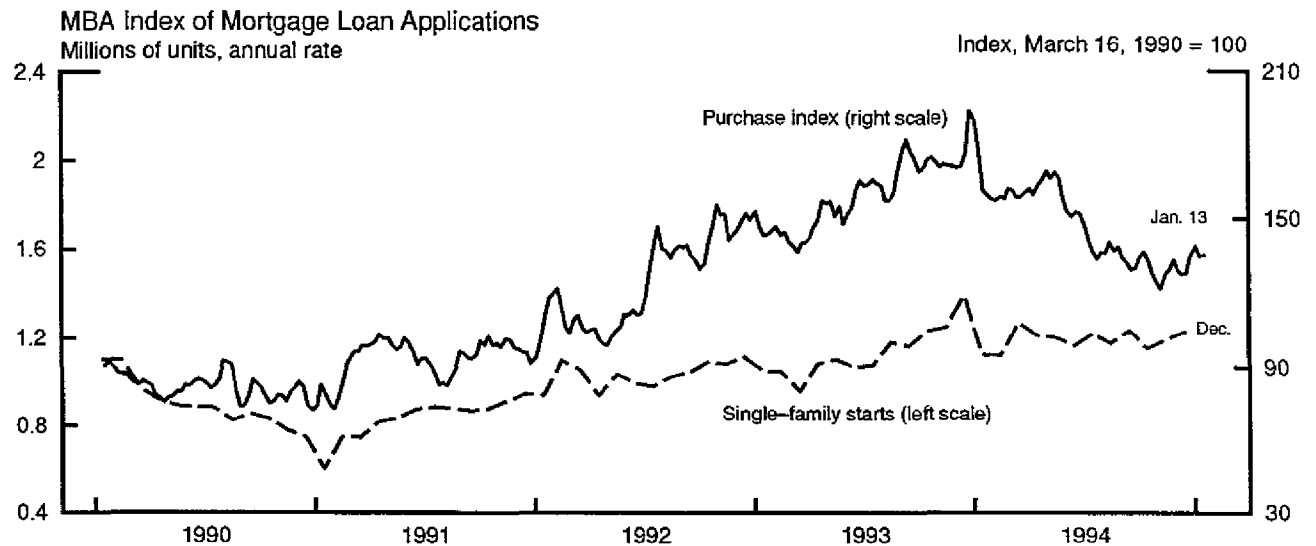
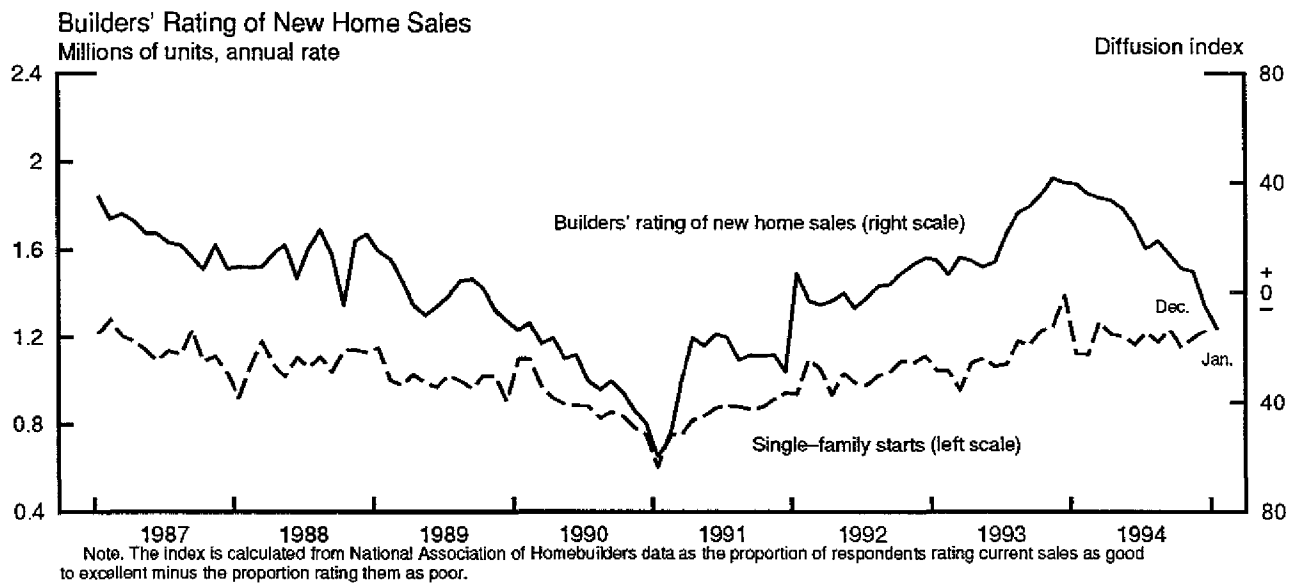
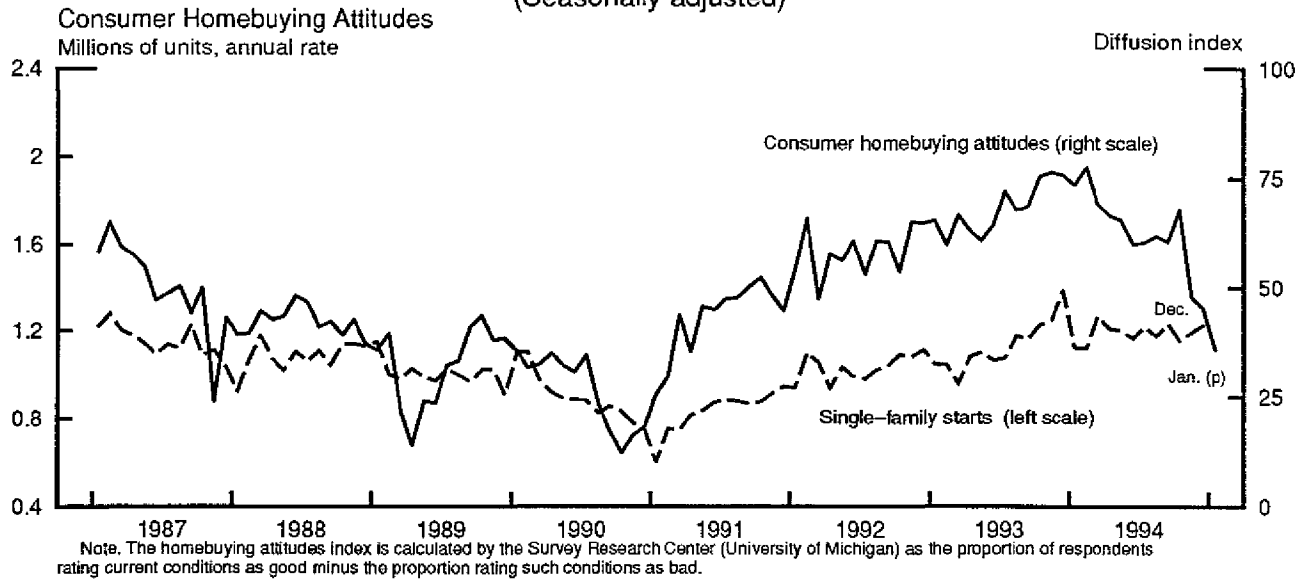
Months' Supply of New Homes on the Market

(Three-month moving average)



Indicators of Housing Demand

(Seasonally adjusted)



seasonal change is difficult. Typically, the key housing indicators fall 10 percent to 20 percent in November and an additional 7 percent to 15 percent in December. But even after seasonal adjustment, market assessments of both builders and consumers softened in December and January. Nonetheless, purchase loan applications at mortgage bankers, which have held at a reduced level since the middle of last year, appear to have firmed a bit in recent weeks (chart).

In the multifamily housing market, starts in December reversed the sharp jump in November, which had lifted construction in this sector well above the gradual recovery path observed since early 1993. Despite firming in many apartment markets, rental vacancy rates remain high for the nation overall, and rents as measured in the CPI have not accelerated. Until these conditions change, the gains in construction should remain moderate.

Business Fixed Investment

Real business fixed investment grew at an annual rate of 11-1/2 percent over the first three quarters of 1994, and the data in hand suggest that investment outlays may have advanced at an even faster pace in the fourth quarter. In addition, order backlogs and strong permits suggest that considerable momentum is being carried forward into the first quarter of 1995.

Equipment purchases have been rising rapidly for some time now, underpinned by a strong set of fundamental determinants of business investment. Although interest rates have increased, moderate price increases for capital goods--driven by declines in prices for computers and other high-tech equipment--have been an offsetting factor. The cost of capital for equipment other than computers is only now beginning to increase slightly, and the upturn is small compared with the very large jumps experienced in past periods of

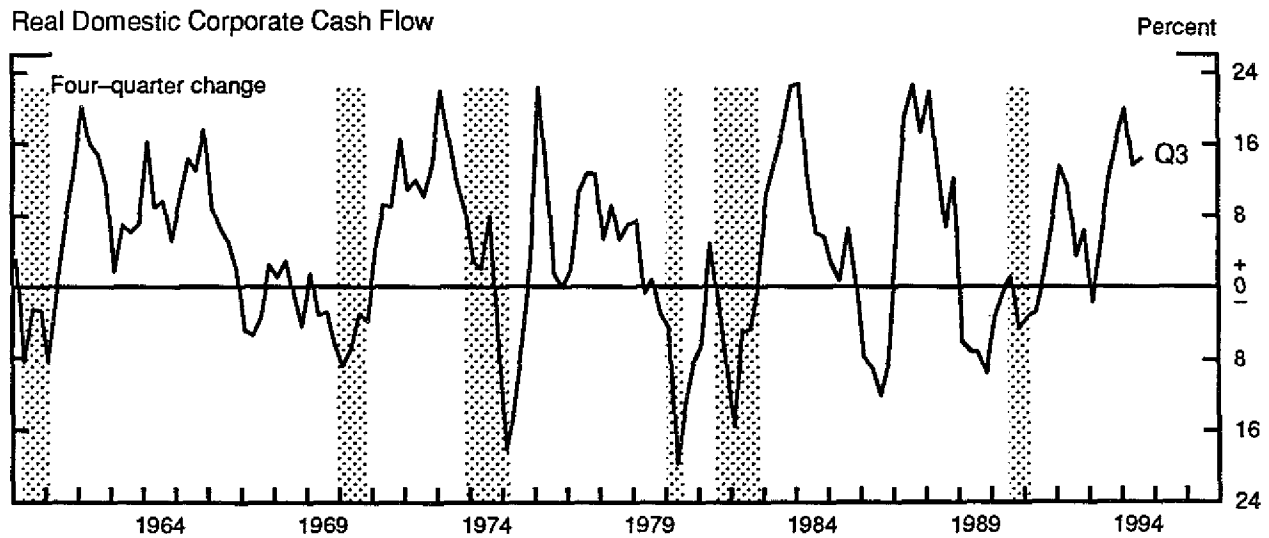
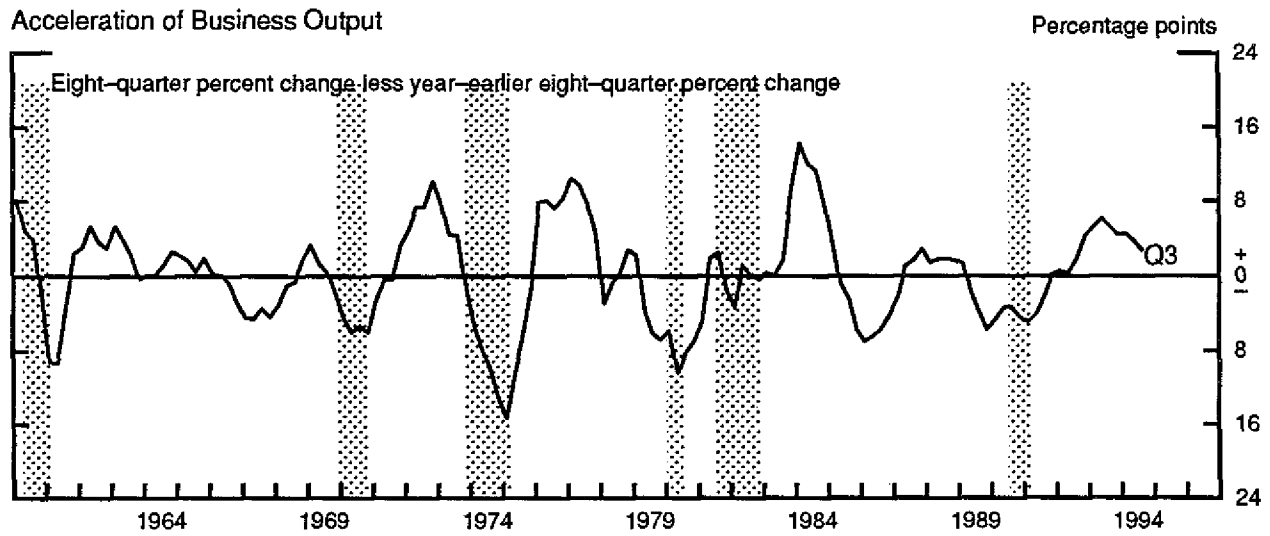
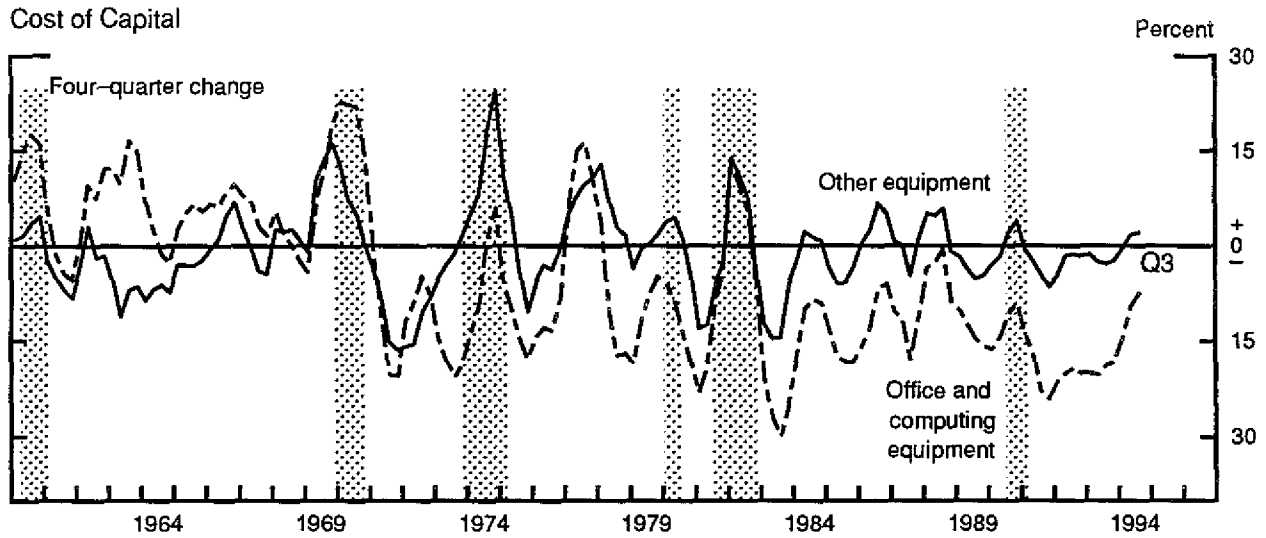
high resource utilization. The cost of capital for computers continues to decline. In addition, accelerator and cash flow effects continue to be positive: In the past, these factors have proved to be reliable indicators of business investment, tracking reasonably well the accelerations and decelerations in spending.

In addition to tracking quarter-to-quarter capital spending, the staff also monitors the cumulative effects of this spending on the growth in the capital stock. The sharp advances in business purchases of capital goods have led to solid--but not unprecedented--growth in the aggregate capital stock in real terms. Early on in the current recovery, the level of capital spending was barely high enough to offset depreciation, and net capital stock growth was very low. By the third quarter of 1994, however, investment had climbed to a level well above replacement needs, leading to growth of the capital stock roughly equal to the postwar average. While the current growth rate may be fairly typical, the composition is not (chart). The boom in equipment outlays accounts for most of the recent acceleration: Indeed, growth in the capital stock of producers' durable equipment is now quite high by historical standards. On the other hand, growth in the stock of nonresidential structures remains very low.

Turning to the recent spending indicators, shipments of nondefense capital goods excluding aircraft advanced 1.5 percent in November, with like-sized gains for computers and other types of equipment. Because this gain followed earlier advances, shipments in the first two months of the fourth quarter were 2.3 percent (not an annual rate) above their level in the third quarter.¹⁰ Orders

10. In addition, net exports of capital goods dropped considerably in the first two months of the fourth quarter, indicating that an unusually large percentage of these shipments went to U.S. firms.

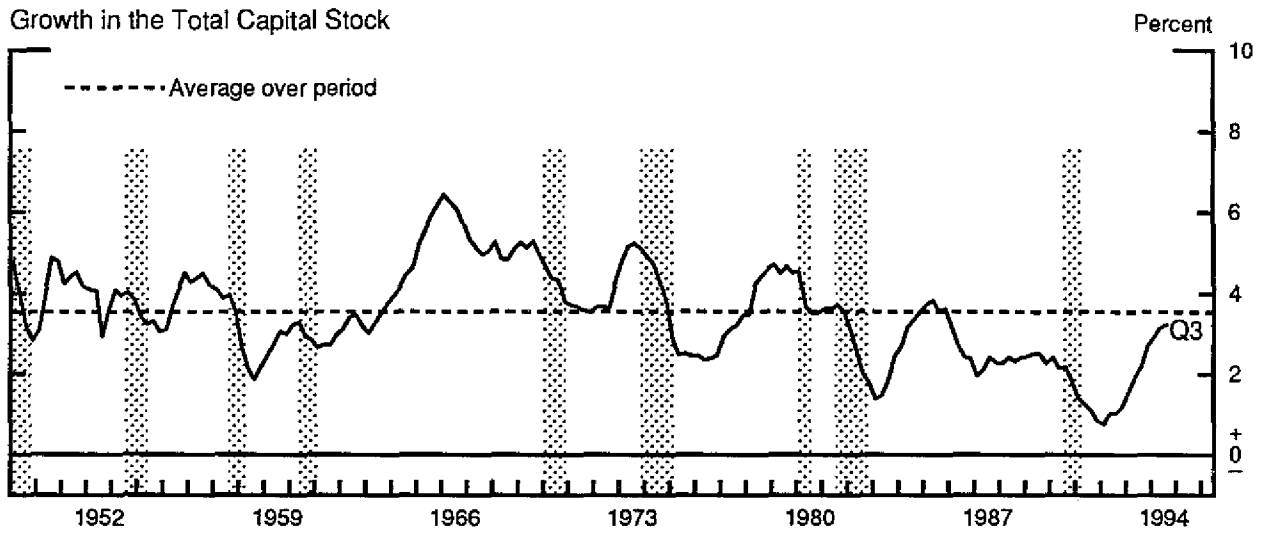
Fundamental Determinants of Business Fixed Investment



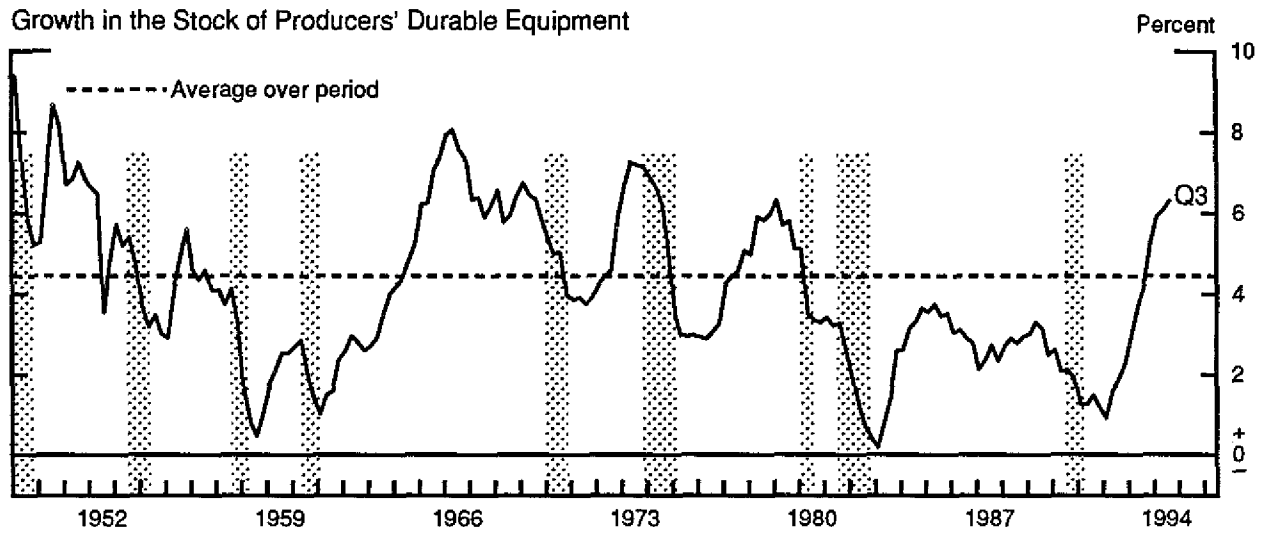
Growth in the Capital Stock

(Change, annual rate)

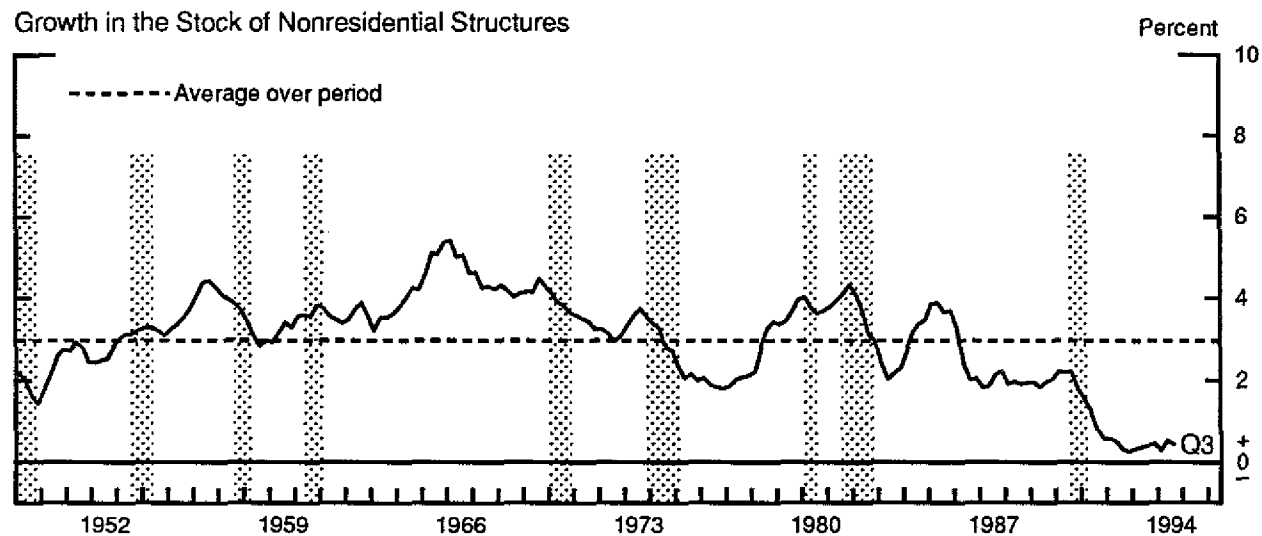
Growth in the Total Capital Stock



Growth in the Stock of Producers' Durable Equipment



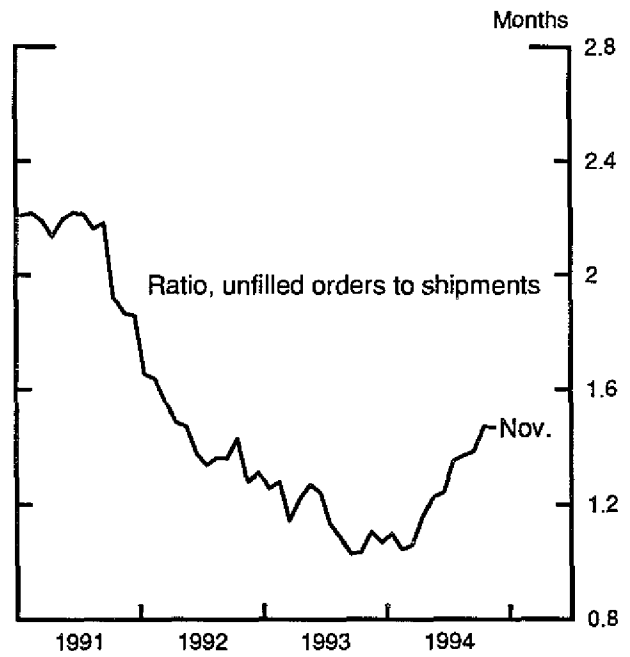
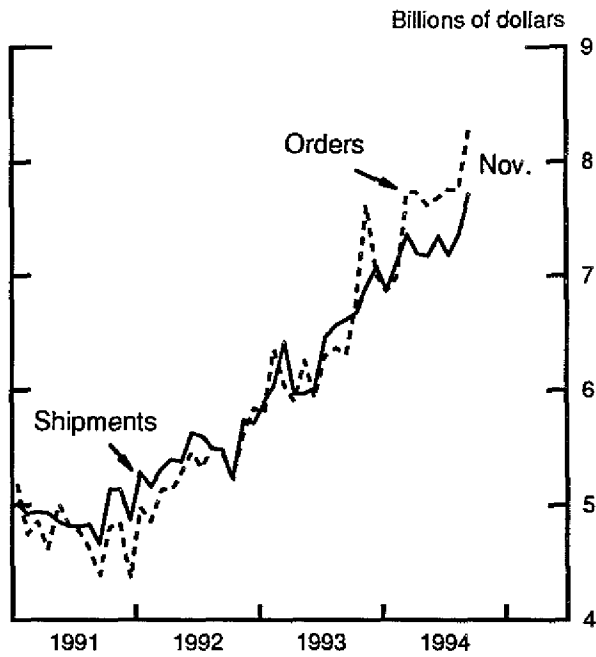
Growth in the Stock of Nonresidential Structures



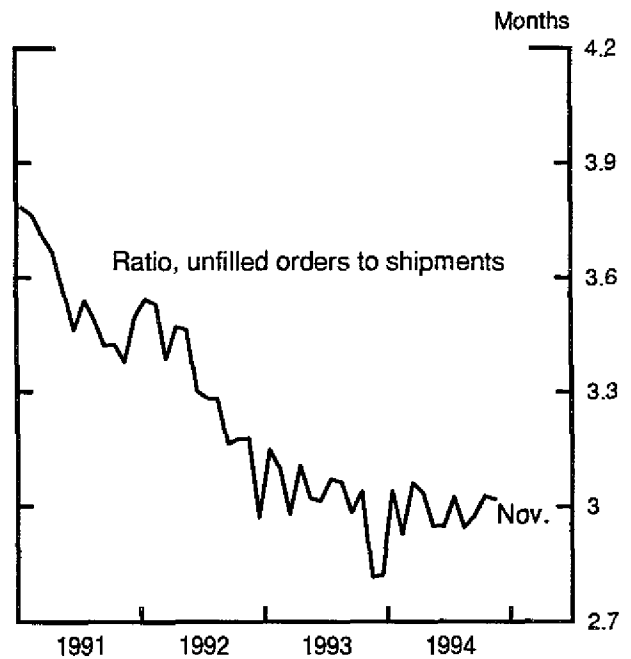
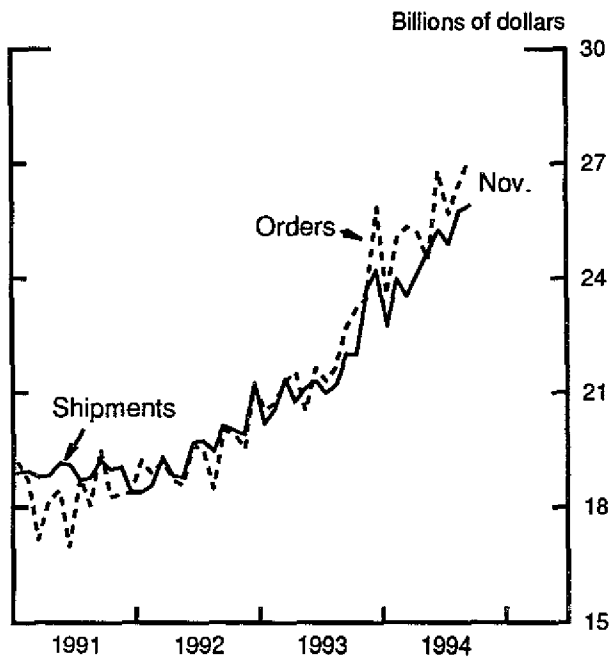
Based on quarterly BEA real capital stocks, through 1994:Q3.

Orders and Shipments of Nondefense Capital Goods

Office and Computing Equipment



Other Equipment (Excluding Aircraft and Computing Equipment)



continued to run well above shipments, thereby expanding backlogs, especially for computers.

Shipments of transportation equipment were also up sharply in the first two months of the fourth quarter. Business purchases of motor vehicles rose in November, boosted by a pickup in sales of automobiles to rental car companies and increased heavy truck sales.¹¹ Sales of complete aircraft also jumped in November. While aircraft purchases have declined to a relatively low level, a number of deliveries to U.S. firms apparently were bunched in the fourth quarter.

Recent construction data are consistent with the view that a widespread recovery is under way in the nonresidential sector. Construction put in place advanced 3.7 percent in November after having climbed in each of the previous two months. Thus, average outlays in October and November were well above their third-quarter levels in every category. Office construction, where average outlays in October and November were 10.9 percent above their third-quarter level (not at an annual rate), and public utilities, where outlays were 8.6 percent higher than their third-quarter average, registered especially notable gains. Permit issuance has, if anything, been running ahead of construction.

With regard to prices, the National Real Estate Index (NREI)--now available through the third quarter of 1994--showed solid increases in transaction prices for office, industrial, and other commercial structures. This signals a clear departure from the pattern of large price declines experienced on and off since the mid-1980s. The Russell-NCREIF index, which measures assessed values of real estate, has shown some signs of a leveling off in the office and other commercial sectors and has registered a modest increase

11. For the fourth quarter as a whole, medium and heavy truck sales rose 8 percent from third-quarter levels.

BUSINESS CAPITAL SPENDING INDICATORS
(Percent change from preceding comparable period;
based on seasonally adjusted data, in current dollars)

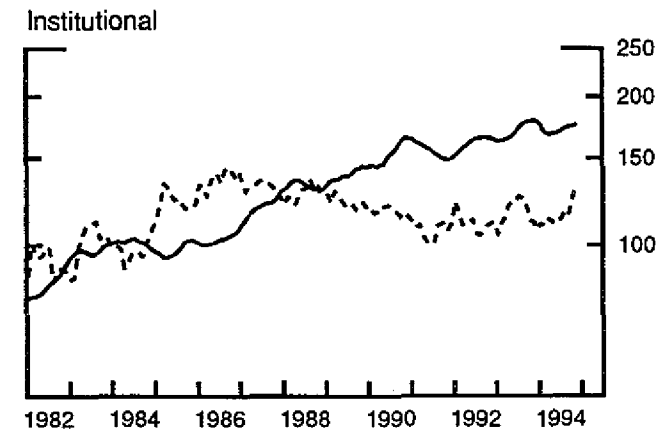
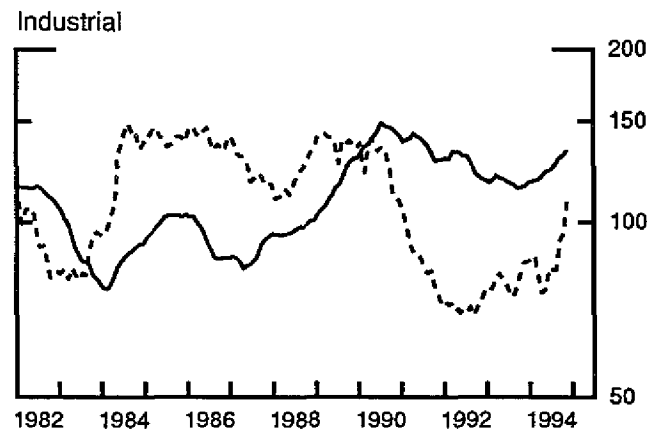
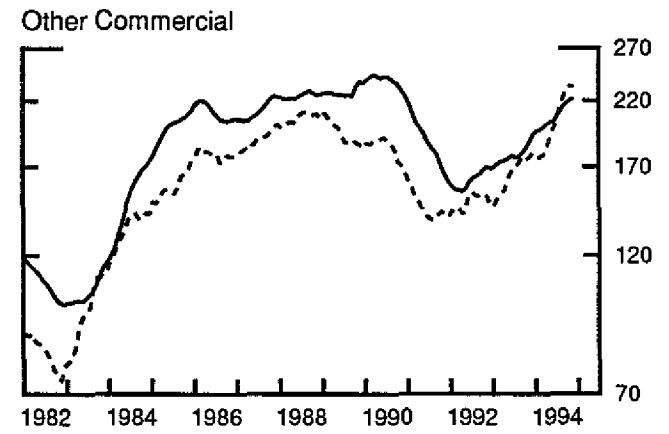
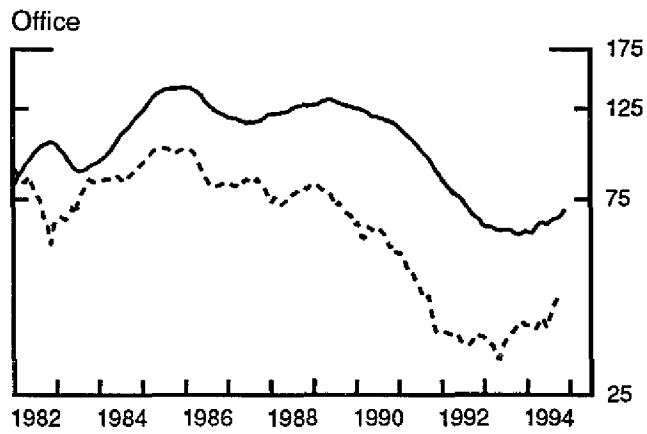
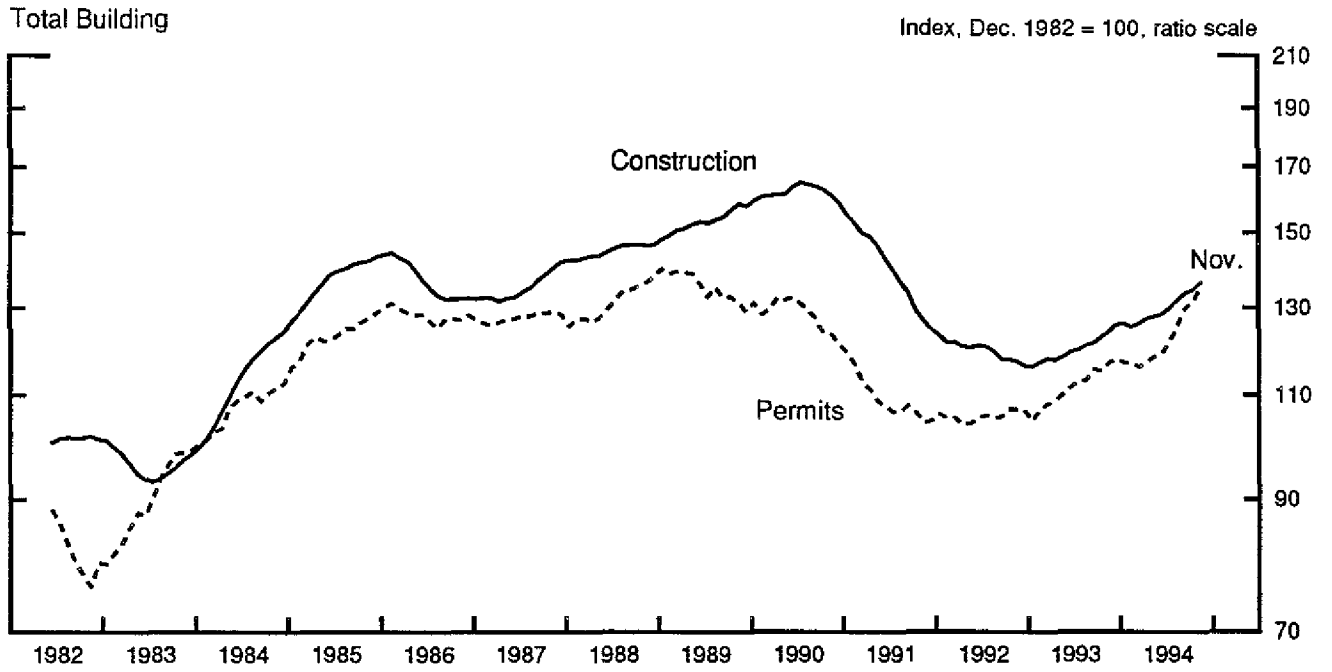
	1994			1994		
	Q1	Q2	Q3	Sept.	Oct.	Nov.
<u>Producers' durable equipment</u>						
Shipments of nondefense capital goods	1.0	2.3	3.4	1.6	-.9	2.2
Excluding aircraft and parts	1.2	4.6	3.2	1.4	.1	1.5
Office and computing	3.3	1.7	2.5	4.6	1.2	1.3
All other categories	.5	5.4	3.4	.5	-.2	1.6
Shipments of complete aircraft ¹	9.6	-33.1	-4.5	11.6	-41.8	62.5
Sales of heavy trucks	-1.0	5.3	1.3	-6.7	4.8	8.6
Orders of nondefense capital goods	6.2	.2	3.3	3.9	-2.0	8.4
Excluding aircraft and parts	1.7	4.2	3.4	3.5	.8	-1.0
Office and computing	.8	6.7	3.3	7.0	3.8	-6.9
All other categories	1.9	3.5	3.5	2.5	-.1	.8
<u>Nonresidential structures</u>						
Construction put-in-place	-3.1	3.6	2.4	3.2	1.5	3.7
Office	-.3	3.7	2.8	2.0	4.9	6.0
Other commercial	-6.0	11.9	1.9	5.3	-.3	2.2
Institutional	-6.7	7.4	-1.3	2.7	.1	3.6
Industrial	1.0	6.6	3.5	2.8	-1.4	7.6
Public utilities	-2.2	-4.5	5.4	2.3	5.8	1.4
Lodging and miscellaneous	-2.7	-.6	-4.6	4.3	-4.7	7.5
Rotary drilling rigs in use	.8	2.2	-.8	3.1	-4.9	-3.6
Memo:						
Business fixed investment ²	10.9	9.2	14.1	n.a.	n.a.	n.a.
Producers' durable equipment ²	18.6	6.1	18.1	n.a.	n.a.	n.a.
Nonresidential structures ²	-11.8	20.6	1.6	n.a.	n.a.	n.a.

1. From the Current Industrial Report "Civil Aircraft and Aircraft Engines." Monthly data are seasonally adjusted using FRB seasonal factors constrained to BEA quarterly seasonal factors. Quarterly data are seasonally adjusted using BEA seasonal factors.

2. Based on constant-dollar data; percent change, annual rate.

n.a. Not available.

Nonresidential Construction and Permits (Six-month moving average)

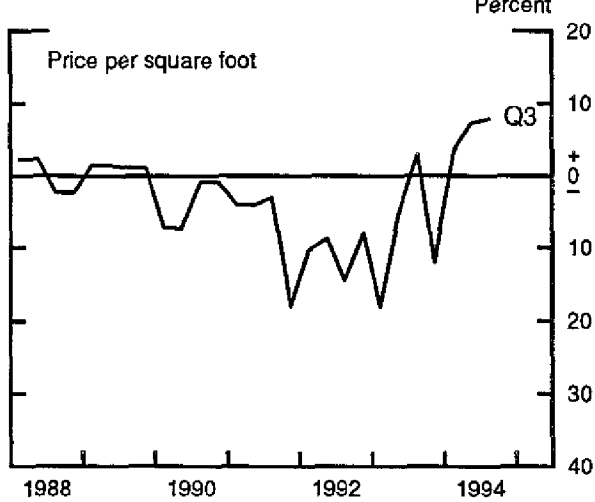


Indicators of Real Estate Conditions

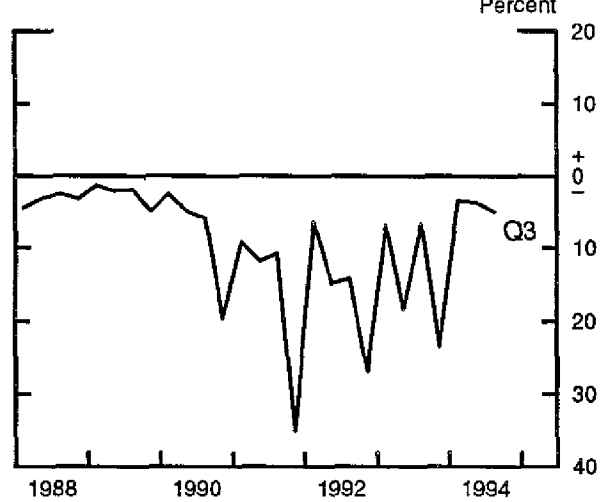
(Change, annual rate)

Office Sector

National Real Estate Index

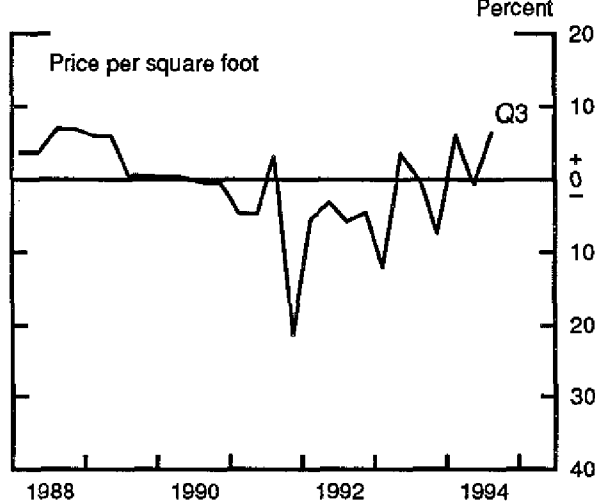


Russell-NCREIF Property Value

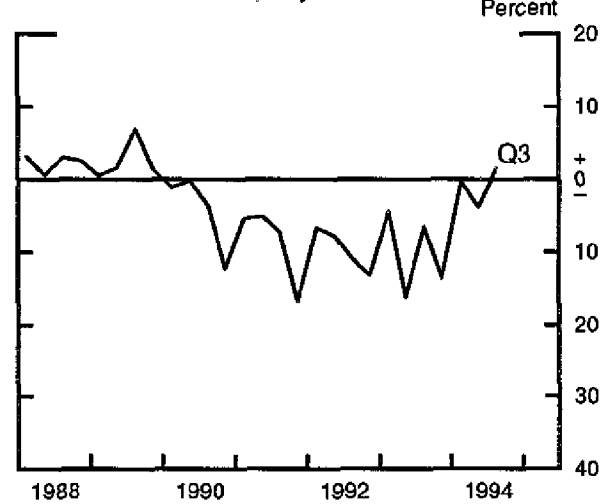


Industrial Sector

National Real Estate Index

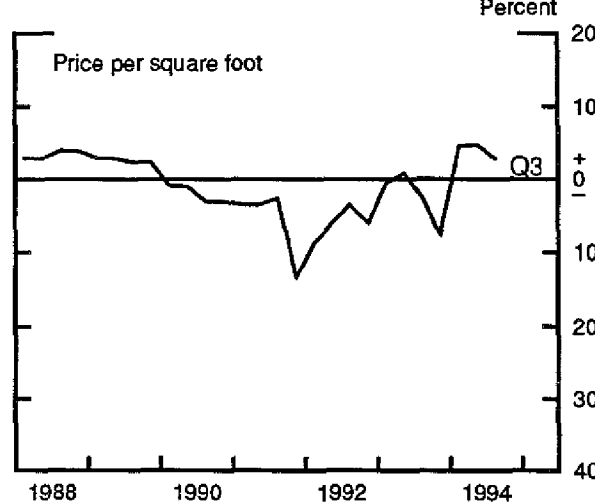


Russell-NCREIF Property Value

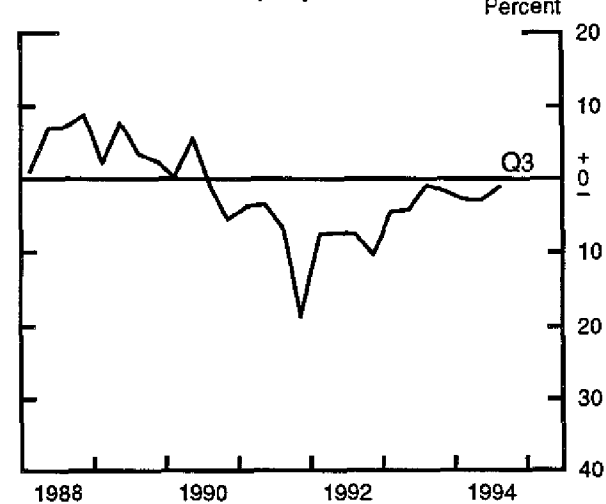


Other Commercial Sector

National Real Estate Index



Russell-NCREIF Property Value



for industrial structures. Because it is based on assessed values, this index tends to lag transaction prices somewhat, and the current gap between the two series is roughly consistent with that seen in previous episodes of increasing values.¹² Finally, vacancy rates have declined, and the proportion of bank examiners surveyed by the FDIC reporting price declines for commercial real estate has dropped dramatically.

Inventories

Business inventory investment remained brisk through November. In that month, stocks in all manufacturing and trade expanded at an annual rate of \$77 billion (book value), a pace similar to the average in the preceding several months. The November inventory buildup was accompanied by a 1.0 percent gain in shipments and sales, and inventory-sales ratios in major sectors remained in line with their recent trend values.

As economic activity gained momentum over the past year, business inventory investment in general shifted toward stocks of producer goods, especially producers' durable equipment. The substantial accumulation of capital goods inventories probably reflects expectations that strong demand for capital goods will continue in coming quarters. The relatively low inventory-sales ratio for capital goods in 1994 is consistent with the view that inventory buildups in this area have largely been intended.¹³

To illustrate the shift in inventory investment toward stocks of producer goods, stocks in manufacturing and trade can be grouped into three broad categories: capital goods, materials and supplies,

12. As a cautionary note, some industry contacts are arguing that the positive price movements may be reversing more recently. They maintain that the run-up in interest rates may be leading firms to apply higher discount rates to future rents.

13. One notable exception to this pattern of inventory expansion is aircraft manufacturing, where stocks have continued to trend down over the past year.

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

	1994			1994		
	Q1	Q2	Q3	Sept.	Oct.	Nov.
Total	18.4	75.6	70.6	50.8	79.6	77.1
Excluding wholesale and retail motor vehicles	21.1	58.9	53.4	27.9	80.6	70.5
Manufacturing	9.4	13.3	13.7	-5.8	18.4	23.3
Defense aircraft	-4.4	-4.7	-2.3	-2.9	-2.6	-4.1
Nondefense aircraft	-1.4	3.7	-.8	-4.7	-2.4	-.3
Excluding aircraft	15.2	14.4	16.8	1.8	23.4	27.8
Wholesale	3.1	23.0	22.7	14.1	41.4	34.8
Excluding motor vehicles	8.3	16.6	23.0	11.7	35.4	33.6
Retail	5.9	39.4	34.2	42.5	19.8	18.9
Automotive	2.6	10.4	17.5	20.5	-7.0	5.4
Excluding auto dealers	3.4	29.0	16.7	22.0	26.9	13.6
Constant-dollar basis						
Total	9.9	39.0	39.6	15.9	20.6	n.a.
Excluding motor vehicles	11.8	35.6	31.6	8.8	25.3	n.a.
Manufacturing	9.9	.7	4.5	-13.4	3.3	n.a.
Wholesale	-2.0	16.0	15.2	7.6	8.7	n.a.
Excluding motor vehicles	3.0	10.8	15.9	6.0	5.4	n.a.
Retail	2.0	22.3	19.9	21.6	8.6	n.a.
Automotive	2.5	-1.9	7.9	4.3	-7.1	n.a.
Excluding auto dealers	-.5	24.2	12.0	17.3	15.7	n.a.

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

	1994			1994		
	Q1	Q2	Q3	Sept.	Oct.	Nov.
Total	1.41	1.41	1.41	1.40	1.40	1.40
Excluding wholesale and retail motor vehicles	1.39	1.39	1.38	1.37	1.38	1.38
Manufacturing	1.40	1.39	1.36	1.35	1.37	1.34
Defense aircraft	4.80	4.85	4.69	4.95	4.64	4.43
Nondefense aircraft	5.00	5.84	5.54	5.38	5.83	5.41
Excluding aircraft	1.28	1.26	1.25	1.23	1.25	1.23
Wholesale	1.31	1.33	1.32	1.31	1.32	1.34
Excluding motor vehicles	1.30	1.30	1.30	1.29	1.29	1.32
Retail	1.50	1.54	1.55	1.54	1.53	1.53
Automotive	1.61	1.67	1.75	1.71	1.63	1.64
Excluding auto dealers	1.47	1.50	1.50	1.49	1.50	1.50
Constant-dollar basis						
Total	1.46	1.46	1.46	1.44	1.44	n.a.
Excluding motor vehicles	1.52	1.51	1.50	1.49	1.49	n.a.
Manufacturing	1.44	1.43	1.41	1.40	1.41	n.a.
Wholesale	1.39	1.41	1.40	1.39	1.39	n.a.
Excluding motor vehicles	1.39	1.39	1.40	1.38	1.37	n.a.
Retail	1.53	1.56	1.57	1.56	1.54	n.a.
Automotive	1.56	1.57	1.63	1.60	1.53	n.a.
Excluding auto dealers	1.52	1.55	1.55	1.54	1.54	n.a.

1. Ratio of end-of-period inventories to average monthly sales for the period.

and all other goods (chart).¹⁴ As shown in the upper panel, total investment in stocks of capital goods held in both the manufacturing and wholesale trade sectors rose sharply last year, in contrast to the small net decline in 1993. A similar pattern pertains to stocks of materials and supplies.

Outside of capital equipment and production materials, stocks have been rising at a modest pace. Within this grouping, the accumulation of consumer goods inventories at retail outlets appears to have slowed lately. In November, non-auto retail inventories rose at a \$13-1/2 billion annual rate in book-value terms, about half the pace observed in the preceding three months. Nevertheless, inventory buildups at general merchandise stores remained substantial in November, likely because of general merchandisers' upbeat sales expectations for the holiday season. The advance retail sales report for December indicated that holiday sales at general merchandise stores were below earlier expectations, and recent anecdotal reports suggest that general merchandisers may have resorted to aggressive discounting to move their merchandise in the post-holiday period. On the whole, though, no serious overhang of inventories of consumer goods appears to have developed toward year-end.

Federal Sector

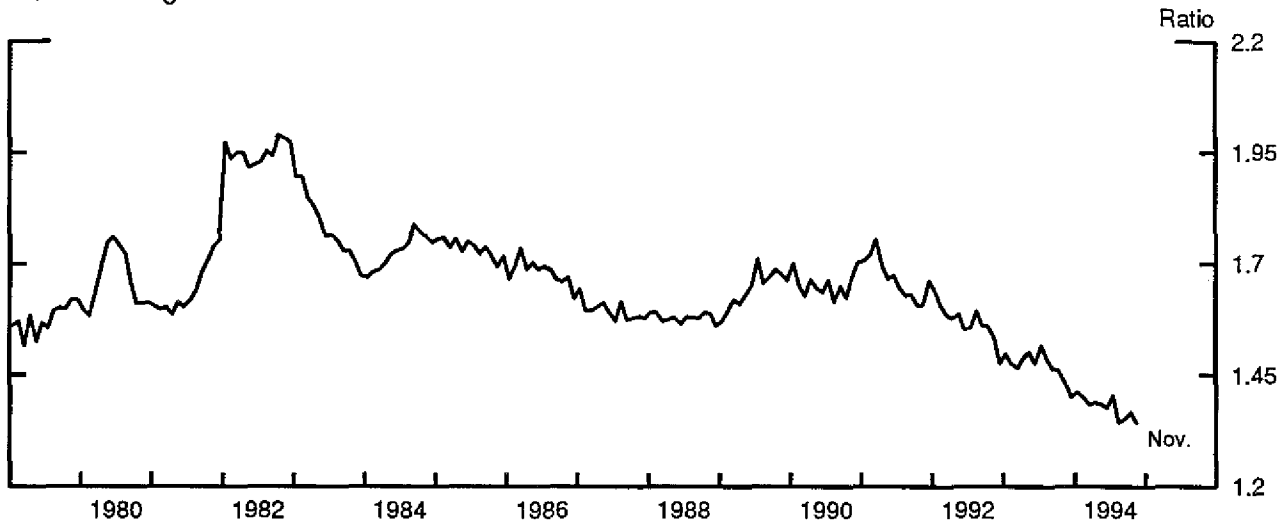
The federal government recorded a deficit of \$4 billion in December, bringing the deficit for the first three months of fiscal

14. Specifically, the regrouping is done as follows: (a) capital goods, consisting of all stocks of machinery and capital equipment in manufacturing, plus wholesale stocks in the categories of machinery, professional and business equipment, and (one half of) motor vehicles and accessories; (b) materials and supplies, consisting of all manufacturing stocks in the "materials and supplies" stage of processing, plus manufacturing stocks of finished goods held at four material-producing industries (primary metals, chemicals, rubber and plastics, and textiles), plus wholesale stocks held by distributors of metals and minerals and farm product raw materials; and (c) all other stocks not included in the above two groupings.

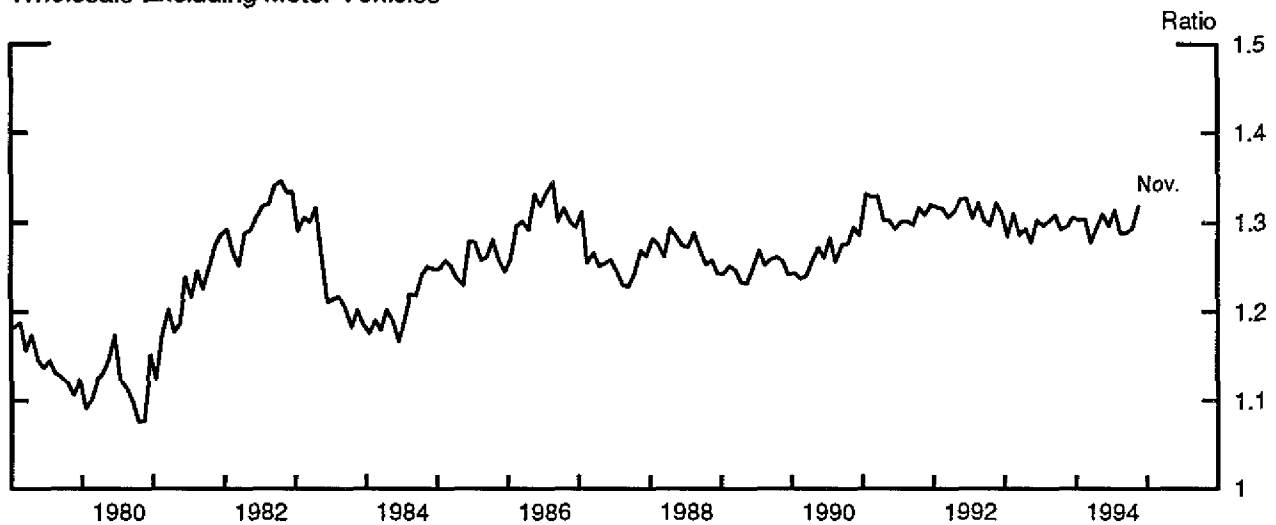
Inventory-Sales Ratio, by Major Sector

(Book value)

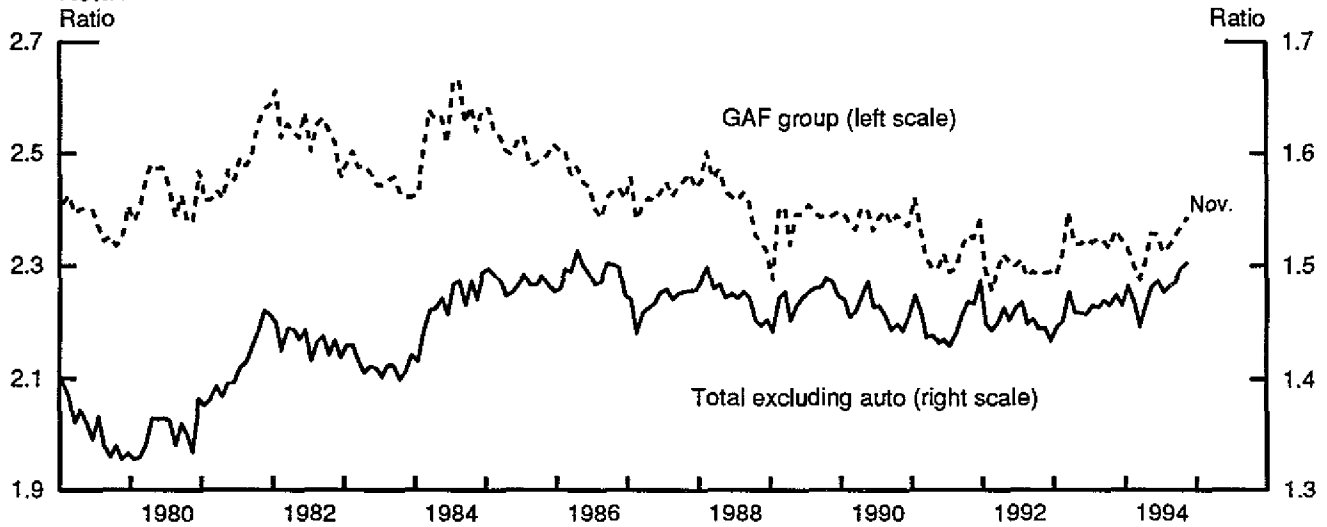
Manufacturing



Wholesale Excluding Motor Vehicles

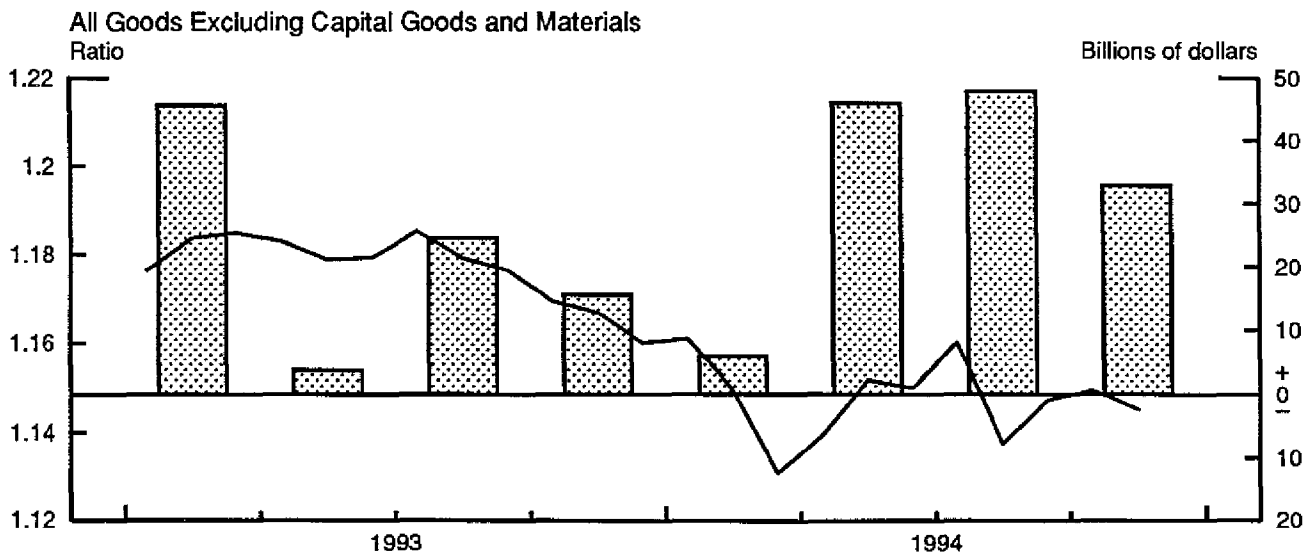
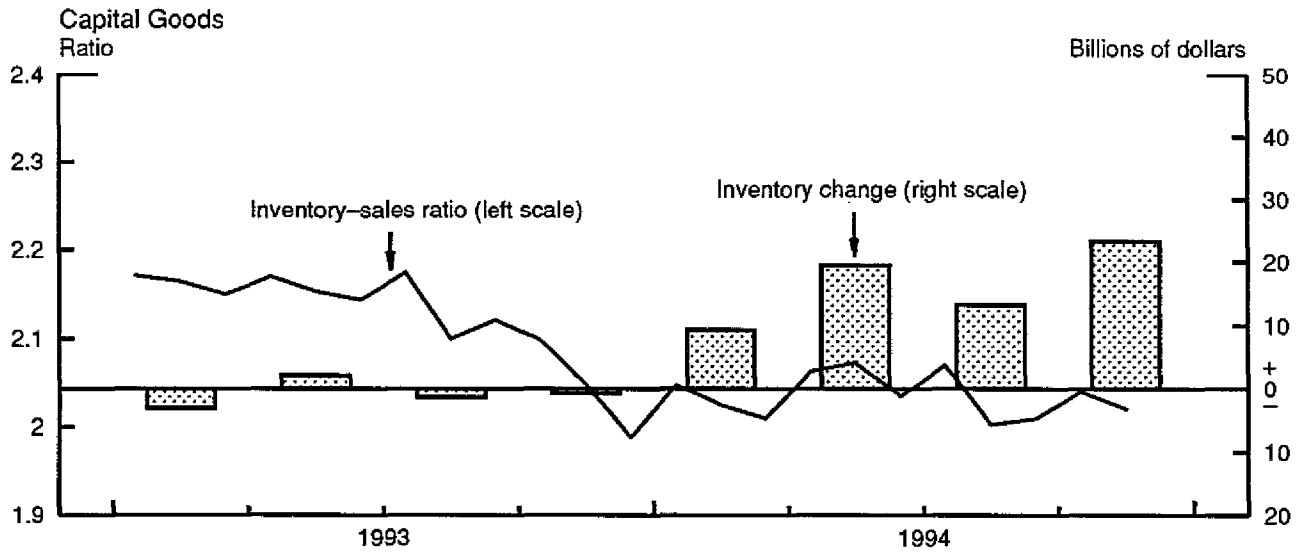


Retail Ratio



Inventory Change and Inventory-Sales Ratio, by Type of Goods

(Book value, seasonally adjusted annual rate)



Note. 1994:Q4 estimated by average of October and November.

year 1995 to \$74 billion. After adjusting for differences in the timing of some payroll and benefits payments, the three-month deficit was \$12 billion lower than during the comparable period of fiscal 1994. This favorable trend in the deficit reflected a combination of continued robust growth in receipts and relatively small increases in outlays.

FEDERAL GOVERNMENT OUTLAYS AND RECEIPTS
(Unified basis, billions of dollars, except where otherwise noted)

	December		Fiscal year to December			
	1993	1994	FY94	FY95	Dollar change	Percent change
Outlays	133.1	134.9	378.6	381.5	2.9	.8
Deposit insurance (DI)	1.0	-2.5	-.6	-4.4	-3.8	n.m.
Outlays excluding DI	132.1	137.4	379.2	385.9	6.7	1.8
National defense	26.8	26.3	74.1	67.6	-6.5	-8.8
Net interest	16.6	19.3	49.9	56.2	6.3	12.6
Social security	25.9	27.2	77.0	80.5	3.5	4.5
Medicare and health	22.7	23.3	62.9	65.2	2.3	3.7
Income security	19.8	19.3	53.9	50.8	-3.1	-5.7
Other	20.2	22.0	61.4	65.6	4.2	6.8
Receipts	125.4	130.8	287.2	307.5	20.3	7.1
Personal income and social insurance taxes	88.1	90.1	228.9	241.2	12.3	5.4
Corporate income taxes	28.2	31.9	32.6	36.5	3.9	12.0
Other	9.0	8.8	25.6	29.8	4.2	16.4
Deficit(+)	7.7	4.1	91.4	74.0	-17.4	-19.0
Excluding DI	6.7	6.6	92.0	78.4	-13.6	-14.8

Note. Components may not sum to totals because of rounding.
n.m. Not meaningful.

Receipts were about 7 percent higher for the current fiscal year through December than in the comparable period for fiscal 1994. Corporate tax receipts continued to be strong, although their 12 percent advance was only half that seen for the comparable period a year before. Personal income and social insurance taxes rose at about a 5-1/2 percent rate through December, slightly less than wages and salaries. Data from the Daily Treasury Statements through

January 24 show that final quarterly estimated tax payments on calendar year 1994 liabilities are apparently running about \$3 billion below January 1994's \$35 billion. The decline has occurred despite two factors that would tend to push up total 1994 tax liabilities--the solid income growth in 1994 and the effects of the OBRA93 tax increases. In contrast, for tax years 1994 and thereafter, the "safe harbor" provisions, which specify when taxpayers can avoid penalties for underpayment of estimated taxes, were relaxed.¹⁵ The relaxed provisions allow some taxpayers to meet a greater portion of their 1994 tax obligations through final payments in April instead of through estimated tax payments.

Adjusted for the timing shifts, outlays in the first three months of fiscal 1995 were only about 2 percent higher than during the comparable period of fiscal 1994. Interest outlays rose substantially because of both higher interest rates and the larger outstanding federal debt. However, increases in outlays for Medicare and Medicaid remained on the low side, and spending for defense and for income security posted outright declines.

The Congressional Budget Office has updated its projections for the economic and budget outlook. The CBO now projects a deficit of \$176 billion in fiscal 1995, \$13 billion higher than in its August Report, and has raised its annual deficit projections for the fiscal

15. Under current safe-harbor provisions, taxpayers with adjusted gross income in 1993 of less than \$150,000 can avoid IRS penalties for late payments of 1994 taxes if payments in 1994 (including the estimated payment in January 1995) are at least as great as the lesser of 90 percent of 1994's tax liability or 100 percent of 1993's tax liability (the so-called "previous year's safe harbor"). For higher income taxpayers, the previous year's safe harbor is 110 percent of their 1993 tax liability. These provisions are looser than the law that applied to estimated tax payments due in January 1994. Under that law, taxpayers were denied the option of the previous year's safe harbor if their AGI was greater than \$75,000, or if their AGI had jumped by more than \$40,000, or if they had paid estimated taxes or penalties for underpayment of estimated taxes in any of the prior three years.

CBO BUDGET PROJECTIONS¹
(Billions of dollars, except where noted)

	Fiscal years					
	1995	1996	1997	1998	1999	2000
Outlays	1531	1625	1699	1769	1872	1981
Receipts	1355	1418	1475	1546	1618	1697
Deficit	176	207	224	222	253	284
Deficit (percent of GDP)						
Total	2.5	2.8	2.9	2.7	3.0	3.1
Excluding deposit insurance	2.7	2.9	2.9	2.8	3.0	3.1

CBO ECONOMIC ASSUMPTIONS

	Calendar years					
	1995	1996	1997	1998	1999	2000
	-----Percent change, year over year-----					
Real GDP	3.1	1.8	2.4	2.3	2.3	2.3
GDP deflator	2.6	2.8	2.8	2.8	2.8	2.8
CPI-U	3.1	3.4	3.4	3.4	3.4	3.4
	-----Percent, annual average-----					
Civilian unemployment rate	5.5	5.7	5.8	5.9	6.0	6.0
Interest rates						
Treasury bills	6.2	5.7	5.3	5.1	5.1	5.1
Treasury notes	7.7	7.0	6.7	6.7	6.7	6.7

1. The projections assume that revenues and outlays for major benefit programs evolve according to laws in effect at the time the projections are made, and that appropriations for other programs are consistent with the discretionary spending caps through FY1998 and rise at the rate inflation thereafter. The projections include Social Security and the Postal Service, which are off-budget.

Source: Congressional Budget Office, The Economic and Budget Outlook: A Preliminary Report, January 5, 1995.

1996-99 period nearly \$30 billion, on average. The largest changes on the outlay side were in interest outlays, which were revised up because of higher interest rate assumptions, and in spending for Medicaid and Medicare, which was revised down. The projected path for receipts was lowered somewhat to reflect both technical adjustments and changes in economic assumptions.

The Congress has started to consider various elements of the program that was outlined in the Republican "Contract with America." The floor debate on the balanced budget amendment is under way in the House, with a vote possible by the end of the week. The Senate Judiciary Committee has reported out a version, but floor action has not yet been scheduled. The Administration is expected to present its fiscal 1996 budget to the Congress on February 6.

State and Local Governments

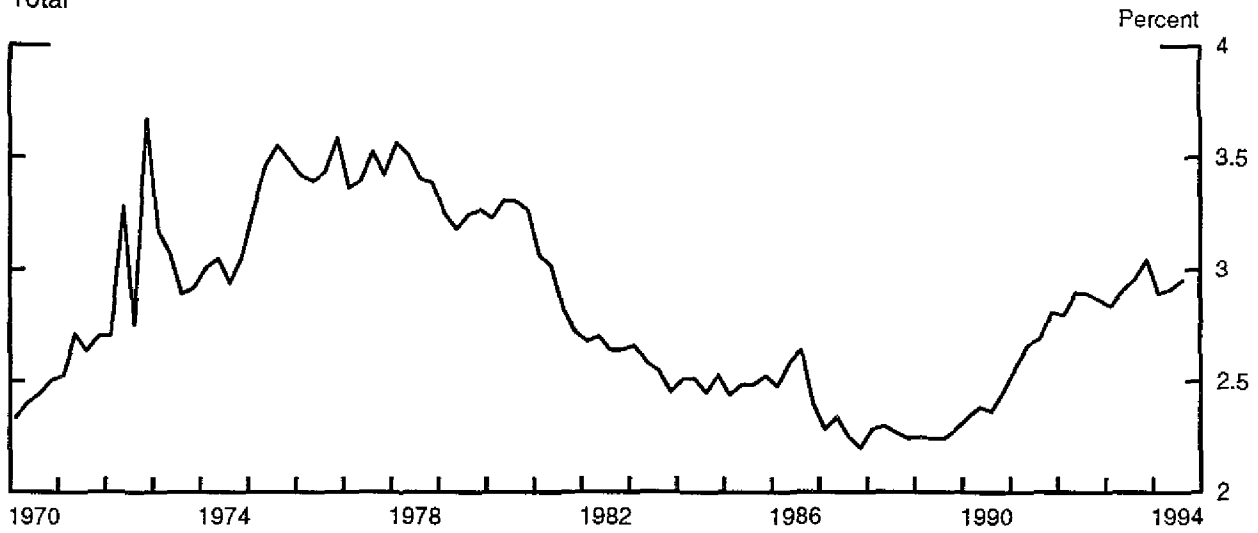
Real purchases of goods and services by state and local governments rose further in the fourth quarter of last year, but the increase probably was smaller than the 4.3 percent advance (annual rate) in the third quarter. The pattern of monthly changes in employment was influenced in late 1994 by the hiring of election workers in November by local governments; nonetheless, for the quarter as a whole, employment rose 73,000, nearly as much as the average during the first three quarters of the year. Real construction spending fell in November, but a strong October gain put the average October-November level at 1.8 percent above the level in the third quarter. With the exception of water and sewer facilities, outlays in all major categories stood substantially above their third-quarter levels.

Total federal grants to state and local governments have reached a plateau when measured as a percent of nominal GDP, after rising rapidly in the early 1990s (chart). This pattern mainly

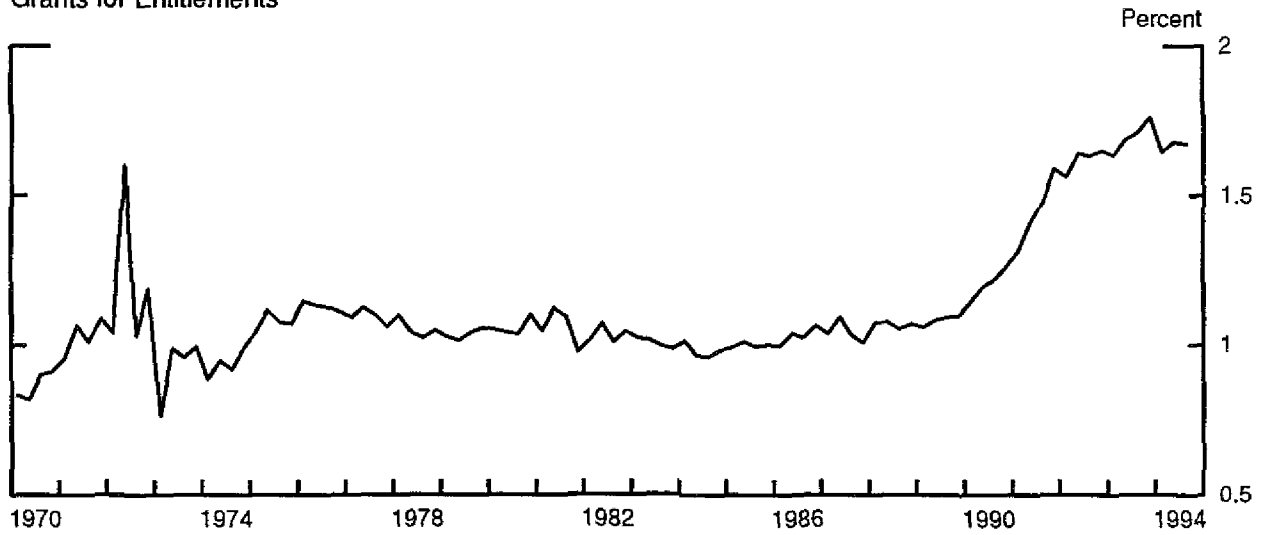
Federal Grants to States and Localities

(Percent of GDP)

Total

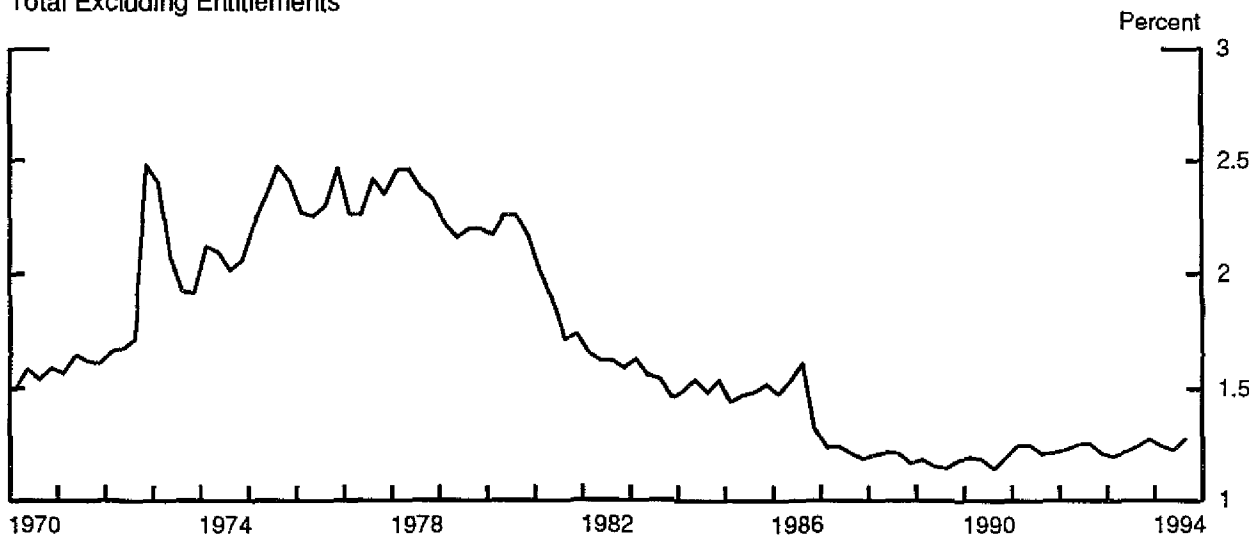


Grants for Entitlements



Note: Includes Medicaid, AFDC, WIC, and school lunches.

Total Excluding Entitlements



reflects the marked deceleration in grants for Medicaid and other entitlements over the past several quarters. Grants for discretionary programs, which now account for less than half of federal aid, have changed little as a percent of GDP since the mid- to late 1980s: Grants for mass transit, waste treatment, and community development and urban renewal have continued to decline, while grants for education and highways have moved up.

Labor Costs

The only recent data on labor costs are the readings on average hourly earnings of production or nonsupervisory workers in December. This series indicates that wages rose 0.3 percent in December; over the last three months of 1994, average hourly earnings increased at a 3.3 percent annual rate, the same pace as during the preceding three months. Taking a longer perspective, the trend in average hourly earnings--proxied by its twelve-month change--rose to 2.8 percent in 1994 from 2.6 percent in 1993 and 2.1 percent in 1992.

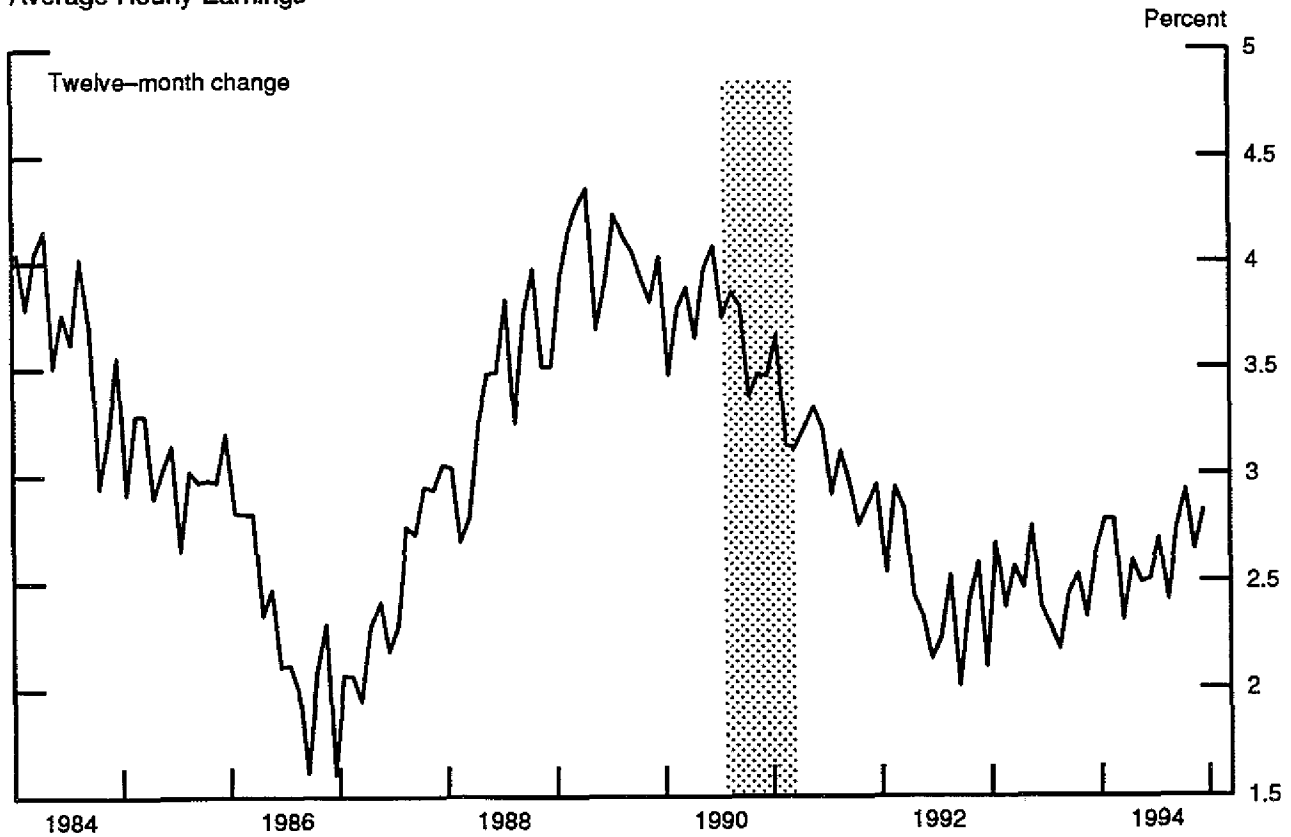
The more comprehensive data from the Employment Cost Indexes for the final quarter of 1994 will not be available until January 31. Through September, the ECI--like average hourly earnings--showed a slight uptrend in wages, from a low of 2.6 percent over the twelve months of 1992 to 2.9 percent in the year ending last September. However, the change in overall hourly compensation remained fairly stable as the modest firming in wages was offset by a further deceleration in employer costs for benefits. Indeed, as of September 1994, the year-over-year change in ECI benefits had dropped to 4 percent--the slowest pace since 1987. Since 1992, the largest contributor to the slowing in benefits has been the cost of employer-provided health insurance.

AVERAGE HOURLY EARNINGS
 (Percentage change; based on seasonally adjusted data)¹

	1993	1994	1994			1994		
			Q2	Q3	Q4	Oct.	Nov.	Dec.
			-Annual rate-			-Monthly rate-		
Total private nonfarm	2.6	2.8	2.2	3.3	3.3	.7	-.2	.3
Manufacturing	3.2	2.3	1.0	3.0	3.0	.2	.2	.3
Durable	3.4	2.2	.0	3.5	2.5	.0	.3	.3
Nondurable	2.5	2.5	1.4	2.5	2.9	.4	.0	.3
Contract construction	1.2	2.2	5.6	4.2	-2.1	.6	-.7	-.5
Transportation and public utilities	1.3	3.0	-.3	3.2	6.8	1.0	.3	.4
Finance, insurance, and real estate	5.5	3.2	1.7	5.2	2.7	1.4	-.7	-.1
Total trade	2.3	2.7	2.3	2.3	3.7	.8	-.3	.5
Services	2.2	3.0	3.0	3.3	3.6	.9	-.4	.4

1. Annual changes are measured from final month of preceding year to final month of year indicated.

Average Hourly Earnings



In part, the deceleration in employers' health costs probably reflects ongoing efforts by employers to shift costs to their workers and to move away from traditional indemnity plans. Data from the Employee Benefits Survey of Medium to Large Firms (100 or more employees) indicate that the proportion of health care plans wholly financed by employers declined from 61 percent in 1985 to 35 percent in 1993.¹⁶ The percentage of employees participating in employer-sponsored health plans declined from more than 90 percent in 1989 (a rate that had held for some time) to 82 percent in 1993. The survey also reported a significant drop in employee participation in traditional fee-for-service plans, from 74 percent in 1988 (the first year these data were collected) to 50 percent in 1993. Preferred provider organizations experienced the greatest increase in participation over this period, from 7 percent to 26 percent; enrollment in health maintenance organizations also rose.

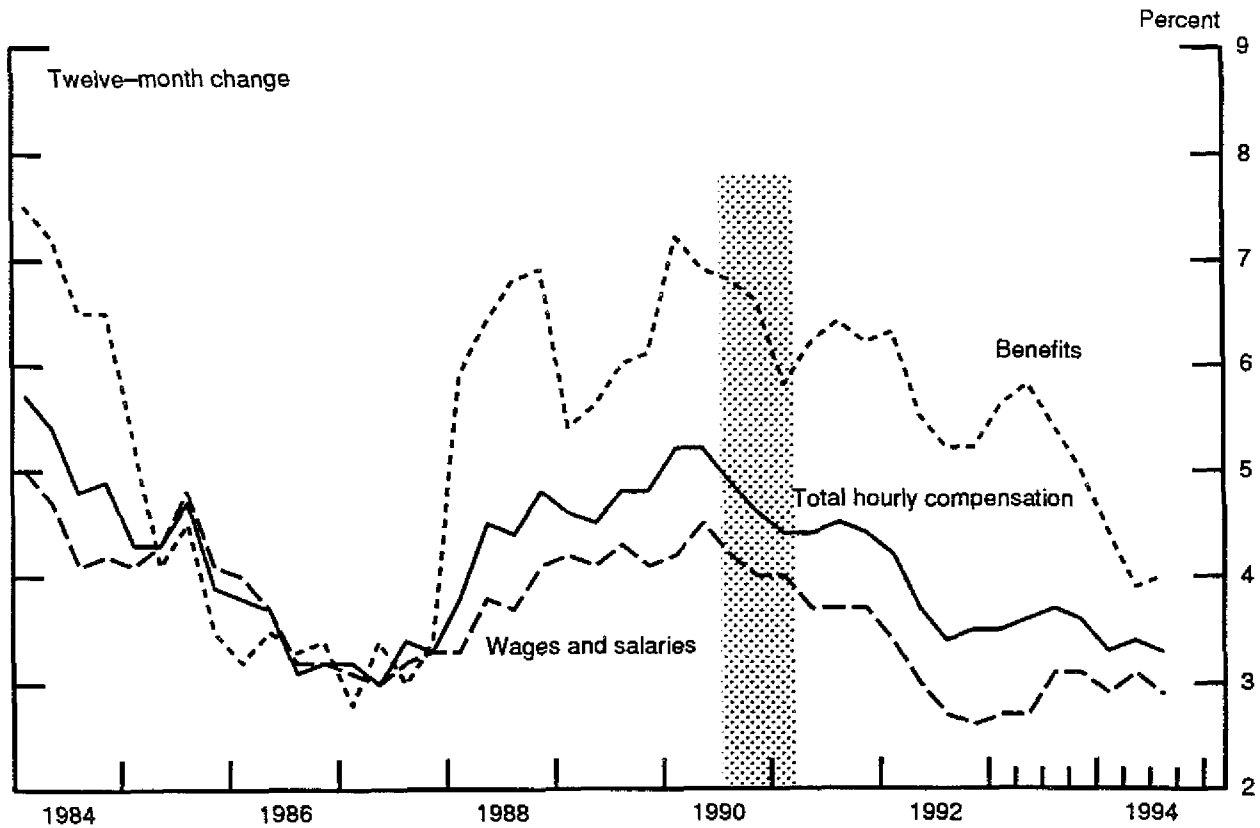
Slower increases in prices of medical commodities and services have also constrained benefit costs. For example, the implicit deflator for PCE medical services rose 4 percent over the twelve months ended in November--down 0.9 percentage point relative to the twelve-month period ended in November 1993; the most recent peak in growth in the deflator for medical services occurred in 1988, when it increased 8-1/2 percent.¹⁷

Despite the divergence of wage and benefit trends during the past several years, the overall pace of hourly compensation does not, on balance, look to have deviated significantly from the

16. The survey covers the same group of firms as contained in the ECI. The most recent survey was conducted in 1993 and refers to permanent, full-time employees.

17. Although the PCE deflator is based partly on the CPI measure of list prices of a fixed basket of medical services, it also incorporates information on transactions prices, which should make it a better measure of costs paid.

Employment Cost Index



EMPLOYMENT COST INDEX OF HOURLY COMPENSATION
(Twelve-month percent change)

	1992	1993	1994		
			Q1	Q2	Q3
Total hourly compensation	3.5	3.6	3.3	3.4	3.3
Wages and salaries	2.6	3.1	2.9	3.1	2.9
Benefit costs	5.2	5.0	4.4	3.9	4.0
Insurance	8.1	6.4	5.1	4.4	3.9
Health insurance	8.6	6.9	5.7	5.0	4.3
Legally required	4.8	4.4	3.7	3.1	2.9
Retirement and savings	5.2	4.9	9.5	9.6	10.2
Supplemental pay	2.7	2.8	5.3	5.5	6.2
Paid leave	3.3	3.4	2.9	2.8	3.2

predictions of a typical Phillips-curve wage equation. The versions of these equations maintained by the staff generally overpredicted the 3.3 percent rise in the ECI for the year ended in September 1994 by about 1/2 percentage point.¹⁸ However, these overpredictions offset roughly comparable underpredictions for the year ended September 1993; both misses were within one standard error of the models.

Prices

In reviewing the performance of the staff's "price-price" Phillips curves--equations that relate resource utilization directly to prices--our conclusion is much the same: We have little reason to modify our views of the influence of labor market slack on inflation. The unemployment rate averaged 6.1 percent last year, well within the range of NAIRU estimates generated by various models. Thus, the staff models of inflation interpret the year as one of roughly neutral pressure on prices and--conditioned on the unemployment rate--would have forecasted about flat inflation, just under 3 percent for the CPI excluding food and energy, in 1994. In the event, actual inflation, measured by its change from four quarters earlier, slowed 0.3 percentage point between the fourth quarters of 1993 and 1994.¹⁹ As models go, this error is small--especially considering that the same equations were very much on target in 1993.

Most of last year's model error occurred during the fourth quarter when CPI inflation (excluding food and energy) dropped about 1/2 percentage point (annual rate). Most notably, the CPI for consumer goods excluding food and energy was little changed. Motor

18. These results, and those presented below for price-price Phillips curves, were dynamic simulations with models that were estimated over a period that ended in 1992:Q4.

19. On a December-to-December basis, the deceleration was 0.6 percentage point.

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

	Relative importance, Dec. 1993	1993	1994	1994			1994	
				Q2	Q3	Q4	Nov.	Dec.
				-----Annual rate-----			-Monthly rate-	
All items ²	100.0	2.7	2.7	2.5	3.6	2.2	.3	.2
Food	15.8	2.9	2.9	2.8	5.1	5.0	.2	1.0
Energy	7.0	-1.4	2.2	-4.9	10.9	-1.1	.7	-.3
All items less food and energy	77.2	3.2	2.6	3.1	2.6	2.0	.2	.1
Commodities	24.4	1.6	1.4	4.2	.6	.3	.1	.0
Services	52.8	3.9	3.2	2.4	3.6	2.6	.3	.1
Memo:								
CPI-W ³	100.0	2.5	2.7	2.5	3.6	2.2	.3	.2

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

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

	Relative importance, Dec. 1993	1993	1994	1994			1994	
				Q2	Q3	Q4	Nov.	Dec.
				-----Annual rate-----			-Monthly rate-	
Finished goods	100.0	.2	1.7	-.3	2.6	1.0	.5	.2
Consumer foods	22.9	2.4	1.0	-5.5	3.9	6.8	.2	1.6
Consumer energy	13.3	-4.1	3.4	-1.0	3.2	-2.6	2.1	-1.5
Other finished goods	63.7	.4	1.6	2.1	2.1	-.6	.1	.2
Consumer goods	40.3	-.4	1.4	1.5	2.0	.3	.2	.1
Capital equipment	23.4	1.8	2.0	3.0	2.4	-1.8	.1	.4
Intermediate materials ²	95.2	.8	4.8	3.1	5.9	7.9	1.1	.4
Excluding food and energy	82.3	1.6	5.1	3.9	6.2	9.0	.9	.6
Crude food materials	44.1	7.2	-9.3	-20.6	-12.9	2.0	1.5	1.1
Crude energy	34.4	-12.3	-1.9	21.0	-20.5	-12.3	-1.0	-2.3
Other crude materials	21.5	10.7	17.0	-.8	18.8	30.7	3.4	2.5

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

vehicle pricing is one of the few "special factors" affecting the CPI late last year that we can readily identify. The CPI for new motor vehicles declined 0.3 percent (not annual rate) in the past three months. Light truck prices fell, partly reflecting stiff competition between Ford and GM to sell the most pickup trucks during calendar year 1994. But the quarterly variations in motor vehicle prices also appear to be reflecting a shift by automakers away from their recent pattern of once-a-year price increases in October in favor of several smaller increases distributed throughout the year. In the 1994 model year, below-trend increases posted in 1993:Q4 were followed by above-trend increases in the first three quarters of 1994. The drop in seasonally adjusted prices in 1994:Q4 may be the precursor of a similar pattern in the current model year.²⁰

Favorable price developments in the fourth quarter were not confined to motor vehicles. Apparel prices fell sharply in the second half of the year; as a result the apparel index declined 1.9 percent over 1994, after edging up in each of the preceding two years. Prices of house furnishings fell 2.1 percent last quarter, ending 1994 unchanged from a year earlier; prices of appliances, including electronic equipment, continued to fall at about a 2 percent annual rate.

Price changes for non-energy services excluding shelter in the fourth quarter were slightly below the trend earlier in the year. For the year as a whole, these prices slowed noticeably from their year-earlier pace. In addition, prices of medical care services increased 1/2 percentage point less, and tuition charges 1.2 percentage points less, in 1994 than in 1993. Most

20. Indeed, at the turn of the year, the Big Three automakers raised prices for their best-selling models--largely light trucks and sport utility vehicles. The announced increases came to 0.7 percent when averaged across the GM and Chrysler product lines.

INFLATION RATES EXCLUDING FOOD AND ENERGY

	Percent change from twelve months earlier		
	Dec. 1992	Dec. 1993	Dec. 1994
CPI	3.3	3.2	2.6
Goods	2.5	1.6	1.4
Alcoholic beverages	2.9	1.5	1.0
New vehicles	2.3	3.3	3.3
Apparel	1.2	0.8	-1.9
House furnishings	1.5	1.5	.0
Housekeeping supplies	-0.2	1.9	0.8
Medical commodities	5.2	3.1	3.0
Entertainment	1.8	1.9	1.8
Tobacco	8.1	-5.9	3.0
Services	3.7	3.9	3.2
Owners' equivalent rent	3.0	3.2	3.3
Tenants' rent	2.3	2.2	2.5
Other renters' costs	4.1	3.7	1.6
Airline fares	6.6	17.0	-9.5
Medical care	7.0	5.9	5.4
Entertainment	3.7	3.5	2.7
Auto financing	-13.9	-5.6	23.0
Tuition	8.5	7.1	5.9
PPI finished goods	2.0	0.4	1.6
Consumer goods	2.1	-0.4	1.4
Capital goods, excluding computers	2.6	2.3	2.1
Computers	-14.9	-12.5	-6.7
PPI intermediate materials	1.2	1.6	5.1
PPI crude materials	5.7	10.7	17.0
<u>Factors affecting price inflation</u>			
ECI hourly compensation ¹	3.4	3.7	3.3
Goods-producing	3.9	4.0	3.3
Service-producing	3.1	3.6	3.2
Civilian unemployment rate ^{2,3}	7.3	6.4	5.4
Capacity utilization ² (manufacturing)	80.4	82.2	85.1
Inflation expectations ^{4,5}			
Michigan Survey	3.5	3.5	3.6
Conference Board	4.4	4.2	4.1
Non-oil import price ⁶	2.8	0.3	3.2
Consumer goods, excluding autos, food, and beverages	4.0	0.6	0.7
Autos	2.3	1.6	3.5

1. Private industry workers, periods ended in September.
2. End-of-period value.
3. Data for 1994 are not directly comparable with earlier values because of a redesign of the CPS in January 1994.
4. One-year-ahead expectations.
5. Latest reported value: January.
6. BLS import price index (not seasonally adjusted), periods ended in September.

dramatically, air fares fell nearly 10 percent after rising 17 percent in 1993. The exceptions to the pattern of slowing in services prices were auto finance charges, which increased along with interest rates, and "rent of shelter," which rose at the same pace in 1994 (3 percent) as during the two previous years.

INFLATION EXCLUDING FOOD AND ENERGY

	PPI				CPI	
	Crude	Inter.	Finished		Commodities	Total
			Total	Ex. tobacco		
	-----December to December-----					
1992	5.7	1.2	2.0	1.7	2.5	3.3
1993	10.7	1.6	0.4	1.5	1.6	3.2
1994	17.0	5.1	1.6	1.7	1.4	2.6
	-----Six-month percent change at an annual rate ¹ -----					
1994:H1	10.3	2.9	2.5	1.8	2.4	3.0
:H2	24.6	7.6	0.7	1.5	0.4	2.3

1. December to June, and June to December.

Price changes for finished producer goods (excluding food and energy) remained modest throughout 1994. Excluding the sharp swings in tobacco prices, this index rose only about 1-3/4 percent.²¹ While the measured decline in the PPI for computers was less steep in 1994 than in 1993, the rise in prices of other capital goods remained modest (2.1 percent), despite the strength in demand. The prices that motor vehicle manufacturers charge their dealers rose 2.8 percent in 1994--down 0.8 percentage point from the increases in 1993. Producer prices of other consumer durables rose 1-1/2 percent last year, the same as in 1993. Among consumer nondurables, the PPIs for apparel and tobacco were little changed; however, producer prices for other finished nondurable items began to pick up in the

²¹ Excluding the index for tobacco prices is analytically useful because the industry cut prices 24 percent in August 1993. That drop subtracted 1.1 percentage points from the rise in the PPI for finished goods (excluding food and energy) during 1993. Finished tobacco prices in the PPI rose 0.3 percent during 1994.

second half of the year and rose 1-1/4 percent for the year as a whole.

Energy prices have generally been a slight moderating factor on inflation over the past two years. In recent months, the spot price for West Texas Intermediate has fluctuated in a fairly narrow range--usually between \$17 and \$19 per barrel. Prices of heating oil and natural gas edged lower, in part because of the unusually warm winter in the northeastern states. In addition, natural gas prices have been pushed down in the past year by abundant supplies and by a regulatory change that reduced the market power of interstate pipelines. U.S. independents have maintained production in the face of falling prices, and the level of imports from Canada is high. In the week ended January 13, stocks of natural gas were 71 percent of storage capacity--a high level for this time of year.

Although the EPA did not require retailers to sell reformulated gasoline (RFG) until January 1, about 55 percent of the gas stations in the participating regions were selling RFG in December. The BLS estimates that RFG adds about 5-1/2 cents to retail prices in the participating areas, and the agency made an equal-sized quality adjustment to exclude this effect from the CPI. Without this quality adjustment, the CPI for gasoline would have been 0.9 percent higher last month; by January, the full adjustment will have lowered the gasoline index by a cumulative 1.6 percent from what it otherwise would have been.

For 1994 as a whole, consumer food prices increased at about the same rate as other consumer prices; coffee accounted for about one-fourth of the rise. Recently, supply developments have again turned unfavorable. Consumer food prices rose 1.0 percent in December. While the indexes for most grocery store items fell last month, the effects of tropical storm Gordon on prices of fresh

fruits and vegetables grown in the southeastern United States were substantial; the recent flooding in California could further affect prices of these products in the near term.

In contrast to prices of finished goods, inflation has clearly picked up at the early stages of processing. Prices of intermediate goods excluding food and energy accelerated in the second half of 1994 at a 7.6 percent annual rate--4.7 percentage points more than in the first half. The acceleration was most notable among materials used in durable and nondurable manufacturing. Crude materials excluding food and energy rose at almost a 25 percent annual rate in the second half.

High rates of capacity utilization have become a source of upward pressure on prices in a number of industries. Among the primary processing industries, paper and allied products, chemicals, primary metals, and fabricated metals, all posted substantial price increases in the fourth quarter. In advanced processing, prices were generally flat even in industries such as non-electrical and electrical machinery where operating rates are high.

With one exception, the surveys of inflation expectations that we monitor have been roughly stable over the past two years, a pattern that mirrors the path of the total CPI. But while the CPI has been stable at 2.7 percent, most of the inflation surveys have been stable at higher expected rates. Both the University of Michigan and the Conference Board surveys of one-year-ahead expectations are hovering around 4 percent; the Livingston survey (of one-year-ahead expectations), and the professional forecasters survey (of ten-year-ahead expectations), is hanging around 3-1/2 percent. In contrast, the five-to-ten-year-ahead expectations reported by the Michigan Survey dropped about 3/4 percentage point over the past year to around 4-1/4 percent.

SURVEY OF (CPI) INFLATION EXPECTATIONS
(Percent)

	Actual inflation ¹	University of Michigan		Livingston (1-year) ⁴	Conference Board (1-year)	Professional forecasters (10-year) ⁵	Michigan (5- to 10-year) ⁶
		Mean (1-year) ²	Median (1-year) ³				
1991-Q1	5.3	4.8	3.7		5.1	4.4	5.9
Q2	4.8	4.6	3.3	3.8	4.7	4.1	5.5
Q3	3.9	3.9	3.3		4.7	4.1	5.2
Q4	3.0	4.4	3.1	3.4	4.7	4.0	5.1
1992-Q1	2.9	3.4	2.7		4.6	3.7	4.8
Q2	3.1	3.8	3.1	3.6	4.6	3.9	5.0
Q3	3.1	4.0	3.0		4.5	3.8	4.9
Q4	3.1	3.8	2.9	3.4	4.5	3.6	5.3
1993-Q1	3.2	4.3	3.1		4.6	3.5	5.2
Q2	3.1	4.4	3.3	3.4	4.8	3.7	5.2
Q3	2.7	4.7	3.1		4.6	3.5	4.7
Q4	2.7	3.8	3.2	3.2	4.4	3.5	4.7
1994-Q1	2.5	3.9	2.9		4.3	3.5	5.0
Q2	2.4	4.2	3.0	2.9	4.2	3.5	4.8
Q3	2.9	4.5	3.2		4.3	3.5	5.0
Q4	2.7	4.1	3.1	3.5	4.2	3.5	4.3
1994-Jan	2.5	3.5	2.9		4.3		4.8
Feb	2.5	3.7	2.8		4.4		4.7
Mar	2.5	4.4	3.0		4.3	3.5	5.4
Apr	2.4	4.5	3.0		4.3		5.0
May	2.3	3.9	3.2		4.2		4.6
Jun	2.5	4.1	2.8	2.9	4.2	3.5	4.8
Jul	2.8	4.2	2.9		4.3		4.7
Aug	2.9	4.6	3.1		4.3		5.5
Sep	3.0	4.6	3.5		4.2	3.5	4.9
Oct	2.6	3.9	3.0		4.3		4.6
Nov	2.7	4.5	3.4		4.2		4.2
Dec	2.7	4.0	3.0	3.5	4.1	3.5	4.2
1995-Jan		3.6	3.0				4.0

1. CPI; percent change from the same period in the prior year.

2. Average increase for responses to the question, By about what percent do you expect prices (CPI) to go up, on the average, during the next twelve months?

3. Median increase for responses to the question above.

4. Average twelve-month-ahead forecast of the CPI by "informed" business economists. Constructed by the Federal Reserve Bank of Philadelphia from disaggregated Livingston data, data are for the last month of the period indicated.

5. Compiled by the Federal Reserve Bank of Philadelphia.

6. Average increase for responses to the question, By about what percent per year do you expect prices (CPI) to go up, on the average, during the next five to ten years?

DOMESTIC FINANCIAL DEVELOPMENTS

1
SELECTED FINANCIAL MARKET QUOTATIONS
(Percent except as noted)

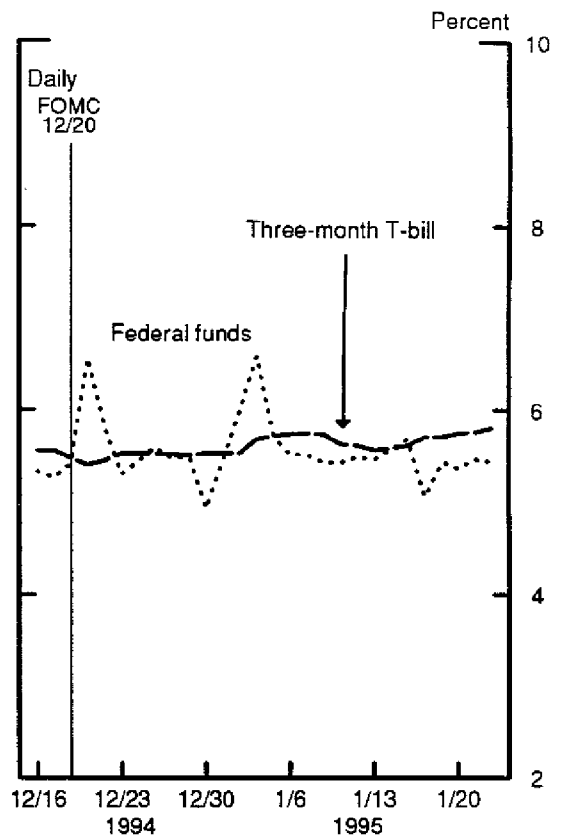
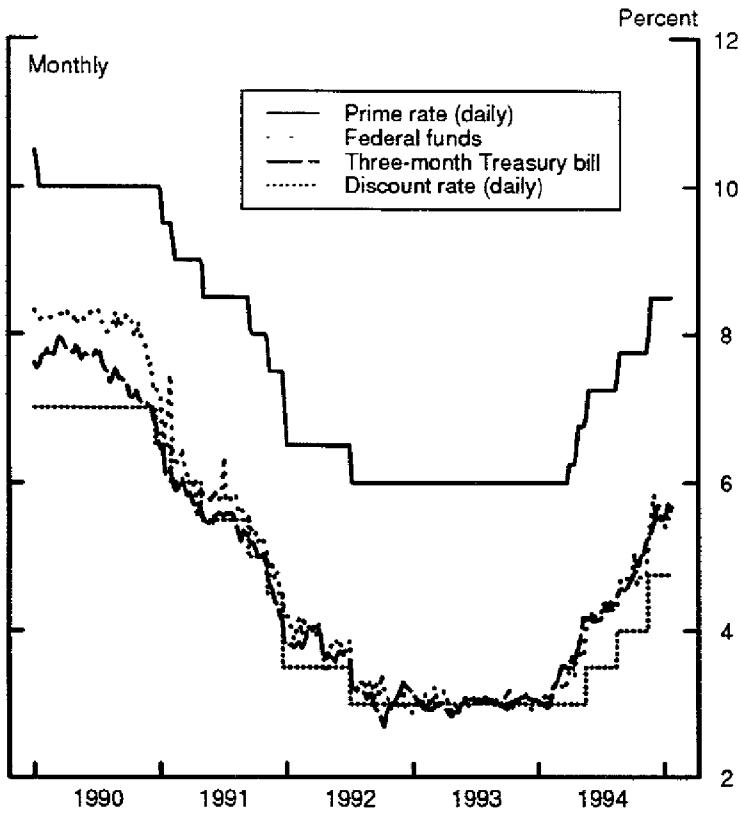
Instrument	1993	1994		1995	Change to Jan 24, 1995			
	Oct lows	Feb 3	FOMC Dec 20	Jan 24	From Oct 93 lows	From Feb 3	From FOMC Dec 20	
SHORT-TERM RATES								
Federal funds ²	3.07	3.07	5.44	5.41	2.34	2.34	-.03	
Treasury bills ³								
3-month	3.01	3.13	5.48	5.81	2.80	2.68	.33	
6-month	3.09	3.27	6.19	6.25	3.15	2.98	.06	
1-year	3.23	3.52	6.61	6.59	3.36	3.07	.02	
Commercial paper								
1-month	3.13	3.16	6.10	5.91	2.78	2.75	-.19	
3-month	3.23	3.25	6.27	6.22	2.99	2.97	-.05	
Large negotiable CDs ³								
1-month	3.08	3.11	6.01	5.89	2.81	2.78	.12	
3-month	3.22	3.25	6.27	6.22	3.00	2.97	-.05	
6-month	3.23	3.41	6.77	6.65	3.42	3.24	-.12	
Eurodollar deposits ⁴								
1-month	3.06	3.06	6.00	5.88	2.82	2.82	-.12	
3-month	3.25	3.25	6.25	6.25	3.00	3.00	.00	
Bank prime rate	6.00	6.00	8.50	8.50	2.50	2.50	.00	
INTERMEDIATE- AND LONG-TERM RATES								
U S Treasury (constant maturity)								
3-year	4.06	4.60	7.68	7.71	3.65	3.11	.03	
10-year	5.19	5.81	7.81	7.86	2.67	2.05	.05	
30-year	5.78	6.31	7.85	7.93	2.15	1.62	.08	
Municipal revenue ⁵ (Bond Buyer)	5.41	5.49	7.02	6.78	1.37	1.29	-.24	
Corporate--A utility, recently offered	6.79	7.35	8.77	8.84	2.05	1.49	.07	
Home mortgages ⁶								
FHLMC 30-yr fixed rate	6.74	6.97	9.25	9.05	2.31	2.08	-.20	
FHLMC 1-yr adjustable rate	4.14	4.12	6.75	6.82	2.68	2.70	.07	
Stock exchange index	Record high		1989	1994	1995	Percentage change to Jan 24:		
	Level	Date	Low, Jan 3	FOMC, Dec 20	Jan 24	From record high	From 1989 low	From FOMC, Dec 20
Dow-Jones Industrial	3978.36	1/31/94	2144.64	3767.15	3862.70	-2.91	80.11	2.54
NYSE Composite	267.71	2/2/94	154.00	249.80	253.70	-5.23	64.74	1.56
NASDAQ (OTC)	803.93	3/18/94	378.56	728.51	763.20	-5.07	101.61	4.76
Wilshire	4804.31	2/2/94	2718.59	4491.92	4602.44	-4.20	69.30	2.46

1 One-day quotes except as noted
2 Average for two-week reserve maintenance period closest to date shown. Last observation is average to date for maintenance period ending Feb 1, 1995.
3 Secondary market

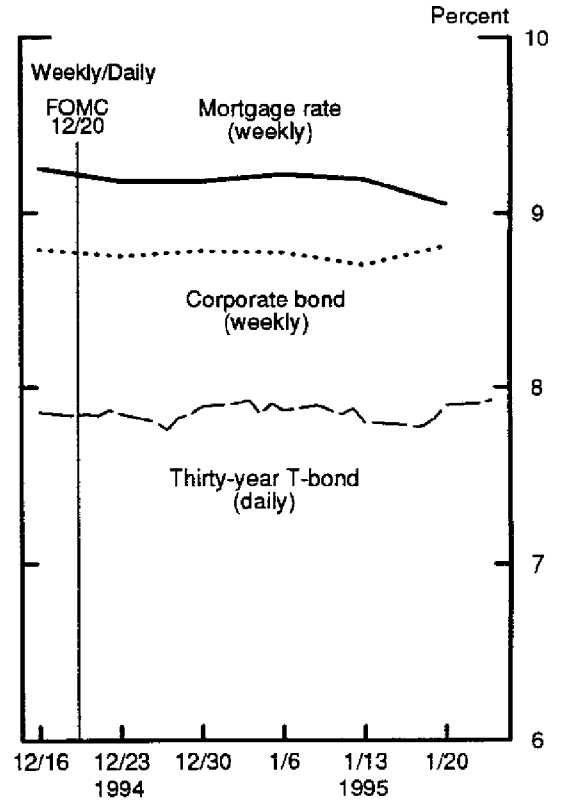
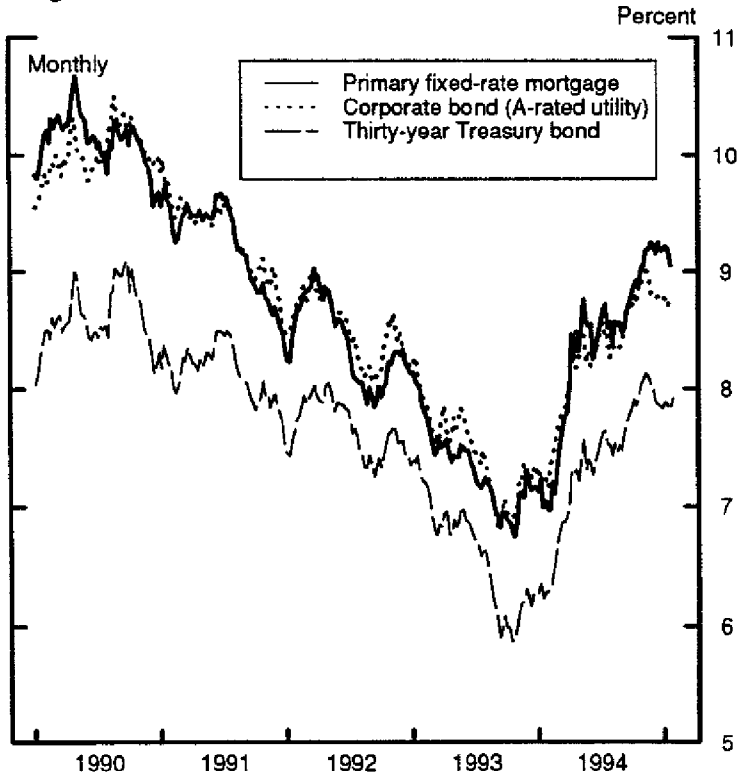
4 Bid rates for Eurodollar deposits at 11 a.m. London time
5 Most recent observation based on one-day Thursday quote and futures market index changes
6 Quotes for week ending Friday previous to date shown.

Selected Interest Rates

Short-Term



Long-Term



DOMESTIC FINANCIAL DEVELOPMENTS

The absence of policy action at the December 20 FOMC meeting and in the weeks following has not greatly surprised market participants. Apparently, the financial stresses exerted by the Orange County and Mexican crises were viewed as sufficient reason to delay additional policy tightening. Nonetheless, with the economy still displaying considerable strength, the market continues to expect a substantial increase in money market rates over the next few quarters, including a 50 basis point firming at the upcoming meeting.

On balance, interest rates have registered mixed changes since the FOMC meeting. One-month maturities registered declines as the year-end premium disappeared and most three-month rates are off slightly, on net. Yields on Treasury notes and bonds have edged up several basis points.

Quality spreads, on the whole, have remained narrow, suggesting that investors foresee no near-term deterioration in the financial health of borrowers. Spreads on corporate bonds remain near cyclical lows, and the ratio of tax-exempt to taxable yields has retraced much of its earlier rise, as the municipal market has mostly shrugged off the problems associated with Orange County. Major equity indexes have advanced about 1-1/2 to 5 percent as news on corporate earnings has been generally favorable.

Borrowing by businesses and households has strengthened somewhat. While gross public issuance of bonds by nonfinancial firms remained subdued in December and early January, these firms have again turned to banks and the commercial paper market in volume. In the household sector, consumer credit continued to increase at double-digit annual rates late last year, and home mortgage credit is estimated to have slowed only slightly from its

MONETARY AGGREGATES
Based on newly benchmarked & seasonally adjusted data.

Aggregate or component	1994	1994		1994			1993:Q4	Level
		Q3	Q4 (p)	Oct	Nov	Dec (p)	to Dec 94 (p)	(bil \$) Dec 94 (p)
<u>Aggregate</u>	Percentage change (annual rate) ¹							
1 M1	2.3	2.4	-1.2	-2.9	-0.6	0.2	2.2	1147.7
2 M2	1.0	0.8	-0.3	-1.2	0.5	1.5	1.0	3613.9
3 M3	1.4	2.0	1.7	1.9	1.8	3.1	1.5	4301.2
<u>Selected components</u>								
4. Currency	10.2	9.1	8.6	9.3	10.6	4.8	10.0	354.4
5. Demand deposits	0.4	0.3	-4.2	-6.5	-6.6	-1.3	0.2	381.9
6 Other checkable deposits	-2.1	-1.4	-6.7	-10.0	-4.7	-2.7	-2.2	402.9
7 M2 minus M1	0.4	0.0	0.1	-0.4	1.1	2.1	0.5	2466.2
8 Savings deposits	-4.4	-7.1	-11.6	-12.8	13.4	-14.0	-5.1	1144.5
9. Small time deposits	2.1	5.0	13.2	14.5	16.4	15.0	3.1	817.1
10. Retail money market funds	7.5	5.0	8.8	9.9	14.2	17.2	8.2	389.7
11 Overnight RPs, n.s.a.	13.6	15.2	7.8	-7.2	-2.9	17.4	13.5	84.1
12. Overnight Eurodollars, n.s.a.	46.8	100.8	29.5	93.2	-41.4	93.5	48.3	33.2
13. M3 minus M2	3.5	8.5	12.7	18.9	8.9	11.8	4.1	687.4
14. Large time deposits, net ²	7.2	11.9	18.8	19.7	19.7	15.4	8.1	363.4
15. Institution-only money market mutual funds	-8.2	-4.5	7.2	30.6	-2.0	2.0	-7.5	180.8
16. Term RPs, n.s.a.	6.3	9.6	3.5	-2.4	8.2	17.5	7.0	104.1
17. Term Eurodollars, n.s.a.	14.8	27.4	15.6	20.7	38.5	-46.1	12.1	52.6
<u>Memo</u>								
18. Monetary base	8.3	7.4	6.5	6.7	9.0	1.7	8.0	417.1
19. Household M2 ³	0.4	-0.2	0.0	-0.3	1.6	1.3	0.5	109.3
Average monthly change (billions of dollars) ⁴								
<u>Memo</u>								
20. Managed liabilities at commercial banks (lines 22 + 23)	15.6	17.0	9.4	-6.1	-3.9	38.1	. .	1021.7
21. Large time deposits, gross	2.3	4.3	5.2	5.0	6.3	4.4	. .	372.8
22. Nondeposit funds	13.4	12.8	4.1	-11.1	10.2	33.7	. .	648.9
23. Net due to related foreign institutions	8.5	10.3	1.8	-1.7	-5.5	12.5	. . .	220.9
24. Other ⁵	4.9	2.5	2.3	-9.5	-4.7	21.2	. . .	428.0
25. U.S. government deposits at commercial banks	-0.2	-0.7	0.5	-0.1	0.7	1.0	. .	21.0

1. For the years shown, fourth quarter-to-fourth quarter percent change. For the quarters shown, based on quarterly averages.

2. Net of holdings of depository institutions, money market mutual funds, U.S. government, and foreign banks and official institutions.

3. Sum of seasonally adjusted currency, retail money funds, and other checkable, savings, and small time deposits.

4. For years, "average monthly change" is based on the dollar change from December to December. For quarters, it is based on the dollar change across the last months of quarters.

5. 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.

p Preliminary. n.s.a. Not seasonally adjusted.

rapid rate of growth of the third quarter, with banks satisfying an unusually large share of the demand.

Bank credit surged in December, reflecting both an acceleration in lending and a cessation in the runoff of securities. Survey responses for early January indicated that some banks continued to ease terms and standards on both business and consumer loans. With the growth of retail deposits still sluggish on balance, banks have continued to rely heavily on managed liabilities to fund loan expansion, and this has been reflected in a pickup in M3 growth.

Monetary Aggregates and Bank Credit

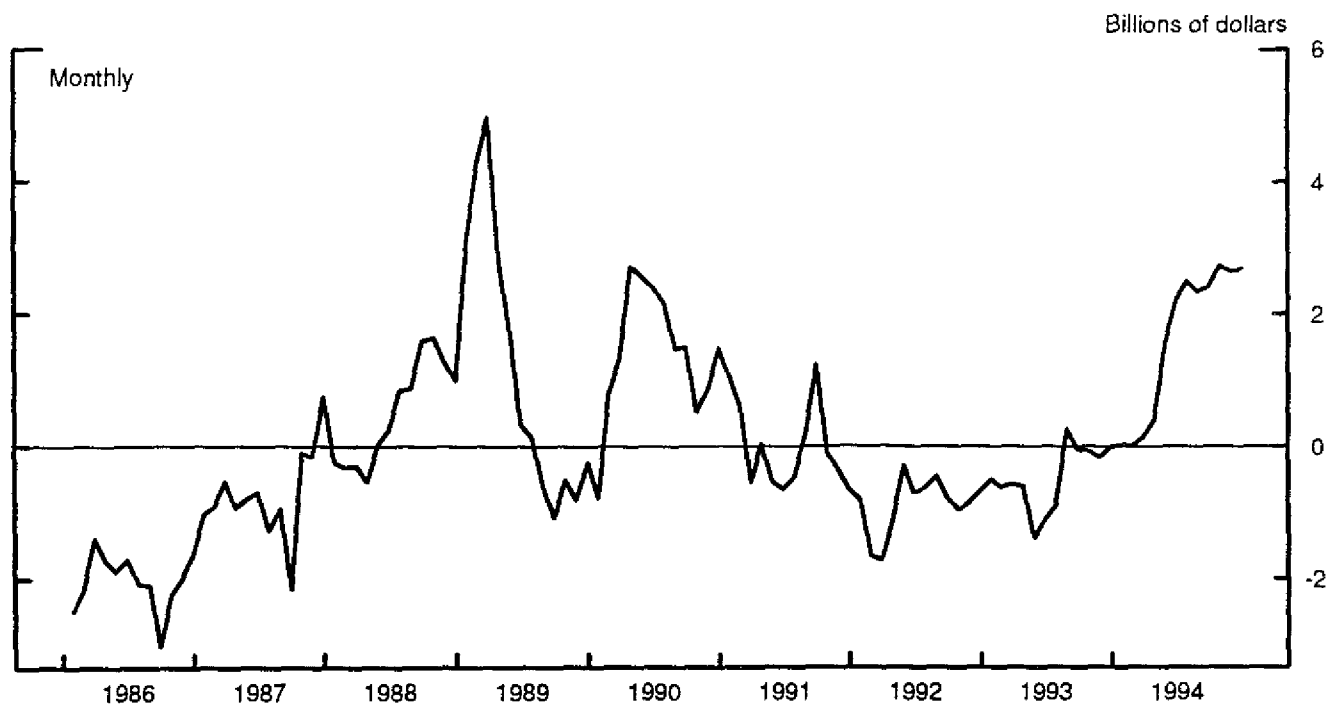
[The monetary data in the Greenbook incorporate new benchmarks and seasonal adjustments, which are scheduled to be published in early February and are strictly confidential until that time.]

The rate of expansion of the broad monetary aggregates picked up somewhat in December as M2 grew at about a 1-1/2 percent annual rate and M3 at a 3 percent pace.¹ Data through the first half of January suggest a further strengthening this month.

The growth in M2 owed mostly to a turnaround in overnight repurchase agreements and Eurodollars at banks rather than to a build-up in retail deposits. As the opportunity cost of savings deposits (including MMDAs) has widened further, households have continued to shrink their holdings of these assets. Some of those funds shifted within M2 to small time deposits and retail money funds, whose rates adjust more quickly to market rates. Households also appear to have moved funds toward direct investments outside of M2, such as Treasury bills and notes obtained by noncompetitive tenders. These tenders increased substantially in 1994 (chart).

1. From the fourth quarter of 1993 to the fourth quarter of 1994, M2 grew 1 percent, coming in at the lower end of its annual range. Over the same period, M3 expanded at a touch faster rate, 1-1/2 percent, to fall comfortably within its annual range of 0 to 4 percent.

Net Noncompetitive Tenders of Treasury Securities



Note. A three-month moving average of total net noncompetitive tenders of Treasury bills, bonds, and notes. Net noncompetitive tenders represent the increase in the amount of Treasury securities outstanding bought through noncompetitive tenders. It is calculated by taking the difference between the amount of securities issued and the amount of securities maturing that have been purchased via noncompetitive tenders.

The non-M2 component of M3 grew 12 percent in December, about in line with the average for the last quarter of 1994. To help finance credit expansion, banks continued to rely on wholesale funding, including large time deposits and nondeposit sources of funds. Some slowing in the growth of large time deposits seems evident in January.

Growth in bank credit picked up noticeably in December from previous months, bolstered by rapid growth of loans and a halt in the runoff of securities holdings. Bank holdings of U.S. government securities fell only slightly as acquisitions by large banks mostly offset run-offs at other banks. The "other securities" component,

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

Type of credit	Dec. 1993 to Dec. 1994	1994 Q3	1994 Q4	1994 Oct	1994 Nov	1994 Dec	Level, Dec 1994 (\$billions)
Commercial bank credit							
1. Total loans and securities	7.0	7.0	5.2	2.7	3.5	9.5	3,323.3
2. Securities	4.3	-2.7	-7.2	-13.0	-8.6	-.1	950.5
3. U.S. government	-1.3	-5.3	-12.5	-21.1	-13.2	-3.7	717.7
4. Other	26.2	5.9	10.2	14.3	5.2	10.9	232.8
5. Loans	8.2	11.2	10.5	9.2	8.4	13.4	2,372.8
6. Business	10.4	11.6	10.3	11.5	10.0	9.2	644.3
7. Real estate	6.3	9.7	8.5	6.0	7.8	11.6	1,000.0
8. Consumer	15.1	18.2	13.8	19.0	7.6	14.3	450.2
9. Security	-12.7	-37.3	43.4	52.1	20.0	54.0	76.6
10. Other	5.9	21.6	1.8	-17.9	4.2	19.3	201.7
Short- and intermediate-term business credit							
11. Business loans net of bankers acceptances	10.6	11.6	11.2	12.8	11.1	9.3	635.7
12. Loans at foreign branches ²	5.5	17.9	-6.9	-36.1	5.3	10.6	22.9
13. Sum of lines 11 and 12	10.4	11.8	10.5	11.0	10.9	9.4	658.6
14. Commercial paper issued by nonfinancial firms	5.1	11.0	31.8	32.8	23.6	36.6	165.7
15. Sum of lines 13 and 14	9.3	11.7	14.6	15.1	13.4	14.7	824.3
16. Bankers acceptances, U.S. trade-related ^{3,4}	-9.5	-3.9	-37.8	-35.8	-30.8	-50.5	18.2
17. Loans at finance companies ⁴	n.a.	7.2	n.a.	17.0	15.0	n.a.	348.2 ⁵
18. Total (sum of lines 15, 16, and 17)	n.a.	10.1	n.a.	14.9	13.1	n.a.	1,181.5 ⁵

1. Except as noted, levels are averages of Wednesday data and percentage changes are based on averages of Wednesday data; data are adjusted for breaks caused by reclassification; changes are measured from preceding period to period indicated.

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

3. Acceptances that finance U.S. imports, U.S. exports, and domestic shipment and storage of goods.

4. Changes are based on averages of month-end data.

5. November 1994.

n.a. Not available.

which has exhibited considerably more volatility in the wake of an accounting change in 1994, expanded nearly 11 percent in December.

All major loan categories exhibited strength in December. Real estate loans rose briskly at domestic banks and were about flat at foreign banks; about 3 percentage points of December's growth owed to the acquisition of thrift assets by banks. Consumer loans also grew smartly in December and would have been even more robust if not for securitizations. Responses to the Senior Loan Officer Opinion Survey in January indicated that the willingness of banks to extend credit to consumers continued to rise. About 2 percentage points of total loan growth in December reflected the rapid expansion of loans to purchase or carry securities; such loans are a small but highly volatile component of bank credit.

Business loans grew rapidly in December and early January as both domestic and foreign banks continued to accommodate robust demand from nonfinancial businesses. Moreover, indications from the January Senior Loan Officer Opinion Survey suggest that banks continued to seek new business loans by easing both standards and terms of business lending, but the extent of easing lessened from previous surveys. Press reports also indicate that banks remain aggressive in competing for better quality business credits: Spreads on loan rates over market rates in the syndicated loan market reportedly have returned to around 1989-1990 levels. The narrowing of spreads is reported to have slowed in the fourth quarter, and spreads may be about as slim as can be expected for investment- and near investment-grade credits. The lower pricing and eased covenants have occurred even as the maturities of revolving loan agreements in the investment-grade syndicated loan market have lengthened.

Long-Term Mutual Funds

Investors' appetites for mutual funds remained subdued in December and early January. Total net sales of stock and bond funds were close to zero, but adjusted to take account of capital gain distributions they showed a substantial outflow. Emerging-market equity and bond funds with exposure to Mexico experienced redemptions in the wake of the devaluation of the Mexican peso, even

NET SALES OF MUTUAL FUNDS BY TYPE
(Billions of dollars, monthly rate, NSA)

	1994					Memo: Nov. assets
	Q3	Q4 ^e	Oct.	Nov.	Dec. ^e	
Total stock	11.2	6.6	9.4	3.4	7.1	858.5
International	3.9	1.8	3.3	0.7	1.4	163.4
Domestic	7.3	4.8	6.1	2.7	5.7	695.1
Total bond	-1.3	-7.5	-6.0	-9.1	-7.3	724.9
GNMA	-1.0	-1.2	-1.3	-1.3	-1.2	54.6
Government	-1.5	-1.9	-2.1	-1.9	-1.7	89.1
High-yield	0.1	-0.2	-0.3	-0.4	0.2	44.6
Tax-exempt	-0.1	-2.9	-2.0	-4.1	-2.5	227.4
Income	1.7	-0.4	0.3	-0.4	-1.1	215.5
Other	-0.6	-0.9	-0.7	-1.0	-1.0	59.5

^e Estimate.

Source: Investment Company Institute.

though trade reports suggest that many investors are willing to ride out the recent hit to asset values.

All major categories of bond funds continued to exhibit outflows in December and early January, except high-yield funds, which attracted modest inflows. While redemptions of tax-exempt shares have slowed since December, outflows from California-only funds have been relatively somewhat larger than the rest of the industry, owing to the Orange County debacle.

GROSS OFFERINGS OF SECURITIES BY U.S. CORPORATIONS¹
 (Billions of dollars; monthly rates, not seasonally adjusted)

Type of security	1993	1994 ^p	1994				
			Q3	Q4 ^p	Oct. ^p	Nov. ^p	Dec. ^p
All U.S. corporations	53.20	39.87	33.03	29.48	32.30	34.08	22.05
Stocks ²	9.43	5.50	4.19	4.14	3.70	5.98	2.75
Bonds	43.77	34.37	28.84	25.33	28.60	28.10	19.30
<u>Nonfinancial corporations</u>							
Stocks ²	5.18	3.11	1.79	2.94	1.99	4.60	2.22
Sold in U.S.	4.91	2.89	1.65	2.71	1.93	4.12	2.08
Utility	1.05	.38	.20	.22	.08	.41	.17
Industrial	3.82	2.51	1.45	2.49	1.85	3.71	1.91
Sold abroad	.27	.22	.14	.23	.05	.49	.14
Bonds	16.19	7.37	5.71	5.72	6.33	5.97	4.87
Sold in U.S.	15.55	6.49	4.90	4.70	5.00	5.10	4.00
Utility	7.34	2.36	1.14	1.80	1.90	2.00	1.50
Industrial	8.21	4.13	3.76	2.90	3.10	3.10	2.50
Sold abroad	.64	.88	.81	1.02	1.33	.87	.87
By quality ³							
Aaa and Aa	2.56	.68	.41	.92	.85	1.25	.66
A and Baa	8.70	3.78	3.49	2.67	3.61	2.32	2.08
Less than Baa	4.17	1.99	.93	1.11	.54	1.53	1.26
Unrated or rating unknown	.09	.00	.01	.00	.00	.00	.00
<u>Financial corporations</u>							
Stocks ²	4.31	2.40	2.40	1.21	1.71	1.37	.53
Sold in U.S.	4.06	2.14	1.84	1.17	1.63	1.35	.53
Sold abroad	.25	.25	.56	.04	.08	.02	.00
Bonds	27.58	27.00	23.13	19.61	22.27	22.13	14.43
Sold in U.S.	25.02	23.42	20.15	16.73	19.00	18.20	13.00
Sold abroad	2.56	3.58	2.98	2.88	3.27	3.93	1.43
By quality ³							
Aaa and Aa	1.78	3.40	2.48	1.52	2.27	1.28	1.00
A and Baa	9.01	8.77	7.41	6.53	6.99	7.95	4.65
Less than Baa	.49	.29	.21	.13	.20	.00	.20
Unrated or rating unknown	.08	.06	.00	.09	.00	.00	.28

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 occurred in restructurings.

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

p Preliminary.

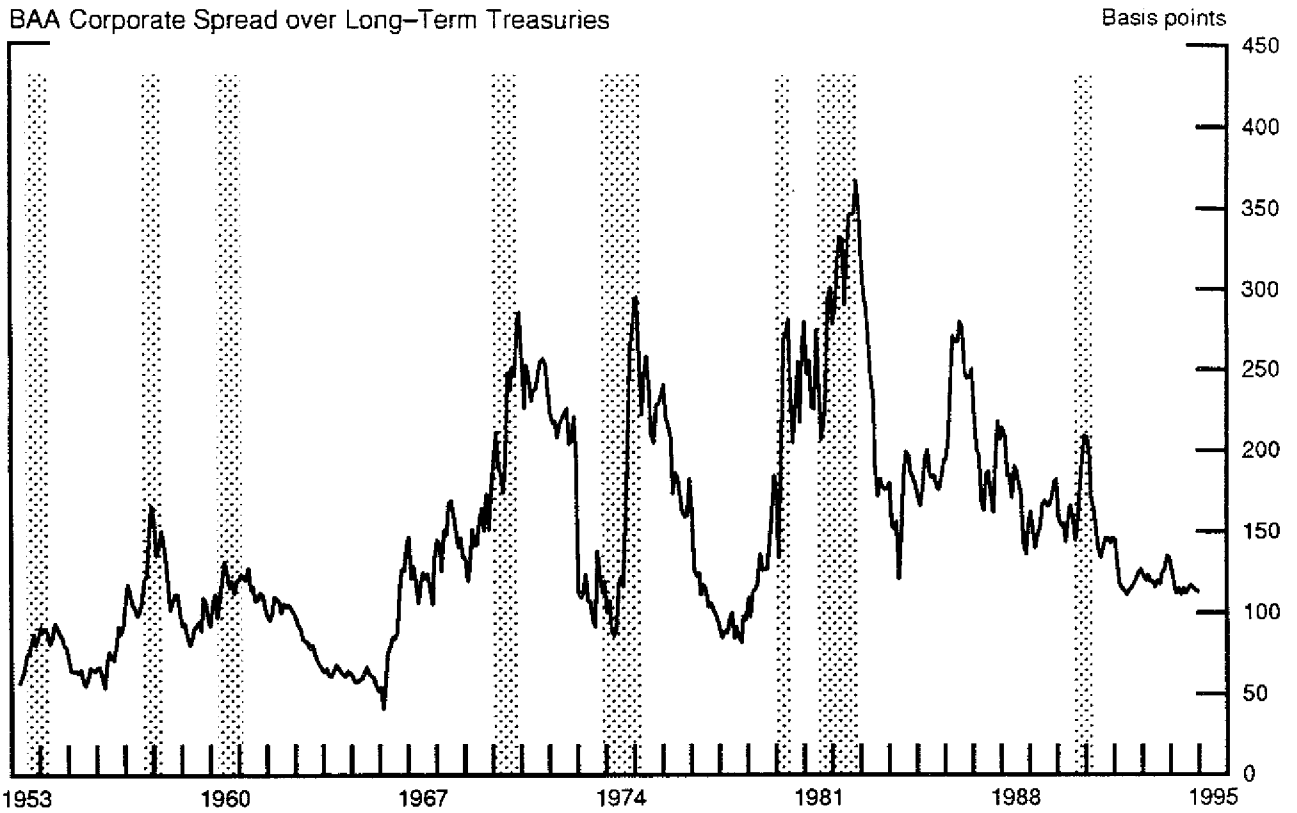
Business Finance

Gross public offerings of bonds by nonfinancial corporations remained light in December and the first half of January. Given the current level of bond rates, an abundance of internal funds, and the ready availability of bank loans, firms largely have continued to shun the bond market. Several speculative-grade firms delayed or cancelled bond issues scheduled for December because investors proved uncomfortable with the quality of the credits. However, in recent weeks inflows to junk bond mutual funds have picked up.

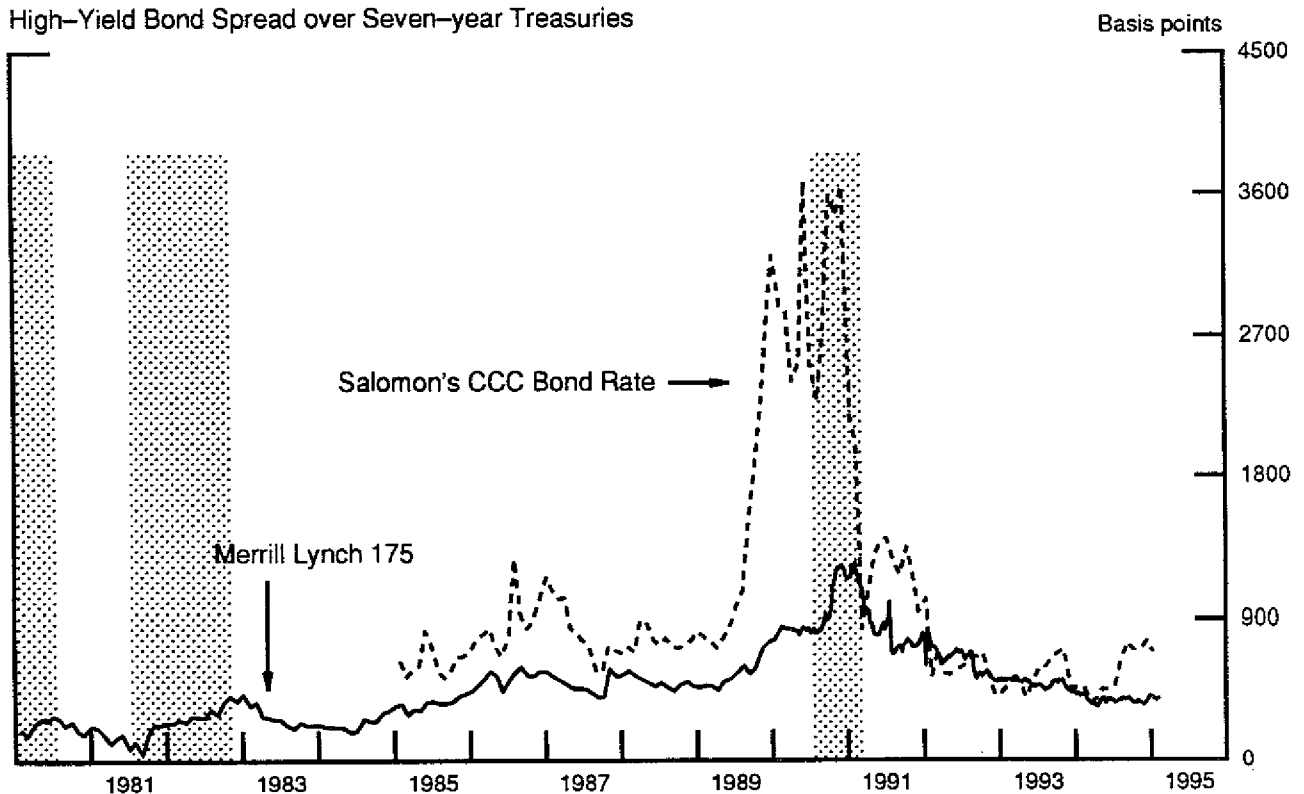
Spreads between yields on corporate bonds and those on Treasuries largely were unchanged in December after narrowing on balance over 1994. Although the dearth of new corporate issues has been a factor keeping spreads tight, the robustness of the economy likely has been important as well. Spreads on these bonds tend to decline during periods of expansion and then widen either slightly ahead of or coincident with the onset of a recession; throughout 1994, the spread on bonds rated Baa by Moody's hovered around the lower end of its historic range (chart). In addition, investors apparently remain confident about the creditworthiness of speculative-grade firms: Spreads on all but the weakest credits closed the year at their lowest levels since the mid-1980s.

Gross public issuance of equity by nonfinancial corporations picked up slightly in the fourth quarter from the depressed third-quarter pace. Even so, equity offerings for the fourth quarter were off more than 50 percent from the volume in the same quarter of 1993, and they remained sluggish through the first half of January. The staff estimates that net equity issuance was negative in the fourth quarter and likely will remain so in the current quarter, owing to merger-related share retirements and a high level of share repurchases.

Interest Rate Spreads on Corporate Bonds



Note. Twenty-year Treasury bond rate used until 1977; thirty-year Treasury rate used thereafter.
 Source. Moody's Investors Service.



Note. The Merrill Lynch 175 is constructed from yields on bonds currently rated B on average and frequently traded.
 Sources. Merrill Lynch and Salomon Brothers.

Merger activity among nonfinancial firms has continued at a hefty pace, with the announcement of four more transactions valued at \$1 billion or more since the last FOMC meeting. Consistent with the pattern throughout 1994, the recently announced mergers were concentrated in a few industries--notably, telecommunications, health care, and food products--in which firms hope to realize efficiencies in operations or marketing. For 1994 as a whole, \$80 billion of large nonfinancial mergers were completed, more than three times the amount completed in 1993 and the highest annual figure since 1989.² The large mergers completed last year were financed about equally by stock swaps and cash payments (with the latter often involving borrowing by the acquirer). This 50-50 split implies considerably less substitution of debt for equity than occurred in the wave of highly leveraged mergers in the late 1980s. Lenders appear to be more selective in the 1990s, although they have shown a greater willingness to fund mergers and acquisitions in the past year or two as reflected in reportedly narrow spreads. Overall, the Senior Loan Officer Opinion Survey for January found that merger and acquisition lending made up a slightly larger share of bank business loans than a year ago.

Nonfinancial corporations continued to rely heavily on commercial paper to finance mergers and acquisitions in December: Overall, year-end outstandings were 12 percent above the level at the end of August, when the merger and acquisition upswing began. Although some of the paper is very short-term bridge financing for these mergers, reports from dealers suggest that the bulk of the

2. The \$80 billion total for merger activity in 1994 is substantially less than the \$350 billion figure presented in several recent trade reports. The larger figure incorporates several types of transactions omitted from our totals: mergers among financial companies, nonfinancial mergers valued at less than \$1 billion, and transactions in which the acquirer obtains only part of the target company.

this paper is expected to be rolled over in the market for some time, before being paid down with internal funds or replaced with bond financing.

So far, the surge in merger activity has had little effect on the overall credit quality of U.S. corporations. Among the thirty-four companies that either announced or completed mergers valued at \$1 billion or more during 1994, Moody's downgraded the debt of six companies for merger-related reasons. The book value of the downgraded debt was only \$3-1/2 billion, roughly 3 percent of the value of all nonfinancial debt downgraded in 1994.

According to ratings changes from Moody's, the credit quality of U.S. corporations more broadly was little changed on balance in the fourth quarter. In the nonfinancial sector, the pattern of ratings changes was mixed: The number of upgrades exceeded the number of downgrades, but a few large downgrades caused the value of downgraded debt to exceed the value of upgraded debt. Public utilities accounted for nearly 90 percent of the value of all nonfinancial debt downgraded last quarter. As was the case throughout 1994, the recent downgrades of utilities reflected regulatory changes that have increased competition in the industry. In contrast, industrial companies recorded a net improvement in credit quality last quarter, with upgrades outnumbering downgrades by a margin of 38 to 28; most of the improvement occurred at investment-grade firms. In the financial sector, the number of upgrades exceeded the number of downgrades for the eighth straight quarter, but the net improvement in ratings was far smaller than those recorded earlier this year; the upward momentum has waned because credit ratings already reflect the stronger balance sheet conditions at commercial banks and insurance companies.

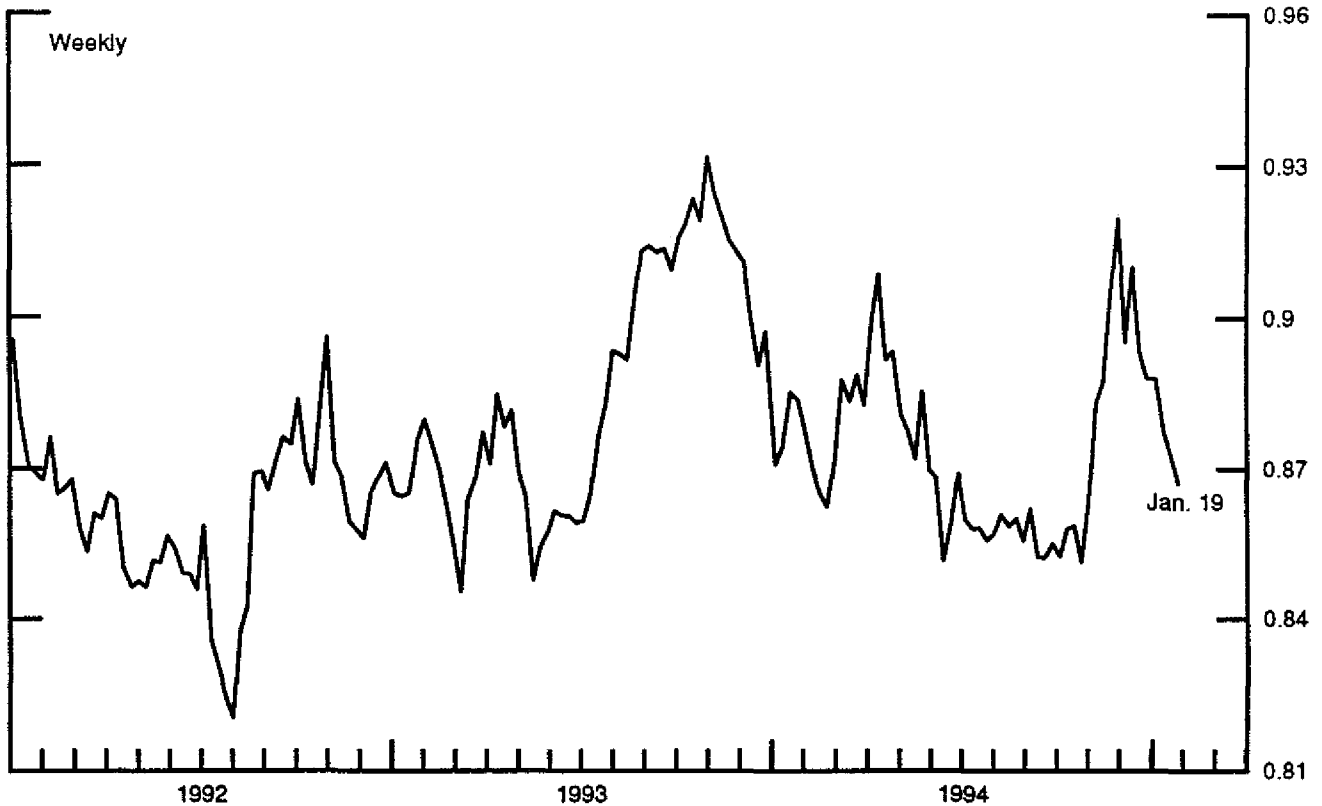
Major stock market indexes rose about 1-1/2 to 5 percent over the intermeeting period. Transportation stocks rose more than 6 percent as airlines and railroads exhibited strong gains. For all corporations, fourth-quarter reports of earnings appear to be coming in significantly higher than expected by private analysts, with positive surprises outnumbering negatives by more than two to one. For 1995, earnings growth is expected to remain strong, but down slightly from the previous year.

Municipal Markets

Municipal bond prices have continued to gain relative to Treasuries, and the ratio of long-term tax-exempt to taxable yields in mid-January was the lowest level since the end of October (chart). In part, the yield ratio declined because the national municipal market came to view the type of financial problems encountered by Orange County as less widespread than had been feared. In addition, the decline in the yield ratio probably was assisted by the slowdown in outflows from municipal bond funds, after extremely large redemptions in November, and by a further net reduction in outstanding long-term municipal debt. During December, municipal issuers sold about \$10 billion in long-term debt while about twice that amount was retired. For 1994 as a whole, long-term gross issuance was down about 45 percent from 1993; outstanding long-term debt is estimated to have fallen about \$15 billion, the first annual decline since the beginning of the Flow-of-Funds series in 1952. Net issuance probably will be negative again in January as new offerings remained sluggish through mid-month and another sizable chunk of debt will be retired by month-end. Short-term municipal debt outstanding fell in 1994 from \$39 billion to \$34 billion, and a further decline appears likely in January.

Yield Ratio on Long-Term Municipal Bonds

Tax-Exempt to Taxable



Note. Bond Buyer municipal thirty-year revenue bond yield to thirty-year Treasury bond yield.

GROSS OFFERINGS OF MUNICIPAL SECURITIES¹ (Billions of dollars; monthly rates, not seasonally adjusted)

	1993	1994	1994				
			Q3	Q4	Oct	Nov	Dec
Total tax-exempt	27.2	15.8	16.1	12.1	12.0	12.8	11.2
Long-term	23.3	12.7	11.1	10.6	10.5	11.6	9.5
Refundings ²	15.7	3.8	1.9	1.4	1.6	1.5	1.0
New capital	7.6	8.9	9.2	9.2	8.9	10.1	8.5
Short-term	3.9	3.1	5.0	1.5	1.5	1.2	1.7
Total taxable	.7	.7	.3	1.1	2.4	.4	.4

1. Includes issues for public and private purposes.

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

Meanwhile, Orange County has initiated \$40 million in budget cuts for the year, but current estimates place this year's cash shortfall at \$172 million. The county failed to set aside funds as required to meet payments due on taxable notes in June and, thus, is in technical default. The county has flip-flopped between announcements that it intends to return to the capital markets to raise funds to meet its obligations and that it might delay making payments on some debt obligations.

The financial adviser to Orange County has completed the sale of all the assets in the pool's original portfolio. Most of the assets were sold through auctions, but some were repurchased by Fannie Mae and the Federal Home Loan Banks, the issuers of the notes. Sales in the market reportedly went well, and current estimates place the total investment loss of the pool near \$1.7 billion, about \$300 million lower than previous estimates. The mix of maturities of assets in the pool now resembles a typical money market fund.

Since the Orange County crisis came to light, other tax-exempt entities--including San Diego, San Bernadino, Sacramento, and Texas --have announced leverage-related losses. However, the extent of the leverage in these cases was quite limited, and the losses were small compared with those incurred by Orange County.

During 1994, Standard and Poors downgraded about \$37 billion of municipal bonds and upgraded about \$20 billion. These figures are skewed by the downgrade of \$18.6 billion of California debt from A+ to A on July 15. Excluding the California downgrades, the credit quality of the municipal sector was little changed on balance last year. More recently, Standard and Poors has placed New York City's \$23 billion of outstanding general obligation bonds on Creditwatch

for a possible downgrade, as the city's budget cuts were not viewed as sufficient to this point.

Treasury and Sponsored Agency Financing

The staff anticipates that the Treasury will finance the projected \$95 billion first-quarter fiscal deficit partly by borrowing \$76 billion from the public and by drawing down its cash balance by \$2 billion. Because the upcoming mid-quarter refunding includes an issue of thirty-year bonds, the Treasury is likely to rely less heavily on regular bill sales. To help bridge seasonal financial needs, the Treasury is expected to raise \$30 billion by auctioning cash management bills that will mature after the April tax date.

TREASURY FINANCING¹
(Total for period; billions of dollars)

Item	1994	1995			
	Q4	Q1 ^P	Jan. ^P	Feb. ^P	Mar. ^P
Total surplus/deficit (-)	-69.9	-95.2	3.4	-49.6	-49.1
Means of financing deficit:					
Net cash borrowing/ repayments (-)	59.7	75.7	7.8	27.2	40.7
Nonmarketable	-2.9	-5.0	-6.4	-.5	2.0
Marketable	62.5	80.7	14.3	27.7	38.7
Bills	36.4	42.9	3.5	3.0	36.4
Coupons	26.1	37.8	10.8	24.7	2.3
Decrease in the cash balance	9.4	2.2	-22.6	25.4	-.5
²					
Other	.9	17.3	11.4	-2.9	8.9
Memo:					
Cash balance, end of period	26.6	24.4	49.2	23.9	24.4

1. Data reported on a payment basis.

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

p Projected.

Note: Details may not add to totals because of rounding.

NET CASH BORROWING OF GOVERNMENT SPONSORED ENTERPRISES¹
(Billions of dollars)

Agency	1994		Nov.	Dec.
	Q3	Q4		
FHLBs	13.6	--	8.0	--
FHLMC	10.6	9.3	2.0	2.6
FNMA	11.4	17.9	5.2	9.5
Farm Credit Banks	0.6	-1.2	1.2	-1.6
SLMA	1.8	0.6	--	--

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

Overall, issuance of securities by the federally sponsored credit agencies continued at a brisk pace in the fourth quarter. The expansion of the portfolios of the mortgage agencies--Fannie Mae, Freddie Mac, and the Federal Home Loan Banks--appears to reflect a decision to exploit the still narrow spreads on their debt relative to the current spreads on pass-throughs. To remain successful in an increasingly competitive environment, Sallie Mae is also moving to expand the range of its services. In December, Sallie Mae announced its intention to acquire HICA Holding, an insurer of student loans, to enhance its ability to service the student loans it buys.

Mortgage Markets

The spread between interest rates on fixed-rate and adjustable-rate home mortgages narrowed further during the intermeeting period. From a high of 350 basis points last April, the interest rate spread between FRMs and ARMs has tightened to 225 basis points, with a pronounced 95 basis point decline in just the past two months (chart).

Last year, rising fixed mortgage rates and an unusually wide spread between FRM and ARM rates fostered a resurgence of ARM originations, which reached 55 percent of total mortgage

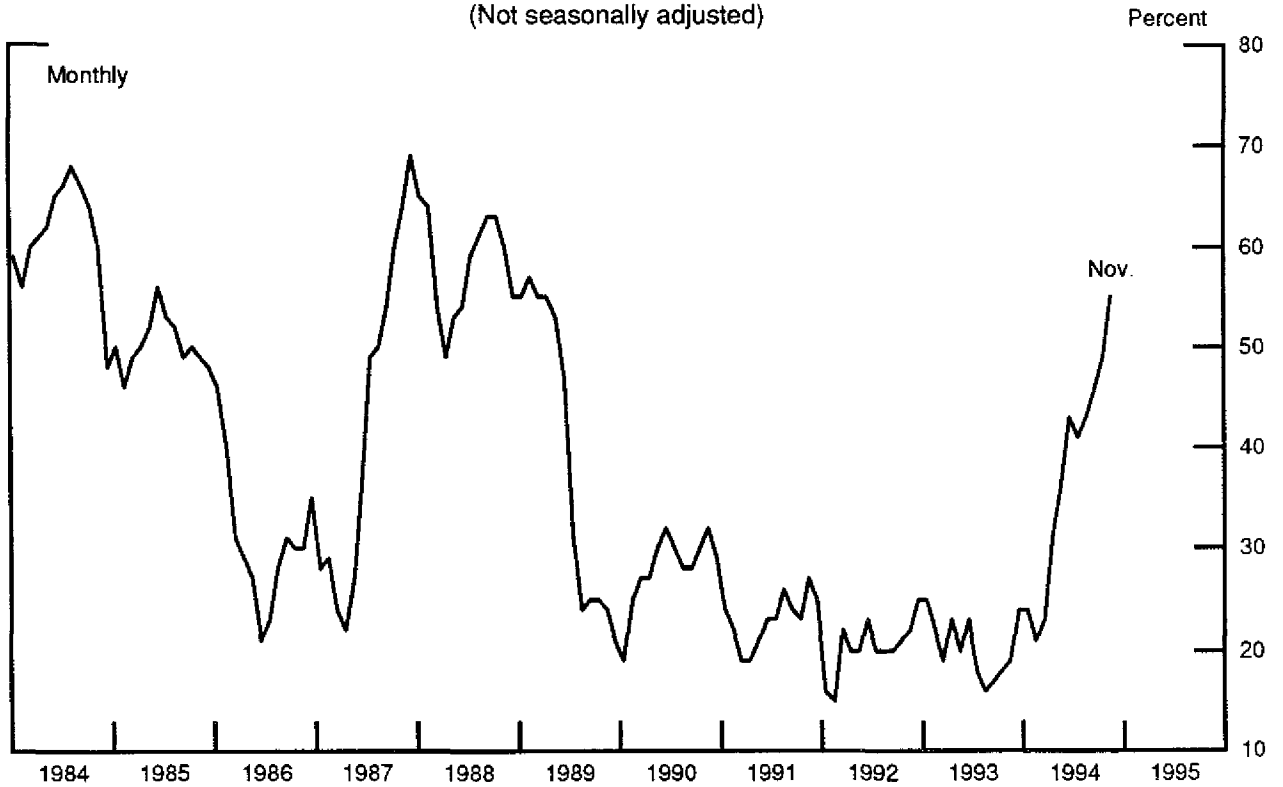
FRM-ARM Rate Spread

(Not seasonally adjusted)



ARM Origination Proportion

(Not seasonally adjusted)



originations in November (chart). The ARM proportion at commercial banks alone reached 69 percent in November.

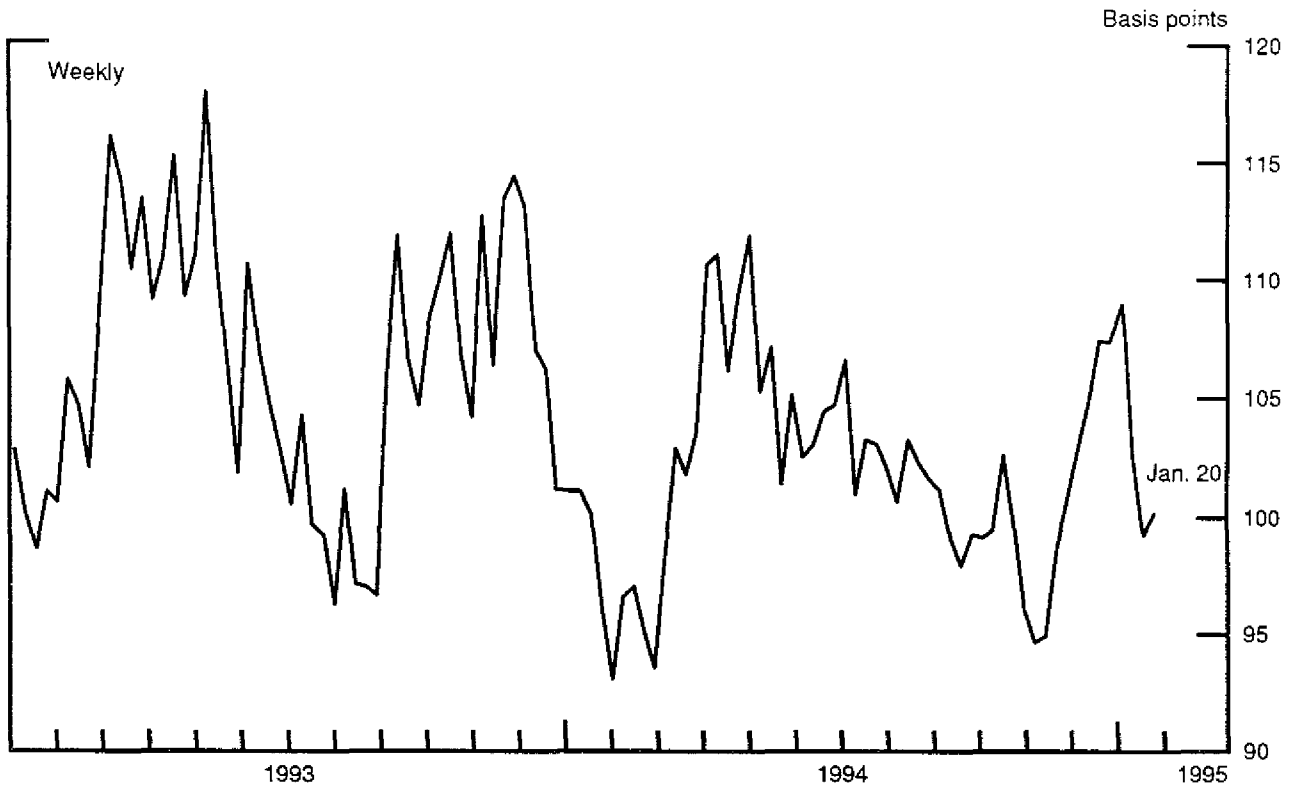
In the secondary market, yield spreads over comparable Treasuries on mortgage-backed securities collateralized by newly originated conventional, fixed-rate mortgages have narrowed sharply in recent weeks, retracing much of the widening that occurred in December (chart). Before the December spike, secondary market spreads had narrowed fairly consistently since the first quarter of 1994, owing to the continuing decline in security issuance over the past year (chart). The widening of spreads in December reflected spillover effects from the Orange County fiasco--namely, fears that mortgage agency spreads would rise and that liquidation of the county's pools would hurt secondary market pricing for mortgage-backed securities. Apparently, however, the orderly dismantling of the county pool investment portfolio has provided some measure of calm to the market.

The nearly 2-1/2 percentage point rise in thirty-year mortgage rates since October 1993 halted the decline in the average interest rate on the stock of outstanding single-family mortgages; the rate remained relatively stable just below 8-1/4 percent through the end of last year (chart). Because the stock of fixed-rate mortgages dwarfs new originations, even abrupt increases in rates on new fixed-rate loans raise the average rate on the total stock relatively slowly. The average interest rate on outstanding adjustable-rate mortgages is estimated to have moved up about a percentage point over the past year.

Preliminary data indicate that home mortgage growth in the fourth quarter slowed only slightly from the pace recorded in the third quarter. Partial data for commercial banks indicate that

Yield Spread on FNMA New-Issue Mortgage-Backed Securities

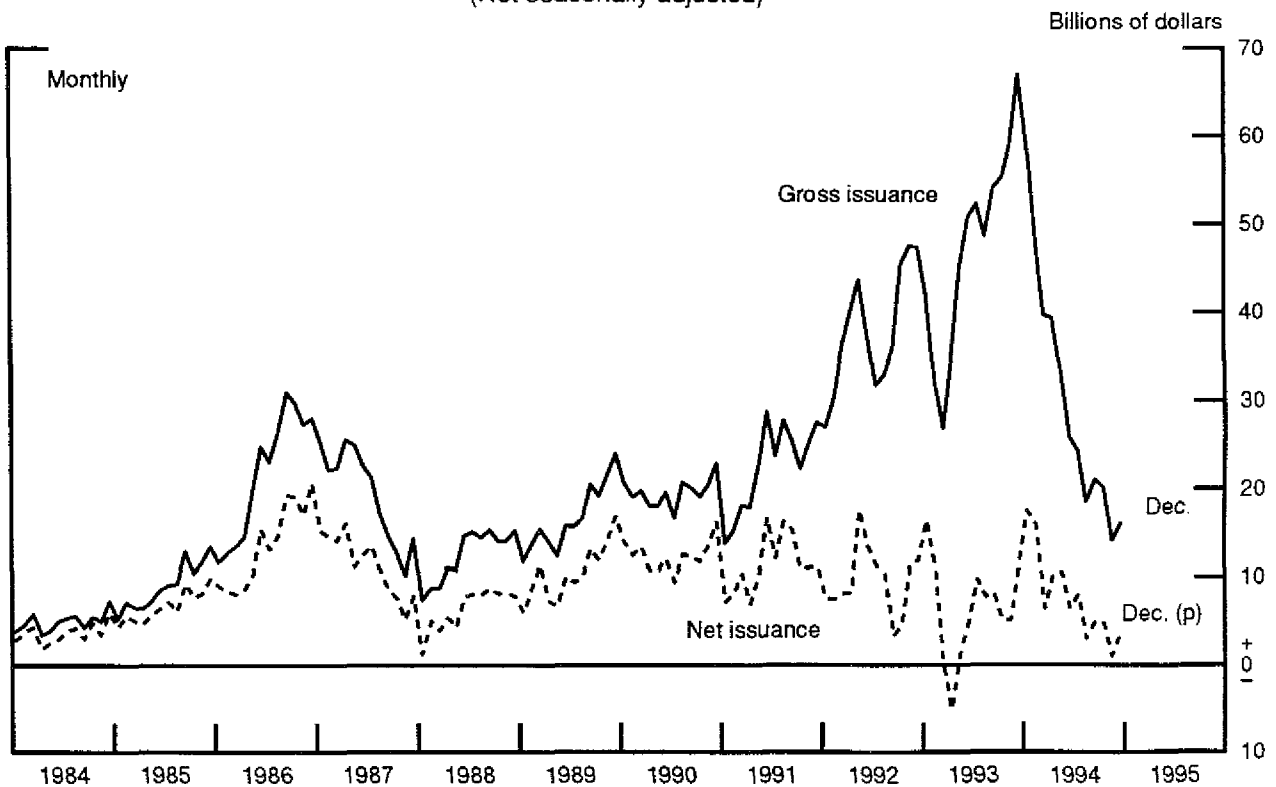
(Not seasonally adjusted)



Note. Spread of yield on FNMA securities backed by newly originated conventional fixed-rate mortgages over the yield on Treasury securities of comparable maturity.

Issuance of Agency Mortgage Pass-Through Securities

(Not seasonally adjusted)



mortgage loan growth so far in the new year remains at about the pace of the fourth quarter.

Average Interest Rate on Fixed-Rate Mortgages
(Not seasonally adjusted)



Consumer Installment Credit

The growth of consumer installment credit outstanding continued to be strong late last year, despite the upward creep in loan rates. The November gain was the most rapid since August and brought the annualized rate of increase through November to 15 percent, almost twice the rise for 1993. Revolving and automobile credit growth also accelerated from their pace of November. Only "Other"

GROWTH OF CONSUMER CREDIT
(Percent change; seasonally adjusted annual rate)

Type of credit	1992	1993	1994		1994		Memo: Outstanding Nov. 1994 (Billions of dollars)
			H1	Q3 ^r	Oct. ^r	Nov. ^p	
Installment	.4	8.6	13.5	15.2	15.9	17.3	904.5
Auto	-.7	9.5	15.2	15.3	10.9	18.0	322.8
Revolving	4.9	11.9	15.0	17.3	18.2	24.6	334.4
Other	-3.3	3.8	9.2	12.4	19.3	6.8	247.3
Noninstallment	6.4	-4.9	-1.8	-8.7	2.4	-52.3	49.4
Total	.8	7.7	12.5	13.8	15.1	13.5	953.9

r Revised.
p Preliminary.

INTEREST RATES ON CONSUMER LOANS
(Annual percentage rate)

Type of loan	1991	1992	1993	1994			
				May	Aug.	Oct.	Nov.
At commercial banks ¹							
New cars (48 mo.)	11.1	9.3	8.1	7.8	8.4	na	8.8
Personal (24 mo.)	15.2	14.0	13.5	13.0	13.3	na	13.6
² Credit cards							
All accounts	na	na	na	na	na	na	15.9
Accounts assessed interest	na	na	na	na	na	na	15.7
At auto finance cos. ³							
New cars	12.4	9.9	9.5	9.9	10.3	10.4	10.5
Used cars	15.6	13.8	12.8	13.5	13.9	14.0	14.2

na Not available.

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

2. The rate for *all accounts* is the stated APR averaged across all credit card accounts at all reporting banks. The rate for *accounts assessed interest* is the annualized ratio of total finance charges at all reporting banks to the total average daily balances against which the finance charges were assessed (excludes accounts for which no finance charges were assessed).

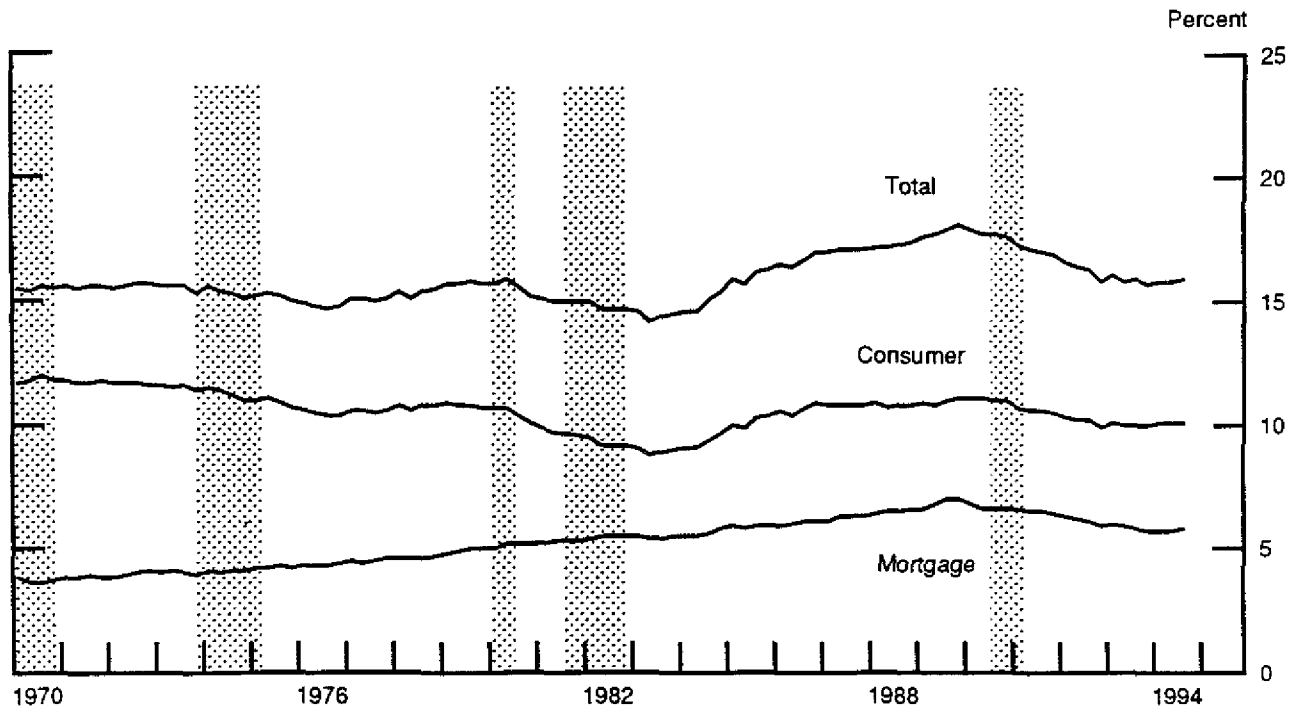
3. For monthly data, rate for all loans of each type made during the month regardless of maturity.

Note: Annual data are averages of quarterly data for commercial bank rates and of monthly data for auto finance company rates.

installment credit slowed from its pace in November. Total consumer credit--installment plus noninstallment--rose at a 14 percent yearly pace--about double the advance for 1993.

Although installment debt increased sharply in the past year, available data do not yet suggest that consumers are overburdened. Consumer delinquency rates continued to decline through the third quarter of 1994. The staff also estimates that the scheduled monthly principal and interest payments on all types of non-mortgage consumer loans have been virtually flat, after declining between late-1990 and late-1992. Although there likely was a slight upturn in the total (mortgage and consumer) debt service burden in the fourth quarter, this measure remained at a relatively low level (chart).

**Household Debt Service
Relative to Disposable Personal Income**



INTERNATIONAL DEVELOPMENTS

INTERNATIONAL DEVELOPMENTS

U.S. International Trade in Goods and Services

The U.S. trade deficit in goods and services rose in November. The October-November deficit was well-above the third-quarter average. In November exports reversed their slight decline in October, while imports accelerated from a marginal rise in October. Data for December will be released on February 17.

NET TRADE IN GOODS & SERVICES
(Billions of dollars, seasonally adjusted)

	Year	Quarters			Months		
	1993	94Q2	94Q3	94Q4e	Sep	Oct	Nov
		(annual rates)			(monthly rates)		
Real NIPA 1/ <u>Net Exports of G&S</u>	-73.9	-111.8	-117.0	--	--	--	--
Nominal BOP <u>Net Exports of G&S</u>	-75.7	-106.6	-117.5	-123.8	-9.4	-10.1	-10.5
Goods, net	-132.6	-166.5	-178.0	-183.7	-14.4	-15.1	-15.6
Services, net	56.8	59.9	60.5	59.9	5.1	5.0	5.0

1/ In billions of 1987 dollars, SAAR.

e/ BOP data are two months at an annual rate.

Source: U.S. Dept. of Commerce, Bureaus of Economic Analysis and Census.

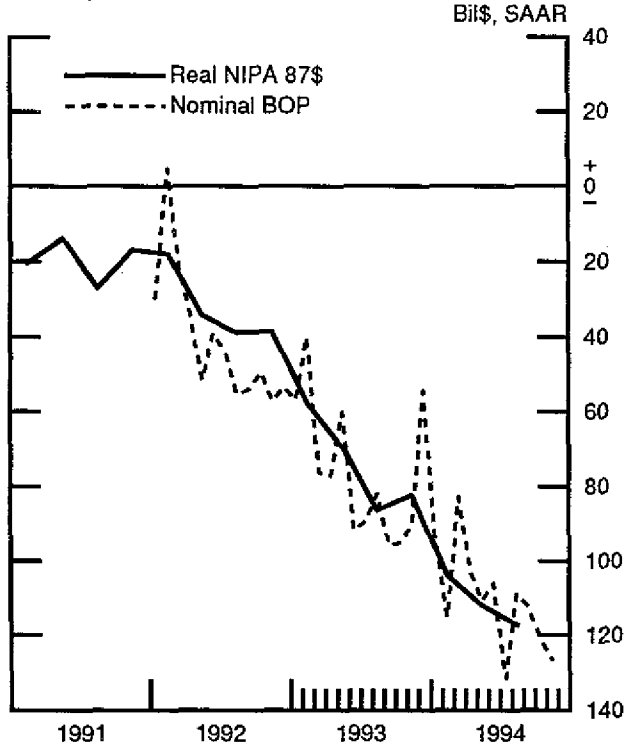
Exports of goods and services in November rose sharply, led by a rise in exported aircraft, other capital goods, and agricultural goods. Total exports rose more slowly in October-November than in the third quarter largely as growth of exported industrial supplies slowed. Most of the rises in exports have been in quantity, with the exception of industrial supplies (where virtually all of the increase was in prices).

Imports rose sharply in November as automotive imports continued to rise and computer and oil imports rebounded from their decline in October. For October-November combined, the rise in imports was led by imported computers, non-oil industrial supplies, automotive, and capital ex-computer and consumer goods, reflecting the strength of consumption and investment spending in the United

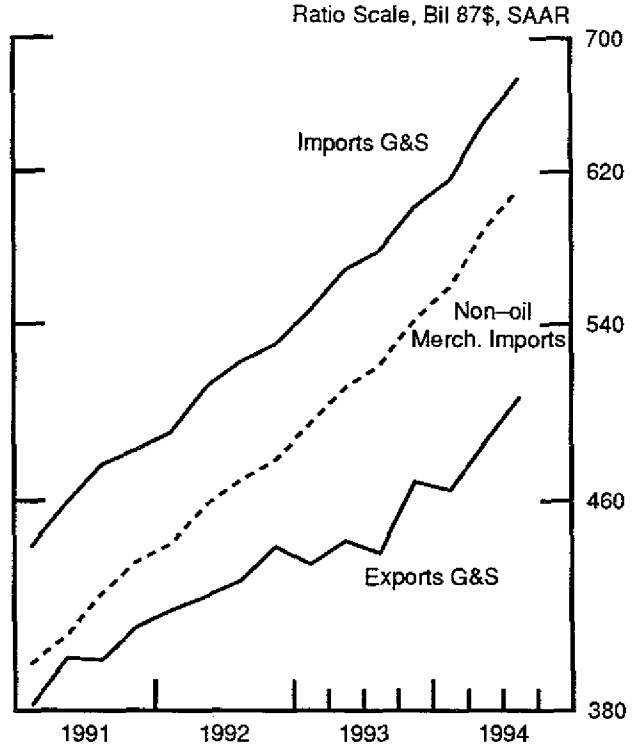
U.S. International Trade in Goods & Services

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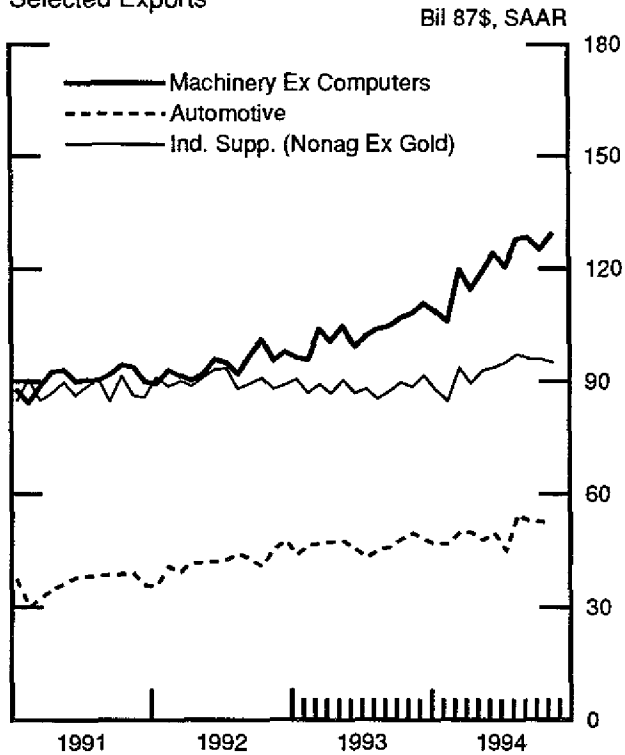
Net Exports of Goods & Services



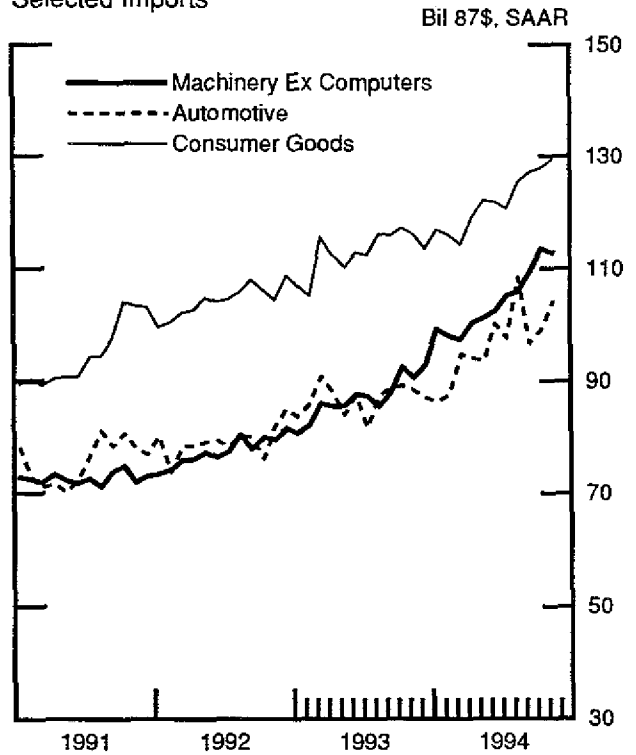
Real NIPA Goods & Services



Selected Exports



Selected Imports



U.S. EXPORTS AND IMPORTS OF GOODS AND SERVICES
(Billions of dollars, SAAR, BOP basis)

	Quarters				Months		
	Levels		Change 1/		Levels		Change 1/
	94Q3	94Q4e/	Q3	Q4e/	Oct	Nov	Nov
<u>Exports of G&S</u>	706.6	726.0	24.3	19.4	718.2	733.9	15.8
Goods Exports	511.4	527.5	20.7	16.1	520.6	534.4	13.9
Agricultural	46.7	52.4	2.9	5.7	51.0	53.8	2.8
Gold	4.6	3.2	-1.1	-1.4	3.7	2.7	-1.0
Computers	33.8	35.7	1.8	1.9	35.0	36.3	1.3
Other Goods	426.3	436.2	17.1	9.9	430.9	441.6	10.7
Aircraft & Pts	28.6	28.7	-5.5	0.2	24.8	32.7	7.9
Semiconductors	25.3	27.2	1.3	2.0	26.7	27.8	1.0
Other Cap Gds	119.4	117.9	5.4	-1.5	116.2	119.6	3.4
Automotive	58.1	59.8	2.1	1.7	60.4	59.1	-1.2
to Canada	31.1	33.6	0.5	2.4	33.2	33.9	0.7
to Mexico	7.6	8.7	-0.8	1.1	9.0	8.4	-0.5
to ROW	19.3	17.5	2.4	-1.9	18.2	16.8	-1.4
Ind Supplies	111.7	115.2	9.4	3.5	114.4	115.9	1.5
Consumer Goods	61.4	65.3	3.1	3.9	64.9	65.7	0.8
All Other	21.8	22.1	1.3	0.2	23.5	20.7	-2.7
Services Exports	195.2	198.6	3.7	3.3	197.6	199.5	1.9
<u>Imports of G&S</u>	824.1	849.8	35.2	25.7	839.3	860.3	21.0
Goods Imports	689.3	711.2	32.1	21.8	701.2	721.2	20.0
Petroleum	60.7	52.2	9.3	-8.6	49.4	54.9	5.5
Gold	2.8	2.9	-1.9	0.1	3.3	2.5	-0.8
Computers	47.1	51.6	2.8	4.4	50.1	53.1	3.0
Other Goods	578.6	604.5	21.8	25.9	598.4	610.7	12.3
Aircraft & Pts	9.8	11.4	-2.5	1.6	10.2	12.6	2.4
Semiconductors	27.0	30.8	3.3	3.8	31.1	30.5	-0.6
Other Cap Gds	103.9	107.6	5.3	3.7	107.6	107.6	0.1
Automotive	123.4	125.9	6.9	2.6	122.8	129.1	6.3
from Canada	44.2	46.9	3.0	2.7	44.2	49.5	5.3
from Mexico	13.9	17.4	-0.3	3.5	17.0	17.9	0.9
from ROW	65.2	61.6	4.2	-3.6	61.6	61.7	0.1
Ind Supplies	110.9	116.5	4.3	5.6	115.2	117.7	2.5
Consumer Goods	148.5	154.4	4.1	5.9	153.4	155.4	2.0
FFB	32.2	31.9	1.7	-0.3	32.1	31.6	-0.5
All Other	23.0	26.0	-1.3	3.0	25.9	26.0	0.2
Services Imports	134.7	138.6	3.1	3.9	138.2	139.1	1.0
Memo:							
Oil Qty (mb/d)	10.24	9.20	0.65	-1.03	8.85	9.55	0.70

1/ Change from previous quarter or month. e/ Average of two months.
Source: U.S. Dept. of Commerce, Bureaus of Economic Analysis and Census

States. The October-November rise in imports was less than that registered in the third quarter.

While rebounding in November from the sharp decline in October, the quantity of imported oil in October-November averaged just over 9.0 mb/d. This was 1.0 mb/d less than the average for the third quarter. Seasonal stock drawdowns reversed the inventory build-up in the third quarter. Preliminary Department of Energy statistics indicate that in December imports should have remained near the October-November average as higher consumption was satisfied by higher production and stock draws.

Prices of Merchandise Imports and Exports

While little-changed in October, the price of imported oil rose about \$0.50 per barrel in November reflecting actual and anticipated supply disruptions in the United States and increased demand by European refiners coming off seasonal maintenance. In October-November, the price of imported oil averaged about \$0.60 per barrel below the third-quarter average. Spot oil prices (West Texas Intermediate) have risen on balance since mid-December. Perceptions of ample reformulated gasoline inventories have dissipated. After initially undermining crude prices, the unseasonably mild weather has underpinned a strong rise in prices as of late reflecting higher demand for gasoline.

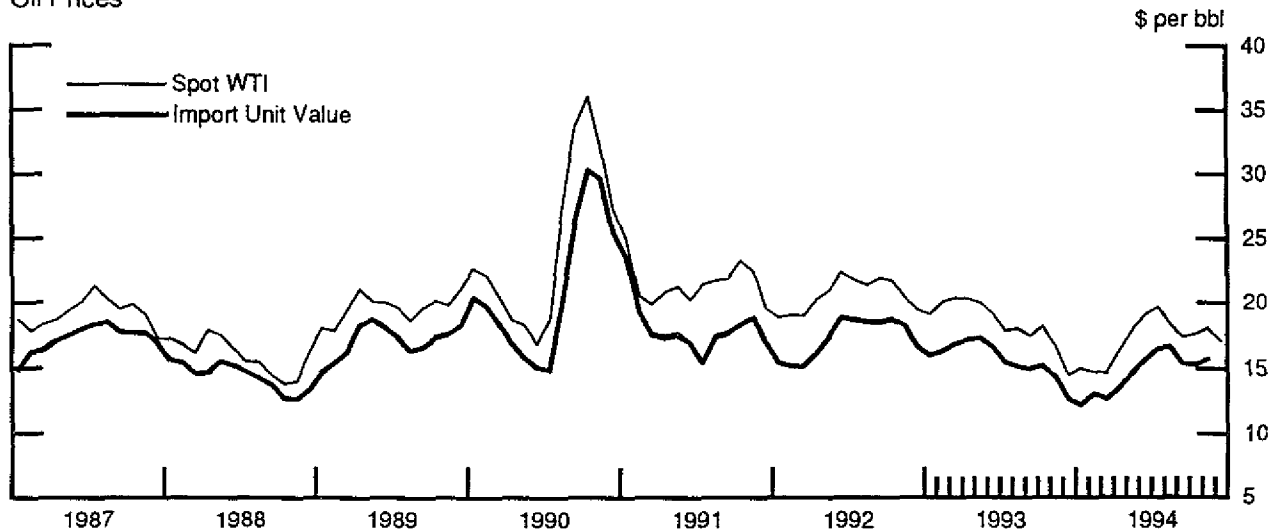
Prices of U.S. non-oil imports rose in November, led by a strong advance in the price of imported industrial supplies. Partially offsetting this rise was a decline in the prices of imported foods, which fell for the first time since February. For October-November combined, non-oil import prices rose 5 percent at an annual rate, about the same as in the third quarter.

PRICES OF U.S. IMPORTS AND EXPORTS
(percent change from previous period)

	Quarters			Months		
	94Q2 (annual rates)	94Q3 (annual rates)	94Q4e/ (annual rates)	Sep (monthly rates)	Oct (monthly rates)	Nov (monthly rates)
-----BLS Prices-----						
<u>Merchandise Imports</u>	7.4	7.9	3.8	-0.4	0.7	0.8
Oil	67.5	36.6	-8.7	-7.4	0.7	5.4
Non-Oil	2.8	5.3	5.0	0.3	0.7	0.3
Foods, Feeds, Bev.	16.0	37.8	8.9	0.7	1.5	-1.3
Ind Supp Ex Oil	4.4	8.6	12.2	1.1	1.0	1.5
Computers	-6.7	-8.7	-5.4	0.1	-0.8	-1.3
Capital Goods Ex Comp	2.7	4.2	2.7	-0.1	0.4	0.2
Automotive Products	2.4	2.4	6.3	0.2	1.1	0.2
Consumer Goods	1.0	1.1	1.2	0.2	0.1	0.2
Memo:						
Oil Imports (\$/bbl)	14.67	16.21	15.52	15.40	15.29	15.74
<u>Merchandise Exports</u>	1.4	2.0	4.7	0.3	0.5	0.8
Agricultural	-7.4	-14.4	2.7	0.5	-0.1	1.6
Nonagricultural	2.9	4.4	4.9	0.3	0.6	0.6
Ind Supp Ex Ag	9.4	17.1	14.9	0.7	1.7	1.8
Computers	-6.2	-11.2	-6.0	0.0	-0.5	-0.3
Capital Goods Ex Comp	-0.2	0.3	0.1	-0.1	0.0	0.2
Automotive Products	0.9	1.2	2.3	0.1	0.5	0.0
Consumer Goods	0.4	-0.5	1.4	0.2	0.1	0.1
-----Prices in the NIPA Accounts-----						
<u>Fixed-Weight</u>						
Imports of Gds & Serv.	7.8	9.1	--	--	--	--
Non-oil Merch Ex Comp	3.6	6.2	--	--	--	--
Exports of Gds & Serv.	2.2	2.9	--	--	--	--
Nonag Merch Ex Comp	3.5	6.1	--	--	--	--

e/ Average of two months.

Oil Prices



Prices of U.S. agricultural exports rose strongly in November, the largest increases recorded since January, boosted in part by robust demand from Asia (particularly China). In November prices of nonagricultural products continued to increase, led by prices of exported industrial supplies which recorded their strongest rise of the previous twelve months. For October-November combined, the prices of nonagricultural products recorded the strongest advance of the three previous quarters.

U.S. International Financial Transactions

Foreign official assets held in the United States fell substantially in November (line 1 of the Summary of U.S. International Transactions table). Almost half of the \$7 billion decline was accounted for by Mexico.

Net banking flows were very small in November (line 3); however, monthly average data in the International Banking Data table show a substantial inflow in December in the \$14 billion range (line 1). This inflows helped finance the robust growth in bank credit in December.

Private foreigners' net purchases of U.S. securities were very large in November (line 4 of the Summary table). The large increase in net holdings of Treasury securities (line 4a) was more than accounted for by purchases of longer-term notes and bonds; most of the increase went to international financial centers in the United Kingdom, the Netherlands Antilles, and Bermuda, with another \$2 billion to Japan.

Foreign net purchases of U.S. corporate and other bonds were also strong in November (line 4b), about evenly divided between corporate and U.S. government agency bonds. Eurobond offerings by U.S. corporations in December were down somewhat from November.

SUMMARY OF U.S. INTERNATIONAL TRANSACTIONS¹
(Billions of dollars, not seasonally adjusted except as noted)

	Year		Quarter				Month		
			1993		1994		1994		
	1992	1993	Q4	Q1	Q2	Q3	Sept.	Oct.	Nov.
<u>Official capital</u>									
1. Changes in foreign official reserve assets in U.S. (+ = increase)	38.3	70.2	23.4	10.3	8.6	18.7	1.8	10.4	-7.3
a. G-10 countries	4.8	29.9	4.8	10.8	15.7	9.1	-5.5	1.1	-3.3
b. OPEC countries	4.9	-5.1	-.9	-2.3	-4.7	3.3	.7	.5	1.0
c. All other countries	28.6	45.5	19.4	1.9	-2.4	6.3	1.6	8.8	-4.9
2. Changes in U.S. official reserve assets (+ = decrease)	3.9	-.7	-.7	-.1	3.5	-.2	-.1	-.2	2.4
<u>Private capital</u>									
Banks									
3. Change in net foreign positions of banking offices in the U.S.	35.6	14.1	5.7	33.8	37.5	8.7	7.2	1.8	2.0
Securities									
4. Foreign net purchases of U.S. securities (+)	68.1	105.7	45.8	31.1	6.3	19.7	5.9	8.8	16.4
a. Treasury securities	37.4	24.7	8.1	9.5	-7.3	5.2	5.3	8.2	9.6
b. Corporate and other bonds	34.3	61.3	25.5	13.7	14.8	13.3	1.7	2.5	5.6
c. Corporate stocks	-3.7	19.6	12.2	8.0	-1.3	1.1	-1.2	-1.9	1.1
5. U.S. net purchases (-) of foreign securities	-47.9	-133.4	-34.6	-24.4	-18.1	-9.6	-.5	-8.5	-4.4
a. Bonds	-15.6	-70.1	-13.9	-6.0	-5.4	-2.6	-1.2	-4.2	-1.9
b. Stocks	-32.3	-63.3	-20.7	-18.5	-12.7	-7.0	.7	-4.4	-2.6
Other flows (quarterly data, s.a.)									
6. U.S. direct investment (-) abroad	-41.0	-57.9	-22.7	-24.8	-8.0	-9.5	n.a.	n.a.	n.a.
7. Foreign direct investment in U.S.	9.9	21.4	8.1	12.0	5.4	13.3	n.a.	n.a.	n.a.
8. Other (+ = inflow)	18.1	63.4	1.6	8.9	7.0	-4.7	n.a.	n.a.	n.a.
<u>U.S. current account balance (s.a.)</u>	-67.9	-103.9	-30.6	-32.3	-37.9	-41.7	n.a.	n.a.	n.a.
<u>Statistical discrepancy (s.a.)</u>	-17.1	21.1	4.0	-14.5	-4.3	5.3	n.a.	n.a.	n.a.

1. The sum of official capital, private capital, the current account balance, and the statistical discrepancy is zero. Details may not sum to totals because of rounding.

2. Changes in dollar-denominated positions of all depository institutions and bank holding companies plus certain transactions between broker-dealers and unaffiliated foreigners (particularly borrowing and lending under repurchase agreements). Includes changes in custody liabilities other than U.S. Treasury bills.

3. Includes commissions on securities transactions and therefore does not match exactly the data on U.S. international transactions published by the Department of Commerce.

4. Includes Treasury bills.

5. Includes U.S. government agency bonds.

6. Transactions by nonbanking concerns and other banking and official transactions not shown elsewhere plus amounts resulting from adjustments made by the Department of Commerce and revisions in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.

n.a. Not available. * Less than \$50 million.

INTERNATIONAL BANKING DATA 1/
(Billions of dollars)

	1991	1992	1993	1994				
	Dec.	Dec.	Dec.	Mar.	June	Sep.	Nov.	Dec.
1. Net claims of U.S. banking offices (excluding IBFs) on own foreign offices and IBFS	-35.8	-71.6	-122.1	-157.5	-175.4	-200.7	-210.3	-224.0
a. U.S.-chartered banks	12.4	17.0	4.2	-15.1	-29.9	-53.0	-63.3	-70.1
b. Foreign-chartered banks	-48.3	-88.6	-126.3	-142.4	-145.6	-147.7	-147.1	-153.9
2. Credit extended to U.S. nonbank residents								
a. By foreign branches of U.S. banks	23.9	24.8	21.8	21.4	22.2	23.2	22.9	23.1
b. By Caribbean offices of foreign-chartered banks	n.a.	n.a.	90.9	88.6	83.9	79.5	n.a.	n.a.
3. Eurodollar holdings of U.S. nonbank residents								
a. At all U.S.- chartered banks and foreign-chartered banks in Canada and the United Kingdom	102.9	90.0	77.8	75.1	73.6	80.9	87.2	86.0
b. At the Caribbean offices of foreign-chartered banks	n.a.	n.a.	79.2	84.2	82.1	85.7	n.a.	n.a.
MEMO: Data as recorded in the U.S. international transactions accounts								
4. Credit extended to U.S. nonbank residents	179	192	203	208	211	n.a.	n.a.	n.a.
5. Eurodeposits of U.S. nonbank residents	240	238	236	235	239	n.a.	n.a.	n.a.

1. Data on lines 1 through 3 are from Federal Reserve sources and sometimes differ in timing from the banking data incorporated in the U.S. international transactions accounts.

Lines 1a, 1b, and 2a are averages of daily data reported on the FR 2950 and FR 2951.

Lines 2b and 3b are end-of-period data reported quarterly on the FFIEC 002s.

Line 3a is an average of daily data (FR 2050) supplemented by the FR 2502 and end of quarter data supplied by the Bank of Canada and the Bank of England. There is a break in the series in April 1994.

Lines 4 and 5 are end-of-period data estimated by BEA on the basis of data provided by the BIS, the Bank of England, and the FR 2502 and FFIEC 002s. It includes some foreign-currency denominated deposits and loans. Source: SCB

U.S. net purchases of foreign securities moderated in November (line 5). Bond purchases from U.K. residents accounted for most of the \$1.9 billion total; stock purchases were widely dispersed.

None of the private capital flows in lines 3, 4, or 5 for November showed any direct evidence of capital flight from Mexico -- on the part of either Mexican or American investors.

As noted in the supplement to the December Greenbook, the overall outflow of U.S. direct investment abroad in the third quarter, at \$9.5 billion, was roughly equal to that of the second quarter (line 6). For Mexico, the third quarter outflow from the United States was \$762 million, up considerably from a rather low \$227 million in the second quarter. For the first three quarters, the direct investment outflow to Mexico, at \$2.4 billion, has already matched the level for all of 1993 (and has exceeded the levels for 1992 and 1991).

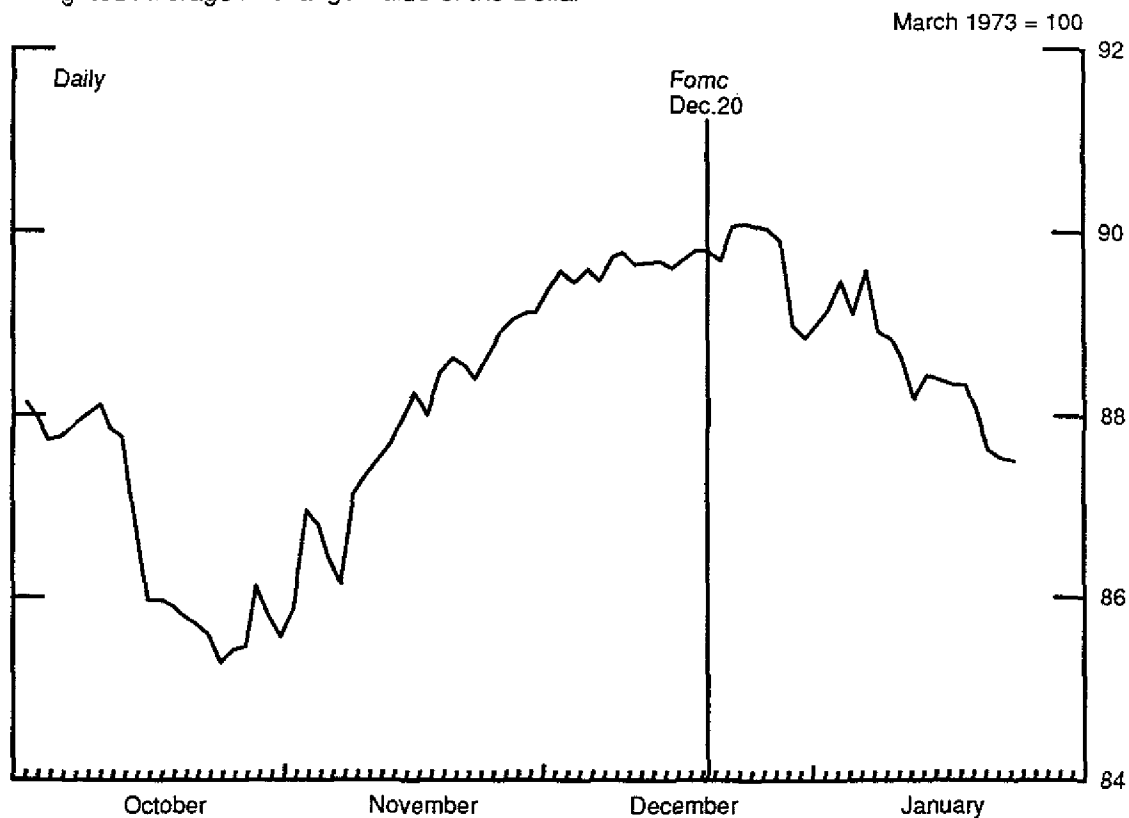
Foreign Exchange Markets

Since the December 20 FOMC meeting, the weighted-average value of the dollar in terms of the other G-10 currencies, shown in the chart, has declined 2-1/2 percent. The dollar has declined less than 1 percent on net against the yen. Since the Kobe earthquake on January 17, the yen has eased about 1 percent and Japanese stock price indices have fallen about 6 percent. The dollar has declined nearly 4 percent against the German mark since the last FOMC meeting. The mark appears to have benefitted from safe-haven inflows from troubled markets, particularly other markets in Europe. In contrast, the dollar has been weighed down by concern over the implications of U.S. financial support for Mexico. In particular, some market participants have worried that U.S. monetary policymakers might hesitate to raise interest rates aggressively in fear of exacerbating Mexican financial problems.

The Mexican peso has lost about 40 percent of its value in dollar terms since December 19, the day before the peso devaluation. The initial 13 percent shift in the "lower limit" of the band to 4 pesos per dollar lasted only two days before heavy Mexican reserve losses forced a floating and further depreciation of the peso. Investor reluctance to roll over Mexican short-term government debt has pushed up interest rates on that debt. Rates on three-month peso-denominated bills (Cetes) have risen from 15 percent before the devaluation to 38 percent at the last auction. Rates on three-month dollar-indexed bills (Tesobonos) have risen from 7.4 percent before the devaluation to nearly 25 percent at the last auction. Even at those elevated rates, the Bank of Mexico was only able to place \$275 million out of \$400 million of Tesobonos offered at the last auction. As shown in the second chart, the Mexican stock market has fluctuated widely since December 19 and is currently about 6 percent lower in peso terms. In dollar terms, the Mexican stock index is down about 45 percent.

The Mexican crisis has increased investor perceptions of risk in other emerging markets. Brady bond stripped yields, the yields

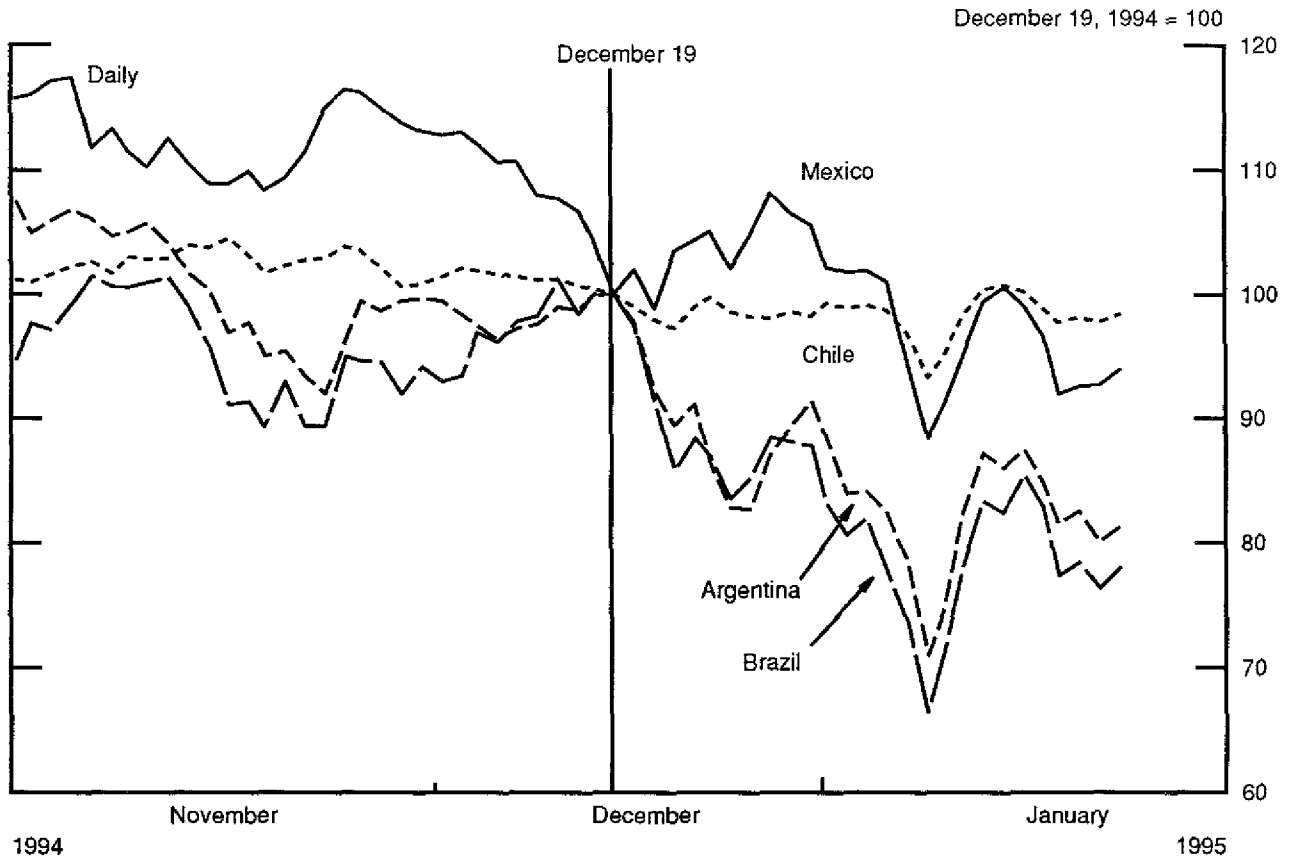
Weighted Average Exchange Value of the Dollar



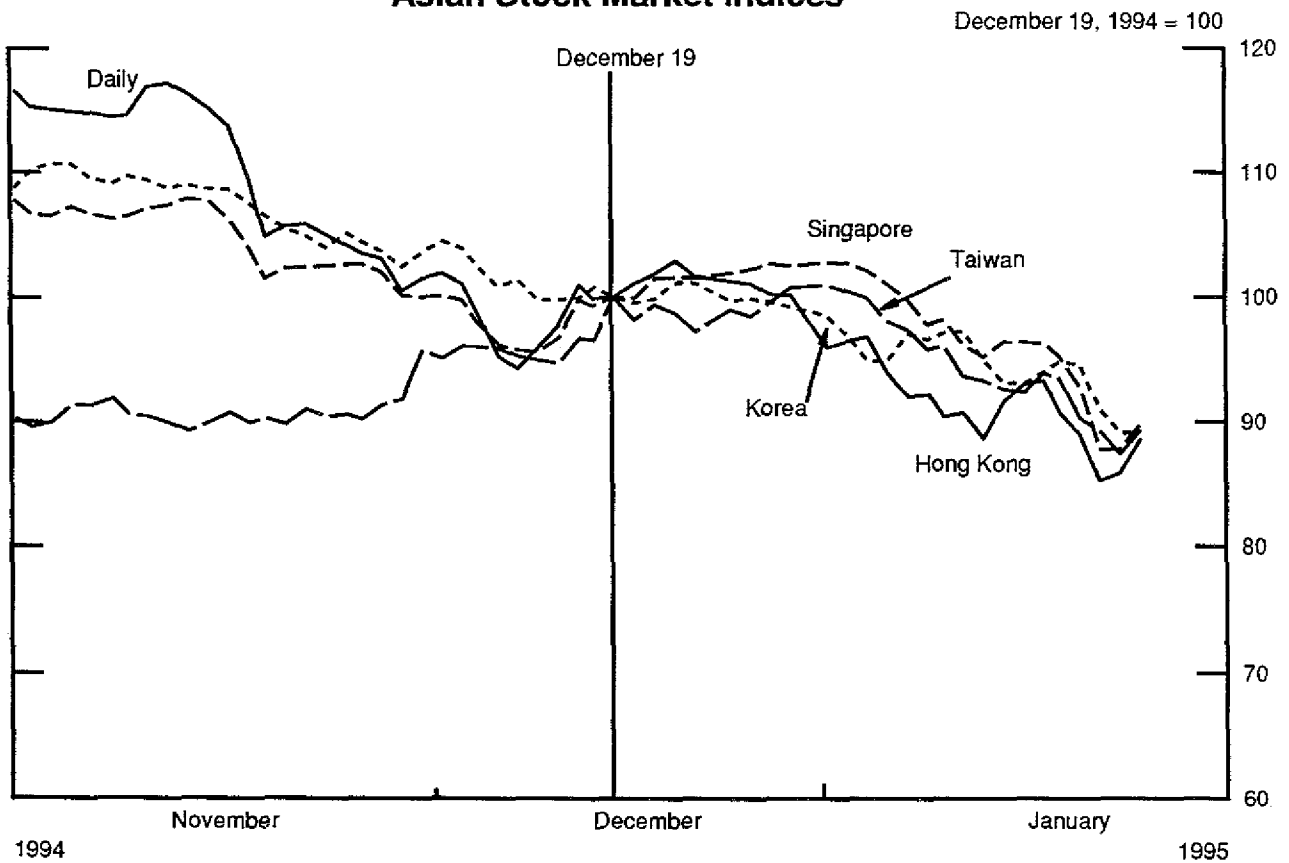
INTEREST RATES IN MAJOR INDUSTRIAL COUNTRIES

	Three-month Rates			10-year Bond Yields		
	Dec. 20	Jan. 24	Change	Dec. 20	Jan. 24	Change
Germany	5.40	5.00	-0.40	7.51	7.58	0.07
Japan	2.32	2.28	-0.04	4.53	4.63	0.10
United Kingdom	6.25	6.63	0.38	8.53	8.77	0.24
Canada	6.95	8.45	1.50	9.10	9.56	0.46
France	5.92	5.62	-0.30	8.12	8.25	0.13
Italy	9.13	8.94	-0.19	12.36	12.26	-0.10
Belgium	5.39	5.33	-0.06	8.39	8.50	0.11
Netherlands	5.40	5.10	-0.30	7.65	7.76	0.11
Switzerland	4.13	3.94	-0.19	5.34	5.32	-0.02
Sweden	8.43	8.45	0.02	10.87	11.12	0.25
Weighted-average foreign	5.37	5.32	-0.05	7.75	7.88	0.13
United States	6.27	6.22	-0.05	7.81	7.86	0.05

Latin American Stock Market Indices



Asian Stock Market Indices



on the uncollateralized part of Brady bonds, have risen nearly 4 percent since December 19 for bonds issued by Mexico and about 2 percentage points for bonds issued Argentina and Brazil. Stock price indices in Argentina and Brazil have declined about 20 percent. Prices in Asian emerging stock markets have declined about 10 percent, partly due to the Japanese stock market selloff and concerns over the health of Chinese leader Deng. The worst day for Latin American financial markets was January 10, when the Mexican stock market dropped 6 percent and Argentine and Brazilian stock indices fell nearly 10 percent. Latin American stock and bond markets have recovered somewhat since January 11, when President Clinton pledged further U.S. financial support to help Mexico meet its short-term financial obligations. Those markets have remained volatile, however, amid indications that the passage of the loan guarantees through Congress will not be smooth.

The Mexican crisis appears to have contributed to downward pressure on currencies of industrial countries that are seen as heavily dependent on foreign capital or that are subject to political uncertainties. In particular, market concerns have been heightened over Canada's large fiscal and current account deficits and the possibility of secession by Quebec. The Canadian dollar declined nearly 2 percent over the past month, to a nine-year low. The Bank of Canada has responded by pushing up short-term Canadian rates by 150 basis points in the past two weeks. As shown in the table, Canadian short-term rates are now more than 2 percentage points above U.S. rates, after dipping below U.S. rates in October and November.

In Europe, the fallout of the Mexican crisis added downward pressure to some of the more vulnerable currencies. The Spanish peseta, already pressured by political turmoil, declined 3-1/2 percent against the German mark over the past month. The peseta has fallen to about 10-1/2 percent below its central parity with the topmost currency in the European exchange rate mechanism, the Dutch guilder. That is the closest any currency has come to the 15 percent limit of deviation since the ERM widened its bands in August 1993. It has prompted speculation that the peseta might have to leave the exchange rate mechanism or devalue its central rate for the fourth time since 1992.

Developments in Foreign Industrial Countries

Recent information from the major foreign industrial countries suggests continued growth in the fourth quarter of 1994, although probably at a slower rate than observed earlier in the year. Japanese economic indicators imply some deceleration from Japan's strong third-quarter pace. Industrial production and retail sales in Europe have slowed, and forward-looking indicators such as orders and both business and consumer confidence have been mixed. In Canada, recovery may have slowed slightly in the fourth quarter but still appears to have sustained a healthy pace.

In Japan, consumer-price inflation has remained very low, and wholesale prices have continued to fall. Even after excluding the effects of recent excise tax cuts, Canadian inflation has remained subdued. In the European countries with advanced recoveries or depreciating currencies, there are early indications of emerging

inflationary pressures. In Germany, wholesale and import prices have been trending up, while both consumer and wholesale price increases have accelerated in the United Kingdom and Italy.

Although evaluations of the effects of the disastrous Kobe earthquake on the Japanese economy are still incomplete, it is estimated to have destroyed roughly 1/2 percent of the country's capital stock (roughly equivalent to a \$50 billion loss). Disruptions caused by the earthquake likely will lower current-quarter output, but should lead to increased reconstruction demand in subsequent quarters. Japan's net exports likely also will be less in the near term due to damage to production and shipping facilities.

In Italy, Lamberto Dini, a former Bank of Italy Director General, has been named Prime Minister-designate. He replaces Silvio Berlusconi, who resigned on December 22 rather than face a likely no-confidence vote.

Individual country notes. In Japan, data for the fourth quarter suggest a continuation of growth, although at a slower pace. In November, while industrial production rebounded, and housing starts grew strongly, new orders rose only slightly. Although the November unemployment rate fell somewhat, the job offers/applicants ratio was unchanged, suggesting that the labor market has not recovered yet.

Consumer prices in the Tokyo area fell 0.5 percent in December from a year earlier, and both the nationwide CPI and wholesale prices continued to fall year-over-year in the fourth quarter reflecting, in part, liberalization and increased competition in the Japanese retail and wholesale sectors.

JAPANESE ECONOMIC INDICATORS
(percent change from previous period except where noted, SA)

	1994						
	Q1	Q2	Q3	Q4	Sept.	Oct.	Nov.
Industrial Production	1.9	1.1	1.7	n.a.	-1.3	-0.6	3.0
Housing Starts	3.7	1.7	-1.7	n.a.	-6.9	1.4	5.0
Machinery Orders	6.9	-16.5	19.3	n.a.	3.4	-7.9	0.2
New Car Registrations	8.5	-7.5	8.9	n.a.	1.6	-12.2	n.a.
Unemployment Rate (%)	2.8	2.8	3.0	n.a.	3.0	3.0	2.9
Job Offers Ratio*	0.66	0.64	0.63	n.a.	0.64	0.64	0.64
Business Sentiment**	-56	-50	-39	-29	--	--	--

* Level of indicator.

** Percent of manufacturing firms having a favorable view of business conditions minus those with an unfavorable outlook.

The trade surplus in 1994 totalled \$121 billion (SAAR), about unchanged from its level in 1993, with the bilateral surplus with the United States widening to \$55 billion from \$51 billion in 1993. Through November, the current account surplus registered \$130 billion (SAAR), about equal to its value for all of 1993.

On January 17th, the Kobe region of Japan was hit by a devastating earthquake that is estimated to have damaged about 0.4 percent of the country's capital stock, or roughly \$50 billion equivalent. It is estimated that the disruptions caused by the earthquake will lower current-quarter output, but will lead to increased reconstruction demand in subsequent quarters. Damage to production and port facilities is expected to lower Japan's net exports temporarily in the near term.

The west German economy continued to expand in the fourth quarter, as industrial production in October and November was about 1 percent above the third-quarter level on average. However, on the spending side, retail sales dropped sharply in both October and November, averaging about 2-1/4 percent below the third-quarter level.

Forward-looking indicators are generally positive, although the recent pattern of new orders suggests some moderation in the

recovery. Orders in October and November were 1.4 percent above the third-quarter level after increasing at an average rate of just under 3 percent over the previous three quarters. The deceleration has occurred primarily in domestic orders, while foreign orders have picked up again in the past few months after a lull in the summer. In contrast, the net percentage of firms planning to increase production over the next three months doubled in December, while firms' assessment of their inventory situation continued to improve in the fall.

WEST GERMAN ECONOMIC INDICATORS
(percent change from previous period except where noted, SA)

	1994							
	Q1	Q2	Q3	Q4	Sep.	Oct.	Nov.	Dec.
Industrial Production	0.4	2.6	1.1	n.a.	1.1	1.0	0.5	n.a.
Manufacturing Orders	2.5	4.0	1.9	n.a.	5.4	-1.2	-0.3	n.a.
Capacity Utilization	79.5	81.4	82.9	84.2	--	--	--	--
Retail Sales Volume	1.3	-2.9	1.3	n.a.	0.8	-2.9	-1.2	n.a.
Unemployment Rate (%)	9.2	9.3	9.2	9.1	9.2	9.2	9.1	9.1
Production Plans*	3.3	7.7	8.7	15.3	11.0	13.0	11.0	22.0

e Estimated

* Percent of manufacturing firms planning to increase production in the next three months minus those planning to decrease production.

The recovery still has had only a minor impact on the labor market, as productivity growth has remained quite strong. The unemployment rate edged down to 9.1 percent in November, just two-tenths below its cyclical peak, and remained at that level in December.

The year-over-year west German consumer price inflation rate (NSA) was unchanged in December at 2.7 percent. Wage growth continues to be relatively moderate, but both wholesale and import prices have begun to show some acceleration in the past few months.

Production in eastern Germany has continued to expand at a rapid rate, with industrial production in October nearly 20 percent above its year-earlier level. Orders for manufactured goods surged

in November and were 32 percent above their previous-year level. Foreign orders showed a particularly large increase to a level 19 percent above that of the previous year. The unemployment rate was 13.5 percent in December, about 2 percentage points below its year-earlier level.

At its December 22 meeting, the Bundesbank Council set a 4-6 percent target range for M3 growth for 1995, on a fourth-quarter-to-fourth-quarter basis, the same as the 1994 target. This range is intended to be consistent with growth of 2-3/4 percent in potential output, a maximum of 2 percent inflation, and 1 a percent trend decrease in M3 velocity.

In France, third-quarter GDP growth was revised up to 3.3 percent (SAAR) from 2.8 percent. The revision was largely the result of stronger investment, which increased 6.1 percent (SAAR), rather than the 3.5 percent reported in the preliminary release.

On balance, monthly indicators point to some slowing in economic growth in the fourth quarter. Industrial production rose in November, partly reversing its October decline. Business surveys by INSEE and the Bank of France suggest that production increased moderately in December, and that total orders were flat, while foreign orders rose sharply. Consumption of manufactured products declined in the fourth quarter. This suggests that growth in total consumption also is likely to have been relatively weak since manufactured products make up one-third of total consumption. This weakness is unlikely to persist, because it was largely due to a sharp drop in automobile purchases as the impact of government incentives to purchase autos wore off.

Consumer prices declined slightly in December and were only 1.6 percent above their year-earlier level, the lowest inflation rate since 1956.

FRENCH ECONOMIC INDICATORS
(percent change from previous period except where noted, SA)

	1994							
	Q1	Q2	Q3	Q4	Sep.	Oct.	Nov.	Dec.
Industrial Production	1.2	2.7	1.8	n.a.	-0.2	-0.7	0.4	n.a.
Unemployment Rate (%)	12.5	12.6	12.6	n.a.	12.7	12.6	12.6	n.a.
Consumption of Manufactured Products	0.7	1.5	1.5	-0.5	0.2	-1.9	1.5	0.7
Consumer Prices (NSA)	0.4	0.6	0.1	0.4	0.3	0.3	0.0	-0.1

The Bank of France announced in mid-December that it would maintain its medium-term growth target for M3 of an average rate of 5 percent over four years. It stated that this target was consistent with its commitment to limit inflation to less than 2 percent. It also reaffirmed its commitment to the current exchange rate parity vis-a-vis the DM.

In the United Kingdom, the pace of economic activity in the fourth quarter has continued at about the same rate as in the third quarter due to a surge in oil production. Real GDP rose a preliminary 3.1 percent (SAAR) in the fourth quarter; growth of non-oil GDP slowed to 2.7 percent. In November, industrial production fell back to its third-quarter average level, while growth of retail sales in the fourth quarter slowed to 0.5 percent. Producer confidence improved in the fourth quarter, but consumer confidence fell sharply. In December, the unemployment rate fell further to 8.6 percent.

UNITED KINGDOM ECONOMIC INDICATORS
(percent change from previous period, SA, except where noted)

	1994							
	Q1	Q2	Q3	Q4	Sep.	Oct.	Nov.	Dec.
GDP	4.4	5.5	3.2	3.1	n.a.	n.a.	n.a.	n.a.
Non-oil GDP	3.7	5.3	3.2	2.7	n.a.	n.a.	n.a.	n.a.
Industrial Production	1.1	2.1	1.2	n.a.	1.0	0.3	-1.0	n.a.
Retail Sales	0.9	0.9	0.7	0.5	0.5	0.1	0.0	0.5
Unemployment Rate (%)	9.8	9.4	9.2	8.8	9.1	8.9	8.8	8.6
RPI ex. MIP *	2.7	2.4	2.2	2.2	2.0	2.0	2.3	2.5
Input Prices *	-3.0	0.6	4.5	7.9	6.3	7.2	8.3	8.3

* NSA; percent change from preceding year.

Rapid increases in manufacturers' input prices throughout 1994 were offset in large part by falling unit labor costs. However, both producer-price inflation and underlying retail-price inflation appear to have bottomed out in October.

In Italy, growth in the third quarter continued near the robust pace set in the second quarter. Total domestic demand remained strong as every component advanced except fixed private investment, which declined marginally. Exports and imports both grew over 20 percent (SAAR).

ITALIAN REAL GDP
(percent change from previous period, SAAR)

	1992	1993	1994		
	Q4/Q4	Q4/Q4	Q1	Q2	Q3
GDP	-0.6	0.4	0.9	4.8	4.0
Total Domestic Demand	-1.7	-3.4	-0.8	9.1	3.7
Net Exports (contribution)	1.2	4.0	1.7	-4.1	0.3

More recent indicators suggest that activity may have decelerated in the fourth quarter. Industrial production, which was essentially flat in October, fell in November due to strikes and a severe flood, and the unemployment rate (NSA) jumped to over 12 percent in the fourth quarter as employment in all sectors of the economy fell. In addition, consumer and business confidence dipped from highs recorded in September.

In October, wholesale-price and producer-price inflation (year-on-year) continued to move up, and consumer-price inflation in December exceeded 4 percent for the first time since May. On December 22 Prime Minister Berlusconi resigned rather than face a likely no-confidence vote in Parliament. On January 13 President Scalfaro asked Treasury Minister and former Bank of Italy

ITALIAN ECONOMIC INDICATORS
(non-seasonally adjusted except where noted)

	1994						
	Q1	Q2	Q3	Q4	Oct.	Nov.	Dec.
Industrial Production*	0.1	4.6	3.7	n.a.	0.2	-0.4	n.a.
Capacity Utilization (%)	74.5	76.0	75.8	n.a.	--	--	--
Unemployment Rate (%)	11.3	11.6	11.0	12.1	--	--	--
Consumer Confidence	100.6	112.8	117.1	112.7	112.0	112.9	113.2
Business Sentiment** (%)	19	17	19	n.a.	16	18	n.a.

* Percent change from earlier period (seasonally adjusted).

** Percent of manufacturing firms having a favorable view of business conditions minus those with an unfavorable outlook.

Director General Lamberto Dini to form the next government. Mr. Dini passed a confidence vote in the lower house of parliament on January 25th and faces a confidence vote in the upper house on February 1. The program of the Dini government consists of a supplemental 1995 budget, pension system reform, regional electoral reform, and new rules on media access for political parties.

Indicators for the fourth quarter suggest economic activity in Canada continued to expand at a healthy pace. The average volume of retail sales in October and November was 1.9 percent above the third-quarter average, and manufacturing shipments and new orders grew strongly in November. After a surge in job growth in November, employment was unchanged in December as full-time job increases were offset by a drop in part-time jobs.

Consumer-price inflation remains subdued. Excluding the effects of recent excise tax cuts, 12-month inflation was 1.6 percent in December.

As the Canadian dollar has come under increasing pressure this month, the Bank of Canada has raised its target for the overnight (call) rate by 50 basis points on three occasions. The latest increase on January 17 set the range to 6.75 - 7.25 percent. These

moves came after two 25 basis point increases in November and December.

CANADIAN ECONOMIC INDICATORS
(percent change from previous period except where noted, SA)

	1994							
	Q1	Q2	Q3	Q4	Sept.	Oct.	Nov.	Dec.
Industrial Production	0.7	3.3	2.2	n.a.	-0.3	0.3	n.a.	n.a.
Manufacturing Shipments	1.0	6.2	4.6	n.a.	-1.1	1.5	4.0	n.a.
Manufacturing New Orders	0.1	5.9	5.9	n.a.	-0.5	0.3	2.5	n.a.
Retail Sales	3.3	1.3	0.4	n.a.	-0.1	1.6	-0.3	n.a.
Employment	0.3	0.8	1.0	0.7	0.5	-0.2	0.7	0.0
Unemployment Rate (%)	11.0	10.7	10.2	9.7	10.1	10.0	9.6	9.6
Consumer Prices**	0.6	0.0	0.2	0.0	0.2	-0.2	-0.1	0.2

* NSA.

** Percent change from year earlier.

EXTERNAL BALANCES
(Billions of U.S. dollars, seasonally adjusted)

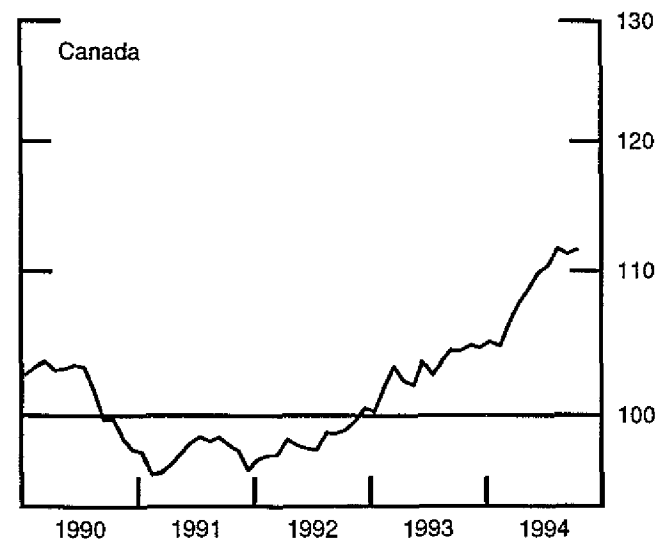
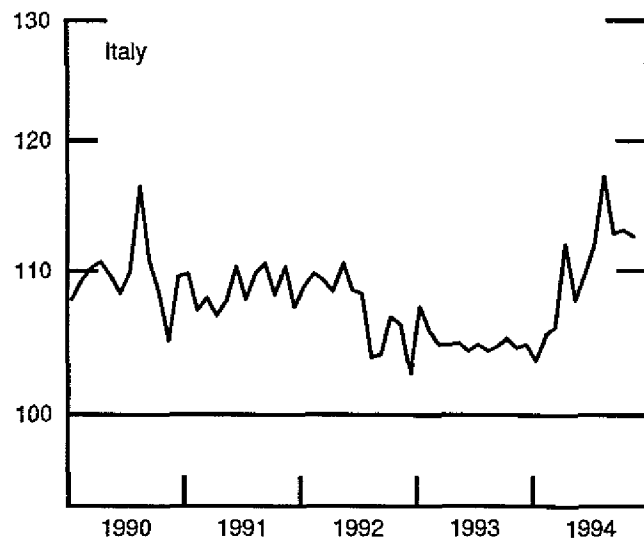
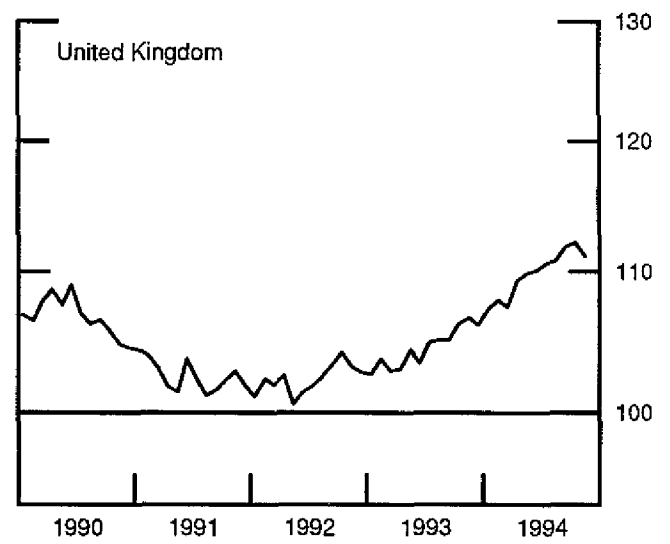
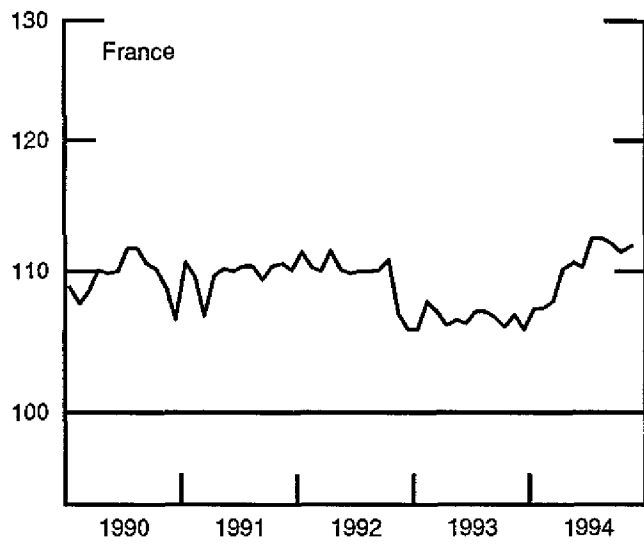
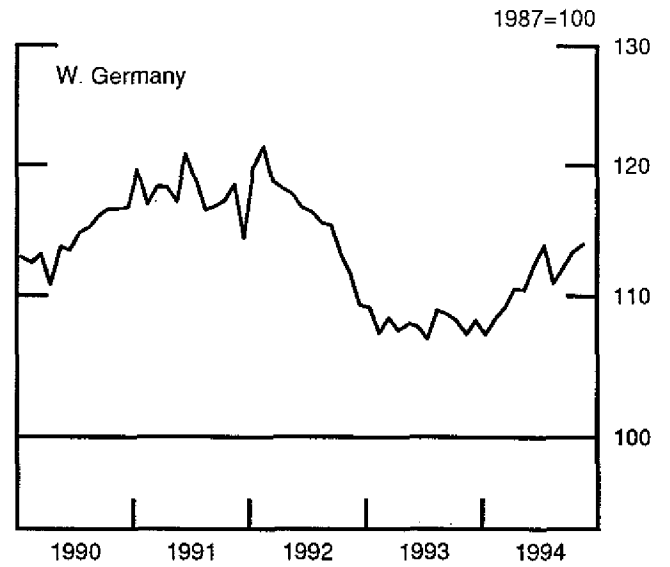
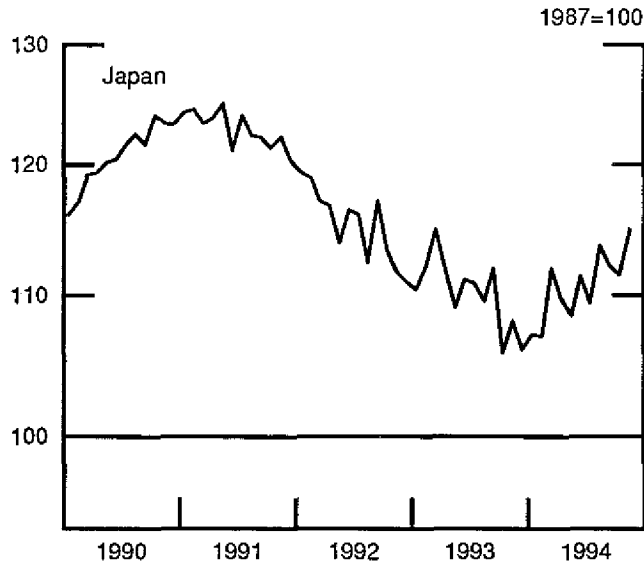
	1994							
	Q1	Q2	Q3	Sept.	Oct.	Nov.	Dec.	
Japan: trade	31.3	30.9	28.4	8.5	8.6	11.1	10.6	
current account	33.8	34.2	32.0	10.5	8.0	10.9	n.a.	
Germany: trade	8.6	12.8	10.0	3.3	4.6	n.a.	n.a.	
current account*	-6.6	-3.1	-16.3	-3.5	-4.7	n.a.	n.a.	
France: trade	2.7	3.7	3.9	1.7	2.1	1.3	n.a.	
current account	3.5	n.a.	n.a.	--	--	--	n.a.	
U.K.: trade	-4.4	-3.7	-2.4	-0.9	-1.0	n.a.	n.a.	
current account	-2.2	-1.7	1.3	--	--	--	n.a.	
Italy: trade	6.8	5.9	5.4	2.2	1.6	n.a.	n.a.	
current account*	1.3	3.5	5.5	1.0	0.5	-1.3	n.a.	
Canada: trade	1.6	2.0	3.5	1.1	1.6	1.5	n.a.	
current account	-5.5	-5.5	-3.7	--	--	--	n.a.	

* Not seasonally adjusted.

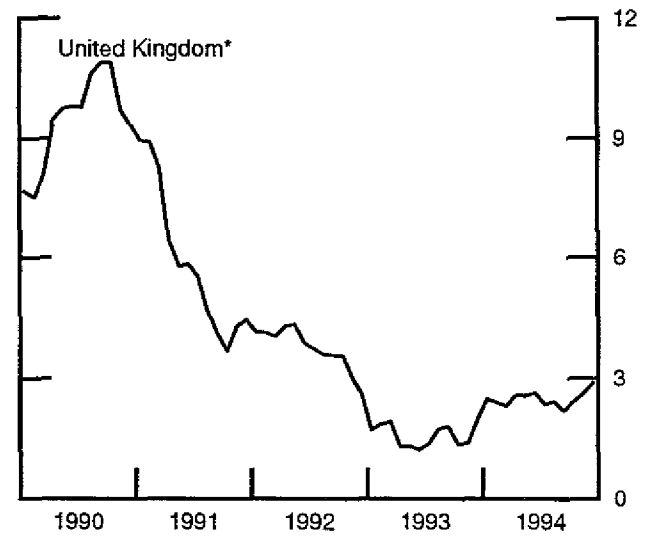
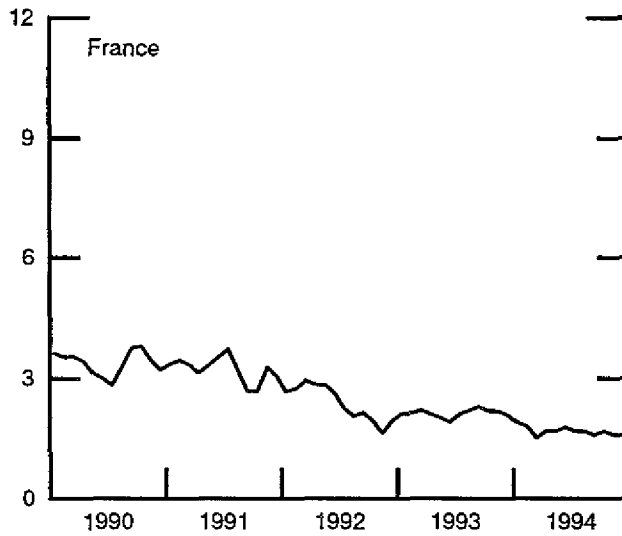
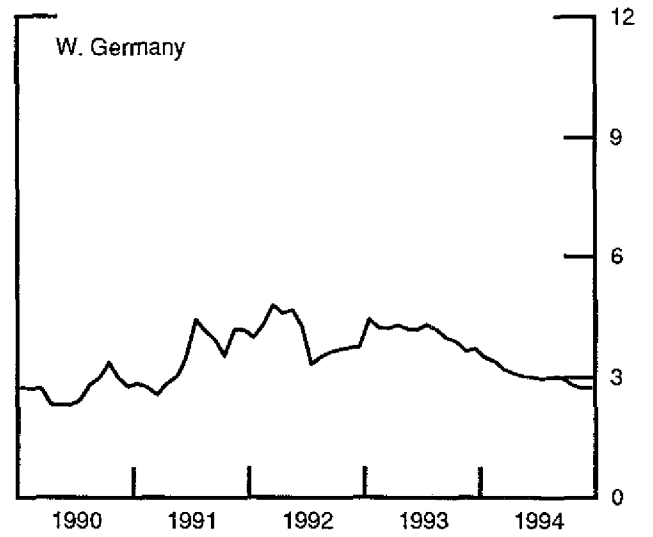
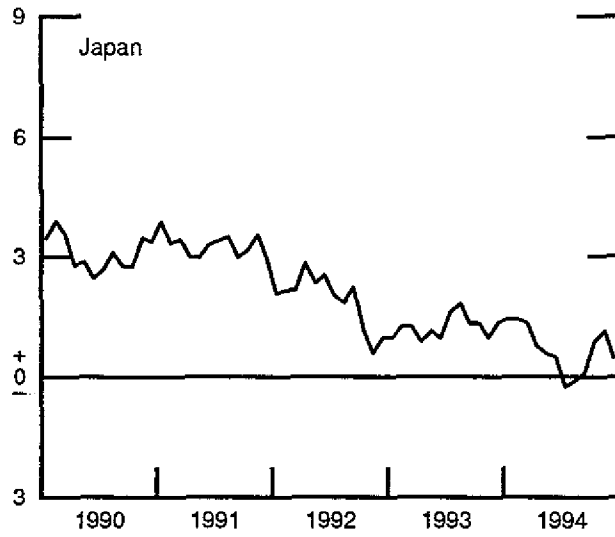
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Industrial Production for Major Foreign Countries

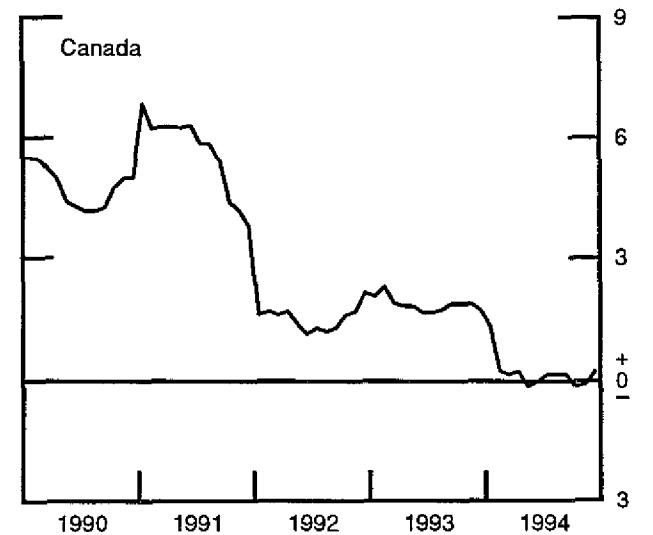
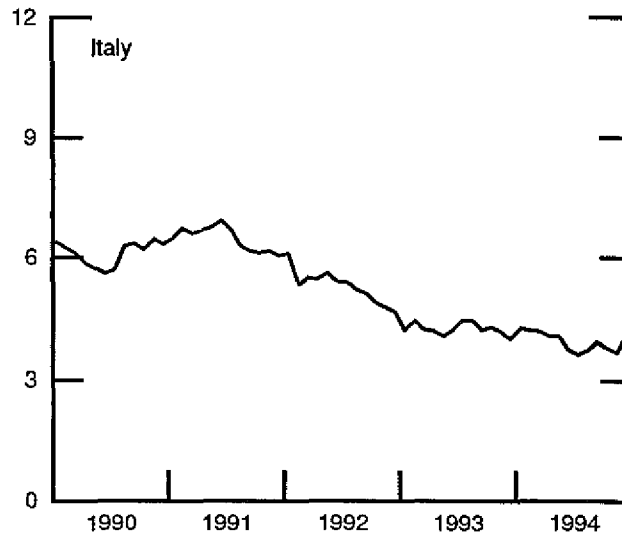
(Ratio scale; seasonally adjusted; monthly)



Consumer Price Inflation for Major Foreign Countries (12-month percent change)



* Excluding mortgage interest payments.



Mexico

On December 20, faced with continuing downward pressure on the peso and declining international reserves, Mexico announced a widening of the trading band for the peso, moving the lower limit from about 3.5 pesos per dollar to roughly 4 pesos per dollar, an increase of about 15 percent. This action only accelerated downward pressures on the peso, however, and as the exchange rate fell quickly to its new lower limit, Mexico spent more than \$4-1/2 billion out of its estimated \$10-1/2 billion in remaining reserves defending the peso on December 20 and 21. On December 22 the authorities decided to let the peso float, and it subsequently fell to a low of 5.8 pesos per dollar on January 6. As of January 25, the peso is at the rate of 5.7 pesos per dollar. On December 22, the authorities also announced the activation of the North American Swap Facility, consisting of \$6 billion from the U.S. Treasury and the Federal Reserve and C\$1 billion from the Bank of Canada.

On December 28, in response to the turmoil in financial markets prompted by the floating of the peso, Finance Minister Jaime Serra was replaced by Guillermo Ortiz, previously Secretary of Communications and Transport. On January 2, a \$3 billion increase in the swap lines provided by the United States was announced, along with a C\$500 million increase in the Canadian swap line, a \$5 billion facility provided by the BIS, and prospective credit lines from private banks of \$3 billion, for a total international support package of \$18 billion.

On January 3, the government announced an emergency economic program. The program included:

- A guideline of 7 percent for wage growth in 1995, the same as agreed to last September in the renewal of the annual pact among representatives of government, business, and

labor. Some provision also was made for additional wage growth based on productivity increases.

- Increases in the public sector prices of final consumer goods (gasoline and electricity for households) of 10 percent in 1995. Adjustment of the public sector prices of energy products used by industry equal to 85 percent of the change in the exchange rate.
- A reduction in government expenditures of 1.3 percent of GDP and in development bank lending of 2 percent of GDP.
- A limit on credit creation by the Bank of Mexico of 12 billion new pesos, consistent with monetary base growth of about 20 percent, the projected rate of increase of nominal GDP in 1995.
- Measures to promote structural change, including legal reforms to privatize railroads and satellites, an increase in the allowance of foreign investment in existing financial intermediaries from 30 to 49 percent of capital, opening of telecommunications to competition; continued privatization of port operations; privatization of airports, electrical power plants, and petrochemical plants; and continued privatization of other public companies.
- An \$18 billion Exchange Stabilization Fund to enhance credibility and support orderly conditions in financial markets.

On January 6, the IMF began talks with Mexico on a stand-by arrangement in support of Mexico's economic program. An IMF mission departed for Mexico subsequently, and discussions on a stand-by are continuing. On January 12, the Clinton Administration announced a proposal to guarantee borrowing in the capital markets by Mexico totalling \$40 billion in order to raise investor confidence and stabilize the Mexican economy. Legislation authorizing this package could be voted on by Congress during the week of January 23.

Consumer prices rose 7 percent on a 12-month basis in December, up slightly from 6.9 percent in November. Reflecting price hikes in the wake of the peso's devaluation, prices in the first half of January rose 2.3 percent above their level in the first half of December, well above the 0.9 percent increase in prices registered

from November to December. The trade deficit grew to \$15.4 billion in the January-October period, up from \$11.2 billion in the same period last year.

Economic Situation in Other Countries

The fallout from the Mexican peso crisis has been limited largely to other major Latin American developing countries, although some effects have been felt in Asian stock markets. Fears concerning the sustainability of the fixed exchange rate regimes in both Argentina and Brazil have led to a marked decline in the stock markets and prices of Brady par bonds of both countries since December 19.

Growth of real output appears to have been strong in the major developing countries in 1994 with the exception of Mexico, discussed in a previous section, and Venezuela. In Argentina, real GDP growth remained strong last year while inflation has reached its lowest level in 40 years. In Brazil, growth increased in 1994 and the new stabilization plan has been successful so far in keeping inflation low. President Fernando Henrique Cardoso took office on January 1 and appointed Pedro Malan as finance minister and Persio Arida as the new central bank president; both have been closely associated with the disinflation program. Venezuela experienced a recession in 1994 with rising inflation. In China strong output growth last year has been accompanied by a rise in inflation to its highest level in almost 46 years. Korea and Taiwan both experienced strong growth with stable moderate inflation. Russian real GDP contracted sharply during 1994, but there are signs that it may now be stabilizing; concerns over the budgetary impact of the war in Chechnya are rising, however.

Individual country notes. In Argentina, growth was strong while inflation remained low. Industrial production during the

first ten months of 1994 was up 5 percent from a year earlier. Consumer prices were 3.9 percent higher in December 1994 than a year earlier. However, despite strong growth in industrial production and exports, the urban unemployment rate reached a record 12.2 percent in October's semi-annual survey, up from 9.9 percent in 1993 due to layoffs and restructuring in newly privatized enterprises.

The cumulative trade deficit for the first eleven months of 1994 widened to \$3.9 billion compared with its year-earlier level of \$1.3 billion. Mercosur, the regional trade arrangement including Argentina, Brazil, Paraguay, and Uruguay, was inaugurated on January 1.

Spillovers from the Mexican peso crisis have affected Argentina's financial markets. As of January 24, the stock market has fallen 19 percent since December 19 and 26 percent since December 30, 1993. Prices of Brady par bonds have fallen 9 percent since December 19.

Mexico's crisis has also prompted a shortage of liquidity in Argentina's banking sector. Three relatively small financial institutions, a merchant bank (Extrader) and two brokerage houses (Finansur and Finmark) have suspended operations for 30 days until they can arrange for financing. In response the Central Bank has adopted certain temporary measures such as: unifying and lowering its minimum reserve requirements on all types of deposits from an average of 24 percent to 21 percent, eliminating the requirement that at least 70 percent of required reserves be in pesos, and eliminated the small exchange band at which it used to transact dollars from commercial banks (1.00 USD/0.998 Peso). Banks can now buy and sell dollars to the Central Bank at exactly one peso per dollar. Total official reserves in December are estimated to be around \$17 billion.

Brazil's central bank sold an estimated \$2.2 billion of its \$40 billion in foreign reserves in late December and early January. The sales were made in the wake of the devaluation of the Mexican peso and mark the first intervention episode since the central bank committed to maintain the exchange rate at no more than one real per dollar in July 1994; the real/dollar exchange rate has been at 0.85 since September 1994. As of January 24, the Bovespa stock market index has fallen 22 percent since December 19, but has risen 41 percent since December 30, 1993 in dollar terms. Prices of Brady par bonds have fallen 9 percent since December 19.

The recent financial turmoil has prompted some debate about Brazil's exchange rate policy. The Real Plan has been successful in reducing inflation from 50 percent per month in June to less than 2 percent per month in December 1994, however, Brazil's currency has appreciated 35 percent in real terms since the plan was implemented in July, causing concern that Brazil's competitiveness may be adversely affected. Revised estimates for November and December indicate that Brazil's trade deficits for the two months were considerably higher than previously believed, bringing the trade surplus for the year down from \$13.1 billion in 1993 to \$10.5 billion in 1994. Exports grew by 12 percent while imports grew by 29 percent. This news, plus skepticism that the government would be able to contain the current account to a target deficit of no more than 3 percent of GDP in 1995 (from roughly 0.5 percent of GDP in 1994) has heightened concerns about the sustainability of the current exchange rate policy. In addition, economic growth has been strong; according to preliminary government estimates, real GDP grew by 5.3 percent in 1994, up from growth of 4.1 percent in 1993.

In late December, the central bank took control of two banks that are majority-owned by state governments, Banespa (Sao Paulo)

and Banerj (Rio de Janeiro). Banespa is Brazil's second largest commercial bank.

Real GDP in Venezuela is estimated to have fallen by 3.3 percent for 1994 compared with a 0.4 percent fall in the previous year. The non-oil sector contracted by 5.4 percent, while the oil sector expanded by 5.7 percent. Consumer price inflation was 3.5 percent in December, down from 4.3 percent in November due in part to the inclusion of five new products in the list of price controlled items. The increase in the official consumer price index for 1994 was 71 percent, up from 46 percent in 1993, and was the highest annual inflation since 1989.

The contraction in activity, however, has contributed to the improvement of Venezuela's external balances. The current account went from a deficit of \$2.2 billion in 1993 to an estimated surplus of \$4.1 billion in 1994. The central bank's official reserves, excluding gold, stood at an estimated \$8.5 billion at the end of December 1994 compared with \$9 billion at the end of 1993.

Venezuela's financial markets have not been affected very much by the Mexican crisis, since the major force driving financial markets is the lack of a consistent macroeconomic program to curb inflation and restore growth. However, conditions in the financial system do not seem to be stabilizing. On December 14, the government took over Grupo Latinoamericana Progreso, one of the nation's largest banking and insurance groups, bringing the total number of banks under government control to 13. The group's two banks, Banco Progreso and Banco Republica, remained open to the public. On the other hand, Banco Latino International, the Miami branch of Banco Latino de Venezuela, reopened on December 15, and became a full subsidiary of the Venezuelan bank.

In China, real GDP rose 11.8 percent in 1994, according to preliminary estimates. Industrial value added rose 17.5 percent for the year; output in the state sector rose 5.5 percent, while output in the non-state sector rose 28 percent. Consumer prices rose 26 percent in 1994, the highest annual inflation rate since the founding of the People's Republic of China in 1949.

China ran a trade surplus of \$5.3 billion in 1994, after recording a trade deficit of \$12.2 billion in 1993. Exports rose 32 percent in 1994 from a year earlier, while imports rose 11 percent. Foreign direct investment into China was reportedly \$29 billion in 1994, up from \$26 billion in 1993. Foreign exchange reserves rose \$28 billion in 1994, reaching \$49 billion at the end of December.

As of January 25, share price indices for China's official stock exchanges were down between 5 and 16 percent for the year. Although this may in part reflect a general reassessment of emerging financial markets by investors, several other factors also appear to be at work. The first is the escalation of U.S.-China trade frictions. The United States announced on December 30 that it would apply punitive tariffs on \$2.8 billion of Chinese goods if China fails to take sufficient steps to improve protection of intellectual property rights by February 4; China has vowed to retaliate against U.S. goods. A second factor is that China raised some lending and deposit rates early this month. A third factor is renewed concerns about the state of Deng Xiaoping's health.

In Taiwan, industrial production was 6.8 percent higher in 1994 than a year earlier, the highest annual growth rate since 1991. Consumer prices rose 2.6 percent in 1994. Taiwan ran a trade surplus of \$7.7 billion in 1994, down slightly from the 1993 surplus of \$7.9 billion. Exports rose 9.4 percent from a year earlier, while imports rose 10.8 percent.

In Korea, concern that very rapid economic growth will lead to a rise in inflation has induced further monetary tightening in recent weeks. Short-term interest rates have increased by about 130 basis points since the end of last year, with interest rates rising a total of about 350 basis points since the Bank of Korea began tightening liquidity in June. The inflation rate has been roughly stable during the past year. The consumer price index in December was 5.6 percent higher than a year earlier.

Merchandise exports increased by 14 percent during the first 11 months of 1994 from a year earlier. However, imports increased by 20 percent over the same period. This led to a widening of the current account deficit to \$4.3 billion through the first 11 months of the year, compared with a deficit of \$0.2 billion during the same period of 1993.

Korea announced recently a plan that progressively eases current restrictions on inward and outward portfolio investment over the 1995-97 period. The plan includes raising the ceiling on purchases of foreign securities by domestic investors by a substantial amount, and allowing Korean firms (especially those in high-technology manufacturing) greater latitude in obtaining offshore financing.

The economic situation in Russia has deteriorated in recent months. Consumer price inflation averaged 14 percent a month during the fourth quarter, reaching 16.4 percent in December, and preliminary reports suggest that inflation has remained high during January. The resurgence of inflation reflects numerous factors, including uncertainty due to the war in Chechnya, monetary emissions to finance the war, and credit creation to satisfy firms' year-end liquidity needs. These factors have also caused the ruble to depreciate rapidly against the dollar; the ruble dropped by 9

percent during December and has fallen another 10 percent during the first three weeks in January. In response to these developments, the Central Bank of Russia on January 6 increased its monthly refinance rate from 15.4 percent to 16.7 percent and on January 17, raised reserve requirements slightly.

On December 23, Russia's parliament gave preliminary approval to the government's 1995 draft budget, which outlines a fiscal deficit of about 8 percent of GDP. Parliamentary leaders, however, are concerned about the budgetary impact of the Chechnya campaign. The Ministry of Finance estimates that the total cost of conducting the war and rebuilding Chechnya will be only 4 trillion rubles (0.4 percent of GDP), but unofficial estimates run as high as 15 trillion rubles (1.5 percent of GDP). The government intends to absorb expenditures on Chechnya into the proposed budget, reducing other expenditures as necessary to maintain an 8 percent of GDP deficit.

According to Russian official statistics, real GDP fell 15 percent in 1994, and industrial production was 21 percent below its 1993 level. The private sector now accounts for 62 percent of GDP. These data also suggest that economic activity may have begun to stabilize during the fourth quarter.

The Russian government and the IMF continue negotiations on a stand-by arrangement. The IMF is reportedly encouraging the government to limit the 1995 fiscal deficit to 7 percent of GDP and to take rapid steps toward liberalizing the energy sector.