Prefatory Note

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

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

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[1] In some cases, original copies needed to be photocopied before being scanned into electronic format. All scanned images were deskewed (to remove the effects of printer- and scanner-introduced tilting) and lightly cleaned (to remove dark spots caused by staple holes, hole punches, and other blemishes caused after initial printing).

[2] A two-step process was used. An advanced optimal character recognition computer program (OCR) first created electronic text from the document image. Where the OCR results were inconclusive, staff checked and corrected the text as necessary. Please note that the numbers and text in charts and tables were not reliably recognized by the OCR process and were not checked or corrected by staff.

Confidential (FR) Class III FOMC

Part 2

August 13, 1998

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Recent Developments

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

Confidential (FR) Class III FOMC

August 13, 1998

RECENT DEVELOPMENTS

Prepared for the Federal Open Market Committee
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DOMESTIC NONFINANCIAL DEVELOPMENTS

Domestic Nonfinancial Developments

Overview

Growth of real GDP slowed sharply in the second quarter; while domestic final demand remained very strong, inventory investment shifted down markedly and net exports continued to plummet. The extension of the General Motors strike well into July has resulted in some soft indicators of activity in the first part of this quarter, such as motor vehicle sales and factory employment. But, filtering out this noise as best we can, the economy appears to have retained considerable forward momentum. Certainly, the labor market has remained extremely tight, enabling workers to capture sizable real wage gains; with firms having little pricing "leverage," especially in the goods sector, inflation has remained relatively low, and profits have suffered in the nonfinancial sector.

Real GDP for 1998:Q2

The BEA issued its initial estimate of second-quarter real GDP growth--1.4 percent, at an annual rate--on July 31. Since then, new data have pointed to the potential for a small downward revision of that figure. Revisions to retail sales in May and June point to just a touch lower level of personal consumption expenditures. Incoming data

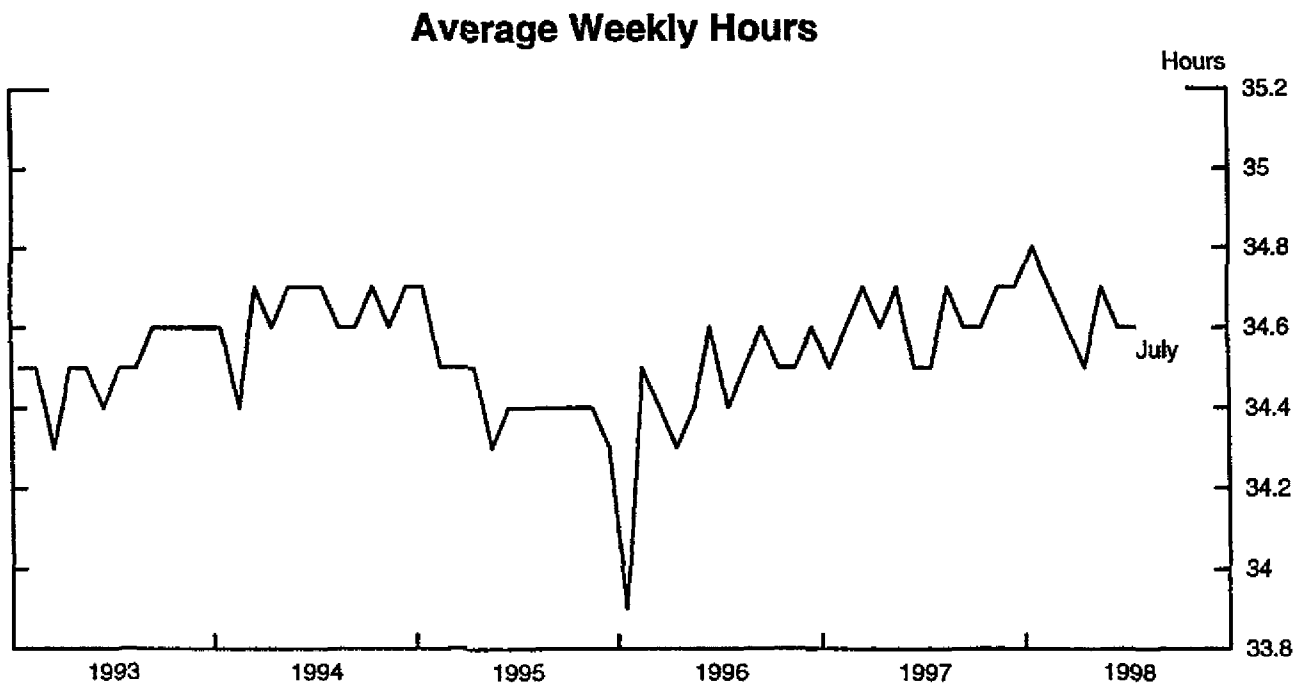
Real GDP and Selected Components

Component	1998:Q1	1998:Q2	
		BEA advance	Expected revision
	Percent change, annual rate		
Real GDP	5.5	1.4	1.2
Final sales	4.3	3.9	3.8
Private domestic final purchases	8.5	6.9	7.2
Consumption	6.1	5.8	5.7
Business fixed investment	22.2	11.4	14.1
Residential investment	15.6	13.2	13.2
Federal government	-8.8	7.0	7.0
State and local government	2.1	2.0	1.3
	Level, billions of chained (1992) dollars		
Inventory investment	91.4	44.7	39.7
Net exports	-198.5	-252.9	-255.9

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

	1996	1997	1997 Q4	1998 Q1	1998 Q2	1998 May	1998 June	1998 July
	---Average monthly changes---							
Nonfarm payroll employment [1]	233	282	336	208	281	328	196	66
Private	224	263	312	192	252	264	208	78
Goods Producing	31	42	67	28	7	-38	-4	-163
Manufacturing	3	21	35	13	-18	-22	-29	-176
Construction	28	20	32	17	27	-13	25	18
Service Producing	193	220	245	165	245	302	212	241
Transportation and utilities	8	14	5	18	11	21	3	18
Trade	54	48	73	22	77	105	35	126
Finance, insurance, real estate	14	17	23	21	25	22	23	32
Services	117	142	144	104	132	154	151	65
Help supply services	19	26	32	12	9	12	29	-33
Total government	9	20	24	16	29	64	-12	-12
Private nonfarm production workers [1]	190	212	246	136	195	244	172	48
Manufacturing production workers	0	16	29	4	-23	-36	-27	-171
Total employment [2]	232	240	339	72	72	70	-244	-142
Nonagricultural	226	243	351	157	2	85	-251	-241
Memo:								
Aggregate hours of private production workers (percent change)[1,3]	3.2	3.4	4.1	3.2	0.8	0.6	-0.1	0.3
Average workweek (hours) [1]	34.4	34.6	34.7	34.7	34.6	34.7	34.6	34.6
Manufacturing (hours)	41.6	42.0	42.1	42.0	41.7	41.8	41.8	41.7

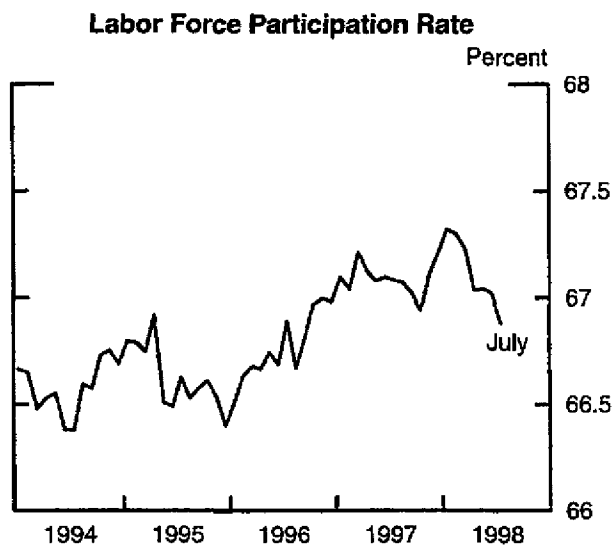
n.a. Not available.
Note. Average change from final month of preceding period to final month of period indicated.
1. Survey of establishments.
2. Survey of households.
3. Annual data are percent change from Q4 to Q4. Quarterly data are percent change from preceding period at an annual rate. Monthly data are percent change from preceding month.

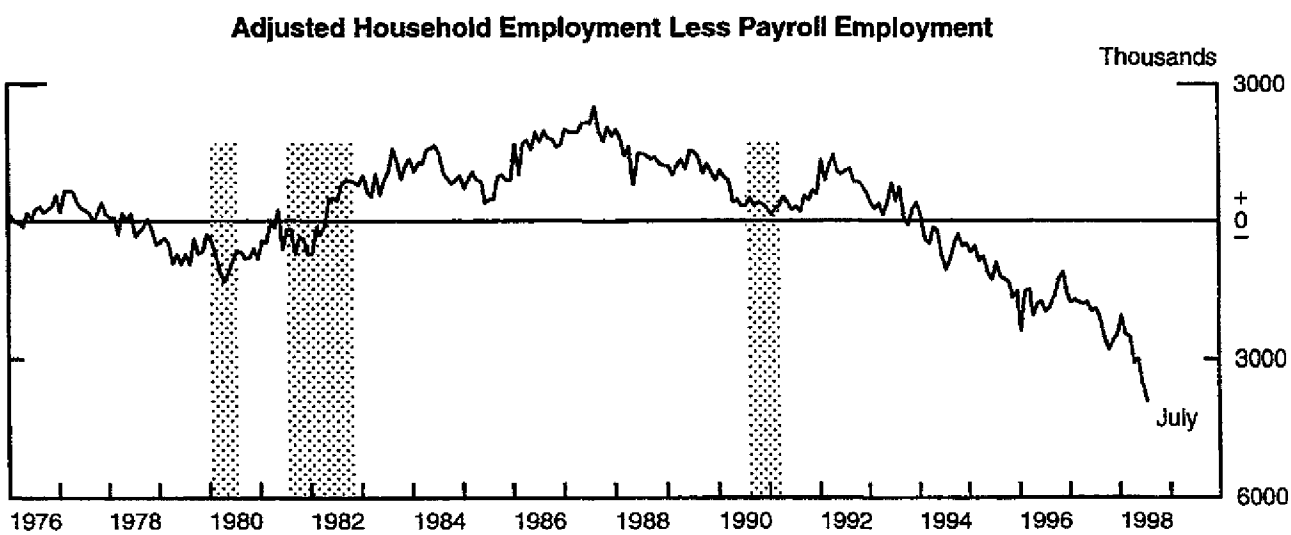


SELECTED UNEMPLOYMENT AND LABOR FORCE PARTICIPATION RATES [1]
(Percent; based on seasonally adjusted data, as published)

	1996	1997	1997 Q4	1998 Q1	1998 Q2	1998 May	1998 June	1998 July
Civilian unemployment rate (16 years and older)	5.4	4.9	4.7	4.7	4.4	4.3	4.5	4.5
Teenagers	16.7	16.0	15.0	14.6	14.0	14.2	14.6	13.7
Men, 20 years and older	4.6	4.2	4.0	3.8	3.6	3.5	3.7	3.9
Women, 20 years and older	4.8	4.4	4.0	4.3	4.0	3.9	4.1	4.0
Labor force participation rate	66.8	67.1	67.1	67.3	67.0	67.0	67.0	66.9
Teenagers	52.3	51.6	51.4	53.3	52.4	52.3	53.0	51.9
Men, 20 years and older	76.8	76.9	76.9	76.9	76.8	76.8	76.7	76.9
Women, 20 years and older	59.9	60.5	60.5	60.6	60.4	60.4	60.4	60.1
Women maintaining families	65.3	67.4	68.2	67.9	67.5	67.9	67.4	68.4

1. Data for 1998 are not comparable with earlier years because of a methodological change introduced by the BLS in January 1998.





Note. Adjusted household employment equals total employment less agricultural, self-employed, unpaid family and private household workers, and workers on unpaid absences; plus workers in agricultural services, an estimate of multiple job holders with more than one wage and salary job, and an estimate of 15-year-old wage and salary workers. To improve comparability over time, household data also are adjusted for several factors concerning census extrapolations, CPS redesign, and changes in data construction techniques. (Due to insufficient information, however, data prior to January 1997 have not been adjusted for the most recent methodological change.)

on construction put in place suggest a lower estimate for state and local construction spending, while information on equipment purchases argues for an upward revision to business fixed investment. The inventory report for wholesale trade came in considerably weaker than the BEA had assumed; together, the manufacturing and wholesale inventory data suggest that inventory investment could be revised down enough to knock a quarter point off GDP growth, all else equal. Tomorrow, the release of the June report on retail stocks will enable us to refine that estimate for the Greenbook Supplement.

Labor Market Developments

Labor demand continued to expand at a robust pace in July. On a published basis, total nonfarm payroll employment rose 66,000, and the unemployment rate was unchanged at 4.5 percent. These figures, however, were distorted by strikes at GM; and we believe that absent the strikes, payroll gains probably would have been on the order of a quarter million in July--in line with the pace of employment growth recorded during the first half of the year--and the unemployment rate probably would have ticked down to 4.4 percent.[1]

The effects of the GM strike were most evident in manufacturing, where the decline in the motor vehicle and parts industry alone accounted for nearly two-thirds of the 176,000 drop in payroll employment. In contrast, construction added 18,000 jobs in July, about in line with the average in the first half of the year. Retail trade posted an unusually large gain of 125,000 last month, led by a big increase in jobs at eating and drinking establishments. Finance, insurance, and real estate and transportation, communications, and utilities also recorded strong gains. Job growth in services slowed dramatically in July; some of the slowing reflected a drop in temporary help jobs related to the GM strike, but employment in health and education services also posted rare declines.

The average workweek of production or nonsupervisory workers on private nonfarm payrolls--which was not noticeably affected by the GM strike--held steady at 34.6

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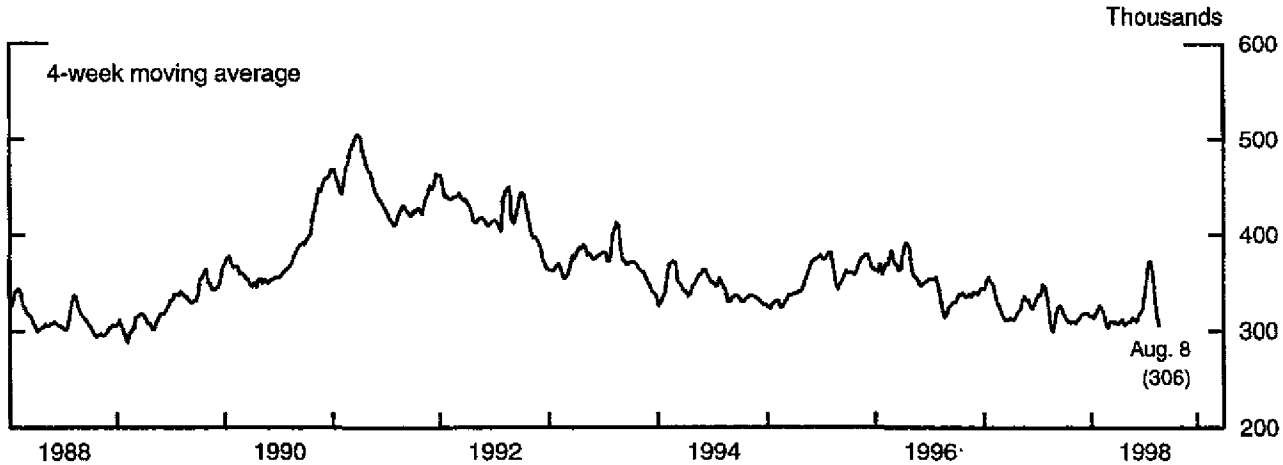
1. GM and the United Automobile Workers (UAW) settled two local strikes at key parts plants in Flint, Michigan, on July 29. The strikes halted nearly all of GM's North American production and caused many outside parts suppliers to curtail their operations. Based on notations by individual respondents to the payroll survey, the BLS estimates that the strike subtracted 141,000 from payrolls in July. The BLS cautions, however, that they may have missed some secondary layoffs. Our assessment is that a realistic estimate of the total effect would be closer to 200,000. In the household survey, workers who are laid off because of strikes are counted as unemployed, while--in contrast to the payroll survey--strikers are still counted as employed.

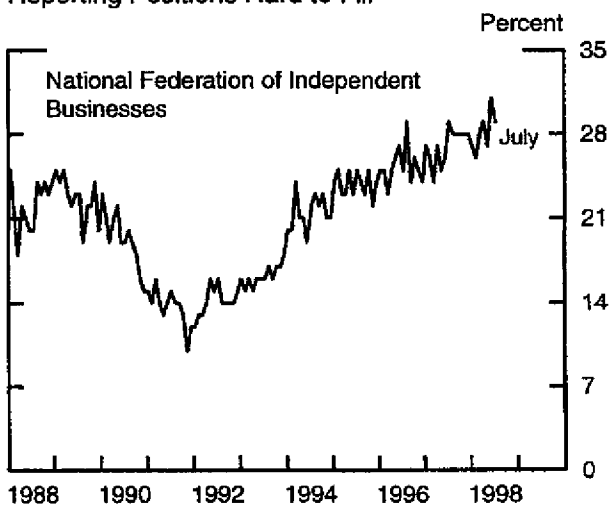
Labor Market Indicators

Initial Claims for Unemployment Insurance

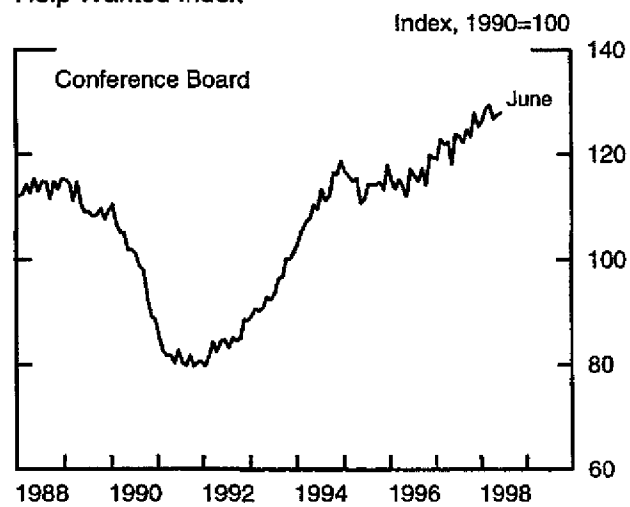


Note. State programs, includes EUC adjustment.

Reporting Positions Hard to Fill

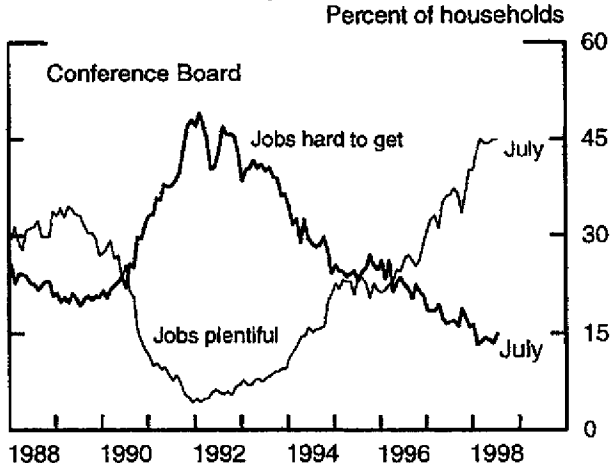


Help Wanted Index

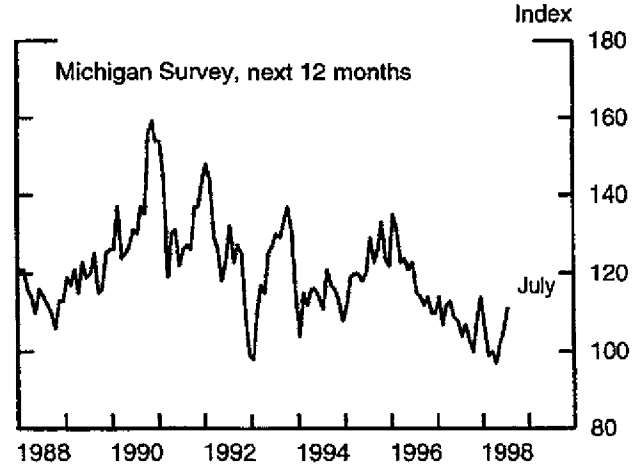


Note. Series has been adjusted to take account of structural and institutional changes, including consolidation of newspaper industry and tendency to increase hiring through personnel supply agencies.

Current Job Availability



Expected Change in Unemployment



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

hours in July. The index of aggregate hours of production or nonsupervisory workers rose 0.3 percent, a little above its average monthly increase during the second quarter. Excluding the estimated effects of the GM strike, aggregate hours were up about 1/2 percent in July, to a level about 2-1/2 percent (annual rate) above the second-quarter average.

In the household survey, employment growth (adjusted for changes in methodology) has slowed from 216,000 per month over the second half of 1997 to 127,000 per month in the first half of 1998. In contrast, growth in payrolls has moderated considerably less, from 293,000 per month over the second half of 1997 to 245,000 per month in the first half of this year. This divergence could be interpreted as an indicator that labor inputs have not been rising as rapidly as the payroll survey suggests. However, the discrepancy between employment growth in the household and payroll surveys is not a recent development; it has been apparent through most of the 1990s and is largely unexplained even after the usual reconciliations have been made between the concepts of employment measured by the two surveys.[2]

Other indicators of labor market activity continue to point to tight labor markets and ample job opportunities. In late July and early August, initial claims for unemployment insurance were back down to the low levels that prevailed before the GM strike. The National Federation of Independent Businesses reported a record 31 percent of firms had difficulty in filling jobs in June. Similarly, the Conference Board's index of help-wanted advertising held steady in June at a level near the top end of the range recorded over the past several years. The Conference Board also reported that the percentage of households believing jobs are "hard to get" remained at a very low level in July, whereas the percentage reporting jobs are "plentiful" was still quite high.

Industrial Production

(The industrial production report for July will be released tomorrow and will be discussed in the Greenbook Supplement.)

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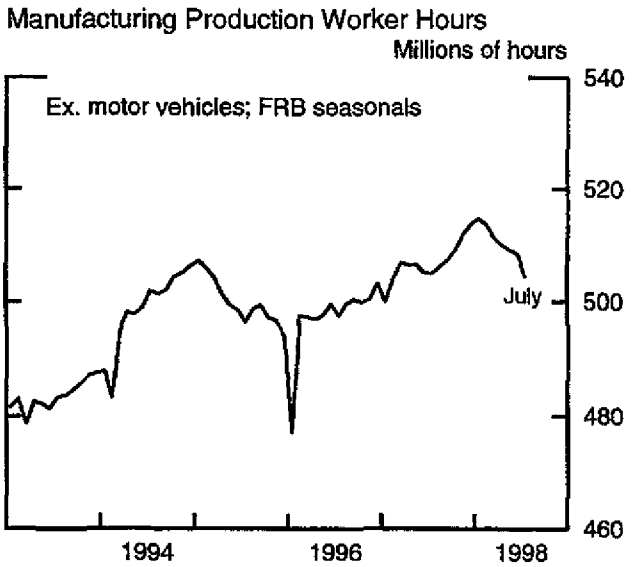
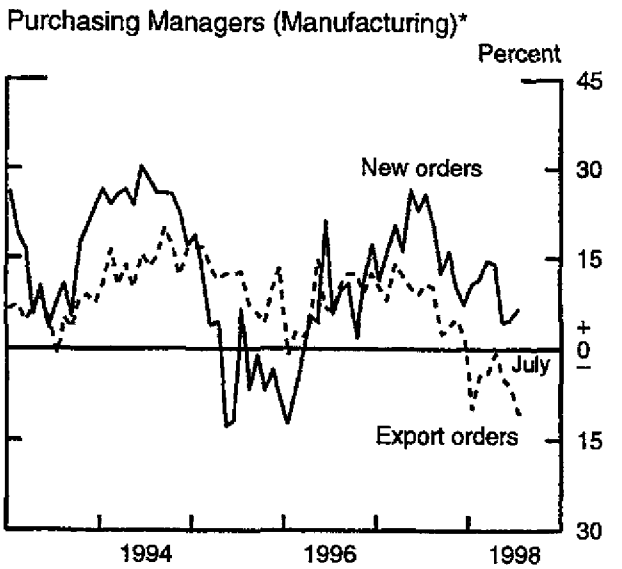
2. The household employment data can be made to more closely match the payroll survey concept by subtracting farm workers, the self-employed, unpaid family workers, and workers in private households, and adding an estimate of multiple-job-holding and an estimate of workers younger than age 16. A small portion of the discrepancy between the adjusted household series and payroll employment may be due to an undercount of illegal immigrants. The employment data in the household survey are based on the responses of a sample of residences, which are then weighted to match Census Bureau estimates of the population as a whole. Thus, if growth in the population of illegal immigrants is being understated, household employment growth will be underestimated as well. Indeed, the discrepancy between employment growth from the two surveys appears largest in the states with the highest proportion of illegal immigrants.

Industrial Production Indicators





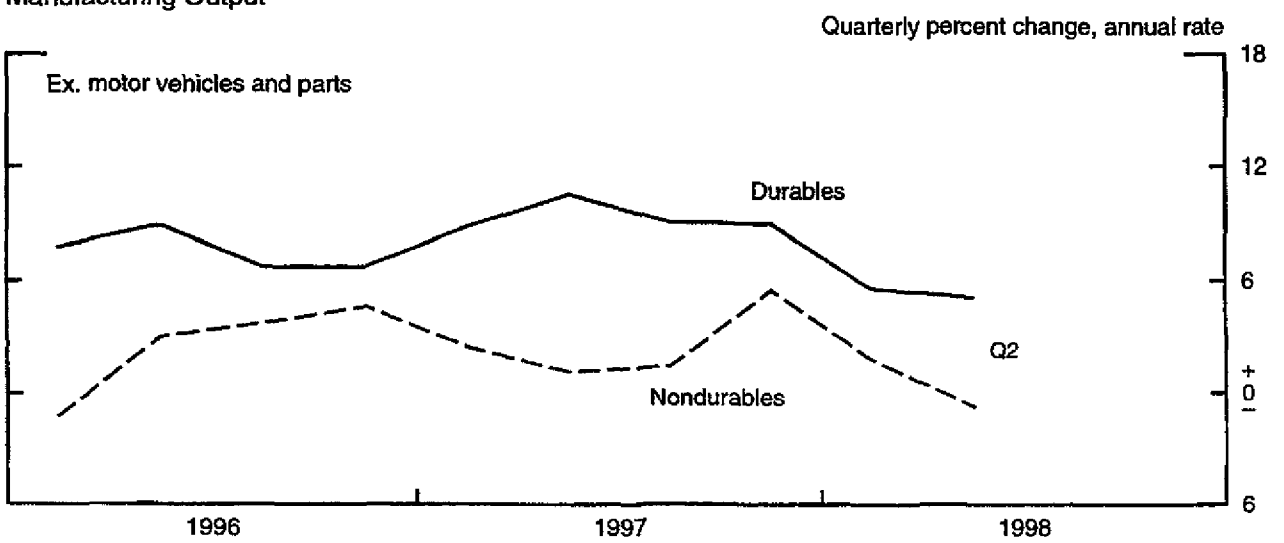
*Percent reporting increases minus percent reporting decreases.

New Orders for Durable Goods

(Percent change from preceding period; seasonally adjusted)

Component	Share, 1998:H1	1998				
		Q1	Q2	April	May	June
Total durable goods	100	–.8	–.9	1.6	–3.3	–.1
Adjusted durable goods[1]	70	.8	–.8	.3	–2.8	2.2
Computers	6	12.1	4.2	.7	–2.5	7.0
Nondefense capital goods excluding aircraft and computers	18	2.0	–2.6	–4.8	2.4	1.3
Other	46	–.9	–.7	2.3	–4.8	1.9
Memo: Real adjusted orders[2]	. . .	2.1	.5	.8	–2.4	2.5

1. Orders excluding defense capital goods, nondefense aircraft, and motor vehicle parts.
2. Deflation and chain–weight aggregation of the computer, electronic components, and "all other" categories of nominal adjusted durable goods.
. . . Not applicable.



Incoming indicators of current and prospective industrial production remain soft on the whole. Production worker hours in the industrial sector fell 1.7 percent in July; although most of this decline was attributable to the GM strike, hours were down somewhat even abstracting from the strike. Meanwhile, over the past several months, the percentage of manufacturers reporting increasing orders in the National Association of Purchasing Management (NAPM) survey barely edged out the percentage reporting decreases. The staff's estimate for real adjusted durable orders also advanced only a bit in the second quarter. Among the few upbeat indicators is the new orders index from Dun & Bradstreet, which has remained at a high level.

Manufacturing output excluding motor vehicles and parts grew sluggishly in the first half of the year. Among durables, relative to the second half of 1997, the production of civilian aircraft has leveled off, the high technology industries as a whole have posted less impressive gains, and production has declined in the primary metals, furniture, and the stone, glass and clay industries. The output of many nondurable products also has decelerated, especially chemicals and textiles.

The Asian crisis and the strengthening of the dollar clearly have contributed to this slowdown. In the NAPM survey for manufacturing, the percentage of respondents reporting decreases in export orders in July further exceeded the percentage reporting increases. The August Beige Book and other anecdotal reports from equipment producers (industrial, construction, and high technology equipment) again cite reduced exports to Asia and increased foreign competition as factors damping domestic output. This situation also applies to more basic industries: In the chemical, paper, furniture, and primary metal industries, net exports deteriorated in the first five months of this year, production slowed, and stocks increased.

Motor Vehicles

The strikes by UAW workers at two GM parts facilities brought assemblies at GM to a virtual halt between late June and the last week in July. The staff estimates that assemblies were held down by 2.1 million units at an annual rate in June, a figure that likely lowered industrial production growth by almost 1 percentage point and reduced second-quarter real GDP growth by a bit more than 1/2 percentage point (annual

rate).[3] Production in July was depressed by nearly 3-3/4 million units at an annual rate, which likely held IP growth down by roughly an additional 1 percentage point that month.

Production of Domestic Autos and Trucks
(Millions of units at an annual rate; FRB seasonal basis)

Item	1998					
	June	July[1]	Aug.[2]	Q1	Q2	Q3[2]
U.S. production	10.3	8.2	12.9	12.1	11.6	11.4
Autos	4.8	3.9	6.2	5.6	5.3	5.5
Trucks	5.6	4.4	6.6	6.6	6.4	5.9
Domestic stocks[3]						
Autos	1.1	n.a.	n.a.	1.4	1.1	n.a.
Light trucks	1.4	n.a.	n.a.	1.6	1.4	n.a.

NOTE. Components may not sum to totals because of rounding.
1. Production rates are latest estimates from Ward's Automotive Communications.
2. Production rates are manufacturers' schedules.
3. Quarterly data are for last month of quarter.
n.a. Not available.

Sales of light vehicles soared in June to 16.9 million units at an annual rate--the highest level in more than a decade. The strong sales reflected the generous incentive programs in place during the second quarter, especially the "coupon" programs of the Big Three. The expiration of those programs explains some of the sharp drop in sales to a 13.8 million unit pace in July. Supply shortages at GM--where inventories fell dramatically in June and somewhat further in July--likely also played an important part in the sales weakness. The shortages led GM to limit fleet sales sharply in July (the company has agreements with major fleet customers that allow them to divert cars to retail customers during periods of short supplies), but even so, shortages crimped retail sales substantially last month.

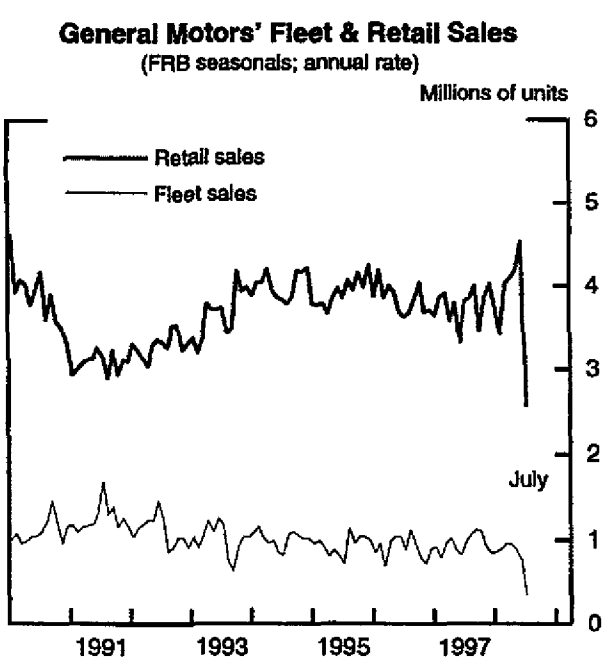
3. The production loss of 2.1 million units reflects the difference between GM's actual June assemblies and our expectation prior to the strike--which had assumed a small underbuild relative to announced schedules. The GDP effect was calculated by multiplying the lost assemblies for June by the average price of all light vehicles ($15,200 in 1992 dollars) and converting to an annual rate for the quarter. The resulting $10.6 billion loss corresponds to a reduction of about 0.6 percentage point (annual rate) in the growth of real GDP. This figure is at the low end of the range suggested by BEA in the advance NIPA release for the second quarter. The BEA estimates incorporated a somewhat larger production loss (2.3 million units) than we did because they compared actual production to announced schedules. In addition, BEA appears to have assumed that more of the losses were in high-value medium and heavy trucks, which seems to us at odds with GM's actual truck production in June.

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

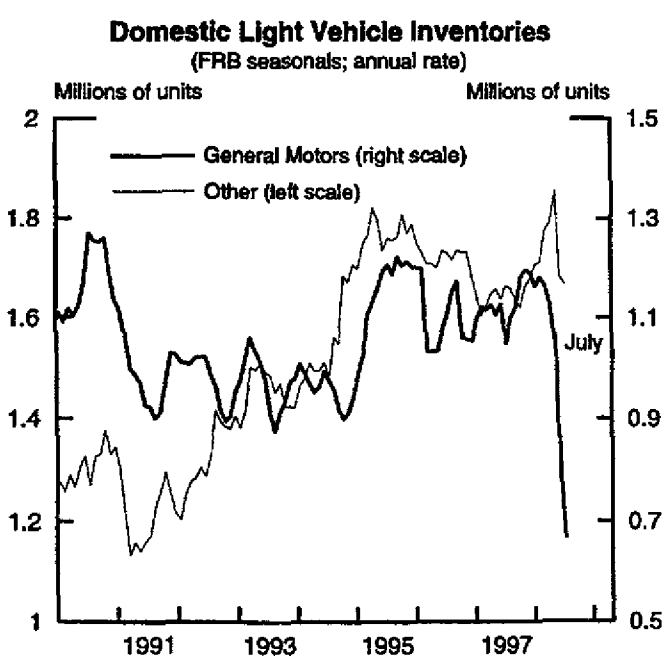
			1997	1998		1998		
	1996	1997	Q4	Q1	Q2	May	June	July
Total	15.0	15.1	15.1	15.1	16.1	16.1	16.9	13.8
Adjusted[1]	15.1	15.0	14.8	15.3	16.0	15.8	17.0	14.0
Autos	8.5	8.3	8.1	8.0	8.4	8.4	8.8	7.2
Light trucks	6.5	6.8	7.0	7.0	7.6	7.6	8.1	6.6
North American[2]	13.3	13.1	13.1	13.1	14.1	14.1	14.9	11.7
Autos	7.3	6.9	6.7	6.6	7.1	7.0	7.4	5.8
Big Three	5.3	4.9	4.7	4.7	5.0	4.9	5.3	3.5
Transplants	2.0	2.0	1.9	1.9	2.0	2.1	2.1	2.3
Light trucks	6.1	6.2	6.5	6.5	7.0	7.0	7.5	5.9
Foreign Produced	1.7	1.9	1.9	1.9	2.0	2.0	2.0	2.1
Autos	1.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Light trucks	.4	.6	.6	.6	.6	.6	.6	.7

Note. Components may not add to totals because of rounding. Data on sales of trucks and imported autos for the most recent month are preliminary and subject to revision.

1. Excludes the estimated effect of automakers' changes in reporting periods.
2. Excludes some vehicles produced in Canada that are classified as imports by the industry.



Note. Data are confidential. Retail includes consumer leasing.



Limited supplies are likely to constrain sales again in August. Production at GM is not expected to return to pre-strike levels until later this month, leaving their dealers short of vehicles, probably through the summer. Moreover, the demand for light vehicles is still strong. Manufacturers' incentives remain favorable this quarter, and despite its low inventories, GM reportedly is attempting to boost showroom traffic with aggressive pricing. Consumer attitudes toward new vehicle purchases also remained positive in July as reported in both the Conference Board survey and the Michigan Survey.

GM plays a somewhat less important role in the medium and heavy truck market, and sales and production of these vehicles have not been so severely disrupted by the recent strikes. In the second quarter, sales rose to the highest level in twenty-five years. While the pace of new orders has slowed a bit recently, the backlog of orders continues to rise, suggesting continued strength in the coming months.

Consumption and Personal Income

Real consumer spending posted another huge gain in the second quarter, and the limited data available for the beginning of the third quarter point to a further substantial advance other than for motor vehicles. Moreover, the fundamentals continue to be extremely favorable: Real disposable income has maintained its solid uptrend; household net worth has risen substantially this year; and consumer sentiment remains buoyant.

Nominal sales in the retail control category, which excludes spending at automotive dealers and building material and supply stores, increased 0.4 percent in July. Nominal outlays rose in all major categories, with the largest gains at furniture stores and apparel outlets. Even with the plunge in unit sales of light motor vehicles, the level of real consumer spending on goods in July is estimated to have been 0.1 percentage point above its second-quarter average, not at an annual rate.

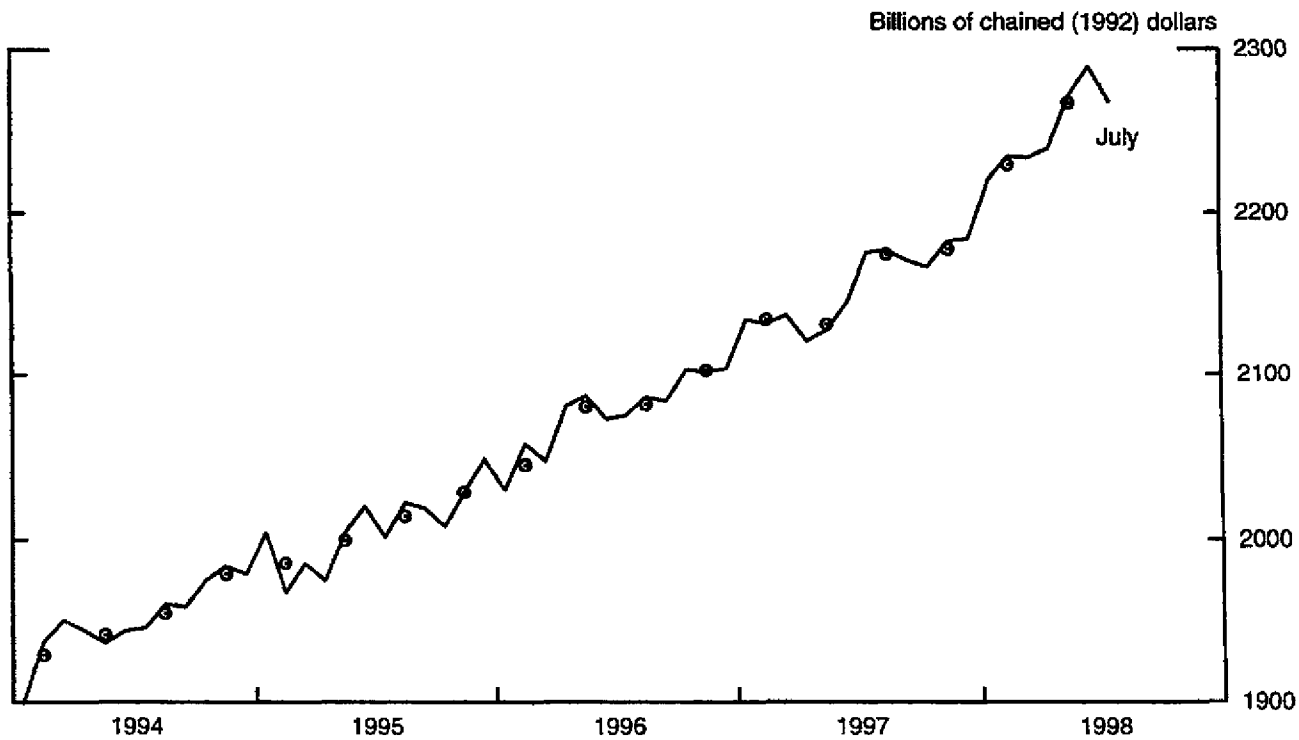
The most recent data on services show a 0.4 percent increase in real spending in June, putting growth for the second quarter as a whole at a 4.8 percent annual rate. The unseasonably warm weather in June led to a step-up in spending on energy services in that month. Expenditures in all major categories of non-energy services were up in June, with the largest gains in outlays for recreation, household operation, and transportation. The scraps of information available for July are mixed. Outlays for energy services will likely edge down because average temperatures were not so far above seasonal norms as in June, but expenditures on personal business services in July should be boosted by the jump in stock market volume.

RETAIL SALES
(Percent change from preceding period)

	1998		1998		
	Q1	Q2	May	June	July
Total sales	2.0	1.9	1.2	.1	-.4
Previous estimate		2.0	1.2	.1	
Building materials and supplies	5.8	2.3	.2	-1.6	1.1
Automotive dealers	2.3	3.8	2.5	.6	-3.0
Retail control[1]	1.6	1.3	.8	.1	.4
Previous estimate		1.3	.9	.1	
GAF[2]	3.6	1.1	.4	-.1	.5
Durable goods	3.8	.0	1.3	.7	.7
Furniture and appliances	4.7	-.7	1.2	.6	1.2
Other durable goods	3.0	.7	1.4	.8	.2
Nondurable goods	1.1	1.6	.7	-.1	.4
Apparel	4.1	1.0	-.6	-1.1	.7
Food	.2	1.6	.5	.0	.3
General merchandise	2.9	1.9	.5	.0	.2
Gasoline stations	-4.7	-.5	1.1	-.3	.4
Drug stores	2.4	2.2	.6	.3	.6
Eating and drinking	2.3	1.0	.8	.4	-.4
Other nondurable goods	.6	3.8	2.8	-.3	2.0

1. Total retail sales less sales at building material and supply stores and automotive dealers, except auto and home supply stores.
2. General merchandise, apparel, furniture, and appliance stores.

PCE Goods



Note. The May, June, July and Q2 numbers are staff estimates.

REAL PCE SERVICES
(Percent change from the preceding period)

	1997	1998 Q1	1998 Q2	1998 Apr.	1998 May	1998 June
	Q4/Q4	- Annual rate -		--- Monthly rate ---		
PCE Services	3.8	3.5	4.8	.5	.1	.4
Energy	1.1	-24.1	24.9	-.4	-.3	2.2
Non-energy	3.9	4.8	4.1	.5	.1	.3
Housing	2.4	2.7	2.4	.2	.2	.2
Household operation	8.7	6.5	5.0	.5	.4	.6
Transportation	5.1	3.7	8.5	1.8	-.1	.5
Medical	2.3	3.1	3.2	.8	.1	.1
Recreation	4.8	10.7	11.2	1.3	.8	1.2
Personal business	4.7	6.5	3.2	.7	-.8	.3
Other	6.8	8.2	4.5	-1.0	.7	.3

Note. Derived from billions of chained (1992) dollars.

PERSONAL INCOME
(Average monthly percent change)

	1997	1998 Q1	1998 Q2	1998 Apr.	1998 May	1998 June
	Q4/Q4	Annual rate		--- Monthly rate ---		
Total personal income	5.4	5.9	4.5	.3	.4	.2
Wages and salaries	7.2	7.4	5.5	.5	.6	.2
Private	7.9	7.9	5.9	.5	.7	.1
Other labor income	2.8	5.9	2.8	.2	.2	.1
Less: Personal tax and nontax payments	11.5	17.1	7.8	.4	1.1	.6
Equals: Disposable personal income	4.4	4.0	3.9	.3	.3	.2
Memo:						
Real disposable income[1]	2.9	4.0	2.9	.2	.1	.1
Saving rate (percent)	2.1	1.2	.6	1.1	.5	.2

1. Derived from billions of chained (1992) dollars.

Household income continues to trend up at a good clip. Real disposable personal income rose only a small amount in June, but the average for the second quarter was about 3 percent above its first-quarter level (annual rate). Most components of personal income posted solid gains in the second quarter. The labor market data for July point to moderate growth in wages and salaries in that month, despite a drag from the GM strike.

Growth in personal income has remained substantial this year, but it has been outpaced by the rapid expansion of consumption, leading to a further large decline in the personal saving rate. The personal saving rate stood at 0.6 percent in the second quarter of 1998--down from an annual average of 2.1 percent in 1997.[4] However, trends in the personal saving rate may be an imperfect guide to the net change in households' resources, as the NIPA concept of personal income contains only a portion of capital income. Changes in the treatment of capital income can greatly affect measured personal saving, a point that was underscored in the annual revision to the NIPA, in which a large part of the dramatic shaving of the personal saving rate is attributable to an accounting change in the treatment of capital gains distributions by mutual funds.

Economic theory suggests that, if households recognize that they ultimately own the business sector, then the retained earnings of corporations should be attributed to the household sector. A measure of household saving based on personal income augmented by retained earnings also has declined in recent quarters, but the drop is less pronounced than that in the NIPA personal saving rate. Moreover, this broader measure of saving was unaffected by the change in the treatment of mutual fund distributions mentioned above.

One factor boosting consumption in excess of income growth is the further substantial gain in household wealth.[5] A second, although obviously not entirely independent, factor has been households' very positive attitudes about personal financial situations and the economy more generally. Both the Michigan SRC index of consumer sentiment and the Conference Board index of consumer confidence

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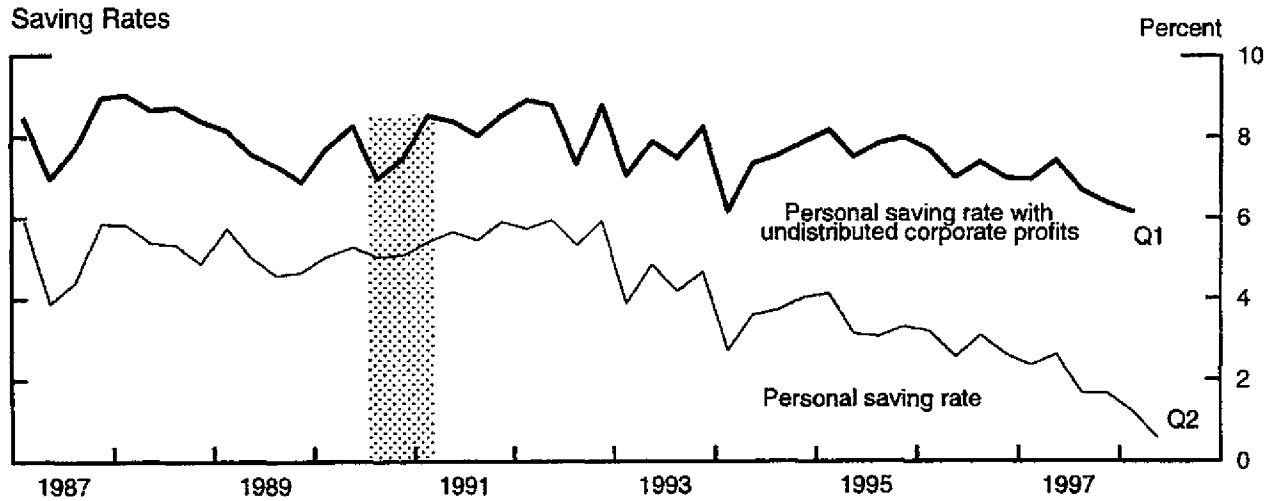
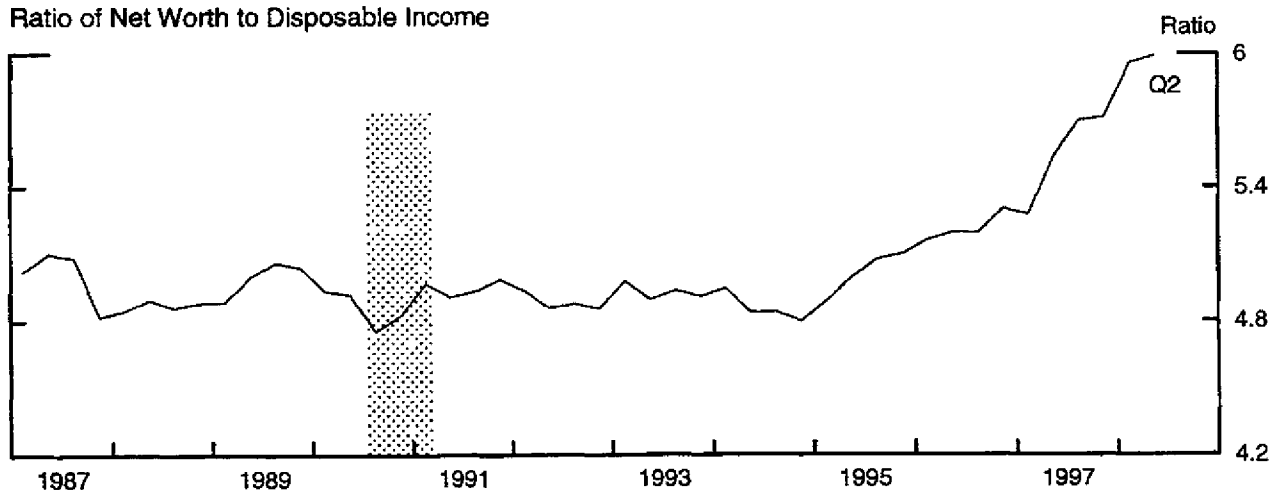
4. The large tax payments last April did not distort the quarterly patterns of disposable personal income and personal saving because BEA's standard practice is to spread such increases over the entire year. Indeed, when preliminary estimates of the national accounts for the first quarter of 1998 were released in late May, they showed substantially upward-revised figures for first-quarter tax payments.

5. Econometric models suggest that every additional dollar of stock market wealth leads to a permanent rise in the level of consumption of between 0 and 6 cents, with the adjustment occurring over several years. Our preferred estimate of the effect is roughly 3 cents; this did not change when we re-estimated the relationship using the revised NIPA data.

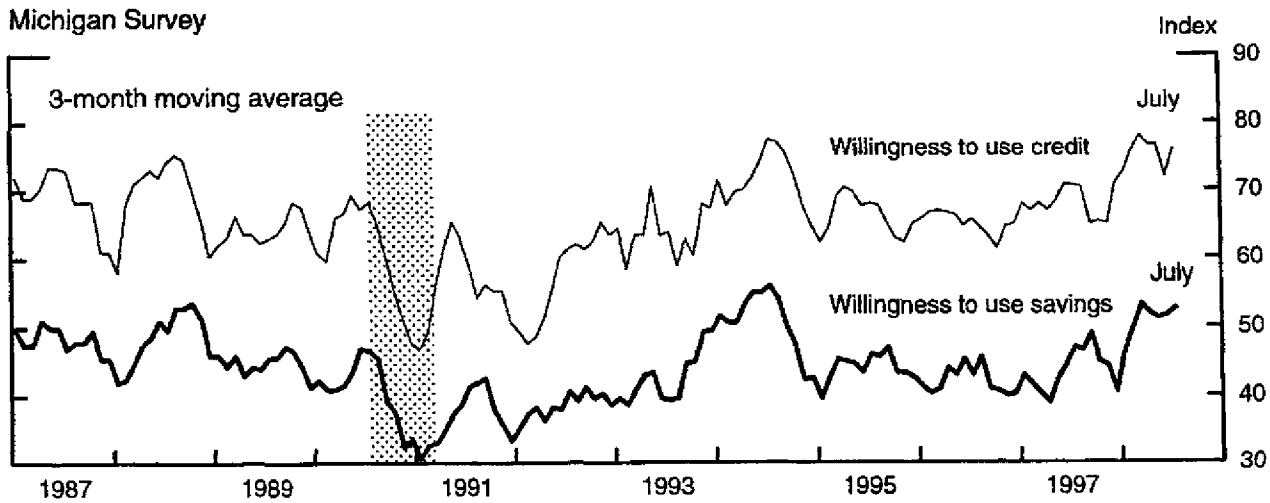
Household Saving and Related Factors



Note. The personal saving rate with undistributed corporate profits equals NIPA personal saving plus undistributed corporate profits, all divided by disposable personal income plus undistributed corporate profits; the personal saving rate equals NIPA personal saving divided by disposable personal income.



Note. *Q2 is a staff estimate.*



Note. Percentage willing to use savings or credit minus percentage not willing to use savings or credit plus 100.

remained in extremely favorable ranges in July; nearly all components of these two indexes have been hovering near record levels since last year. One notable finding comes from questions not included in the overall indexes: The Michigan subindexes of willingness to fund large purchases using savings and using credit appear to have trended up since last year.

Housing Markets

Activity in the single-family housing market remained strong in the second quarter. Low mortgage interest rates, expanding real income, and increased financial wealth continued to bolster the demand for single-family homes, and initial readings for July suggested that the robust pace was maintained through midsummer.

Starts of single-family homes rose to a 1.24 million unit annual rate during the second quarter, only a hair below the strong, first-quarter pace. New home sales set a series record in June, and the second-quarter average was the highest of any quarter in thirty-five years. Although existing home sales have edged down from their record pace in March, their average in the second quarter exceeded any previous quarter since the beginning of this series in 1968. Sales strengthened further in early July, according to a survey of builders, and applications for mortgages to finance home purchases remained at a very high level throughout last month. Reflecting the large volume of home purchases in recent years, the home ownership rate averaged a record 66 percent in the first half of 1998.

Strong sales also have kept the inventory of unsold new homes at a low level. The number of new homes on the market in June was about the same as in other recent months. However, with sales booming, the ratio of inventories to sales declined to 3.7 months, the lowest level on record.

Despite the low inventories and strong demand, the prices of new homes rose only moderately in the second quarter. The nominal constant-quality price of new homes increased 1.1 percent, year over year, a lower rate than in the preceding four quarters. These published data appear to be at odds with the strong demand and with anecdotal reports of rapidly rising land prices. Moreover, increases in prices for existing homes--as measured by the repeat-sales price index--have been running about

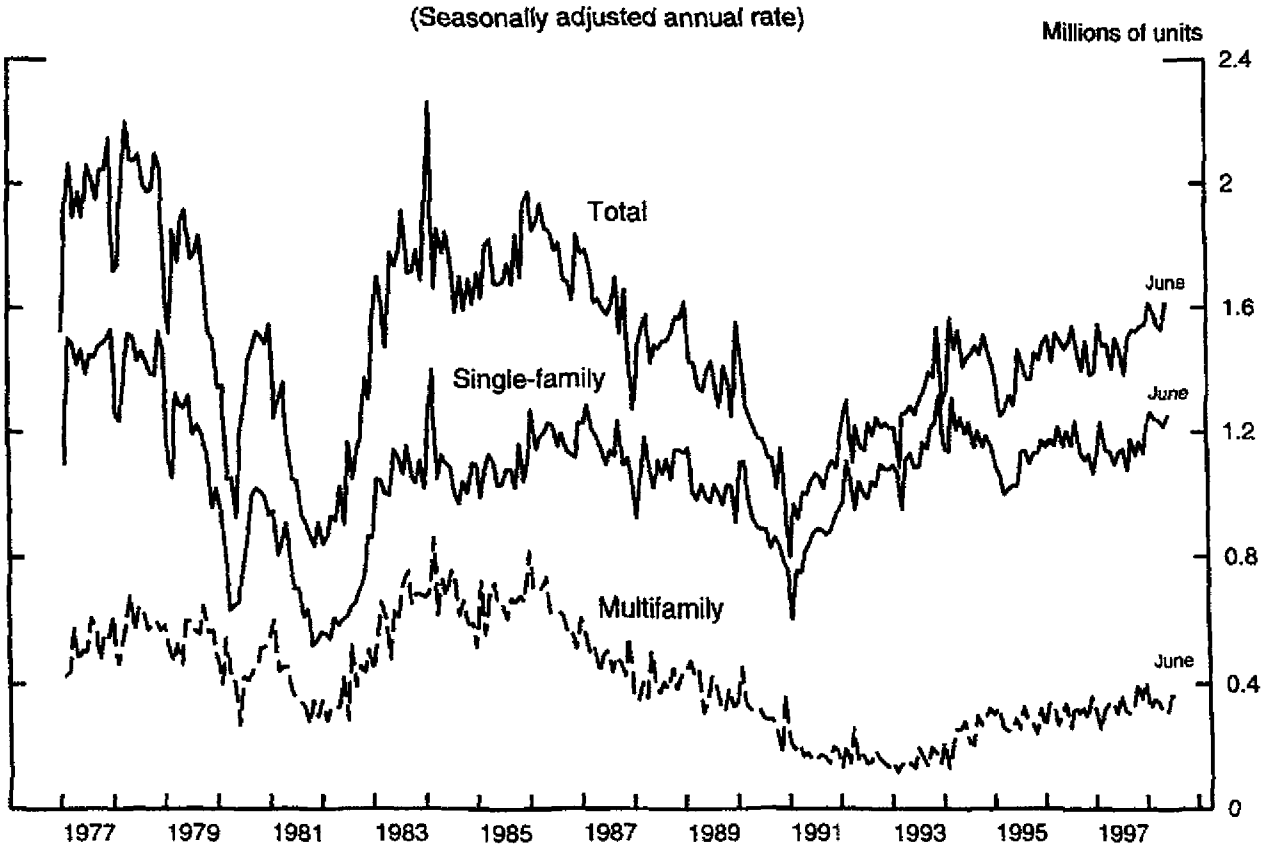
Private Housing Activity
(Millions of units; seasonally adjusted annual rate)

	1997	1997 Q4	1998 Q1	1998 Q2p	1998 Apr.r	1998 May r	1998 June.p
All units							
Starts	1.47	1.53	1.58	1.56	1.55	1.53	1.62
Permits	1.44	1.48	1.59	1.53	1.52	1.54	1.52
Single-family units							
Starts	1.13	1.14	1.24	1.24	1.24	1.22	1.25
Permits	1.06	1.10	1.15	1.14	1.15	1.15	1.13
Adjusted permits[1]	1.14	1.18	1.24	1.23	1.24	1.23	1.23
New home sales	.80	.83	.86	.91	.89	.90	.94
Existing home sales	4.22	4.38	4.68	4.77	4.77	4.83	4.72
Multifamily units							
Starts	.34	.39	.34	.33	.31	.31	.37
Permits	.39	.38	.44	.39	.37	.39	.39
Mobile homes							
Shipments	.35	.35	.37	n.a.	.37	.37	n.a.

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

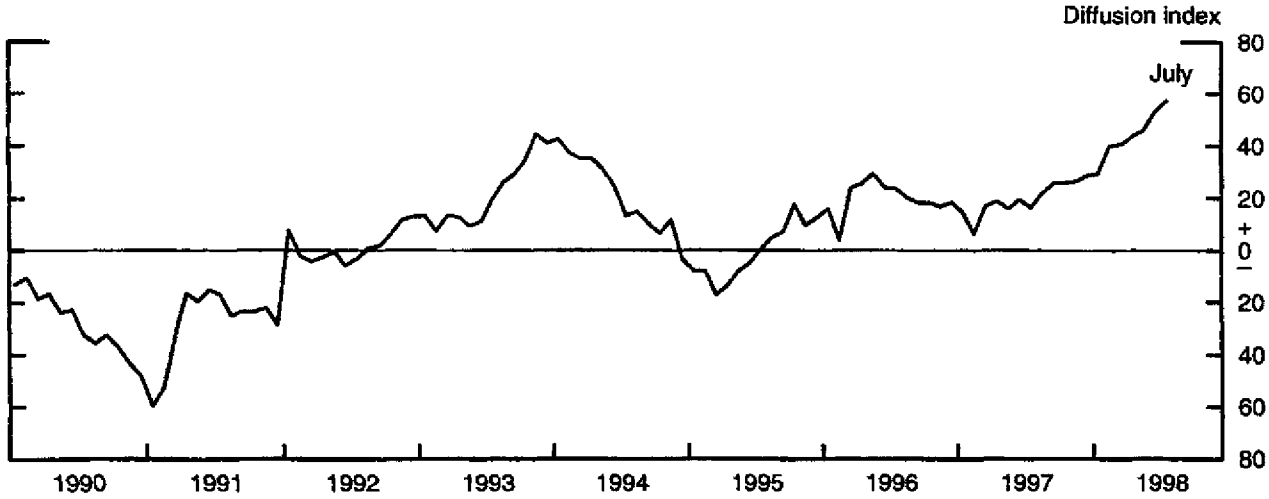
1. Adjusted permits equals permit issuance plus total starts outside of permit-issuing areas, minus a correction for those starts in permit-issuing places that lack a permit.

Private Housing Starts
(Seasonally adjusted annual rate)



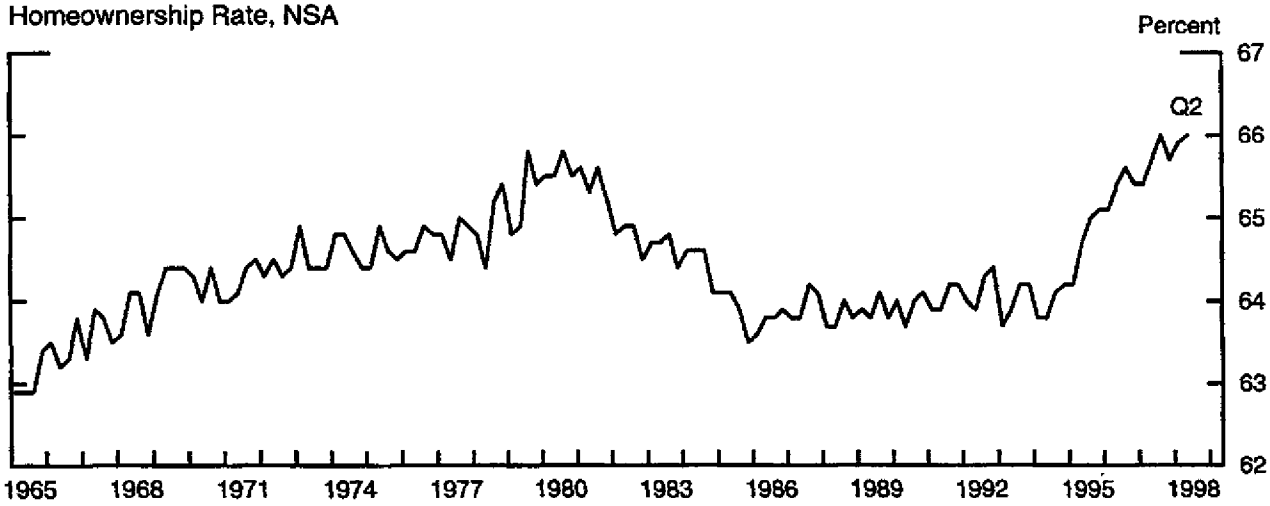
Single-Family Housing

Builders' Rating of New Home Sales, SA

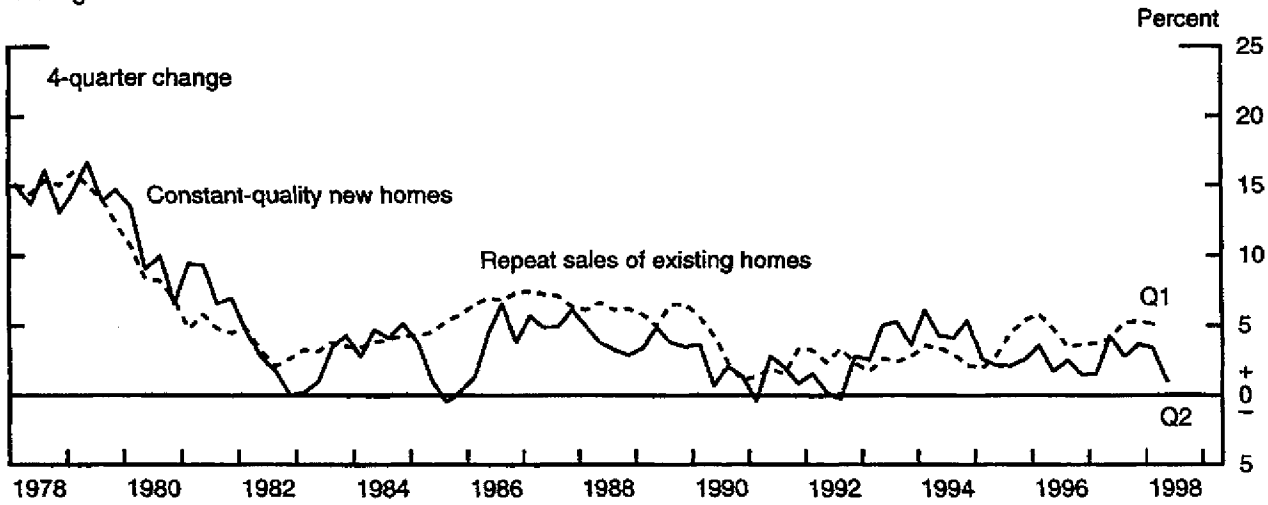


Note. The index is calculated from National Association of Homebuilders data as the proportion of respondents rating current sales as good minus the proportion rating them as poor.

Homeownership Rate, NSA



Change in Nominal House Prices



5 percent from a year earlier.[6] We would expect the new home price series to rebound shortly.

Multifamily housing starts declined 3-1/4 percent in the second quarter, and the vacancy rate for multifamily rental units, measured on a year-over-year basis, edged up for the first time in a year and a half. Nevertheless, residential rent in the CPI continued to rise in real terms through June, and there are no signs of any fundamental weakening of demand in this sector.

Business Fixed Investment

On our estimate, real business fixed investment increased at an annual rate of 14 percent in the second quarter after soaring at a 22-1/4 percent pace in the first quarter, when real outlays for producers' durable equipment posted their strongest quarterly increase since 1983.

Real business purchases of office and computing equipment in the second quarter rose at nearly a 60 percent annual rate. Rapid growth in real computer outlays seems likely to continue, but less dramatic price declines could begin to take some steam out of increases in demand. DRAM prices have flattened recently, and downstream in the PC market, inventories are down and there are signs that prices are falling less rapidly. Real outlays for communications equipment rose at a 19 percent annual rate in the second quarter. Orders for communications equipment have run above shipments so far this year, providing some momentum for expenditures in the current quarter. Furthermore, the huge demand for networks to transmit voice, data, and video likely will continue to lift spending in this sector for some time to come.

We now estimate that real business spending on aircraft was a bit higher in the second quarter than it was in the first, in contrast to the decline embedded in the advance GDP number.[7] Though the value of civilian aircraft shipments was lower last quarter, more of the demand came from domestic customers. Boeing is continuing to

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6. The various house price series differ in their content and construction. The constant-quality new home price index uses a regression model to determine the current value of a fixed set of new house characteristics, such as floor space and geographic location. Existing home prices reflect the gradual turnover of the large, geographically diverse stock of existing homes. The existing-homes repeat-sales price index is based on a comparison of prices for the same property at two or more different times. These repeat-sales prices include any change in value owing to home improvements, and the repeat-sales sample excludes homes priced above Fannie Mae and Freddie Mac securitization limits (currently $227,150).

7. The Census Bureau's Current Industrial Report on aircraft for June--released August 7--points to higher total aircraft shipments for the quarter than the BEA had assumed; for given aircraft exports, this implies higher spending by domestic carriers.

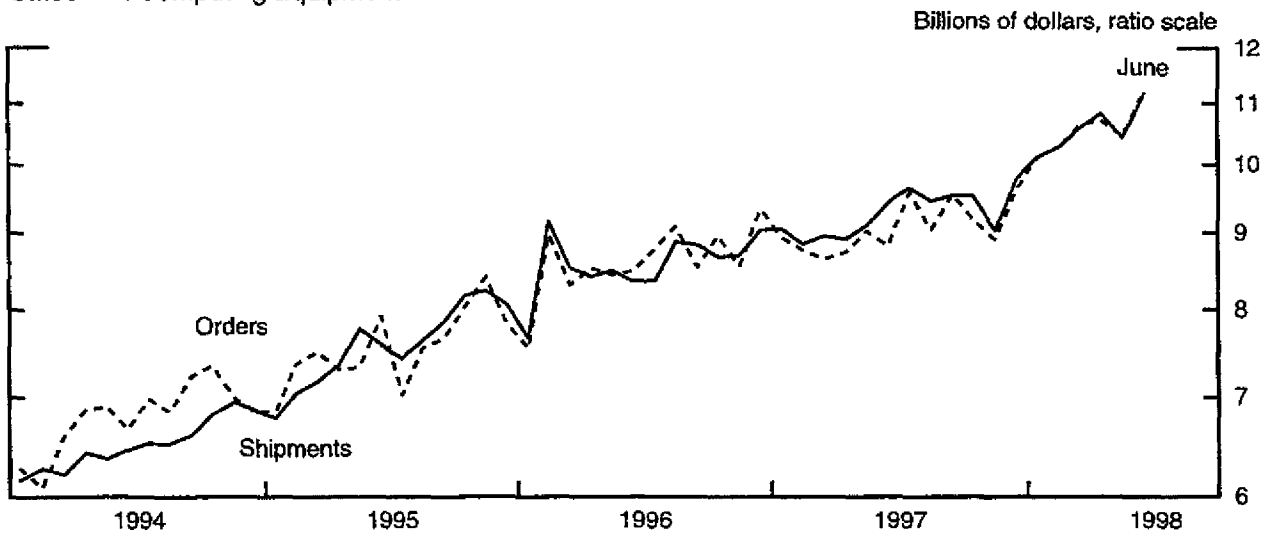
BUSINESS CAPITAL SPENDING INDICATORS
(Percent change from preceding comparable period; based on seasonally adjusted data, in current dollars)

	1998		1998		
	Q1	Q2	Apr.	May	June
Producers' durable equipment					
Shipments of nondefense capital goods	4.6	1.3	-2.0	.1	3.1
Excluding aircraft and parts	3.7	1.4	-2.0	-.1	4.2
Office and computing	9.5	4.4	2.2	-3.7	6.6
Communications equipment	4.4	.7	-5.1	4.3	4.6
All other categories	1.4	.4	-2.9	.4	3.2
Shipments of complete aircraft[1]	37.1	-12.6	11.1	24.6	-10.6
Sales of heavy trucks	2.9	5.0	4.4	1.1	-6.7
Orders of nondefense capital goods	-1.9	-.2	1.5	-.8	.0
Excluding aircraft and parts	4.2	-1.0	-3.5	1.2	2.7
Office and computing	12.1	4.2	.7	-2.5	7.0
Communications equipment	21.8	-5.1	-12.2	19.2	-6.5
All other categories	-2.5	-1.9	-2.7	-1.8	3.7
Nonresidential structures					
Construction put in place, buildings	.8	.5	2.4	-2.7	2.2
Office	2.5	5.9	5.8	.6	5.3
Other commercial	.5	1.3	.5	.1	2.0
Institutional	.8	-3.1	1.1	-4.5	-2.5
Industrial	3.0	-4.8	-.3	-8.5	.5
Lodging and miscellaneous	-4.2	2.5	7.0	-3.6	5.7
Rotary drilling rigs in use[2]	8.1	-11.9	-6.8	-4.6	-3.2
Memo (1992 Chained dollars):					
Business fixed investment	22.2	11.4	n.a.	n.a.	n.a.
Producers' durable equipment	34.3	17.8	n.a.	n.a.	n.a.
Office and computing	101.5	58.4	n.a.	n.a.	n.a.
Communications equipment	35.9	13.7	n.a.	n.a.	n.a.
Other equipment[3]	13.2	8.7	n.a.	n.a.	n.a.
Nonresidential structures	-4.9	-4.5	n.a.	n.a.	n.a.

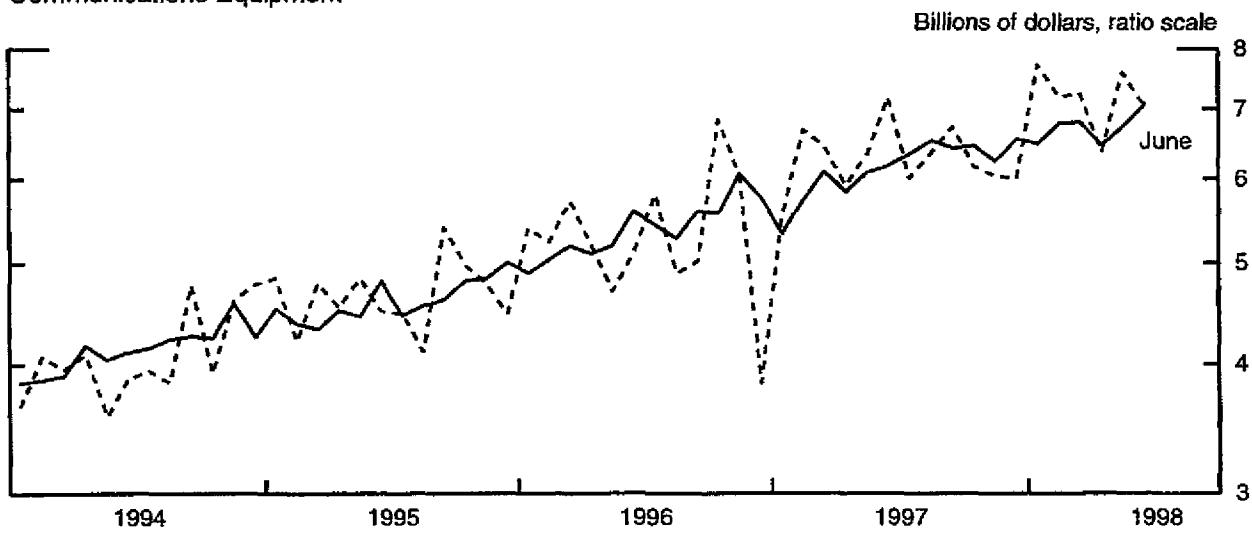
1. From the Current Industrial Report "Civil Aircraft and Aircraft Engines." Monthly data are seasonally adjusted using FRB seasonal factors constrained to BEA quarterly seasonal factors. Quarterly data are seasonally adjusted using BEA seasonal factors.
2. Percent change of number of rigs in use, seasonally adjusted.
3. Producers' durable equipment excluding office and computing, communications, motor vehicles, and aircraft and parts.
n.a. Not available.

Orders and Shipments of Nondefense Capital Goods

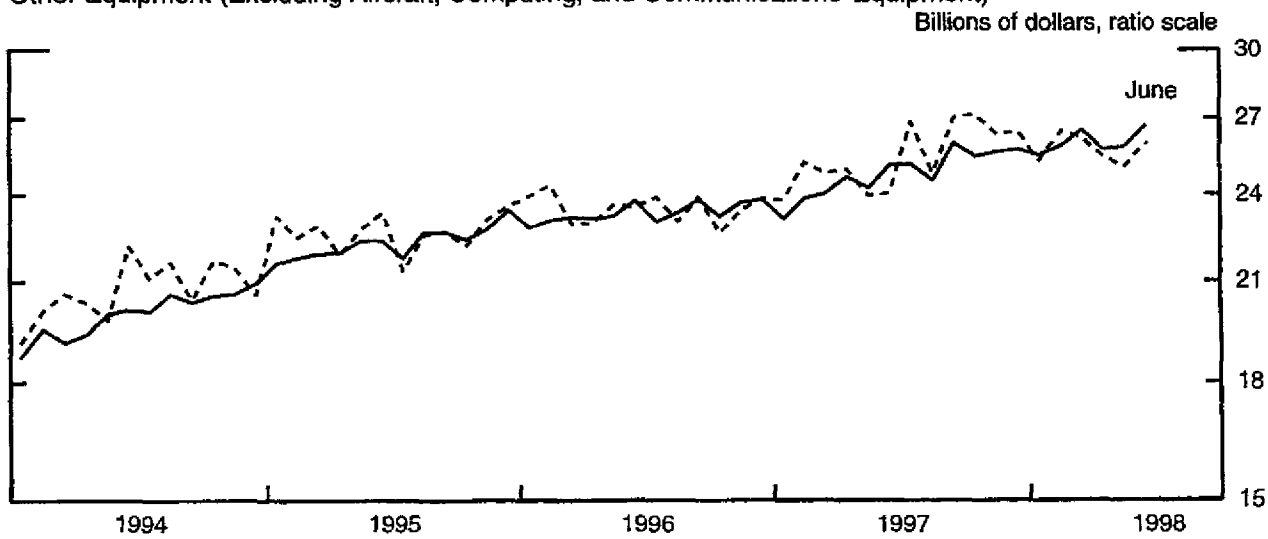
Office and Computing Equipment



Communications Equipment



Other Equipment (Excluding Aircraft, Computing, and Communications Equipment)



ramp up production, and company sources currently expect to meet their ambitious third-quarter delivery schedules. Nonetheless, deliveries of completed aircraft in July were below planned shipments.

Outside of information technology and transportation equipment, real expenditures on capital goods rose at a 10-1/4 percent annual rate in the second quarter. This strength was manifest despite fairly weak growth in shipments of these items by U.S. producers, a combination that reflects sluggish demand from abroad and elevated purchases by domestic customers of favorably priced imported equipment. This pattern is likely to continue.

In contrast to the strength in equipment spending, expenditures on nonresidential structures have been weak this year. The annual revision to the data on construction put in place included a significant drop in the estimate of first-quarter spending, and BEA's advance GDP figures showed a similar-sized decline in outlays during the second quarter. All told, real outlays over the first half of this year fell nearly 4-3/4 percent at an annual rate.[8] Available indicators paint a mixed picture for future growth in building activity. Smoothing through their large monthly swings, contracts for construction declined over the first half of the year, particularly for office buildings and lodging establishments. However, vacancy rates for office buildings continue to fall and commercial real estate prices have moved up, developments that suggest some support for activity in these sectors.

Business Inventories

Accumulation of inventories slowed sharply in the second quarter. In the advance NIPA estimates, real inventories increased nearly $45 billion at an annual rate in the second quarter, down from the $91 billion pace in the first quarter.[9] New data for June and revisions to the figures for April and May contained in the manufacturing and wholesale book-value inventory reports released last week suggest perhaps a $5 billion downward revision to that second-quarter figure. In either case, a decline in motor vehicle inventories, due in part to the GM strike, is responsible for roughly half of the swing between the first and second quarters.

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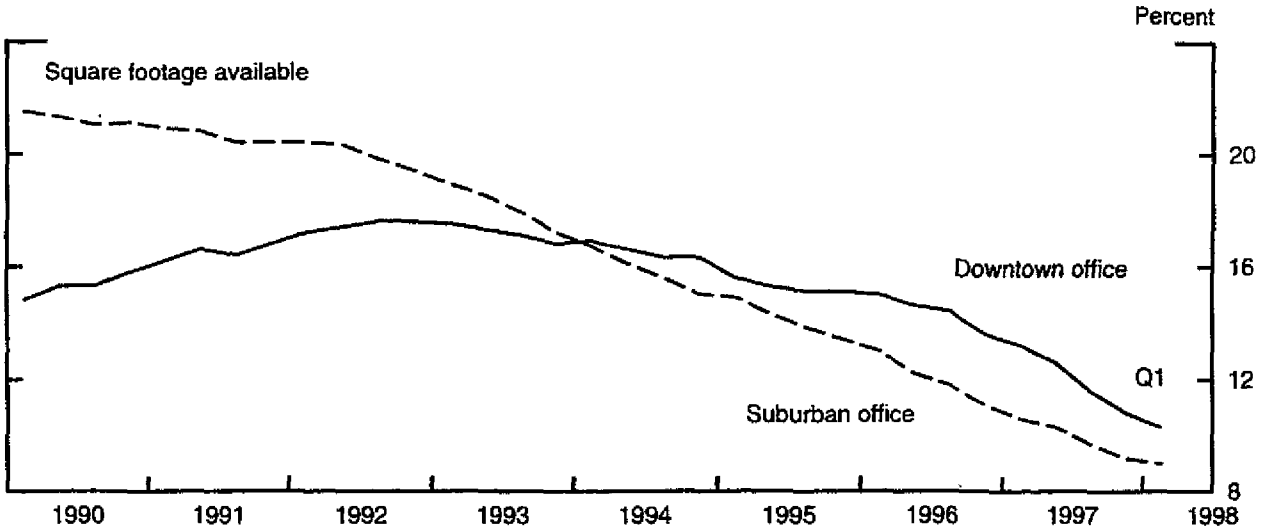
8. Construction put in place in June, which was not available for BEA's advance estimate, was only marginally above BEA's assumption.

9. This $91 billion figure for the first quarter is $15 billion lower than the estimate that was published before the NIPA annual revisions. Downward adjustments to petroleum products held by refiners ($6.6 billion) and farm inventories ($3.7 billion) accounted for most of the difference.

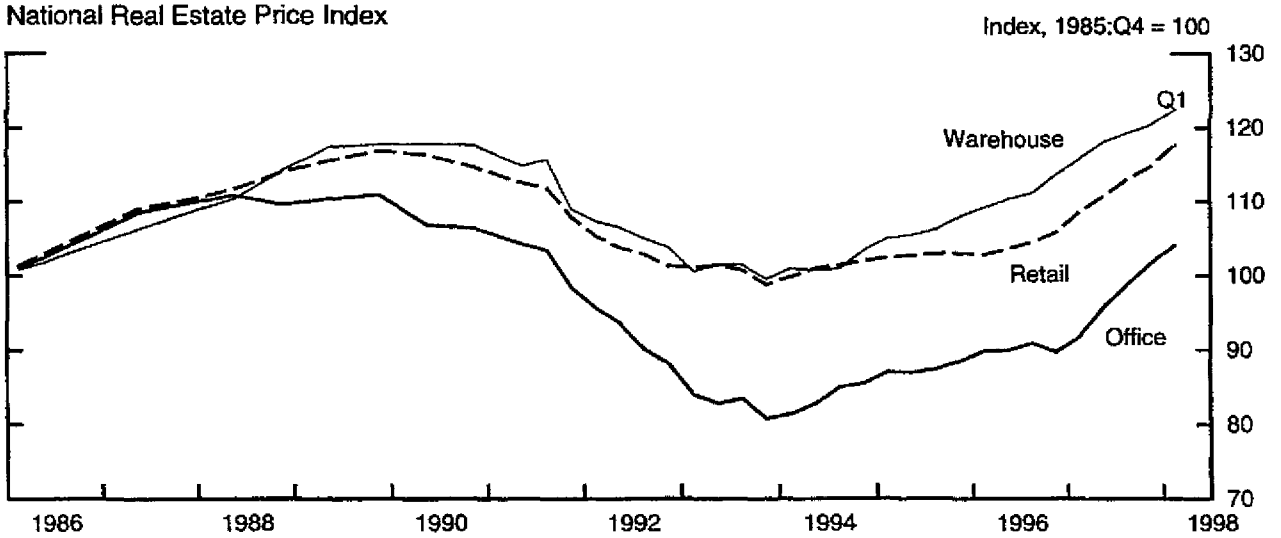
Nonresidential Construction Indicators

Vacancy Rates



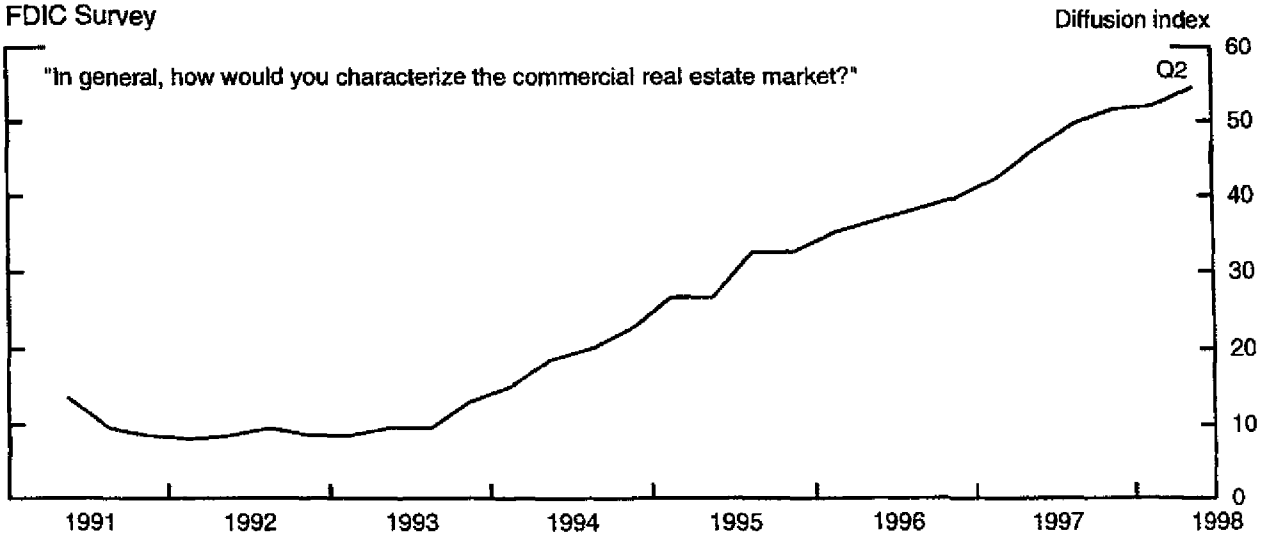
Source. CB Commercial Real Estate.

National Real Estate Price Index



Note. Data are semiannual from 1986 to 1991 and quarterly from 1992 forward.

FDIC Survey



Note. Calculated as [(Percent reporting tight supply - Percent reporting excess supply)/2] + 50.

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

	1997	1998		1998		
	Q4	Q1	Q2	Apr.	May	June
Book value basis						
Total	39.8	62.7	n.a.	21.6	-5.1	n.a.
Excluding wholesale and retail motor vehicles	40.2	55.3	n.a.	36.6	23.3	n.a.
Manufacturing	15.6	23.3	18.6	32.6	12.7	10.4
Excluding aircraft	15.0	19.2	6.5	11.9	6.9	.8
Wholesale	18.1	17.3	1.2	-20.3	21.2	2.8
Excluding motor vehicles	19.5	11.5	11.3	-2.5	28.9	7.6
Retail	6.0	22.1	n.a.	9.3	-39.1	n.a.
Auto dealers	.9	1.6	n.a.	2.8	-20.7	n.a.
Excluding auto dealers	5.1	20.5	n.a.	6.5	-18.4	n.a.

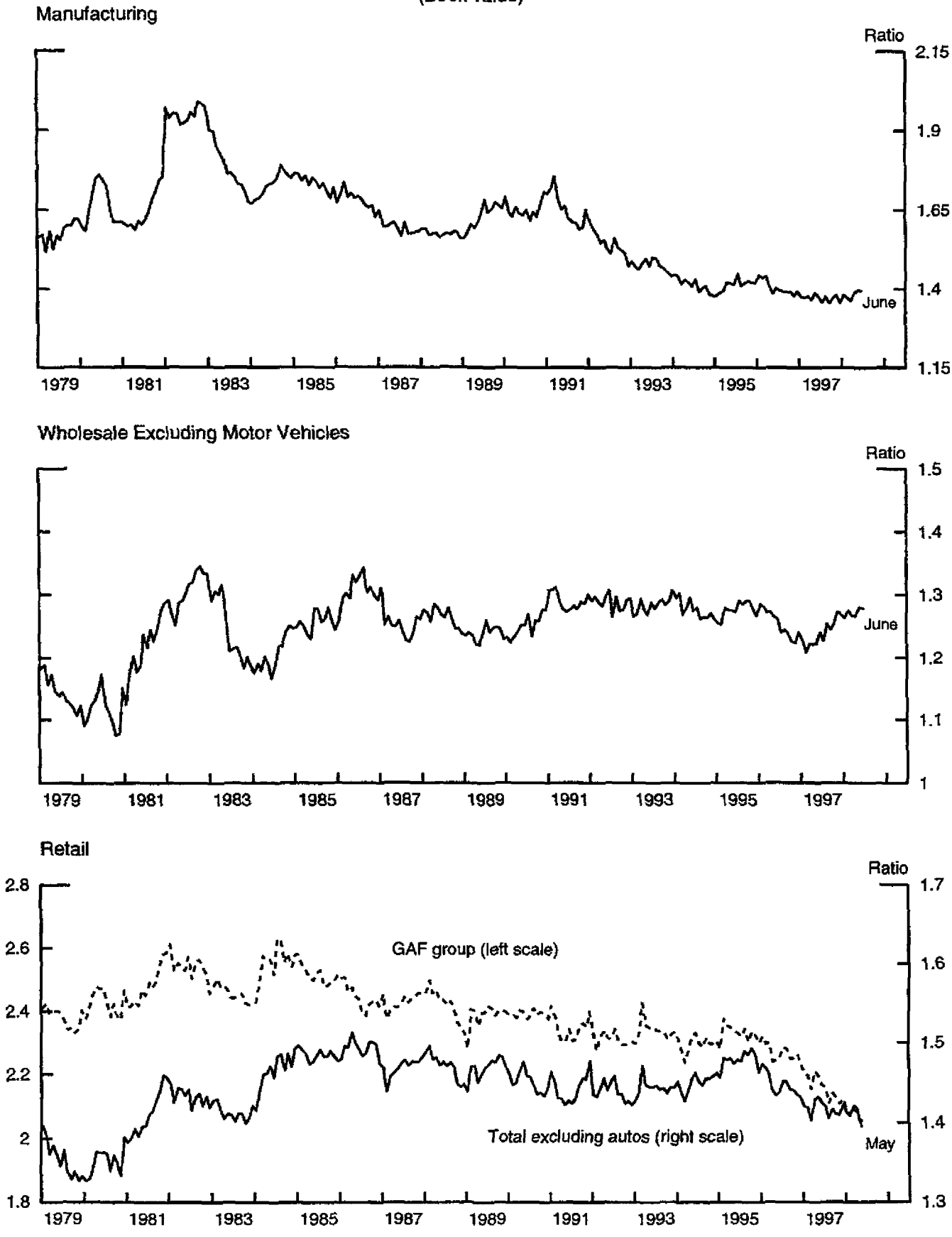
SELECTED INVENTORY-SALES RATIOS
(Months' supply, based on Census book-value data, seasonally adjusted)

	Cyclical reference points		Range over preceding 12 months		June
	1990-91 high	1995-96 low	High	Low	1998
Manufacturing and trade	1.58	1.38	1.39	1.37	1.39
Less wholesale and retail motor vehicles	1.55	1.35	1.36	1.34	1.36
Manufacturing	1.75	1.38	1.40	1.36	1.39
Primary metals	2.08	1.49	1.61	1.53	1.63
Nonelectrical machinery	2.48	1.77	1.75	1.66	1.62
Electrical machinery	2.08	1.41	1.39	1.30	1.33
Transportation equipment	2.93	1.51	1.69	1.57	1.82
Motor vehicles	.97	.56	.59	.54	.63
Aircraft	5.84	4.44	5.12	4.34	4.88
Nondefense capital goods	3.09	2.27	2.33	2.12	2.15
Textiles	1.71	1.42	1.52	1.40	1.55
Chemicals	1.44	1.25	1.41	1.30	1.40
Petroleum	.94	.80	.89	.83	.87
Home goods & apparel	1.96	1.63	1.69	1.59	1.64
Merchant wholesalers	1.36	1.26	1.30	1.26	1.30
Less motor vehicles	1.31	1.22	1.28	1.23	1.28
Durable goods	1.83	1.55	1.62	1.55	1.59
Nondurable goods	.95	.91	.96	.91	.96
Retail trade	1.61	1.50	1.50	1.47	1.45
Less automotive dealers	1.48	1.43	1.42	1.41	1.40
Automotive dealers	2.22	1.69	1.77	1.68	1.61
General merchandise	2.42	2.20	2.14	2.03	2.00
Apparel	2.53	2.27	2.45	2.32	2.38
GAF	2.42	2.23	2.17	2.07	2.06

Note. June 1998 ratios for manufacturing and wholesale; May 1998 ratios for retail trade.

Inventory-Sales Ratios, by Major Sector

(Book value)



In book-value terms, manufacturing inventory investment rose $10.4 billion at an annual rate in June and at an $18.6 billion annual rate in the second quarter. About two-thirds of the second-quarter increase resulted from increasing stocks of aircraft and parts, a development related to production problems at Boeing and their customers' difficulties in finding financing. Excluding this category, a more pronounced slowdown in inventory accumulation was apparent, with stocks increasing at a $6.5 billion rate in the second quarter, down from $19.2 billion in the first quarter. About half of the stepdown was accounted for by electrical machinery. The inventory-shipments ratio for manufacturing ticked up in the second quarter but remained toward the high end of the range of the past year and a half.

The book value of wholesale trade inventories excluding motor vehicles increased at a $7.6 billion annual rate in June. For the second quarter as a whole, stocks rose at an $11.3 billion pace, about the same rate as during the first quarter. The second-quarter buildup was largely concentrated in durable goods, particularly machinery and electrical goods. On balance, stocks held by non-auto wholesalers moved in line with sales last quarter, and the inventory-sales ratio for this category held steady.

In the retail sector, real stocks of motor vehicles--which are based on actual readings through June of cars and trucks on dealers' lots--are estimated to have dropped $14 billion at an annual rate in the second quarter, reflecting the combined effects of an incentive-related surge in sales and strike-reduced production. Excluding motor vehicles, book-value stocks fell at a $6 billion annual rate, on average, in April and May, after rising at a $20.5 billion rate in the first quarter. In the advance NIPA estimates, BEA penciled in an accumulation of roughly $5 billion for the yet-to-be released book-value data for June.

Federal Government

The incoming news on the federal budget has continued to be favorable. The unified budget recorded a $56 billion budget surplus over the twelve months ending in June, reflecting robust growth of receipts and modest increases in spending. Receipts in June were 8-1/2 percent above those of a year earlier as payments on personal income and social insurance taxes rose 11-1/2 percent over the period, more than twice as fast as personal income. June corporate income tax receipts, which include estimated payments for the second quarter, were only 1 percent higher than a year earlier, a pace consistent with the sluggish growth in corporate profits. June outlays, adjusted for payment timing shifts and excluding deposit insurance outlays and spectrum auction

FEDERAL GOVERNMENT OUTLAYS AND RECEIPTS
(Unified basis; billions of dollars)

	June			12 months ending in Jun.		
	1997	1998	Percent change	1997	1998	Percent change
Outlays	118.7	136.8	15.2	1597.6	1640.3	2.7
Deposit insurance	-0.3	-0.3	n.a.	-14.1	-4.5	n.a.
Spectrum auction	-5.2	0.0	n.a.	-10.4	-1.5	n.a.
Other	124.3	137.0	10.3	1622.1	1646.3	1.5
Receipts	173.4	187.9	8.4	1553.1	1696.4	9.2
Deficit (+)	-54.6	-51.1	n.a.	44.5	-56.2	n.a.
	Adjusted for payment timing shifts[1] and excluding deposit insurance and spectrum auction					
Outlays	131.9	137.0	3.9	1622.1	1646.3	1.5
National defense	22.9	22.3	-2.4	272.1	270.2	-0.7
Net interest	19.5	19.4	-0.7	245.2	245.0	-0.1
Social security	34.1	35.4	4.0	361.3	375.8	4.0
Medicare	15.4	16.1	5.1	186.9	193.6	3.5
Medicaid	8.0	9.0	11.6	95.0	100.0	5.3
Other health	2.6	2.6	2.9	28.5	28.6	0.6
Income security	13.4	14.6	8.3	231.7	231.5	-0.1
Other	16.0	17.6	9.6	201.4	201.5	0.1
Receipts	173.4	187.9	8.4	1553.1	1696.4	9.2
Individual income and payroll taxes	121.9	135.9	11.5	1216.0	1338.2	10.1
Withheld + FICA	87.8	97.7	11.2	1036.7	1127.5	8.8
Nonwithheld + SECA	35.9	40.3	12.3	271.8	309.6	13.9
Refunds (-)	1.8	2.1	12.9	92.5	98.9	6.8
Corporate	39.4	39.8	1.0	182.1	189.7	4.1
Other	12.1	12.1	0.4	154.9	168.5	8.8
Deficit (+)	-41.5	-50.8	n.a.	69.0	-50.2	n.a.

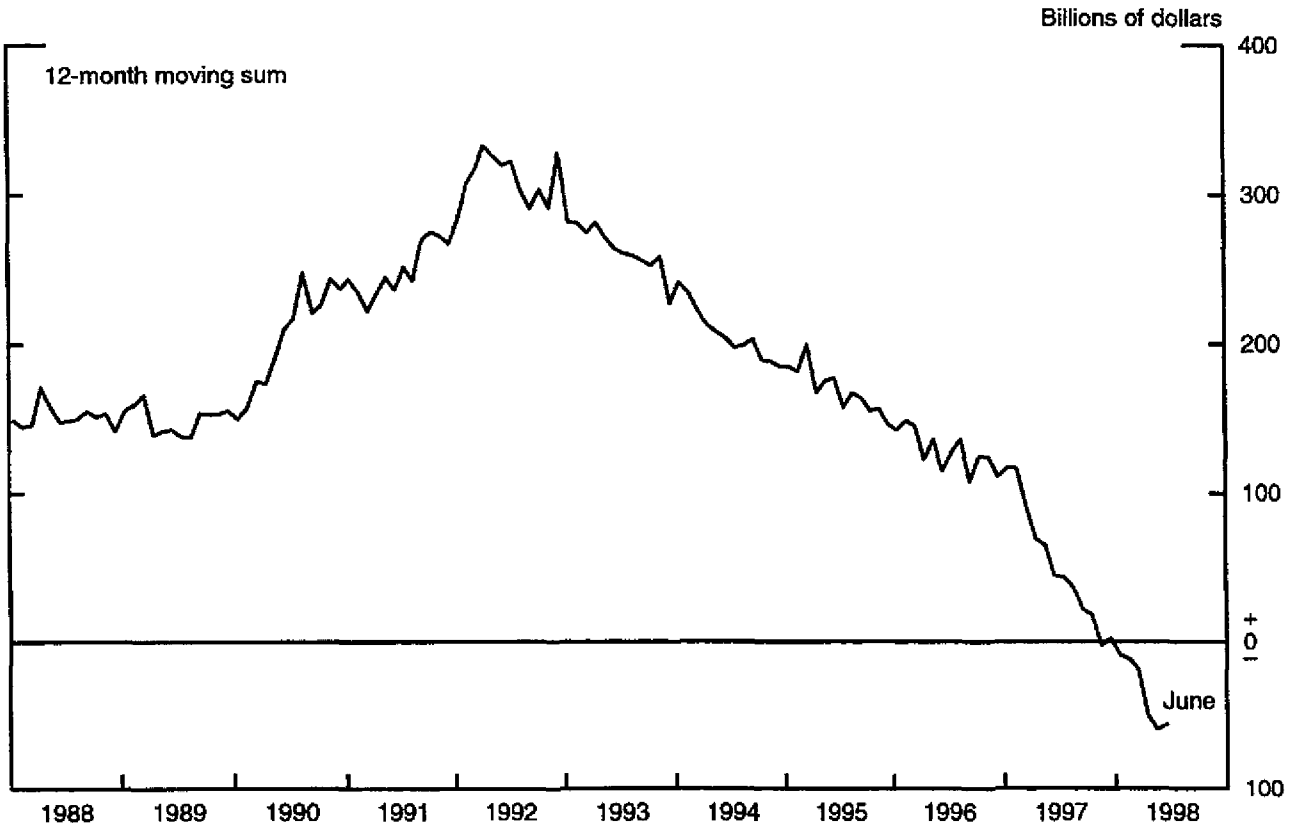
Note. Components may not sum to totals because of rounding.

1. A shift in payment timing occurs when the first of the month falls on a weekend or holiday. Outlays for defense, Medicare, income security, and "other" have been adjusted to account for this shift.

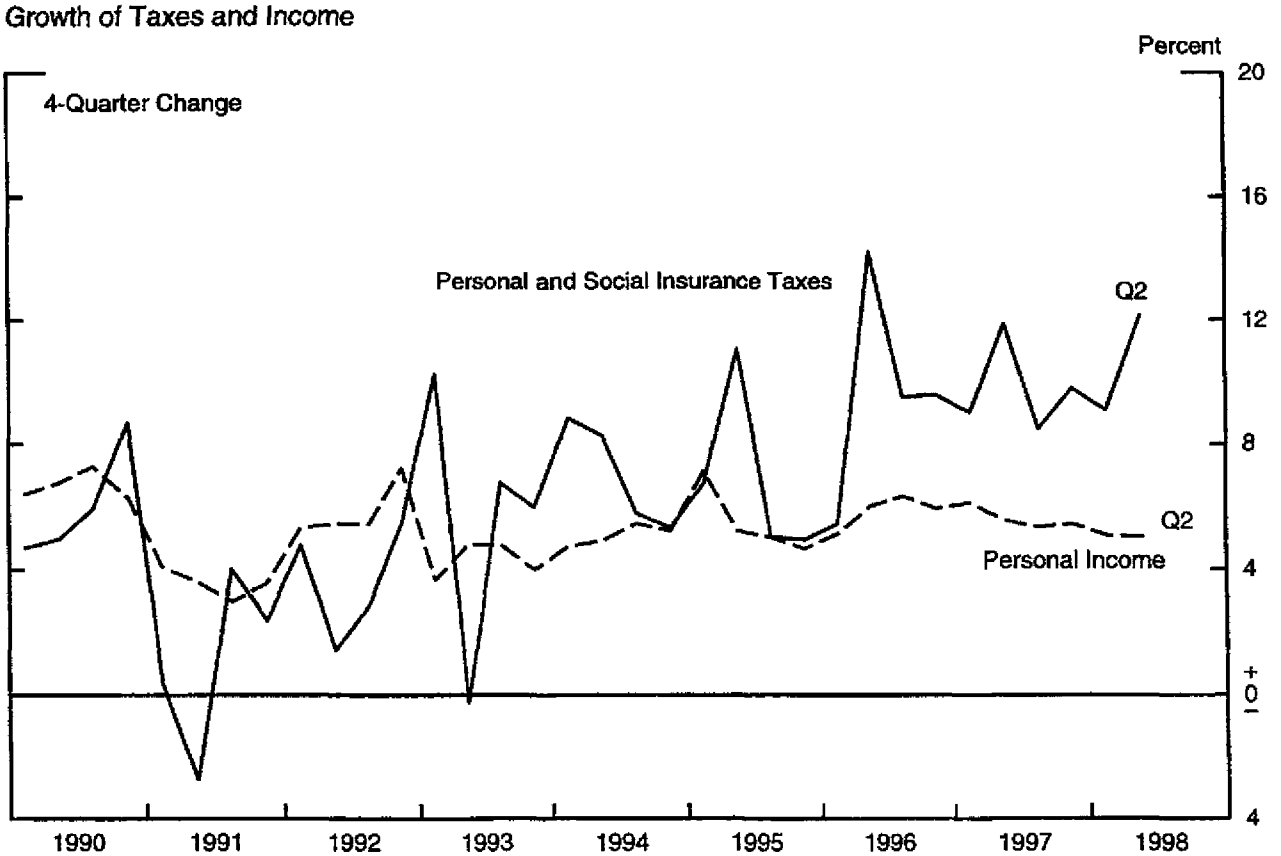
n.a.--Not applicable

Federal Sector Developments

Unified Deficit



Growth of Taxes and Income



proceeds, were nearly 4 percent above a year earlier, reflecting a surge in spending on Medicaid and a variety of smaller programs--all inherently volatile series.

Taking a longer perspective, adjusted outlays in the twelve months ending in June were only 1-1/2 percent higher than during the twelve months ending in June 1997. In the NIPA, real federal consumption and investment rose 7 percent at an annual rate in the second quarter after having declined 9 percent in the first quarter. The swing largely reflected changes in defense spending.

According to its preliminary update of the *Economic and Budget Outlook* released in mid-July, the Congressional Budget Office projects a federal unified budget surplus of $63 billion in fiscal 1998, at the top of the range it had estimated in early May.[10] Moreover, the CBO lifted its projection of the fiscal 1999 surplus under current policies to $80 billion. Looking further ahead, the CBO expects that the surplus will rise to 1-1/2 percent of GDP in 2002 and that the budget excluding social security will reach balance by that year.

The July CBO economic projections were updated to reflect incoming data and to incorporate revisions to long-run economic assumptions. Recent developments led the CBO to boost its projection for real GDP growth this year to 3.3 percent (annual-average basis) and cut its CPI inflation projection to 1.7 percent. The CBO made only minor adjustments to its projections for real GDP growth over the longer run, but it reduced its projections of CPI inflation and long-term real interest rates about 1/4 percentage point in each year. It also reduced its estimate of the NAIRU 0.2 percentage point, to 5.6 percent. All told, the changes in economic assumptions boost the surplus by $20 billion each year, on average.

A more important factor for the CBO's upward revision to the surplus forecast was a "technical" revision that lifted revenues between $45 billion and $58 billion above the levels projected in January. This revision largely reflected the incorporation of the 1998 receipts surprise and the CBO's assumption that the forces that lifted revenues this year will continue to boost them by similar dollar amounts in future years. Projected interest outlays were reduced because of lower borrowing needs and lower interest rates; the reduction in interest outlays in fiscal 2003, for example, was $28 billion. In addition, CBO cut its estimate of fiscal 1998 noninterest outlays by

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10. CBO made its last complete set of official budget forecasts in January. In that forecast, CBO projected that the budget surplus would rise to 3/4 percent of GDP in fiscal 2002. In May, the CBO updated its estimates for fiscal 1998 and 1999 but did not revisit its estimates for beyond 1999. The May forecast was based on the economic assumptions made in January, but it incorporated budget data received between January and May.

CBO BUDGET AND ECONOMIC PROJECTIONS[1]

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Budget projections (Billions of dollars; fiscal years)										
Outlays	1654	1721	1769	1817	1840	1918	1988	2073	2126	2211	2303
Receipts	1717	1801	1848	1903	1978	2053	2142	2243	2342	2446	2553
Surplus	63	80	79	86	139	136	154	170	217	236	251
On-budget[2]	-41	-37	-46	-45	1	-10	0	5	44	55	64
Memo:											
Surplus as a share of GDP	0.7	0.9	0.9	0.9	1.4	1.3	1.4	1.5	1.8	1.9	1.9
	Economic assumptions (Calendar years)										
	Percent change, year over year										
Nominal GDP	5.0	4.3	4.1	4.0	4.6	4.7	4.6	4.5	4.4	4.4	4.3
Real GDP	3.3	2.1	1.8	1.8	2.4	2.4	2.4	2.3	2.2	2.1	2.1
CPI-U	1.7	2.6	2.7	2.6	2.5	2.5	2.5	2.5	2.5	2.5	2.5
	Percent, annual average										
Unemployment rate	4.6	4.7	5.1	5.5	5.7	5.7	5.7	5.7	5.7	5.7	5.7
Yield on selected Treasuries											
Three-month	5.1	5.2	4.8	4.6	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Ten-year	5.8	6.1	5.8	5.6	5.4	5.4	5.4	5.4	5.4	5.4	5.4

1. The projections assume that revenues and mandatory outlays evolve according to laws in effect at the time the projections were made. Discretionary spending is assumed to equal the statutory caps in 1999 through 2002 and to grow at the rate of inflation in succeeding years.

2. The on-budget surplus excludes the OASDI surplus and the Postal Service deficit.

Source. Congressional Budget Office, The Economic and Budget Outlook For Fiscal Years 1999-2008: A Preliminary Update, July 15, 1998.

$16 billion, but beyond the current year, revisions to noninterest outlays were quite small.

State and Local Governments

According to BEA's advance estimate, real consumption plus investment spending by state and local governments rose at a 2 percent annual rate in the second quarter, just matching the increase in the previous quarter but a little below the 2.5 percent average of the previous three years. All of the increase in the second quarter was in consumption and equipment expenditures. Real outlays for construction dropped 4 percent at an annual rate last quarter, and the monthly data for June, which became available after the GDP release, point to a substantial downward revision to this figure. The state and local surplus of operating accounts appears to have fallen off somewhat in the second quarter from the record high range seen in recent quarters.[11] In July, state and local employment fell 10,000, with all of the decline in non-education local government workers.

According to the recent annual survey by the National League of Cities, the fiscal health of cities as a group continues to improve. The percentage of cities whose officials think that they are better able to meet their financial needs rose a bit further, to nearly 70 percent in 1998, the sixth consecutive rise; a low of 20 percent was recorded in 1992. In 1997 growth in city revenues exceeded growth in outlays, and the ending balances rose.[12] Like the more qualitative indicator noted above, this measure of city fiscal well-being has moved up steadily since its low in 1992. Cities ranked spending on public safety and infrastructure high among spending priorities in 1998. The most common revenue actions taken in the past year were increases in various fees and charges and reductions in property taxes.

Prices

Inflation has remained quiescent. In June, both the overall CPI and the CPI excluding food and energy ticked up just 0.1 percent. A slight rise in the index for food was largely offset by a decline in energy prices, while prices of goods excluding food and energy were unchanged, and nonenergy service prices were up only moderately.

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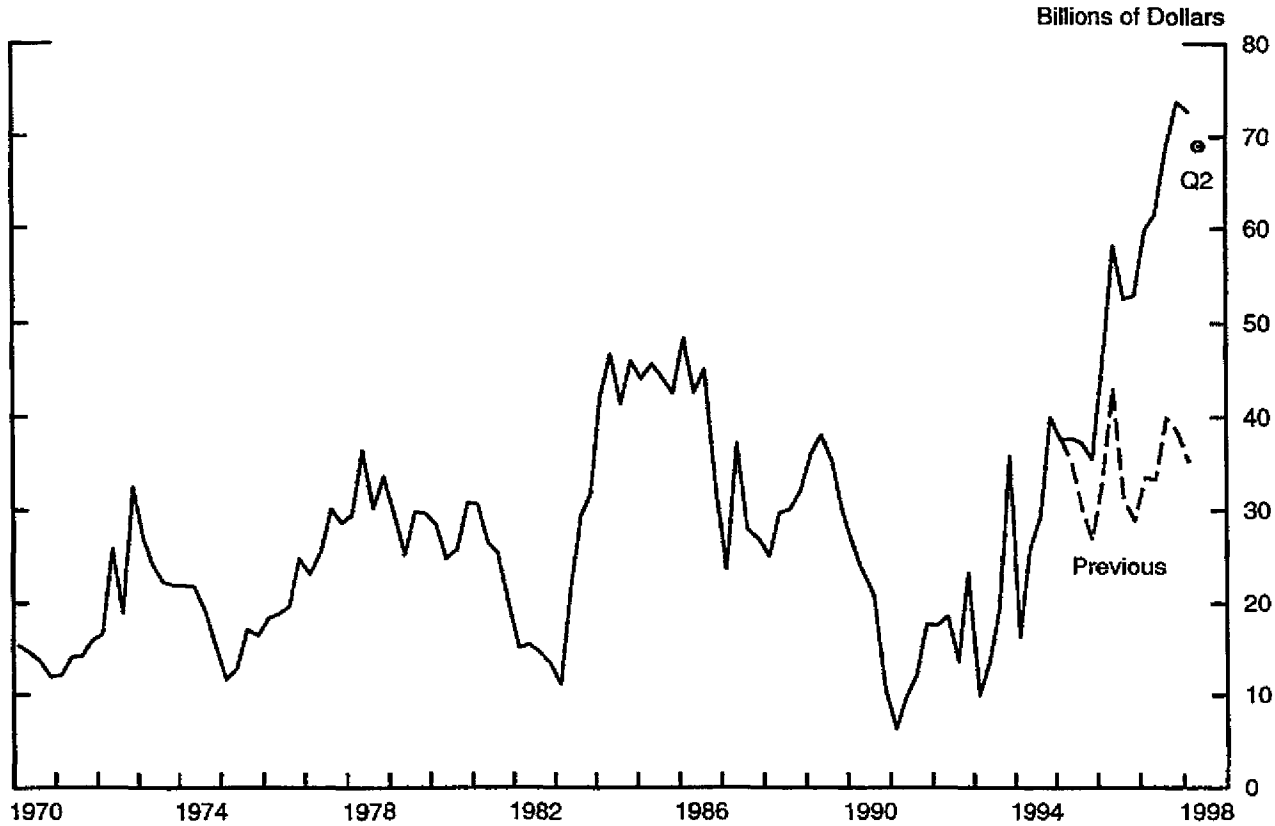
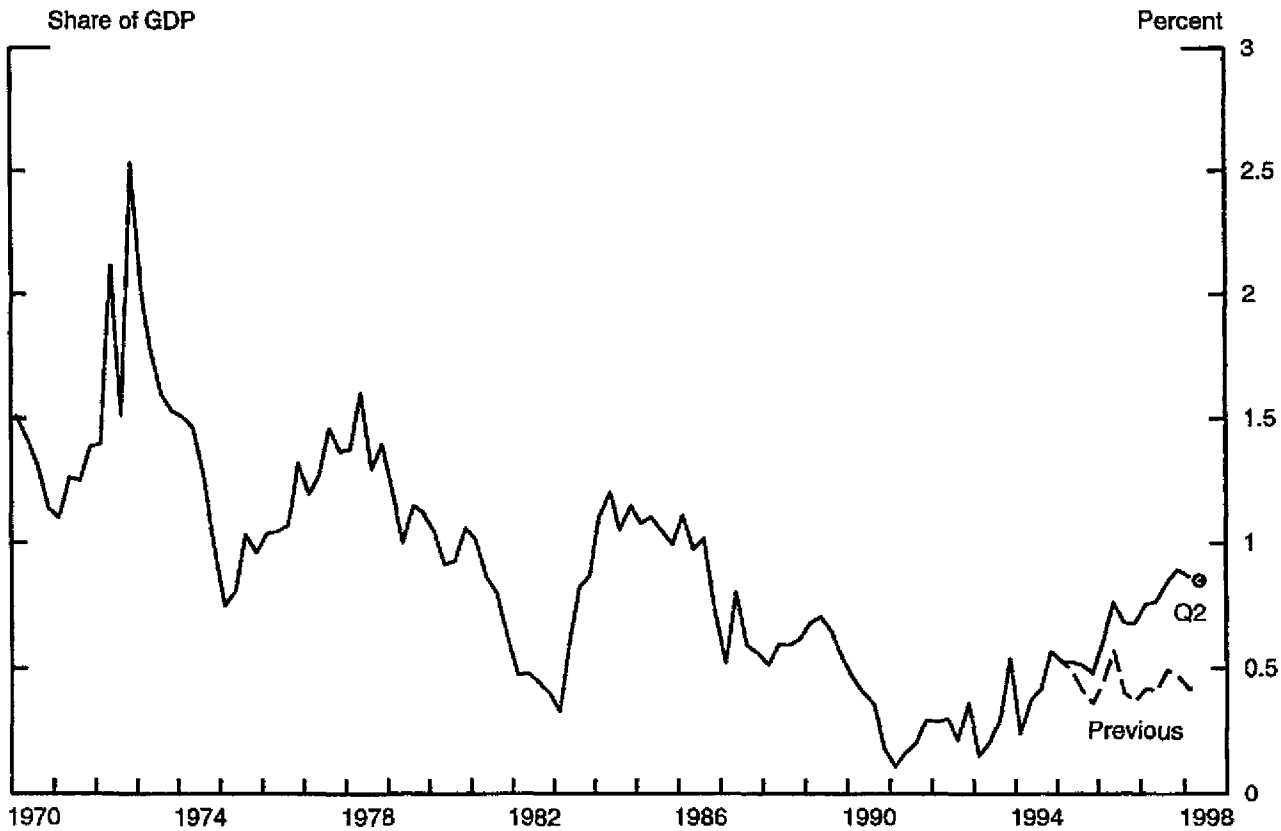
11. The surplus was raised substantially in the annual NIPA revisions largely because of upward revisions to sales and income taxes and to interest received. The surplus in the second quarter is a staff estimate, as BEA has not yet published corporate tax collections.

12. Actual revenue and expenditure data are only available through fiscal 1997. For cities, fiscal years vary and may coincide with the end of the federal fiscal year (September 30), the fiscal year of most states (June 30), or the calendar year.

State and Local Current Account Surplus

(NIPA basis)





Note. Excludes social insurance funds. Q2 is a staff estimate; corporate tax collections have not yet been published.

CPI AND PPI INFLATION RATES
(Percent change)

	From twelve months earlier		1998		1998	
	June 1997	June 1998	Q1	Q2	May	June
			-Annual rate-		-Monthly rate-	
CPI						
All items (100.0)[1]	2.3	1.7	.5	2.0	.3	.1
Food (15.3)	2.6	2.2	1.4	1.9	.6	.1
Energy (7.0)	-.7	-5.9	-19.9	-6.7	.3	-.7
CPI less food and energy (77.7)	2.4	2.2	2.4	2.7	.2	.1
Commodities (24.1)	.9	.4	.8	1.0	.1	.0
New vehicles (5.1)	.5	-1.1	-.3	-1.1	-.3	-.3
Used cars and trucks (1.9)	-3.4	-.6	.4	4.9	1.2	.6
Apparel (4.9)	1.2	.1	-1.5	.8	.4	.2
Tobacco (0.9)	3.6	10.6	9.6	16.5	1.7	-.6
Other Commodities (11.3)	1.0	.2	1.6	.3	.0	.0
Services (53.6)	3.1	3.1	3.1	3.4	.3	.2
Shelter (29.4)	3.1	3.4	3.1	3.8	.4	.2
Medical care (4.4)	2.9	3.3	3.1	4.1	.2	.4
Other Services (19.8)	3.3	2.7	3.2	2.8	.0	.1
PPI						
Finished goods (100.0)[2]	-.1	-.8	-3.7	.1	.2	-.1
Finished consumer foods (23.2)	.3	-.3	-1.8	.4	-.3	.1
Finished energy (13.6)	-1.3	-8.3	-21.8	-8.3	.8	-1.7
Finished goods less food and energy (63.2)	.1	.8	-.1	1.8	.2	.2
Consumer goods (38.0)	.3	1.7	.2	3.3	.5	.3
Capital equipment (25.2)	-.1	-.6	-.8	-.3	-.2	.0
Intermediate materials (100.0)[3]	-.3	-1.9	-4.3	-2.1	-.1	-.3
Intermediate materials less food and energy (81.8)	.1	-.4	-.8	-.7	-.1	-.1
Crude materials (100.0)[4]	-5.5	-8.0	-35.5	-4.6	-.3	-1.4
Crude food materials (42.1)	-13.7	-5.1	-14.0	-1.9	-1.4	.1
Crude energy (36.4)	2.1	-12.6	-61.6	-5.4	.6	-3.9
Crude materials less food and energy (21.5)	1.4	-6.7	-14.5	-8.0	.5	-.5

1. Relative importance weight for CPI, December 1997.
2. Relative importance weight for PPI, December 1997.
3. Relative importance weight for intermediate materials, December 1997.
4. Relative importance weight for crude materials, December 1997.

Consumer food prices increased 0.1 percent in June; prices of fruits and vegetables moved down after surging in May, and other food prices continued to post small increases. Over the twelve months ending in June, the CPI for food rose 2.2 percent, down from a 2.6 percent increase in the year-earlier period. The CPI for energy fell 0.7 percent in June and is down about 6 percent over the past year. Gasoline prices dropped in June for the eighth time in the last nine months; survey evidence suggests that gasoline prices at the pump edged up in July but fell back in early August.

Outside of food and energy, tobacco prices fell 0.6 percent, after large increases in the previous two months, but remained 10-1/2 percent above their level of a year earlier. Prices of new motor vehicles fell 0.3 percent for the second month in a row, likely reflecting the Big-Three coupon incentives. These coupons expired in early July. This week, GM was reported to be planning a new round of incentives that appear somewhat more aggressive than the usual end-of-model-year programs. By contrast, used vehicle prices rose briskly for the third consecutive month in June. Over the twelve months ending in June, core commodity prices have increased only 0.4 percent, down 1/2 percentage point from the year-earlier period.

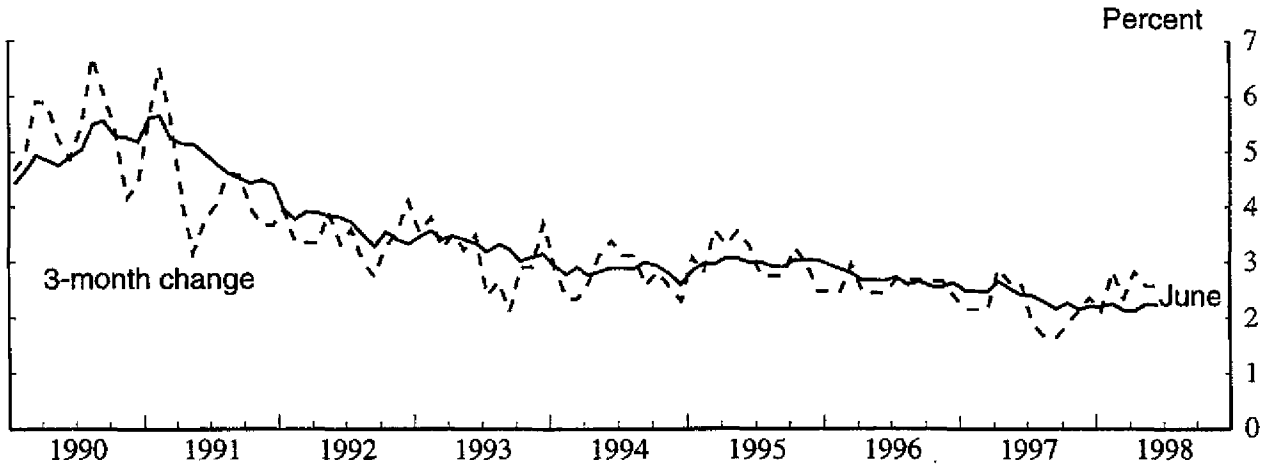
Part of the favorable performance of core commodity prices over the past year reflects the influence of imports--both the direct effect of lower prices for imported finished goods and the indirect effects of lower materials prices and of more intense competition for domestically produced goods. While imported goods cannot be identified in the CPI, we estimate that the share of core consumer goods that are imported is in the range of 15 percent to 20 percent. Such shares suggest that the direct effect of falling import prices over the past year has reduced core commodity price inflation by roughly 1/4 percentage point. In addition, the competition from imports has contributed to the deceleration in prices of some domestically produced goods, such as motor vehicles, household appliances, and toys.

Prices of non-energy services rose 0.2 percent in June and have risen 3.1 percent over the twelve months to June, the same pace recorded in the year-earlier period. Owners' equivalent rent increased 0.2 percent in June, after rising at a relatively elevated pace in recent months. Among services excluding energy and shelter, air fares fell for the third consecutive month, while the prices of medical services accelerated further. Prices for medical care services have risen 3.3 percent over the past year, after increasing only 2.9 percent during 1997. The acceleration has been more evident over the past six months, when medical care services rose at a 3-3/4 percent annual rate.

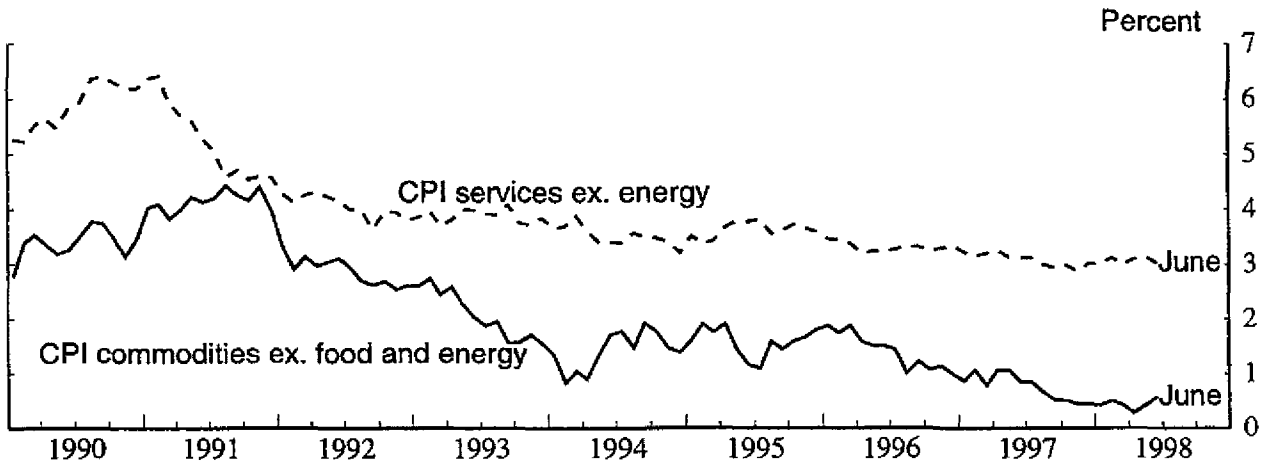
Measures of Core Consumer Price Inflation

(Twelve-month change except as noted)

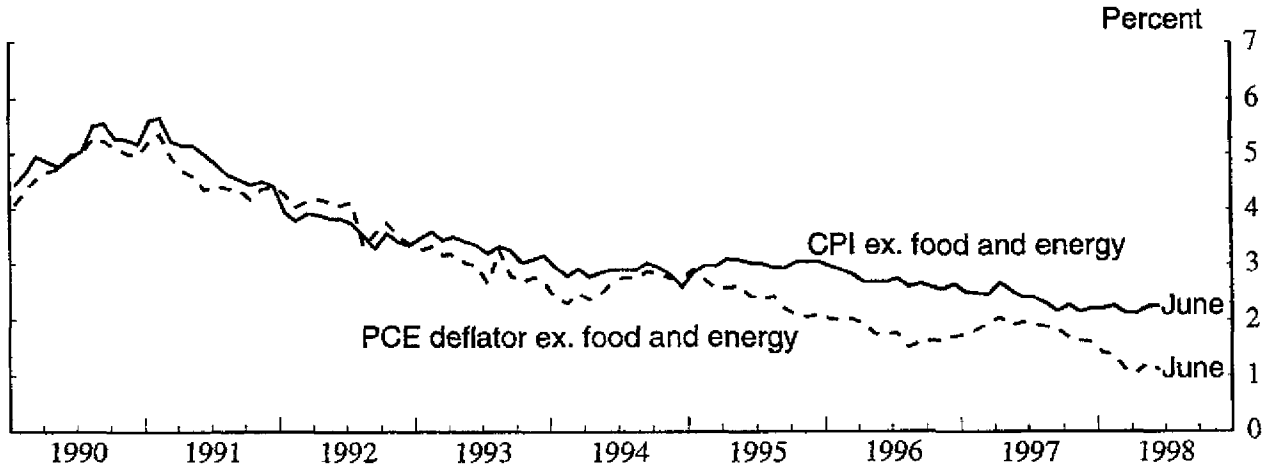
CPI Excluding Food and Energy



CPI Services and Commodities



CPI and PCE



BROAD MEASURES OF INFLATION
(Four-quarter percent change)

	1995 Q2	1996 Q2	1997 Q2	1998 Q2
Product prices				
GDP chain price index	2.4	1.9	2.0	1.0
Nonfarm business chain-type price index[1]	2.2	1.3	2.0	0.7
Expenditure prices				
Gross domestic purchases chain-type price index	2.5	1.7	1.7	0.6
Less food and energy	2.5	1.5	1.7	0.8
PCE chain-type price index	2.6	2.0	1.9	0.9
Less food and energy	2.5	1.8	2.0	1.1
CPI	3.0	2.9	2.3	1.6
Less food and energy	3.0	2.7	2.5	2.2
Median CPI	3.0	3.2	2.9	2.8
Trimmed mean CPI	2.8	2.8	2.5	2.1

1. Excluding housing.

SURVEYS OF (CPI) INFLATION EXPECTATIONS
(Percent)

	Actual inflation[1]	University of Michigan (1-year) Mean[2]	University of Michigan (1-year) Median[3]	University of Michigan (5- to -10-year) Mean[4]	University of Michigan (5- to -10-year) Median[5]	Professional forecasters (10-year)[6]
1996-Q1	2.7	3.9	2.8	4.2	3.2	3.0
Q2	2.8	4.5	3.0	4.3	3.1	3.0
Q3	2.9	4.2	3.1	4.3	3.2	3.0
Q4	3.2	4.0	3.0	3.9	3.0	3.0
1997-Q1	2.9	3.8	2.9	3.8	3.1	3.0
Q2	2.3	3.6	2.9	3.8	3.0	2.9
Q3	2.2	3.4	2.7	3.6	3.0	3.0
Q4	1.9	3.3	2.8	3.8	3.1	2.7
1998-Q1	1.5	2.8	2.4	3.3	2.9	2.6
Q2	1.6	3.0	2.6	3.3	2.8	2.5
1998-Jan.	1.6	2.8	2.3	3.4	2.9	
Feb.	1.4	2.6	2.4	3.2	2.9	
Mar.	1.4	2.9	2.5	3.3	2.8	2.6
Apr.	1.4	2.7	2.4	3.2	2.7	
May	1.7	3.1	2.6	3.3	2.8	
Jun	1.7	3.2	2.7	3.3	2.9	2.5
Jul		3.1	2.6	3.1	2.7	

1. CPI; percent change from the same period in the preceding 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 12 months?
3. Median increase for responses to the question above.
4. 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 5 to 10 years?
5. Median increase for responses to question above.
6. Compiled by the Federal Reserve Bank of Philadelphia.

Other broad measures of inflation also have decelerated over the past year. As of the second quarter of 1998, four-quarter changes in the chain-weighted price indexes for GDP and PCE were down about 1 percentage point from their pace a year earlier. As with the CPI, large declines in energy and non-oil import prices and the deceleration in food prices have helped hold down PCE inflation over the past year.[13] However, core PCE prices have also been held down by changes in the prices of items that are not included in the CPI. In particular, more than half of the deceleration in core PCE prices over the past four quarters can be attributed to a large decline in the rate of change in the index of prices of imputed services provided by commercial banks to consumers--not included in the CPI--from their very rapid pace in the prior year.

Capital goods prices have remained soft. The PPI for capital equipment was unchanged in June and is down 0.6 percent over the past twelve months. This decline reflects a drop in motor vehicle prices and the unusually large declines in computer prices that occurred earlier this year--two areas with particularly large import shares--as well as a deceleration in prices of many other types of capital equipment.

Few signs of inflationary pressure are evident at earlier stages of processing. The PPI for intermediate materials other than food and energy edged down again in June and stood about 1/2 percent below its year-earlier level. The PPI for core crude materials continued to move lower as well through June. Measures of industrial commodity prices have been mixed since late June: The Journal of Commerce industrial price index has increased about 1 percent since then, but the CRB measure of industrial commodity prices has weakened. Futures prices for farm products are considerably lower than they were in late June and suggest that the twelve-month change in farm prices could remain decidedly negative into the early part of next year.

Short-term inflation expectations have backed up lately, on balance, after having dropped notably in the first few months of the year. According to the Michigan survey, median inflation expectations for one year ahead were at 2.6 percent in July--up from 2.3 to 2.4 percent earlier in the year but still a bit below the readings

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13. In the recent annual revision, BEA switched from using published CPIs to using "experimental" geometric-mean CPIs (back to 1995) as the underlying source data for many components of PCE prices. These geometric-mean CPIs incorporate a greater degree of substitution among items within narrowly defined expenditure categories. We estimate that the introduction of geometric means held down increases in PCE prices by about 1/4 percentage point per year starting in 1995. Although BLS will not incorporate this formula into the CPI until January 1999, it has been preparing experimental geometric-mean indexes for some time. At the time of the next benchmark revision, BEA is likely to incorporate the geometric-mean indexes back at least to 1991.

that prevailed in the second half of 1997. However, longer-term inflation expectations have not moved up, as both the Michigan survey's median inflation expectations for five to ten years ahead and the Philadelphia Fed's survey of professional forecasters' ten-year-ahead expectations remain well below 3 percent.

Labor Costs

The Employment Cost Index for hourly compensation of private industry workers increased at an annual rate of 3.6 percent over the three months ending in June, after having risen 2.7 percent in the first quarter and 4.3 percent in the fourth quarter of 1997. On a twelve-month basis, hourly compensation in the ECI accelerated 0.6 percentage point over the past year, from 2.9 percent in June 1997 to 3.5 percent in June 1998.

Although its weight in the index is only about 7 percent, more than half of the pickup in total private hourly compensation between June 1997 and June 1998 resulted from a 4-1/2 percentage point acceleration in compensation in the finance, insurance, and real estate industry (FIRE). Bonuses and commissions for these workers have been boosted, in part, by the wave of mortgage refinancing in recent quarters. In addition, the transportation, communications, and public utilities grouping of industries showed a 1.5 percentage point acceleration, mainly reflecting a large pickup in the compensation of communications workers. Among other industries, increases in compensation in construction and services picked up only slightly over the past year, while compensation gains held fairly steady in manufacturing and trade. Among occupations, the acceleration in compensation over the past year was greatest for white-collar workers, especially sales workers, a category that includes many workers paid commissions and bonuses. Because these types of pay are highly variable and do not make their way into base wages, such increases could be reversed if demand were to soften.

The acceleration in compensation costs over the past twelve months was evident in both wages and salaries and in benefits. Wages and salaries rose 4.0 percent over the twelve months ended in June--0.7 percentage point faster than over the preceding twelve months. FIRE accounted for about half of the acceleration. Although benefits rose only 2.6 percent over the past twelve months, this rate of increase was 0.6 percentage point higher than during the preceding twelve-month period. More than half of the acceleration in benefits resulted from the pickup in employer costs for health insurance, which rose 2.6 percent over the past year compared with just 0.7 percent over the previous period. As we have noted before,

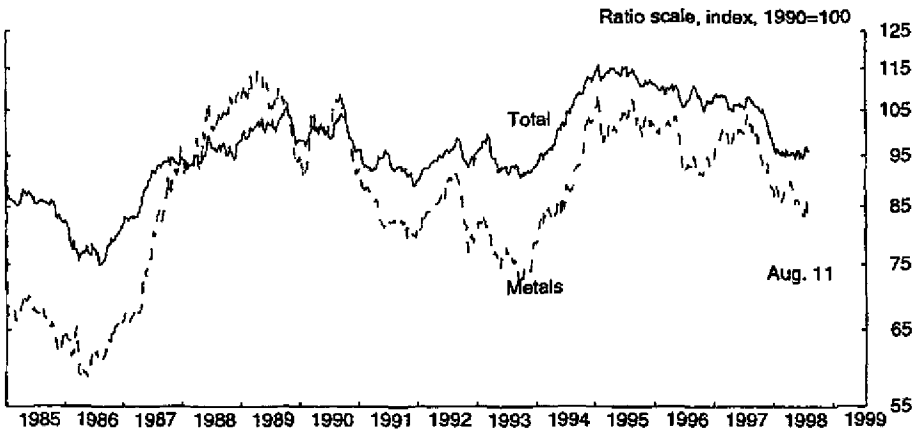
SPOT PRICES OF SELECTED COMMODITIES

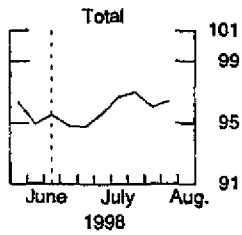
	Current price ($)	Percent change[1] 1996	1997	Dec. 30 to June 23[2]	June 23[2] to Aug. 04	Memo: Year earlier to date
Metals						
Copper (lb.)	.790	-21.3	-24.3	-1.2	-1.3	-28.8
Steel scrap (ton)	130.500	-13.1	23.2	-5.6	-3.7	-9.1
Aluminum, London (lb.)	.586	-8.5	-.6	-12.5	-1.8	-25.1
Precious metals						
Gold (oz.)	286.100	-4.8	-21.4	1.5	-2.8	-10.9
Silver (oz.)	5.420	-6.1	28.3	-12.7	1.3	23.9
Forest products						
Lumber (m. bdft.)	286.000	59.2	-29.6	-4.1	2.1	-14.9
Plywood (m. sqft.)	368.000	-3.2	-4.8	3.3	18.7	8.6
Petroleum						
Crude oil (barrel)	12.110	29.3	-31.7	-23.9	-1.6	-36.7
Gasoline (gal.)	.403	27.2	-25.8	-10.9	-9.8	-43.1
Fuel oil (gal.)	.351	18.3	-29.7	-19.9	-11.3	-39.2
Livestock						
Steers (cwt.)	58.000	-1.1	3.0	-7.4	-7.9	-10.8
Hogs (cwt.)	35.500	14.9	-36.4	18.6	-14.5	-38.3
Broilers (lb.)	.735	12.5	-21.2	35.2	10.2	18.9
U.S. farm crops						
Corn (bu.)	1.935	-24.4	.2	-6.7	-18.9	-22.0
Wheat (bu.)	2.695	-12.8	-22.6	-10.2	-14.7	-26.7
Soybeans (bu.)	5.615	-3.7	-1.8	-2.9	-14.4	-23.4
Cotton (lb.)	.691	-8.7	-9.7	17.6	-8.0	-4.5
Other foodstuffs						
Coffee (lb.)	1.350	34.7	25.4	-29.0	11.6	-41.0
Memo:						
JOC Industrials	96.000	-4.1	-8.6	-2.7	.5	-11.1
JOC Metals	82.900	-8.3	-5.0	-4.4	-2.4	-19.5
KR-CRB Futures	205.570	-.1	-3.2	-6.1	-5.0	-15.6
KR-CRB Spot	ND	.9	-8.4	-3.3	-.8	-11.5

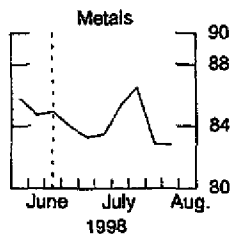
1. Changes, if not specified, are from the last week of the preceding year to the last week of the period indicated.
2. Week of the June Greenbook.

Commodity Price Measures

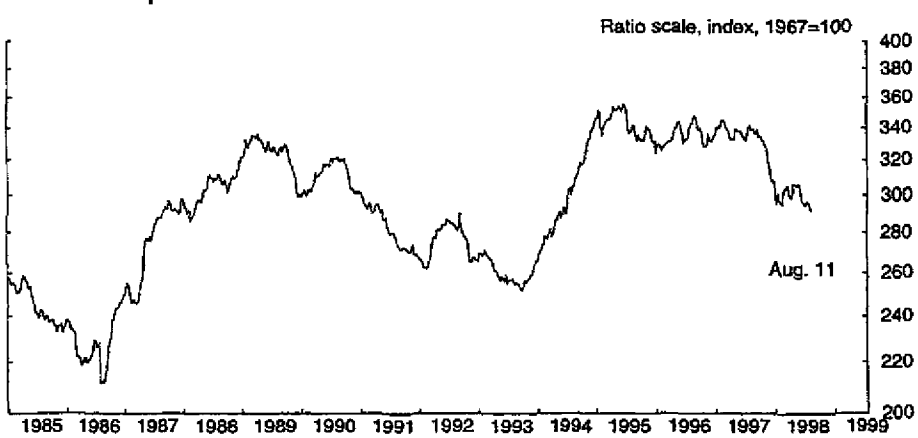
Journal of Commerce Index

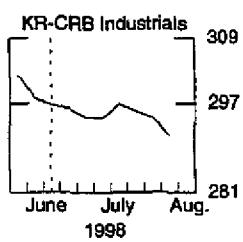




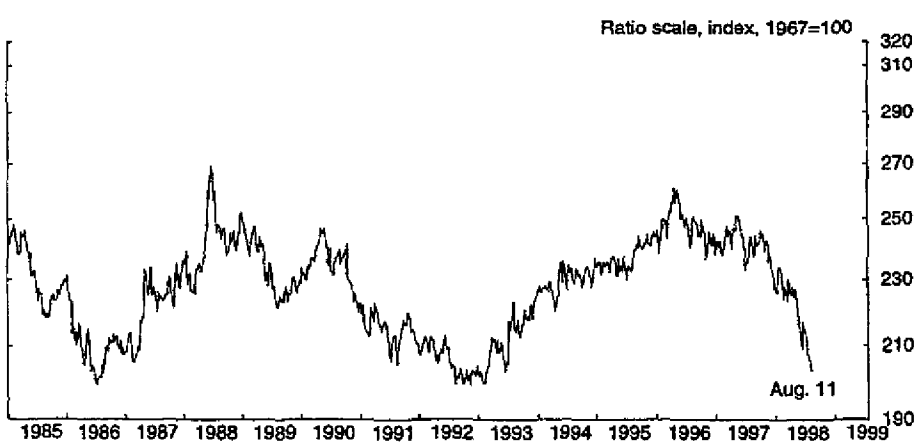


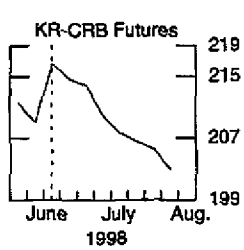
KR-CRB Spot Industrials





KR-CRB Futures





Note. Weekly data, Tuesdays. Vertical lines on small panels indicate week of last Greenbook. The Journal of Commerce index is based almost entirely on industrial commodities, with a small weight given to energy commodities, and the KR-CRB spot price index consists entirely of industrial commodities, excluding energy. The KR-CRB futures index gives about a 60 percent weight to food commodities and splits the remaining weight roughly equally among energy commodities, industrial commodities, and precious metals. Copyright for Journal of Commerce data is held by CIBCR, 1994.

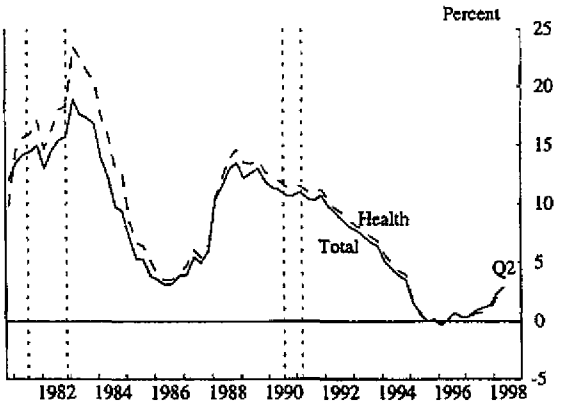
EMPLOYMENT COST INDEX OF HOURLY COMPENSATION
FOR PRIVATE INDUSTRY WORKERS

	1997			1998	
	June	Sept.	Dec.	Mar.	June
	-----Quarterly percent change------- (Compound annual rate)				
Total hourly compensation[1]	3.7	3.4	4.3	2.7	3.6
Wages and salaries	3.8	4.1	4.7	3.4	3.9
Benefit costs	2.6	2.0	3.8	1.1	3.1
By industry					
Construction	3.2	2.8	1.9	2.8	5.0
Manufacturing	3.4	3.0	2.1	3.0	2.1
Trans., comm., and public utilities	2.8	3.1	4.0	3.9	5.4
Wholesale trade	1.5	3.3	2.1	7.6	1.5
Retail trade	2.8	3.8	2.5	5.3	3.0
FIRE	2.5	3.4	12.8	6.7	5.1
Services	3.6	3.9	4.8	1.7	3.2
By occupation					
White collar	3.0	3.6	5.1	3.3	3.8
Blue collar	3.1	3.1	2.8	1.8	3.0
Service occupations	3.8	6.6	2.1	4.3	2.7
Memo:					
State and local governments	1.8	2.4	2.4	3.3	3.0
	-----Twelve-month percent change----				
Total hourly compensation	2.9	3.2	3.4	3.5	3.5
Excluding sales workers	2.9	3.0	3.4	3.4	3.4
Wages and salaries	3.3	3.6	3.9	4.0	4.0
Excluding sales workers	3.3	3.5	3.8	4.0	3.8
Benefit costs	2.0	2.0	2.3	2.3	2.6
By industry					
Construction	2.7	3.0	2.6	2.7	3.1
Manufacturing	2.6	2.5	2.4	2.9	2.5
Trans., comm., and public utilities	2.6	2.8	2.9	3.4	4.1
Wholesale trade	3.5	3.6	3.2	3.6	3.6
Retail trade	3.9	3.9	3.4	3.6	3.6
FIRE	2.5	3.0	6.7	6.3	7.0
Services	3.0	3.2	3.8	3.5	3.4
By occupation					
White collar	3.2	3.1	3.8	3.8	4.0
Sales	3.0	4.3	4.2	4.0	5.0
Nonsales	3.1	3.0	3.7	3.8	3.8
Blue collar	2.5	2.8	2.6	2.7	2.7
Service occupations	3.5	4.5	4.0	4.2	3.9
Memo:					
State and local governments	2.4	2.4	2.3	2.5	2.7

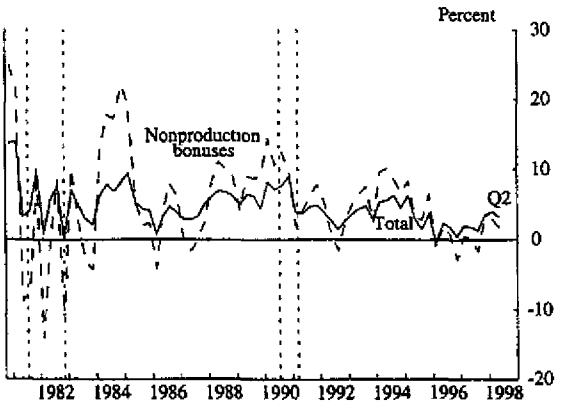
1. Seasonally adjusted by the BLS.

Components of ECI Benefits Costs
(Private industry workers; twelve-month change)

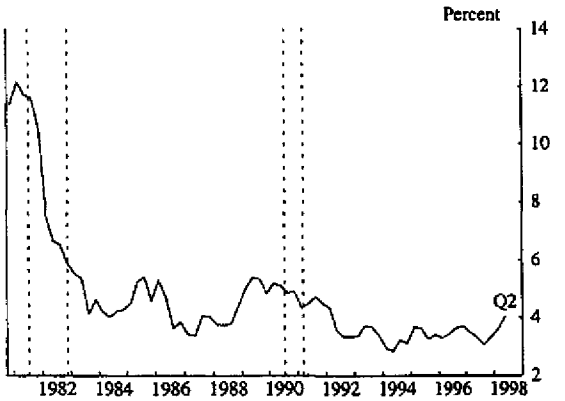
Insurance Costs



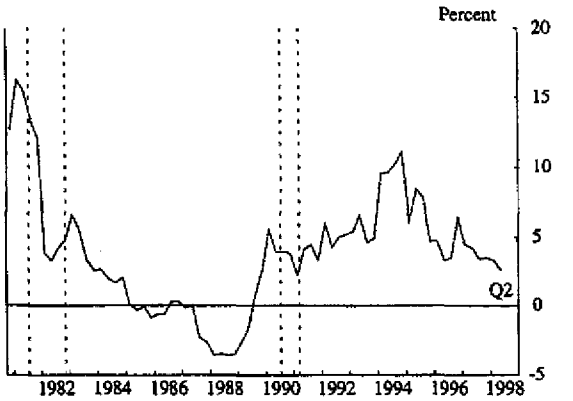
Supplemental Pay



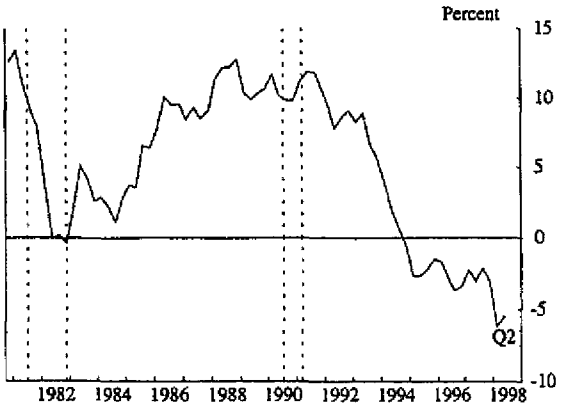
Paid Leave



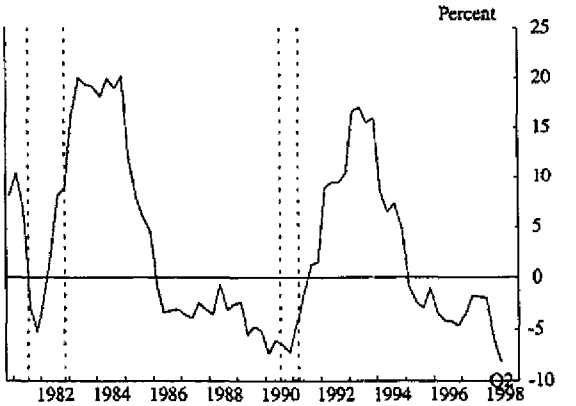
Retirement and Savings



Workers' Compensation Insurance



State Unemployment Insurance



Note. Unpublished ECI benefits detail.

anecdotal reports indicate that a further acceleration in health insurance costs may be in the offing over the coming year. Among the other components of benefits, larger increases in the costs of supplemental pay (including bonuses and wage differentials for overtime and late shifts) and paid leave (which essentially moves in tandem with wages and salaries) were partially offset by a slower rise in costs for pensions, workers' compensation, and state unemployment insurance. Pension costs benefited from rising stock prices, which reduced the size of employers' contributions necessary to maintain required levels of funding, while the strength of the economy over the past couple of years has reduced the tax rates faced by employers to fund unemployment insurance.

Hourly compensation in the nonfarm business sector--as measured in the BLS's Productivity and Cost release--rose at an annual rate of 3.8 percent in the second quarter, down from its 4.6 percent rate of increase in the first quarter.[14] Over the past four quarters, compensation per hour increased 4.3 percent, up from the previous year's reading of 3.4 percent. On a year-over-year basis, this measure of compensation per hour has risen more rapidly than the ECI since late 1995, following a two-year period in which the relationship was reversed. Although the two measures tend to move together over long periods, the Productivity and Cost series tends to be more cyclically variable than the ECI. Conceptually, compensation per hour can vary because of changes in the amount of overtime being worked and changes in the mix of industries and occupations of workers, while the ECI attempts to hold these factors fixed.[15]

Output per hour in the nonfarm business sector edged down 0.2 percent at an annual rate in the second quarter. But given earlier strong advances, productivity was up 1.9 percent over the past year. Unit labor costs in the nonfarm business sector increased 2.4 percent between the second quarter of 1997 and the second quarter of 1998, about the same pace as over the previous four-quarter period.

In July, average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls rose 0.2 percent and were up 4.2 percent over the past twelve months. Abstracting from the GM strike would add about 0.1 percentage point to each of these figures, putting the twelve-month change about where it has been since April.

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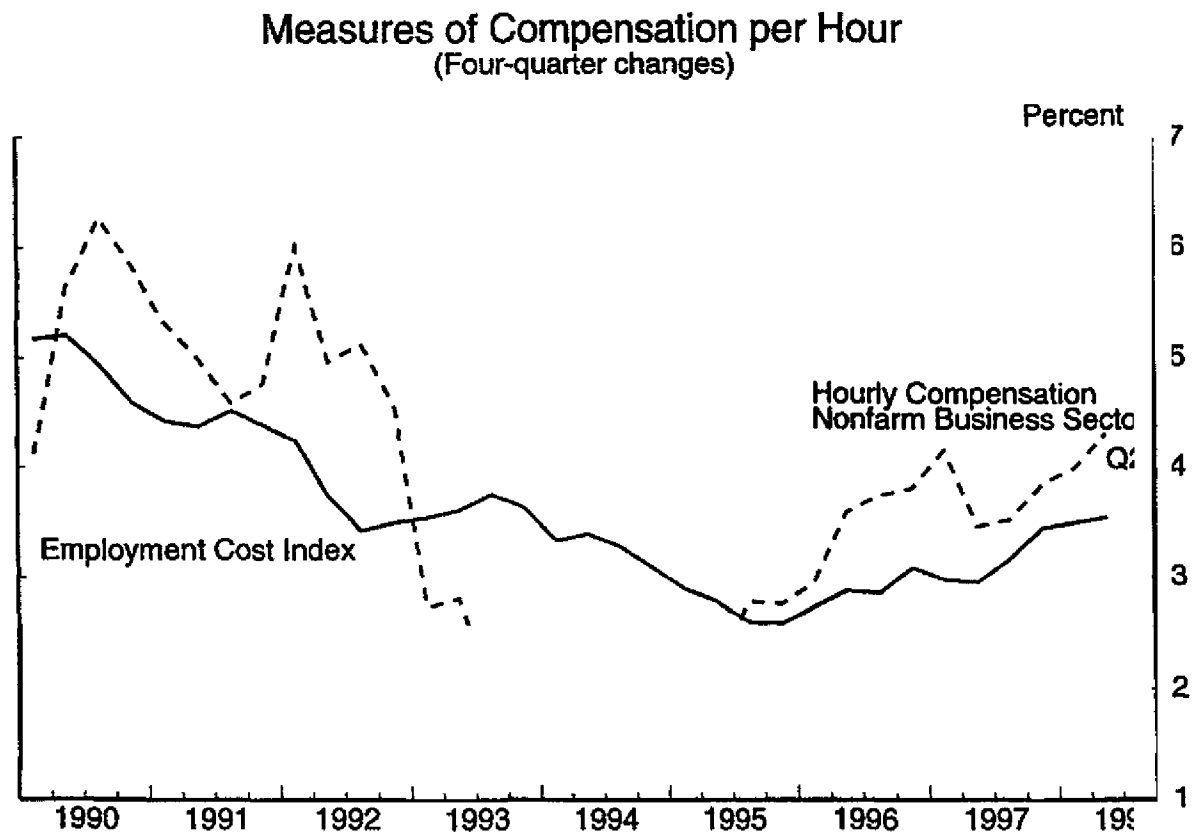
14. With this release, the Productivity and Cost data were corrected for the length-of-pay-period problem discussed in detail in the May Greenbook.

15. In addition, the ECI measures changes in compensation for particular jobs. If companies have reacted to the scarcity of workers by promoting people to higher-level jobs without raising their pay to the averages for those positions, then the ECI would measure a reduction in wage rates even though aggregate wages had risen.

LABOR PRODUCTIVITY AND COSTS
(Percent change; annual rate; based on seasonally adjusted data)

	1996[1]	1997[1]	1997 Q3	1997 Q4	1998 Q1	1998 Q2	1997:Q2 to 1998:Q2
Output per hour							
Total business	2.4	1.9	3.7	.9	4.1	-.6	2.0
Nonfarm business	2.1	1.7	3.6	.9	3.5	-.2	1.9
Manufacturing	4.6	4.5	7.3	4.9	1.4	3.3	4.2
Nonfinancial corporations[2]	2.4	2.6	5.6	1.0	2.6	n.a.	n.a.
Compensation per hour							
Total business	3.9	4.0	4.1	5.3	4.9	3.9	4.5
Nonfarm business	3.7	3.9	3.9	4.9	4.6	3.8	4.3
Manufacturing	2.4	5.3	5.6	8.0	4.1	2.5	5.0
Nonfinancial corporations[2]	3.4	3.9	4.2	5.0	3.6	n.a.	n.a.
Unit labor costs							
Total business	1.5	2.0	.4	4.4	.8	4.5	2.5
Nonfarm business	1.6	2.1	.3	4.0	1.1	4.1	2.4
Manufacturing	-2.1	.7	-1.6	3.0	2.7	-.7	.8
Nonfinancial corporations[2]	.9	1.2	-1.3	4.0	.9	n.a.	n.a.

1. Changes are from fourth quarter of preceding year to fourth quarter of year shown.
2. The nonfinancial corporate sector includes all corporations doing business in the United States with the exception of banks, stock and commodity brokers, finance and insurance companies; the sector accounts for about two-thirds of business employment.



Appendix

The Annual Revision to the NIPA

On July 31, the BEA published its regular annual revision to the national income and product accounts. Data on the spending side of the accounts were revised back through 1995; because of some definitional changes, some income series were revised back through 1982. As usual, the revision incorporated more comprehensive source data, including Census annual surveys of manufacturing (for 1995 and 1996), wholesale and retail trade (1995-96), services (1995-97), and state and local governments (1995-97), unemployment insurance records (1997), tabulations of tax returns (1996), and revised construction and balance of payments statistics (1995-97).

In addition, some changes were made in the way certain components of GDP are measured. Most important, many categories of consumer spending are now being adjusted for inflation with geometric-mean consumer price indexes. These price indexes assume a unitary elasticity of substitution within narrow product groups and generally show smaller increases in recent years than the regular CPIs.[1] The BEA also incorporated new source data for estimating consumer spending on cellular phone and internet services, motor vehicle leasing, light trucks, financial services, and gambling. In addition, some changes were made in the sources and methods used to estimate petroleum and natural gas drilling. Furthermore, the source data underlying the NIPA estimates of aircraft exports are now being seasonally adjusted, which may ameliorate the "residual seasonality" problem in exports--although that is not entirely clear.

Revisions to GDP and its Components

On average, the annual rate of growth in real GDP was revised up 0.3 percentage point over the period from the fourth quarter of 1994 to the first quarter of this year. The largest revisions to growth were in 1995 and 1996--0.5 and 0.7 percentage point respectively--while real GDP growth in 1997 was revised up just 0.1 percentage point.

Annual real PCE growth is now 0.4 percentage point higher, on average, than before, with most of the revision reflecting the new price indexes. Notably, the new source data did not substantially alter the estimates for telecommunications services from BEA's earlier, less sophisticated estimates. Among other components of final sales, the new measures for drilling boosted growth rates for nonresidential construction, and more comprehensive source data resulted in an upward adjustment to state and local outlays.

On balance, changes to the estimates of inventories were small. Given the upward revisions to real final sales, however, aggregate inventory-sales ratios measured using chain-weighted (1992) price data are now lower than previously estimated. Notably, the ratio of inventories relative to final sales of goods and structures now shows only a small increase since early 1996, as compared with the more noticeable uptrend evident in the earlier data.

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1. The BLS will not incorporate these new indexes into the official CPI until next January, and, even at that time, it will not revise the official CPI back in history.

Prices

On average, the annual rate of growth in the chain-type GDP price index was revised down 0.3 percentage point over the period from the fourth quarter of 1994 to the first quarter of 1998. The largest revisions were in 1995 (0.3 percentage point) and 1996 (0.5 percentage point); prices in 1997 were revised down just 0.1 percentage point. Much of the slowing was in PCE prices reflected the switch to the geometric-mean CPIs.

Income-Side Developments

The large and widening gap between the product and income sides of the national accounts was reduced somewhat with this revision. The difference between nominal gross domestic product and nominal gross domestic income--the statistical discrepancy--still shows a decline into negative territory during the past couple of years, but not as much as previously. The statistical discrepancy was revised down (in absolute value) in 1997 by $30 billion, or 0.4 percent of GDP. The revision owed to a higher estimate of nominal spending that reflected the sum of small upward revisions to PCE goods, fixed investment, and exports; in contrast, gross domestic income was revised little.[2]

The most dramatic change in this year's revision was to the personal saving rate, which is now considerably lower than previously estimated. Much of this change is traceable to a redefinition of personal dividend income that no longer includes capital gains distributions by mutual funds (which are not income from current production). All of the series affected by this redefinition were revised back to 1982. The largest revisions to the saving rate were in the most recent years, because of the greater popularity of mutual funds and the strong advances in the stock market, which resulted in substantial capital gains distributions. Over the past three years, the saving rate also was revised down because of lower estimates of some components of disposable personal income--namely, other labor income (largely pensions, profit sharing, and group insurance), social insurance contributions, and net interest. All told, the revised estimates indicate that the personal saving rate fell from 3.5 percent in 1994 to 1.2 percent the first quarter of 1998, as compared with the previously published drop from 4.2 percent to 3.6 percent.

While the change in the treatment of capital gains distributions resulted in a reduction in personal income and saving, there was a corresponding increase in the estimate of undistributed corporate profits. Consequently, national saving was unaffected by this definitional change; other revisions had only a modest effect on the national saving rate. Elsewhere, the annual revisions resulted in relatively small changes to the estimates of corporate profits and labor's share of gross national income.

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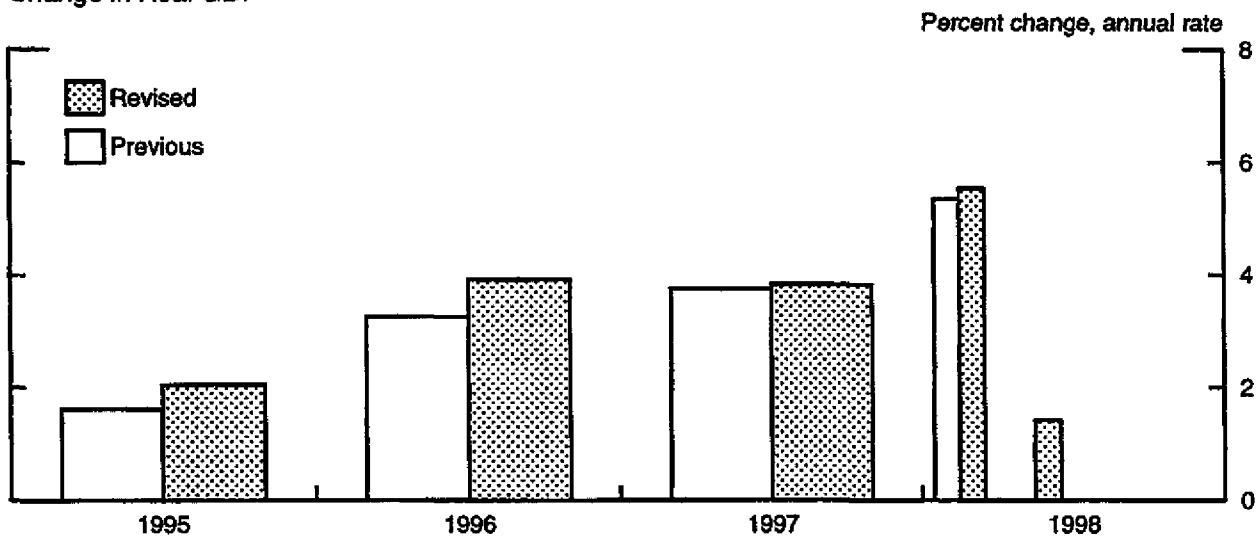
2. In its press release, the BEA noted that this year's annual revisions were largely to the expenditure, or product, side of the accounts and reflected mainly the availability of new or revised source data. They are working on longer-term projects to address problems in the income estimates, such as the inclusion of capital gains in the source data on wages and salaries and the separation of domestic from foreign-source income in corporate profits. This work will be incorporated into subsequent annual and benchmark revisions.

BLS Annual Revisions to Productivity

On August 11, the BLS released updated estimates of productivity, which incorporate the new GDP data as well as the annual revision to the payroll employment survey released in June. The data also have been corrected for the length-of-pay-period problem we have discussed in previous Greenbooks. The new figures show that output per hour in the nonfarm business sector rose at a 1.8 percent annual rate between the fourth quarter of 1994 and the first quarter of this year. Over this period, the average annual growth rate in productivity was boosted 0.3 percentage point, reflecting upward revisions of 0.4 percentage point to growth in nonfarm business output 0.1 percentage point to growth in hours worked. The staff estimates that the new PCE prices accounted for about 1/4 percentage point of the upward revision to growth in nonfarm business output.

Revisions to Real GDP

Change in Real GDP*



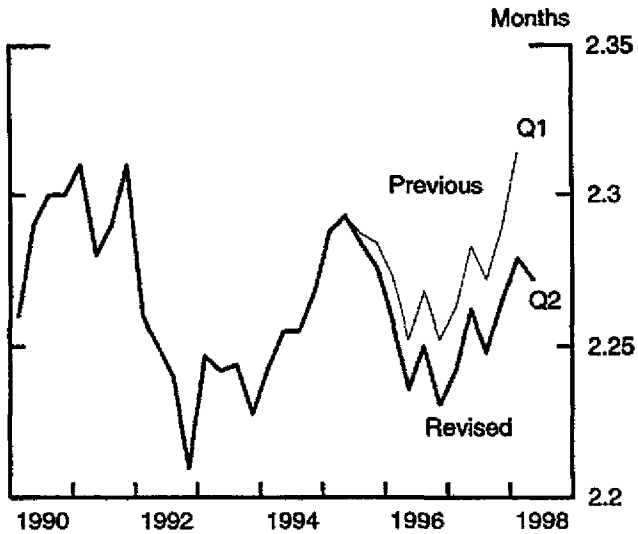
* Annual changes are Q4 to Q4.

Real GDP and Related Items

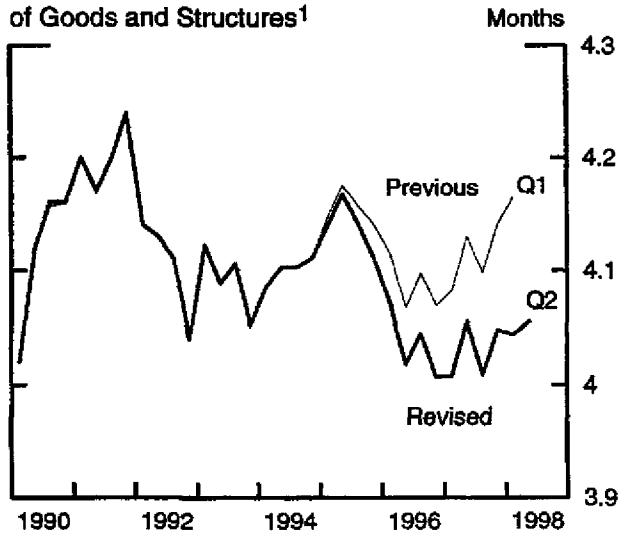
(Annualized percent change from 1994:Q4 to 1998:Q1)

	Previous Estimate	Revised Estimate
1. Gross domestic product	3.1	3.4
2. Final sales	2.9	3.3
3. PCE	3.0	3.4
4. Business fixed investment	9.7	10.5
5. Federal spending	–2.5	–2.3
6. State and local spending	1.8	2.4
MEMO:		
7. Nonfarm business output (less housing)	3.8	4.2
8. GDP price index	2.1	1.8

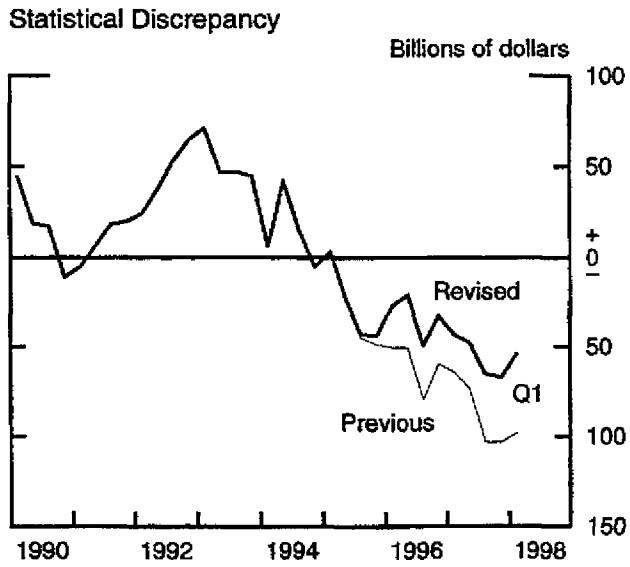
Nonfarm Inventories Relative to Final Sales[1]

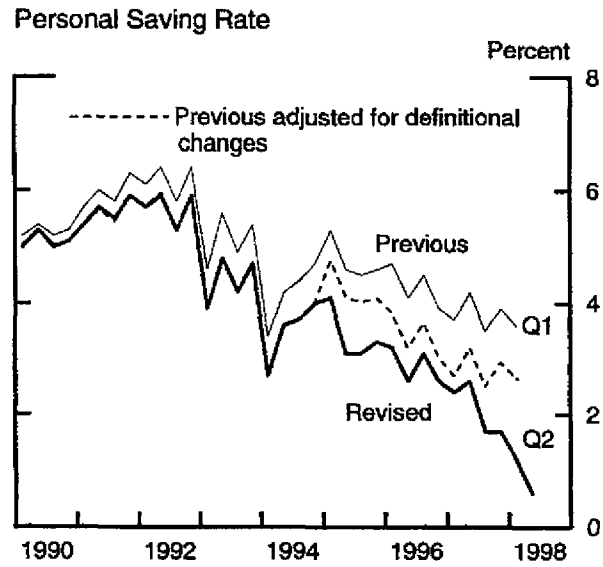


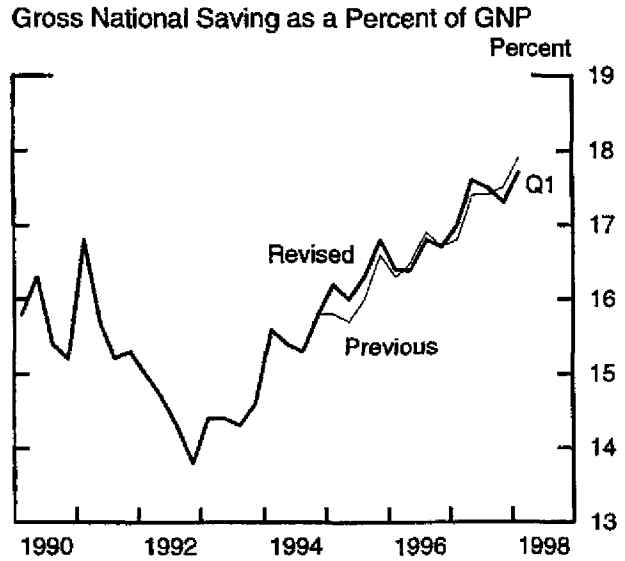
Nonfarm Inventories Relative to Final Sales of Goods and Structures[1]

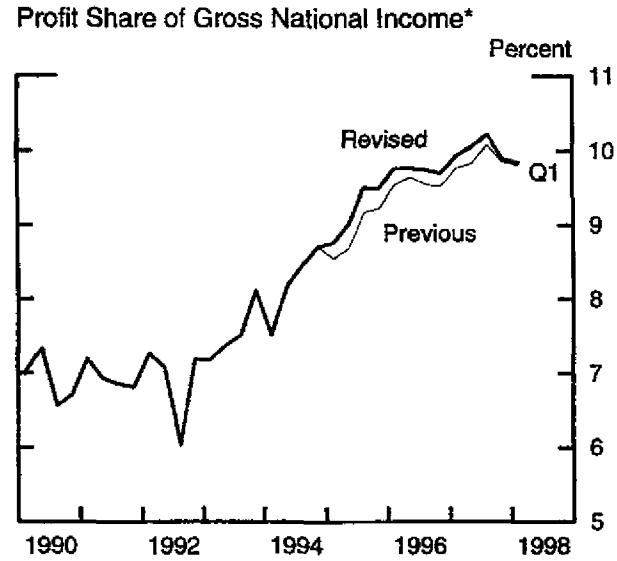


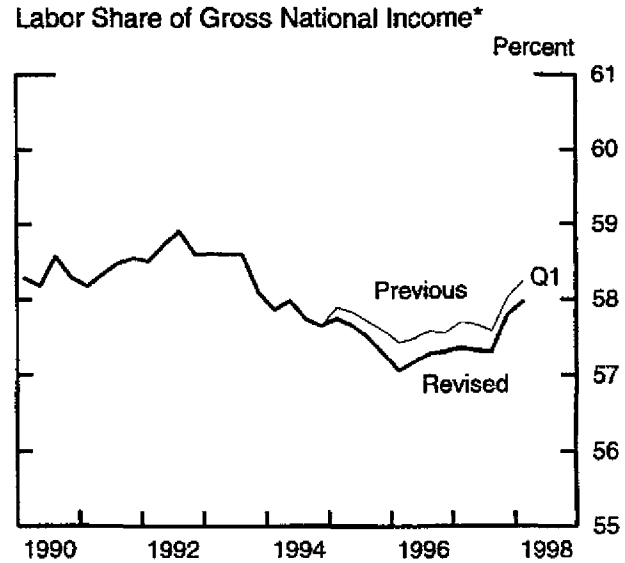
1. Based on chained ($1992) inventories and sales.

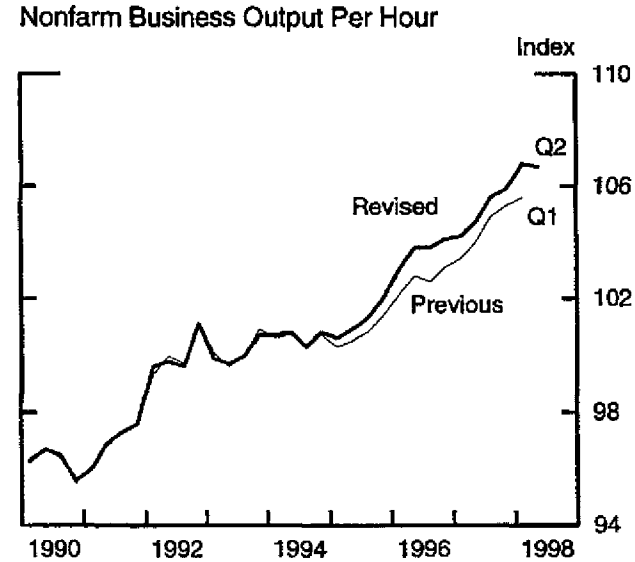












* Gross national income equals gross national product less the statistical discrepancy.

DOMESTIC FINANCIAL DEVELOPMENTS

III-T-1

Selected Financial Market Quotations[1]

(Percent except as noted)

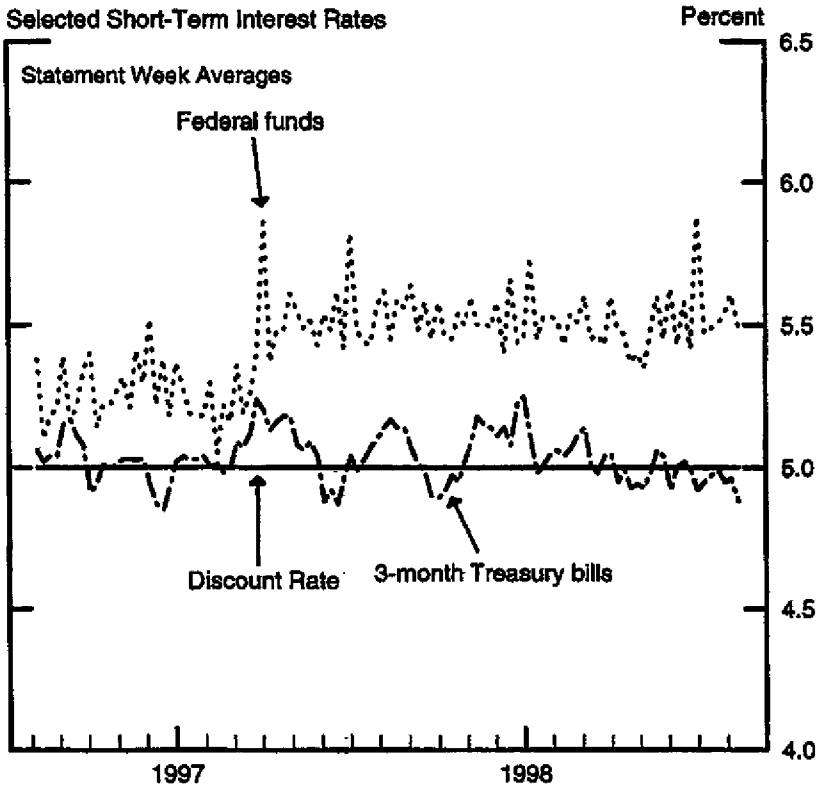
Instrument	1997	1998			Change to Aug. 12, from:		
	Sep. 30	Feb. 24	FOMC * July 1	Aug. 12	Sep. 30	Feb. 24	FOMC * July 1
Short-term rates							
Federal funds							
intended rate [2]	5.50	5.50	5.50	5.50	.00	.00	.00
realized rate [3]	5.51	5.48	5.51	5.55	.04	.07	.04
Treasury bills [4]							
3-month	4.93	5.13	4.97	4.89	-.04	-.24	-.08
6-month	5.08	5.11	5.04	4.94	-.14	-.17	-.10
1-year	5.18	5.18	5.10	4.95	-.23	-.23	-.15
Commercial paper							
1-month	5.51	5.47	5.54	5.49	-.02	.02	-.05
3-month	5.48	5.44	5.47	5.49	.01	.05	.02
Large negotiable CDs [4]							
1-month	5.59	5.54	5.60	5.55	-.04	.01	-.05
3-month	5.67	5.54	5.61	5.58	-.09	.04	-.03
6-month	5.72	5.56	5.68	5.61	-.11	.05	-.07
Eurodollar deposits [5]							
1-month	5.56	5.50	5.56	5.53	-.03	.03	-.03
3-month	5.63	5.53	5.59	5.56	-.07	.03	-.03
Bank prime rate	8.50	8.50	8.50	8.50	.00	.00	.00
Intermediate- and long-term rates							
U.S. Treasury (constant maturity)							
2 -year	5.80	5.57	5.49	5.32	-.48	-.25	-.17
10-year	6.12	5.69	5.44	5.40	-.72	-.29	-.04
30-year	6.41	5.97	5.62	5.62	-.79	-.35	.00
U.S. Treasury 10-year indexed note	3.61	3.68	3.76	3.80	.19	.12	.04
Municipal revenue (Bond Buyer) [6]	5.63	5.29	5.36	5.37	-.26	.08	.01
Corporate bonds, Moody's seasoned Baa	7.66	7.30	7.11	7.15	-.51	-.15	.04
High-yield corporate [7]	9.02	8.93	9.20	9.44	.42	.51	.24
Home mortgages [8]							
FHLMC 30-yr fixed rate	7.28	6.99	6.96	6.94	-.34	-.05	-.02
FHLMC 1-yr adjustable rate	5.51	5.59	5.68	5.61	.10	.02	-.07

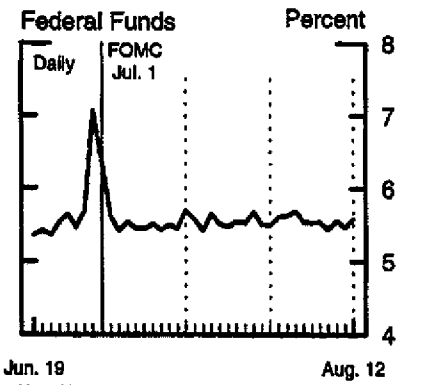
Stock exchange index	Record high		1998			Percentage change to Aug. 12, from:		
	Level	Date	Feb.24	FOMC * July 1	Aug. 12	Record high	Feb.24	FOMC * July 1
Dow-Jones Industrial	9337.97	7/17/98	8370.10	8952.02	8552.96	-8.41	2.18	-4.46
S&P 500 Composite	1186.75	7/17/98	1030.56	1133.84	1084.22	-8.64	5.21	-4.38
NASDAQ (OTC)	2014.25	7/20/98	1738.71	1894.74	1825.53	-9.37	4.99	-3.65
Russell 2000	491.41	4/21/98	454.30	457.39	408.55	-16.86	-10.07	-10.68
Wilshire	11106.10	7/17/98	9834.35	10663.62	10088.31	-9.16	2.58	-5.40

1. One-day quotes except as noted.
2. FOMC's intended rate.
3. Average for two-week reserve maintenance period ending on or before date shown. Most recent observation is average for current maintenance period to date.
4. Secondary market.
5. Bid rates for Eurodollar deposits at 11 a.m. London time.
6. Most recent observation based on one-day Thursday quote and futures market index changes.
7. Merrill Lynch Master II high-yield bond index composite.
8. Quotes for week ending Friday previous to date shown.

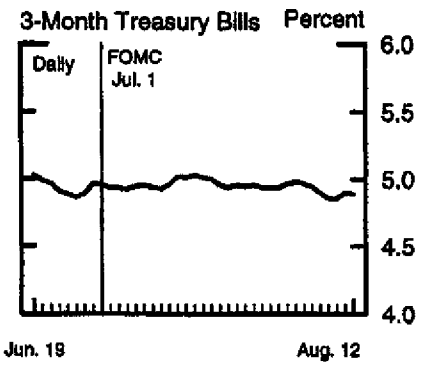
* Figures cited are as of the close on June 30.

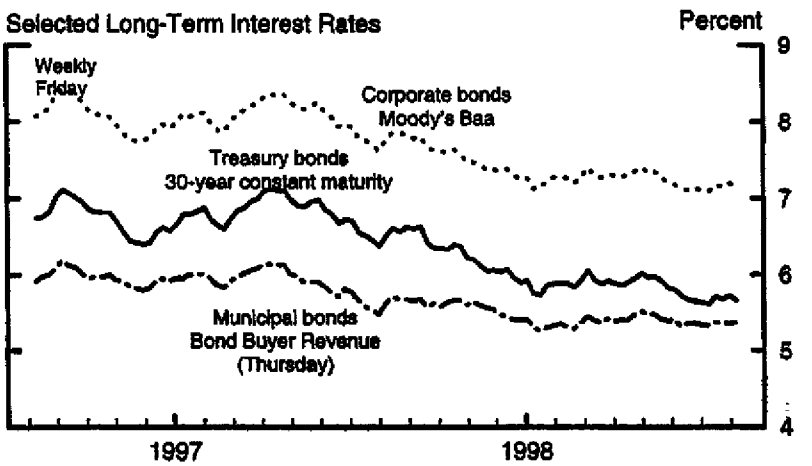
Selected Interest Rates

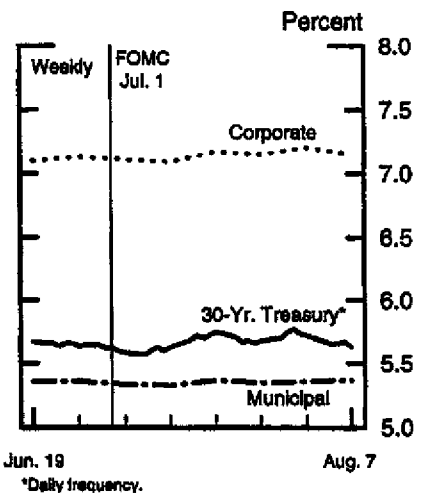




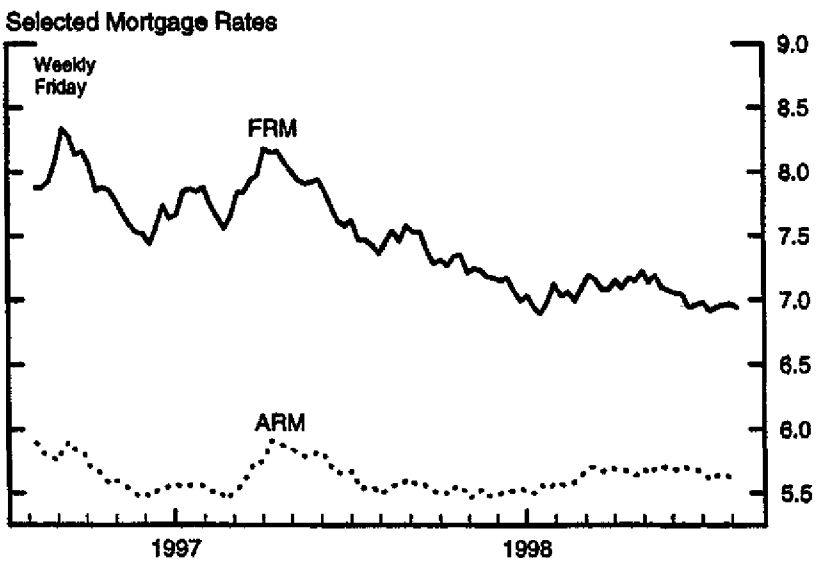
Note. Vertical lines indicate end of reserve period.

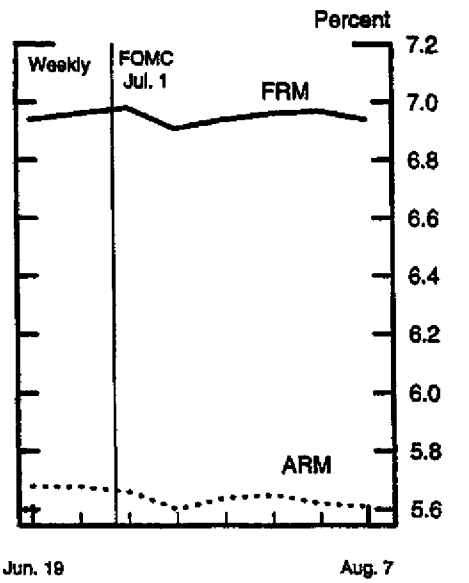






*Daily frequency.





Domestic Financial Developments

Overview

Most interest rates have fallen somewhat, on balance, since the July FOMC meeting. Market participants have primarily focused their attention on developments in Asia, but concerns have deepened as well about Russia and Latin America. The growing pessimism came to a head again in the past week or so, causing the dollar to appreciate further and yields on nominal Treasury securities to drop. The prospect of weaker export markets has added to the fears that corporate earnings might continue tc fall well short of earlier expectations, and the major equity price indexes have dropped about 4 percent to 11 percent since the Committee's last meeting. Looking ahead, monetary policy is widely viewed as being on hold in the near term; the Chairman's Humphrey-Hawkins testimony last month was said to have signaled a greater wariness about inflation risks and less emphasis on the negative impulse from Asia than many observers had expected, but no hints of a predilection toward early tightening. In the past few days, as turmoil in foreign financial markets has deepened, some market participants, albeit a small minority, have begun to talk about the next policy move being an ease.

Private sector borrowing weakened a bit in the second quarter, but it remained heavy. Corporations issued new bonds at roughly the same pace as in first quarter. Ir July, investment-grade issuance picked up, with much of the proceeds being used to fund merger and acquisition activity, but below-investment-grade issuance fell off as the market became a bit more cautious in response to growing concerns about earnings. Household debt growth slowed some in the second quarter, as the growth of consumer credit downshifted. Households continue to substitute mortgage debt for higher-cost consumer credit.

Meanwhile, the favorable budget position enabled the U.S. Treasury to continu to pay down its marketable debt, with cuts concentrated in bills and short-dated coupon securities. State and local government borrowing also has slowed recently from the brisk pace earlier in the year.

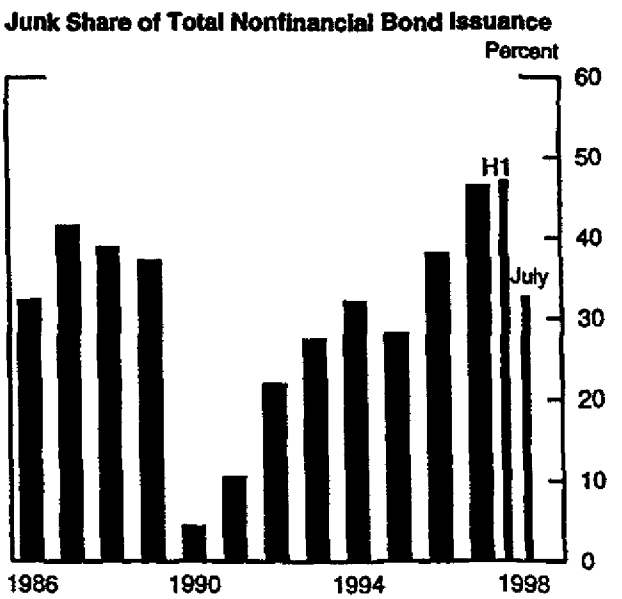
Bank credit growth moderated in July from its second-quarter pace. Bank loar growth was modest, in part reflecting the use of proceeds from corporate bond issuance to fund business loans. Loan standards and terms have changed little since May, according to respondents on the August Senior Loan Officer Survey. The expansion in bank credit was apparently financed by heavier use of sources outside of M3. As a consequence, M3 was about unchanged in July, its weakest monthly

Corporate Securities Market

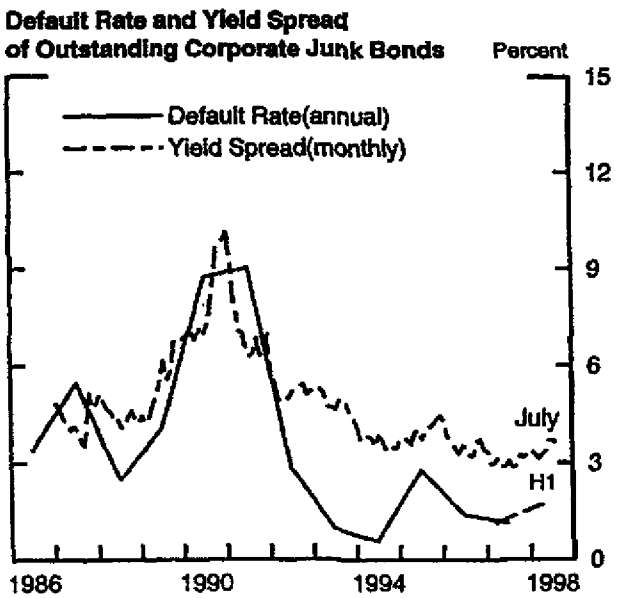
GROSS ISSUANCE OF SECURITIES BY U.S. CORPORATIONS
(Billions of dollars; monthly rates, not seasonally adjusted)

Type of security	1996	1997	1998 Q1	1998 Q2	1998 May	1998 June	1998 July
All U.S. corporations	58.4	69.7	94.3	96.9	89.8	109.0	68.9
Stocks[1]	10.2	9.8	12.7	14.7	14.7	16.9	8.9
Bonds	48.2	59.9	81.6	82.2	75.1	92.1	60.0
Nonfinancial corporations							
Stocks[1]	6.7	5.0	6.1	8.2	9.3	9.9	5.8
Initial public offerings	2.9	1.8	1.2	2.7	2.9	3.4	1.7
Seasoned offerings	3.8	3.2	4.8	5.5	6.3	6.5	4.1
Bonds	12.5	17.3	27.3	27.0	25.2	23.7	21.6
By rating, sold in U.S.[2]							
Investment grade	6.3	7.4	13.1	10.8	8.1	11.8	13.3
Speculative grade	4.8	8.0	12.6	14.3	14.8	11.1	6.7
Public	2.3	1.5	2.1	3.0	2.5	4.5	2.1
Rule 144A	2.5	6.5	10.5	11.3	12.4	6.6	4.6
Financial corporations							
Stocks[1]	3.5	4.8	6.6	6.5	5.4	7.0	3.1
Bonds	35.8	42.6	54.3	55.2	49.9	68.3	38.4
Memo:							
Net issuance of commercial paper, nonfinancial corporations[3]	-.1	1.1	4.5	.5	2.3	7.6	3.0
Change in C&I loans at commercial banks[3]	5.3	6.2	3.8	9.1	8.4	11.1	-.6

Note. Components may not sum to totals because of rounding. These data include speculative-grade bonds issued privately under Rule 144A. All other private placements are excluded. Total reflects gross proceeds rather than par value of original discount bonds.
1. Excludes equity issues associated with equity-for-equity swaps that have occurred in restructurings.
2. 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.
3. End-of-period basis. Seasonally adjusted.



Source. Securities Data Company.



Note. Spread is Merrill Lynch II Index less 7-year Treasuries.

performance in four years, while M2 growth decelerated a bit. Still, both aggregates remain well above the upper bounds of their annual ranges.

Business Finance

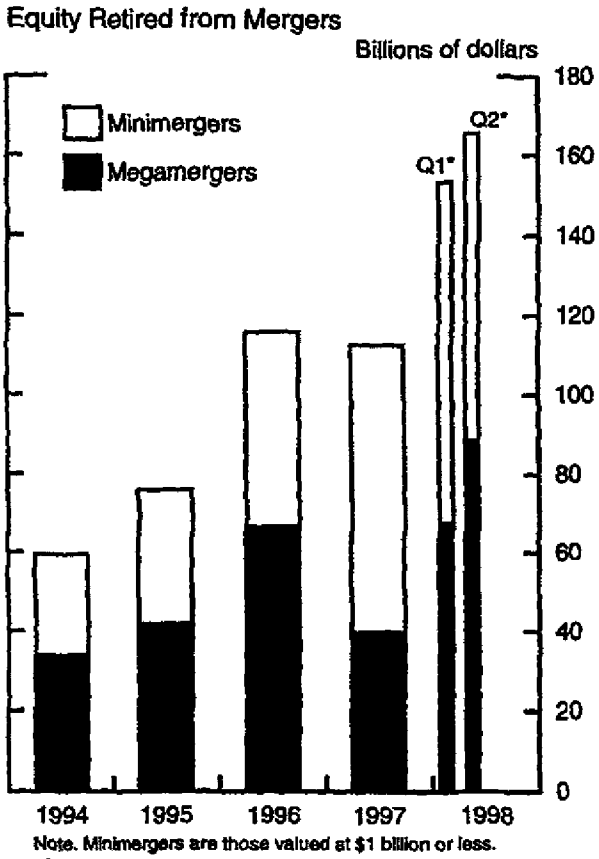
Gross issuance of bonds by nonfinancial corporations slowed only slightly in July from the exceptional pace of previous months. The heavy financing activity of investment-grade corporations about offset a pullback by speculative-grade borrowers (table). Companies used the bulk of proceeds from the bond sales in July to fund new merger and acquisition activity and for general corporate purposes, but they continued to devote some proceeds to refinancing both higher-rate bonds as well as shorter-maturity bank loans and commercial paper. The July pattern extended into early August, when WorldCom sold a record $6 billion of investment-grade debt to finance its merger with MCI. The market remains receptive to bond offerings, like this one, from firms with favorable earnings prospects. Investors were also attracted by the large issue size of the WorldCom offering, which suggested greater trading liquidity.

Gross offerings of speculative-grade debt, particularly in the private-placement (Rule 144A) market, slowed further in July after reaching record levels in the spring. The share of total issuance accounted for by speculative-grade bonds dropped to about a third in July, from a little less than half in the first half of the year (chart, bottom-left panel). The recent slowing appears to reflect a greater degree of investor caution. This less complacent attitude toward risk likely stems from generally less favorable earnings prospects and recent increases in default rates on speculative-grade securities (chart, bottom-right panel). Yield spreads on speculative-grade issues in early August were about 80 basis points above their March lows—but still on the small side by historical standards.

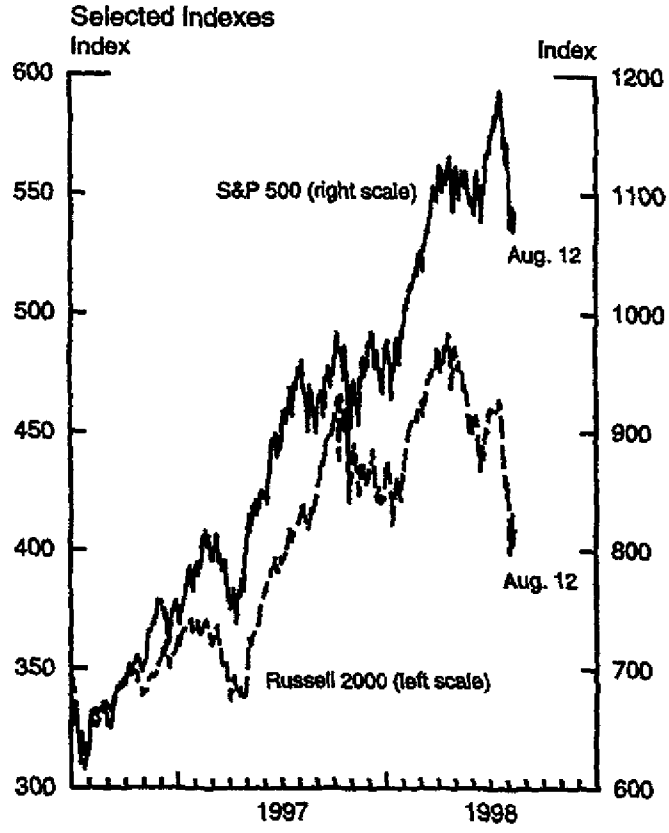
Other measures of credit quality remain favorable. Moody's upgraded, on net, a large volume of corporate bonds in the second quarter, a development that primarily reflected a reassessment of debt issued by General Motors and Chrysler, and its Watchlist suggests only a small net downgrade in coming months. Through July, the rate of business failures stood at its lowest level in a decade.

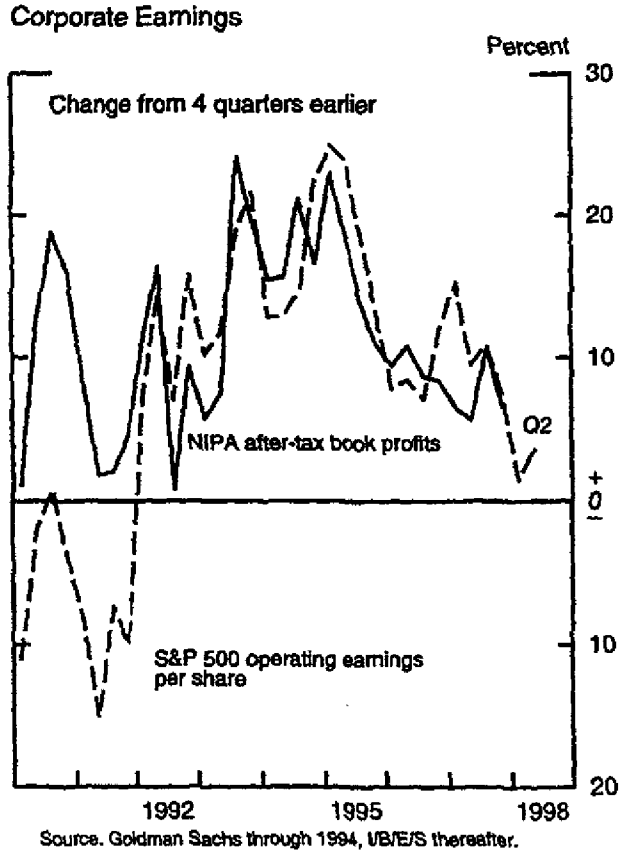
Gross equity issuance was robust in June but dropped off sharply in July (table). A number of companies involved in mergers and acquisitions sold stock in June to raise cash. As stock prices fell through July, investors appeared to be

Equity Market Indicators

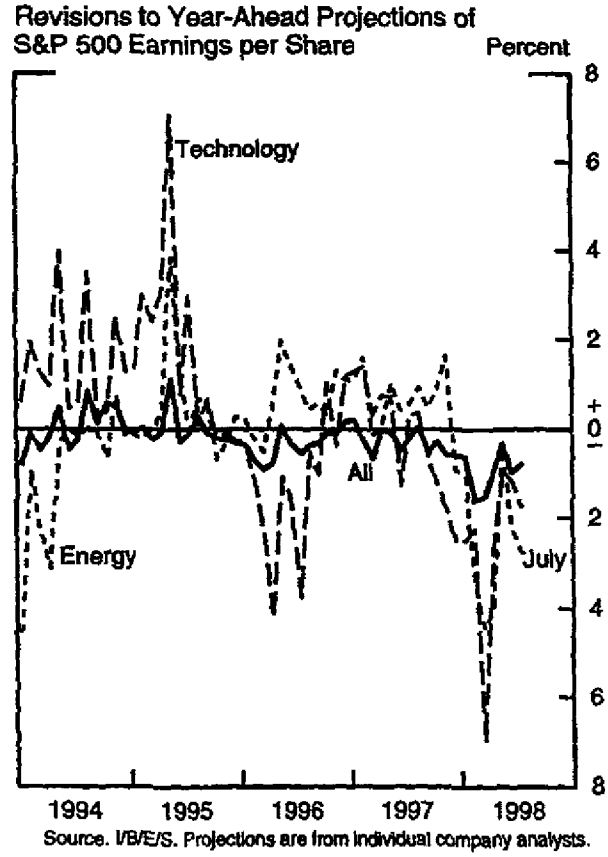


Note. Minimergers are those valued at $1 billion or less.
*Annual rate.
Source. Securities Data Company.





Source. Goldman Sachs through 1994, I/B/E/S thereafter.



Source. I/B/E/S. Projections are from individual company analysts.

approaching offerings by most companies more cautiously, with the exception of Internet-related firms, and the volume of initial public offerings slipped.

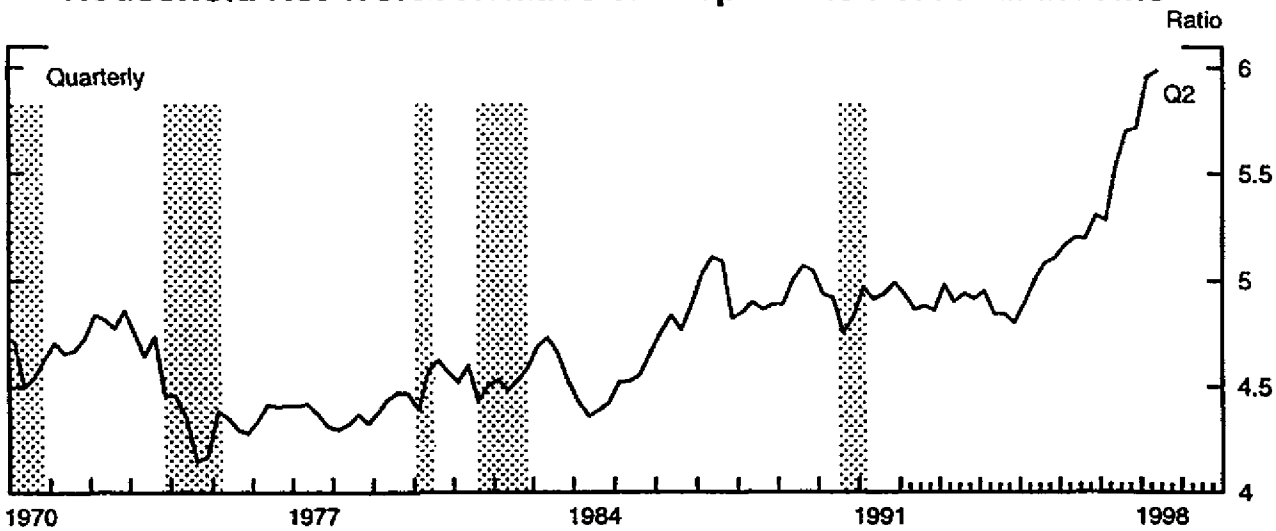
Net equity issuance continued to contract as merger-related share retirements climbed to near-record levels. Retirements associated with completed megamergers (those valued in excess of $1 billion) contributed to the uptick (chart, top left), but smaller mergers continued to account for a sizable share of equity retirements. Like larger deals, the smaller deals have proliferated into all sectors, and most have been friendly and have involved intra-industry combinations. Announcements of share buybacks by nonfinancial companies slowed in the second quarter, but previously announced programs will likely result in close-to-record repurchases this year.

Equity prices went on a roller-coaster ride over the intermeeting period. Paced by large-capitalization stocks, most major share price indexes soared to record highs in early July. Investors were relieved when the first batch of second-quarter earnings reports generally exceeded downward-revised projections. However, sentiment reversed after several major firms warned that earnings would fall short of projections in the second half of 1998 and after the Chairman commented on unrealistic earnings expectations during the Humphrey-Hawkins hearings. Prices tumbled in August when earnings worries intensified as the prospects for recovery and reform in Asia and emerging market economies elsewhere eroded further. Despite little in the way of bad earnings news for small-capitalization firms, the Russell 2000 index did not rally with the other indexes in early July, and this index continued its pattern of failing to keep pace with other market measures (chart, top right). Since its peak in April, it has dropped about 17 percent, raising the likelihood of a fourth-straight year in which this index underperforms the rest of the market by at least 10 percentage points.

Most second-quarter earnings reports are in hand, and the four-quarter growth rate of S&P 500 earnings per share apparently edged up (chart, bottom left). Growth in financial-sector earnings was again very robust, owing to large profits from investment banking activities at brokerage firms and money center banks and higher fee income for commercial banks generally. Growth in profits of nonfinancial firms picked up only slightly, as contractions in earnings in the technology and energy sectors continued to be drags. In addition, almost all of the downward revisions to year-ahead earnings projections for the S&P 500 during the past several months were accounted for by revisions to projections for those two sectors (chart, bottom right). All told, I/B/E/S "bottom-up" projections of year-ahead earnings for the S&P 500—an

Household Sector

Household Net Worth Relative to Disposable Personal Income



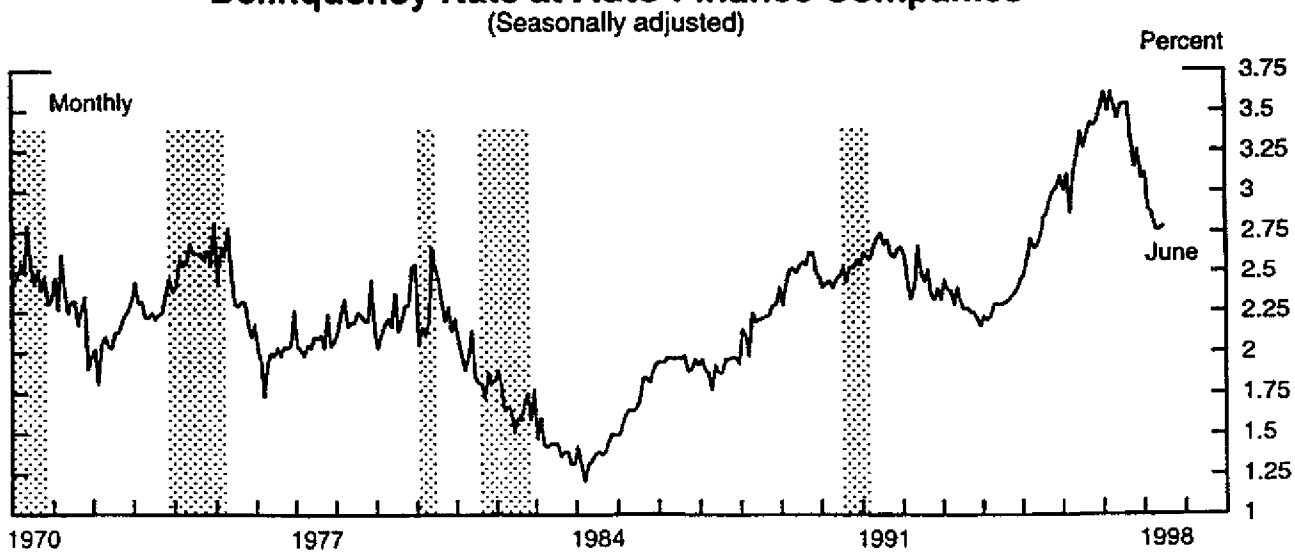
Household Debt Growth

(Percent, seasonally adjusted annual rate)

	1996	1997	1997 Q4	1998 Q1	1998 Q2	May	June
Total household debt	7.8	6.8	7.2	8.3	7.1[e]	-	-
Home mortgage	8.0	7.5	8.2	8.9	8.3[e]	-	-
Consumer	7.8	4.3	2.2	5.0	3.2	-0.2	6.4
Revolving	12.7	6.3	3.4	7.2	1.5	-5.6	5.5
Non-revolving	4.5	2.8	1.4	3.4	4.6	3.9	7.1
Memo: Levels (trillions of dollars)							
Total household	5.14	5.50	5.50	5.61	5.71	-	-
Home mortgage	3.50	3.77	3.77	3.85	3.93	-	-
Consumer	1.18	1.23	1.23	1.23	1.26	1.25	1.26
Revolving	.50	.53	.53	.54	.54	.54	.54

Delinquency Rate at Auto Finance Companies

(Seasonally adjusted)



aggregation of securities analysts' projections for individual companies—imply 1998 growth of 5-1/2 percent, down from 7-1/2 percent at the time of the last Greenbook. Projections for 1999 earnings were trimmed by somewhat less; as a result, implied growth was boosted.

Household Sector Finance

Household balance sheets strengthened further in the second quarter, as rising equity prices lifted asset levels by more than the rise in debt. The ratio of household net worth to income is estimated to have edged up to another record high in that quarter (chart). Estimates suggest that declines in equity prices in recent weeks have trimmed estimated net worth positions only slightly, leaving them well above fourth-quarter levels.

Household debt continued to rise faster than disposable personal income in the second quarter, expanding at an estimated 7 percent annual rate (table). Mortgage borrowing remained brisk, fueled by exceptionally strong home sales and heavy mortgage refinancing, often involving liquification of accumulated equity and likely some continued substitution of mortgage loans for consumer debt. Consumer credit grew at only a 3-1/4 percent annual rate in the quarter, as revolving credit growth dropped sharply.

Recently released data on household credit quality have been favorable. Auto finance companies reported that delinquencies in June stayed well below the first quarter rate (chart). Moody's reported that the credit card delinquency rate registered its seventh straight monthly decline in June, to a level just below 5 percent and near the midpoint of its range over the past decade.

On the asset side, households in the second quarter continued to invest in stock and bond mutual funds at a brisk pace, with net new flows into long-term mutual funds averaging $28-1/2 billion at a monthly rate (table). Inflows to such mutual funds in total are estimated to have remained steady in July, although the composition shifted some toward bond funds and away from equity funds. Moreover, preliminary data, provided by the Investment Company Institute on a confidential basis, indicate that net inflows to equity funds dried up in the latter part of July and early August, when stock prices declined (table).

Mutual Funds

Net Flows into Long-Term Mutual Funds
(Billions of dollars; quarterly and annual data at monthly rate)

			1997	1998				Memo:
	1996	1997	Q4	Q1	Q2	Jun.	Jul.[e]	Jun. Assets
Total Long-Term Funds	**19.3**	**22.7**	**24.1**	**30.1**	**28.4**	**24.3**	**25.3**	**3,983**
Equity Funds	**18.0**	**19.0**	**17.8**	**20.5**	**21.7**	**19.2**	**15.8**	**2,841**
Domestic	14.1	15.8	17.9	18.8	18.3	16.5	13.5	2,430
Growth	8.3	7.9	9.8	8.7	10.2	10.2	6.8	1,303
Income	5.8	7.9	8.0	10.2	8.0	6.3	6.7	1,127
International	4.0	3.1	-0.1	1.6	3.4	2.8	2.3	411
Hybrid Funds	**1.0**	**1.4**	**1.3**	**2.3**	**1.0**	**1.0**	**1.6**	**357**
Bond Funds	**0.2**	**2.4**	**5.1**	**7.3**	**5.7**	**4.1**	**7.9**	**784**
Taxable	0.7	2.3	4.3	6.2	4.5	3.4	6.3	502
Global	-0.2	-0.1	-0.1	0.0	-0.0	-0.2	0.0	26
High-yield	1.0	1.4	1.7	2.5	1.1	1.0	2.0	121
Government	-1.1	-0.8	0.2	0.4	0.0	-0.2	0.6	134
Other	1.0	1.8	2.5	3.3	3.3	2.7	3.7	221
Municipals	-0.5	0.1	0.8	1.2	1.2	0.7	1.5	283

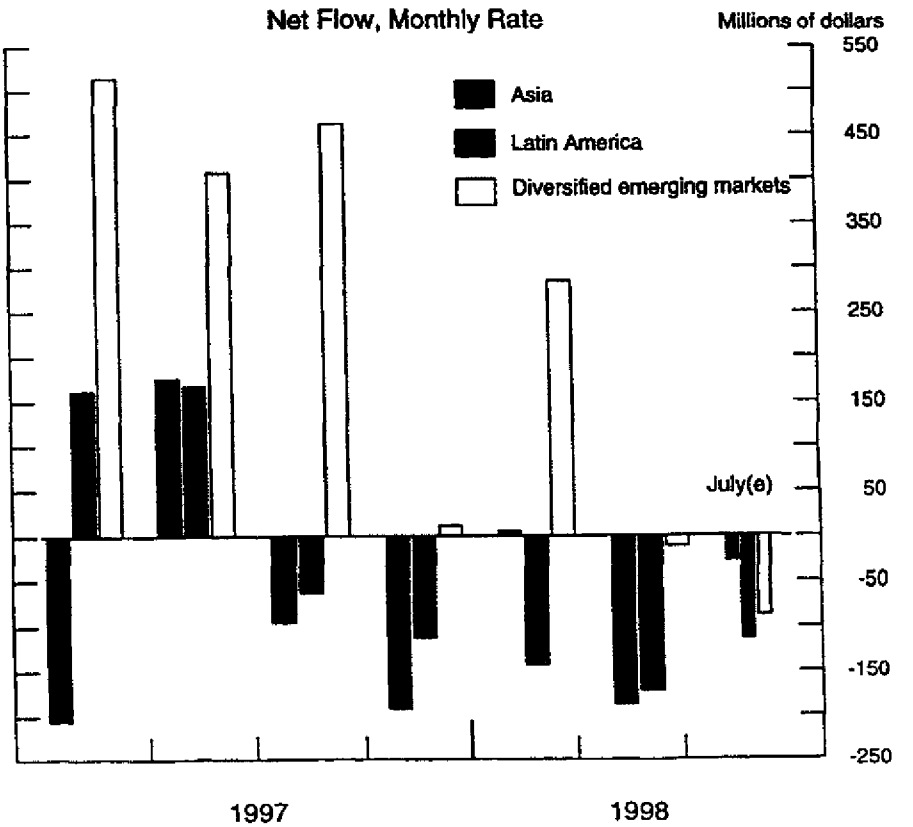
Source. Investment Company Institute (ICI).
e Staff estimates.

Equity Mutual Funds
Excluding
Reinvested Distributions
(Billions of dollars)

Week Ending	Net Flow
Jun. 3	3.2
Jun. 10	8.1
Jun. 17	3.5
Jun. 24	6.9
Jul. 1	4.0
Jul. 8	8.4
Jul. 15	6.8
Jul. 22	-1.1
Jul. 29	1.0
Aug. 5	0.0

Source. Investment Company Institute.
Note. Data are STRICTLY CONFIDENTIAL.

Emerging Market Equity Mutual Funds



Households have continued to redeem shares of mutual funds that specialize in emerging market equities, a trend that began in the middle of last year (chart). Whereas earlier the net outflows were centered in funds that specialized in Asian or Latin American companies, regionally diversified funds have also experienced net redemptions in recent months.

Federal Government Finance

In July, the Treasury began to implement its plan to shift the supply of securities toward shorter maturities and to concentrate its note sales in fewer maturities to maintain their liquidity. It trimmed the number and size of longer-term coupon offerings, eliminated the three-year note, and augmented the amount of Treasury bills and shorter-dated coupons. The two-year note offering was enlarged by $3 billion in July. Further increases in auction sizes, however, have been delayed because strong tax inflows have resulted in smaller-than-expected financing needs. We expect bill auction sizes to rise in the second half of August, and by the end of the third quarter the total offering size of the weekly bill auctions should be $2 billion larger than their current $13 billion. A further $1 billion increase in the size of the two-year note auctions is projected by the end of this quarter. At its August midquarter refunding, the Treasury sold $16 billion of five-year notes—the first offering of a five-year note at the quarterly frequency and an amount that was substantially larger than the $10-1/2 billion offered at the last monthly auction.

One factor prompting a reconfiguration of nominal Treasury issuance is expanded offerings of inflation-protected securities (TIPS). In July, the Treasury reopened the thirty-year TIPS that it had originally offered in April and sold an additional $8.4 billion, bringing the total amount of this issue outstanding to $16.9 billion. With a bid-to-cover ratio of 2.3, the demand for this bond was solid, but less so than in April. The Treasury also announced that it will sell a ten-year indexed note in October. Yields on TIPS rose over the intermeeting period and remain high relative to yields in other countries that have indexed debt outstanding.

In August, the Treasury cut the minimum purchase amounts for Treasury bills and two-year notes to $1,000, from $10,000 and $5,000, respectively. With issuance tilted more toward shorter maturities, the Treasury sought to make these offerings more accessible to the small investor. In addition, starting in September, investors who are Treasury Direct customers will be able to purchase securities over the Internet

Treasury and Agency Finance

Treasury Financing
(Billions of dollars)

Item	1997	1998				
	Q4	Q1	Q2	May	June	July[e]
Total surplus, deficit (-)	**-39.7**	**-30.2**	**136.9**	**-38.8**	**51.1**	**n.a.**
Means of financing deficit						
Net borrowing	33.7	25.9	-81.8	-8.6	-12.6	-15.3
Nonmarketable	15.8	17.3	15.9	4.3	4.5	3.6
Marketable	17.9	8.6	-97.7	-12.9	-17.1	-18.9
Bills	14.4	4.1	-78.8	-10.1	-6.7	-3.0
Coupons	3.5	4.6	-18.9	-2.7	-10.4	-15.9
Decrease in cash balance	11.7	4.3	-44.6	51.9	-36.1	36.2
Other[1]	-5.7	.0	-10.5	-4.5	-2.3	n.a.
MEMO						
Cash balance, end of period	31.9	27.6	72.3	36.1	72.3	36.1

NOTE. Components may not sum to totals because of rounding.
1. Direct loan financing, accrued items, checks issued less checks paid, and other transactions.
e Estimated.
n.a. Not available.

Net Cash Borrowing of Government-Sponsored Enterprises
(Billions of dollars)

Agency	1998				
	Q1	Q2	April	May	June
FHLBs	4.0	10.5	5.2	-1.1	6.4
FHLMC	24.1	7.0	7.5	4.0	-4.4
FNMA	11.3	25.1	14.9	3.5	6.7
Farm Credit Banks	-1.2	2.4	.5	.9	1.0
SLMA	-1.4	-3.1	-.1	-.3	-2.7

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

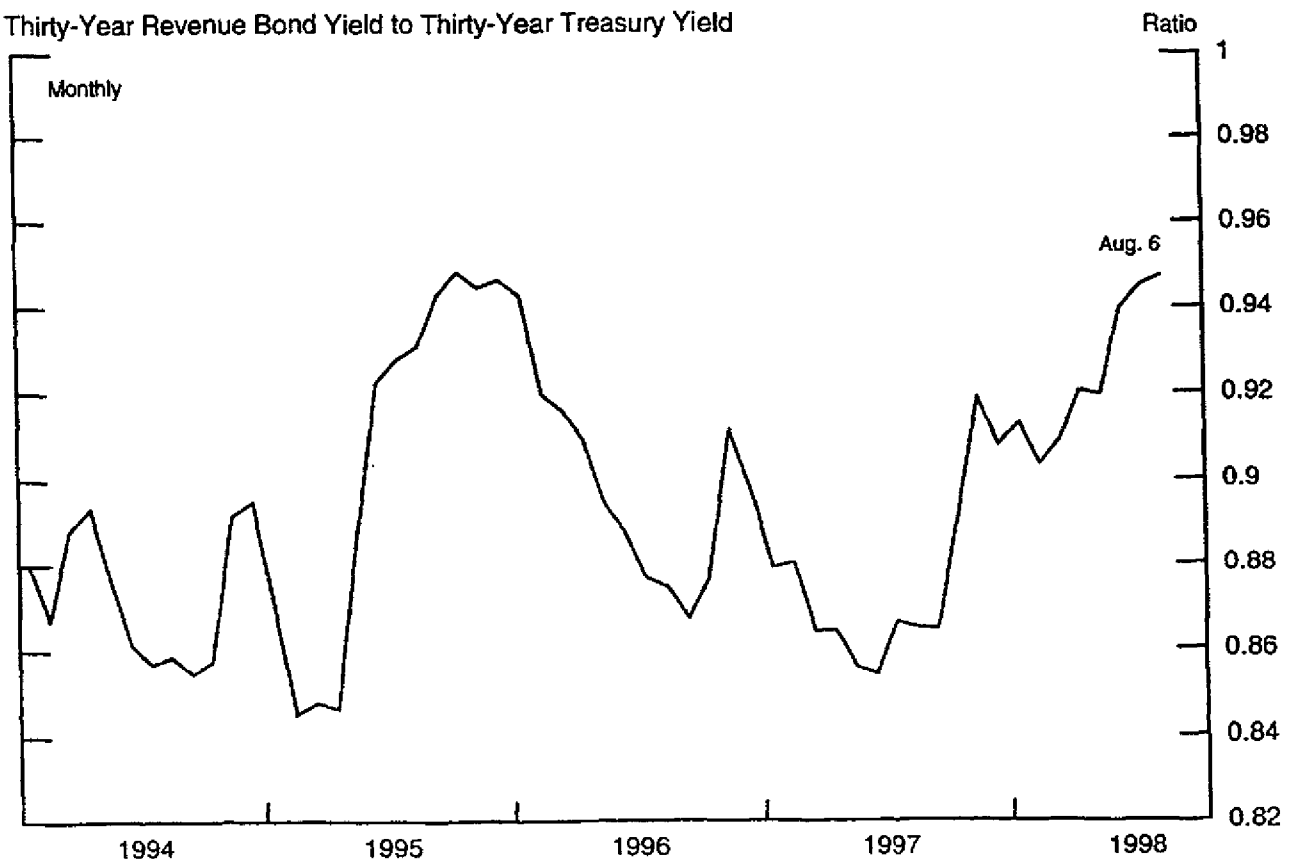
State and Local Finance

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

				1998				
	1995	1996	1997	Q1	Q2	May	June	July
Total tax-exempt	15.4	17.9	21.5	23.3	27.5	23.6	37.3	24.9
Long-term	12.1	14.3	17.9	22.0	24.3	22.9	29.7	22.6
Refundings[1]	3.6	4.9	6.6	9.5	8.5	7.6	10.3	6.7
New capital	8.5	9.4	11.3	12.5	15.7	15.3	19.3	15.9
Short-term	3.3	3.6	3.6	1.3	3.2	0.8	7.6	2.3
Total taxable	0.7	0.8	1.1	1.3	0.8	0.9	0.8	1.3

Note. Includes issues for public and private purposes.
1. All issues that include any refunding bonds.

Tax-Exempt to Taxable Yield Ratio



Note. Average of weekly data. Last value is average of weeks to date.

and, beginning in October, using a touch-tone phone. On September 1, the Treasury will begin sales of inflation-indexed savings bonds.

Gross issuance by government-sponsored enterprises in July and early August featured additional offerings of Fannie Mae's "benchmark" and Freddie Mac's "reference" notes, some of which were reopenings of outstanding issues. Both agencies are seeking to take advantage of the decline in Treasury issuance to establish these noncallable notes as issues that can be used for hedging, short sales, and duration management. Demand from investors, especially from overseas, has been quite strong. The extra liquidity associated with sales of these notes should reduce borrowing costs for the agencies. Indeed, recent yields on these types of notes were about 1-1/2 to 3 basis points lower than those on nonbenchmark agency securities.

Municipal Finance

Gross offerings of long-term municipal bonds dropped off from the high June level but remained substantial in July. Issuance to raise new capital, which had been boosted in June by offerings in the health and transportation areas, eased only slightly. A dropoff of refunding issues in July, with interest rates still at fairly low levels, suggests that a good portion of the stock of higher-rate outstanding debt may have been refinanced.

The market has had some difficulty absorbing all of the new supply of tax-exempts. The ratio of yields on revenue bonds to Treasury yields is at a three-year high. Investor demand has not kept pace with issuance, as manifested by short bid lists and large dealer inventories of unsold bonds. Although flows into municipal bond funds have picked up this year, they have not kept pace with net issuance. In addition, property and casualty firms, which are usually large buyers of municipal securities, reportedly have trimmed purchases as heavy claims payouts have reduced their investible funds.

Credit quality in the state and local sector continued to improve over the intermeeting period. The upgrade of the debt of New York City, which covered $27 billion of bonds, more than offset the modest volume of debt downgraded.[1]

Money and Bank Credit

Bank credit grew at an annual rate near 5 percent in July, after adjusting for mark-to-market accounting effects, as banks boosted their securities holdings. Bank loan growth eased, primarily reflecting a smaller increase in business loans. The supply of

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1. However, the number of downgrades exceeded the number of upgrades for the first time in several years because the tax-exempt securities of several health-related nonprofit organizations were downgraded.

Commercial Bank Credit
(Percent change; seasonally adjusted annual rate)

Type of credit	1997	1998 Q1	1998 Q2	1998 May	1998 Jun	Jul p	Level, Jul 1998 p (billions of $)
1. Bank credit: Reported	9.0	11.6	5.3	7.6	2.7	5.1	4,274.0
2. Adjusted[1]	8.5	11.1	5.9	7.3	0.6	4.9	4,174.3
3. Securities: Reported	10.3	17.1	0.8	16.4	-7.2	8.5	1,124.0
4. Adjusted[1]	8.5	15.7	2.7	16.0	-16.2	8.3	1,024.4
5. U.S. government	6.2	15.7	-3.3	10.5	-26.2	5.7	757.7
6. Other[2]	20.8	20.3	10.1	29.3	34.8	13.9	366.3
7. Loans[3]	8.5	9.6	7.0	4.4	6.2	3.8	3,149.9
8. Business	9.0	10.6	5.1	12.1	13.8	7.6	895.6
9. Real estate	9.1	7.6	6.9	1.1	-0.6	2.3	1,273.0
10. Home equity	15.3	6.2	-0.8	-4.9	-3.7	-3.7	97.3
11. Other	8.6	7.8	7.5	1.6	-0.3	2.8	1,175.7
12. Consumer: Reported	-1.4	-3.5	1.2	0.2	-8.3	-15.0	496.2
13. Adjusted[4]	4.2	3.7	8.8	6.6	4.6	6.0	739.1
14. Other[5]	20.4	29.5	17.2	3.9	26.0	21.1	485.2

Note. Adjusted for breaks caused by reclassifications. Monthly levels are pro rata averages of weekly (Wednesday) levels. Quarterly levels (not shown) are simple averages of monthly levels. Annual levels (not shown) are levels for the fourth quarter. Growth rates shown are percentage changes in consecutive levels, annualized but not compounded.

1. Adjusted to remove effects of mark-to-market accounting rules (FIN 39 and FASB 115).
2. Includes securities of corporations, state and local governments, and foreign governments and any trading account assets that are not U.S. government securities.
3. Excludes interbank loans.
4. Includes an estimate of outstanding loans securitized by commercial banks.
5. Includes security loans, loans to farmers, state and local governments, and all others not elsewhere classified. Also includes lease financing receivables.

p Preliminary.

MONETARY AGGREGATES
(Based on seasonally adjusted data)

Aggregate or component	1997	1998 Q1	1998 Q2	1998 May	1998 June	1998 July (p)	1997:Q4 to July 98 (p)	Level (bil. $) July 98 (p)
Aggregate	Percentage change (annual rate)[1]							
1. M1	-1.2	3.0	.3	-3.1	-3.2	-3.1	.5	1072.3
2. M2[2]	5.7	8.0	7.3	2.8	5.2	4.9	7.0	4210.1
3. M3	8.8	11.0	9.6	6.1	5.4	.4	8.6	5630.0
Selected Components								
4. Currency	7.5	8.0	5.1	5.0	7.4	8.5	6.9	441.3
5. Demand deposits	-2.0	-1.7	-5.2	-1.5	-13.9	-16.6	-5.8	378.4
6. Other checkable deposits	-12.2	2.4	1.1	-20.1	-4.4	-2.4	-.2	244.9
7. M2 minus M1[3]	8.4	9.9	9.8	4.9	8.1	7.7	9.4	3137.8
8. Savings deposits	9.9	12.0	13.6	4.6	9.0	15.1	12.8	1503.5
9. Small time deposits	2.3	.8	-2.9	-4.7	-1.7	-2.1	-1.4	959.4
10. Retail money market funds	16.0	19.6	21.0	19.8	20.7	5.4	19.1	675.0
11. M3 minus M2[4]	19.6	20.2	16.5	15.9	6.1	-12.8	13.6	1419.9
12. Large time deposits, net[5]	17.1	19.0	12.1	3.3	9.0	-34.9	8.1	597.5
13. Institution-only money market mutual funds	21.0	18.9	36.5	38.7	28.7	-5.3	25.2	430.2
14. RPs	17.0	32.7	13.2	6.5	-34.8	13.8	16.6	254.2
15. Eurodollars	31.2	7.8	-13.7	22.4	-.9	14.1	.3	137.9
Memo								
16. Liquid Deposits[6]	4.3	8.2	8.5	.6	3.1	7.3	7.6	2126.8
17. Sweep-adjusted M1[7]	6.1	6.6	5.0	.6	3.1	4.7	5.3	1364.3
18. Monetary base	5.9	6.9	4.1	4.7	6.2	4.8	5.5	493.6
19. Household M2[8]	6.6	9.4	8.6	4.5	7.4	8.2	8.7	3836.7
	Average monthly change (billions of dollars)[9]							
Memo								
Selected managed liabilities at commercial banks:								
20. Large time deposits, gross	11.2	8.5	5.0	3.2	4.1	-17.9	. . .	700.7
21. Net due to related foreign institutions	-3.9	9.5	-16.3	-7.1	-3.7	14.5	. . .	179.2
22. U.S. government deposits at commercial banks	.2	-.4	4.3	14.1	-10.5	8.7	. . .	39.0

1. For the years shown, fourth quarter-to-fourth quarter percent change. For the quarters shown, based on quarterly averages.
2. Sum of seasonally adjusted M1, retail money market funds, savings deposits, and small time deposits.
3. Sum of retail money funds, savings deposits, and small time deposits, each seasonally adjusted separately.
4. Sum of large time deposits, institutional money funds, RP liabilities of depository institutions, and Eurodollars held by U.S. addressees, each seasonally adjusted separately.
5. Net of holdings of depository institutions, money market mutual funds, U.S. government, and foreign banks and official institutions.
6. Sum of seasonally adjusted demand deposits, other checkable deposits, and savings deposits.
7. Sweep figures used to adjust these series are the estimated national total of transaction account balances initially swept into MMDAs owing to the introduction of new sweep programs, on the basis of monthly averages of daily data.
8. M2 less demand deposits.
9. For the years shown, "average monthly change" is the fourth quarter-to-fourth quarter dollar change, divided by 12. For the quarters shown, it is the quarter-to-quarter dollar change, divided by 3.

p--Preliminary.

business loans in recent quarters has been affected by a pullback in lending by branches and agencies of foreign banks. The August Senior Loan Officer Survey showed that a significant share of branches and agencies continued to raise spreads and in response to higher funding costs and concerns about the financial condition of their parents. Domestically chartered banks, in contrast, reported little change in their willingness to make business loans, preserving their accommodative lending posture, and they noted some slight further easing of terms.

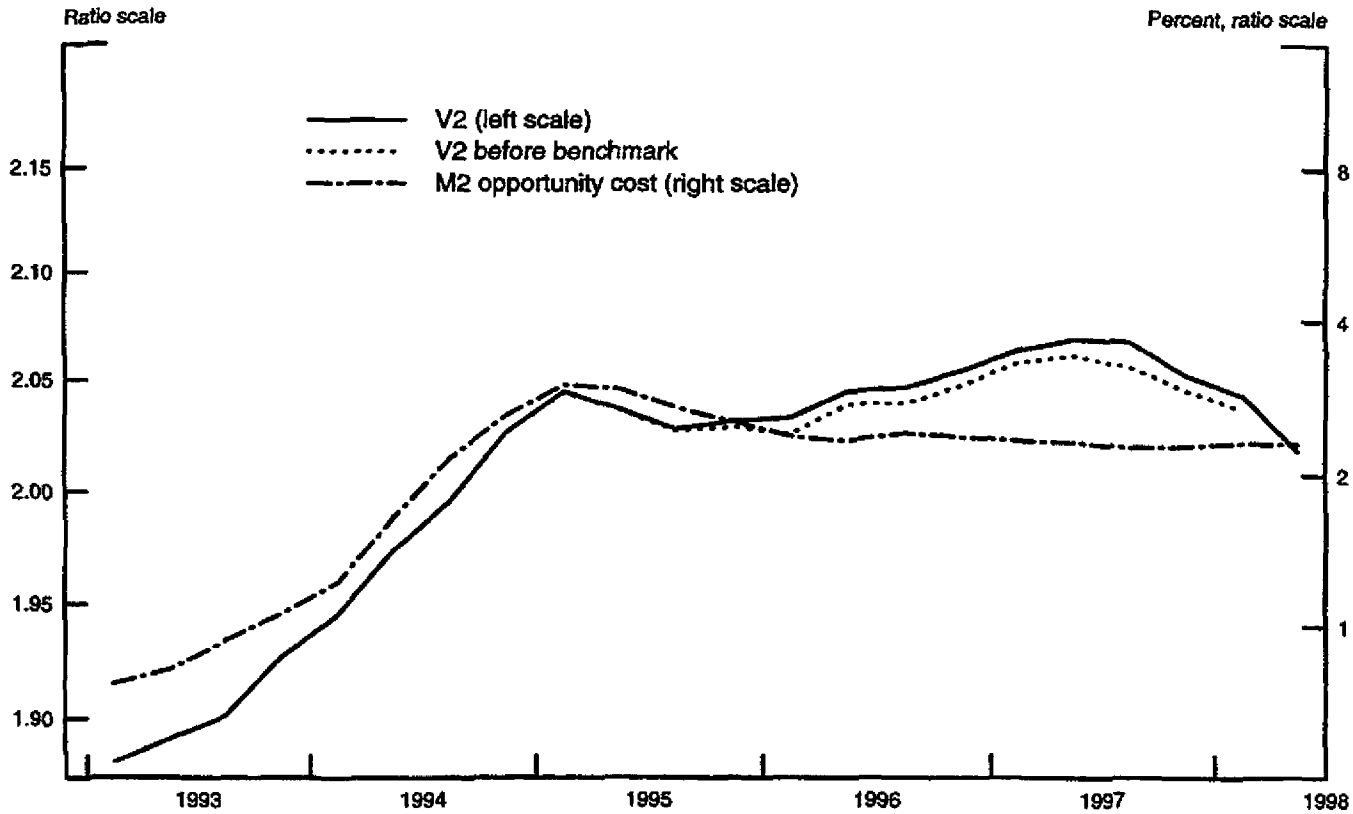
Both the residential and commercial components of real estate loan growth at banks have been sluggish over the past few months. Consistent with reports of robust housing and improving commercial property markets, demand for these loans has been strong, as confirmed by the most recent loan officer survey. Moreover, the survey indicated that spreads on commercial mortgages had narrowed since May. Reported growth, however, has been damped by stepped-up securitization at large banks.

Reported consumer loans ran off at a striking 15 percent annual rate in July, owing to more than $6 billion in securitizations, most of which consisted of credit card loans from one large bank. After adjusting for securitization, however, these loans expanded at a moderate 6 percent pace.

While M3 was about flat in July, it was still up 8-1/2 percent at an annual rate from the fourth quarter of 1997, well above the top of its annual range. A surprisingly steep runoff in large time deposits in July, following double-digit growth over the first two quarters of the year, shaved nearly 4 percentage points off the monthly growth rate. The runoff was concentrated at a handful of U.S. branches and agencies of European banks, which relied more heavily on non-M3 funding sources, particularly borrowing from their head offices overseas. Institution-only money market mutual funds also contracted last month after expanding very briskly over the first half of the year. Investors sharply reduced their holdings of these funds at times during July to avail themselves of short-lived increases in the rate spreads on money market instruments over these funds.

M2 growth in July was a bit slower than in the second quarter, as the expansion of its liquid components, particularly retail money funds, eased. Nonetheless, growth of M2 continued to outpace that of nominal GDP in the second quarter, with velocity declining sharply, at about a 5-1/4 percent annual rate. The rebenchmarking of GDP raised the level of M2 velocity but had little effect on its recent pattern of behavior (chart). From the fourth quarter of 1997 through July, M2 expanded at a 7 percent pace, well above the upper bound of its range.

M2 Velocity and Opportunity Cost



Note. Opportunity cost is constructed as a two-quarter moving average.

Appendix

The August Senior Loan Officer Opinion Survey on Bank Lending Practices

The August 1998 Senior Loan Officer Opinion Survey on Bank Lending Practices, primarily covering changes over the past three months, posed the usual questions bearing on the supply of and demand for bank loans to businesses and households.[1] Additional questions targeted changes in standards and terms on home equity, consumer, and commercial real estate loans, and the effects of reduced participation of U.S. branches and agencies of foreign banks in the U.S. loan market.

On balance, the domestic respondents do not appear to have significantly changed their lending posture over recent months. Although the survey provided additional evidence of narrowing of interest rate spreads for most types of loans, other changes in terms were generally minimal. The respondents attributed the narrowing of spreads primarily to increased competition from other banks. Lesser numbers of respondents indicated that nonbank lenders were a source of greater competition.

In contrast to domestic banks, substantial fractions of the U.S. branches and agencies of foreign banks reported tighter credit standards and terms. In special questions addressed to them, foreign institutions reporting decreased participation in U.S. loan markets indicated that concerns about their parent's financial condition or increased costs of funds due to the parent's financial condition were major reasons for the reduced lending activity.

Lending to Businesses

Domestic respondents reported no changes, on net, in standards for commercial and industrial loans to medium and larger customers, and only 5 percent of respondents, on net, eased standards for commercial loans to smaller firms. About 15 percent of domestic respondents, on net, reported narrowing spreads on loans to medium and large firms, down from about 35 percent in May, but twice as many reported trimming spreads on loans to small firms. Those reporting an easing of credit standards or terms noted more aggressive competition from banks and, to a lesser extent, nonbank lenders.

About 17 percent of the U.S. branches and agencies of foreign banks, on net, reported tighter credit standards for commercial and industrial loans; this is down substantially from the past two surveys. However, large fractions of the branches and agencies continued to tighten business lending terms, including fees and spreads.

August's survey also included special questions for the U.S. branches and agencies of foreign banks regarding their commercial and industrial lending over the past year. More than half, 61 percent, of the foreign respondents indicated that this type of lending had slowed at their institution over the past year. Only one of these gave decreased demand as an important reason, and only three cited concerns about the credit quality of their customers as a reason. Instead, all the Japanese institutions attributed their slowdown to a desire to reduce the loans on their books because of the financial condition of their parent institution or to an increase in

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1. This summary of the survey results is based on responses from the complete panel of fifty-seven domestic banks and twenty-four branches and agencies of foreign banks.

funding costs owing to the financial condition of their parent. Among non-Japanese respondents, three out of five reporters cited "other" reasons for the slowdown. Their comments indicated that the spreads on these loans have narrowed so much that they are no longer an attractive investment.

When queried about the effects that the pullback in lending by some U.S. branches and agencies of foreign banks has had on loan terms for U.S. firms, respondents provided contrasting answers depending on their perspective. About 74 percent of the foreign respondents indicated that the effect was either "moderate" or "substantial." Approximately 40 percent of large domestic banks responded with "moderate" or "substantial" effects.[2] By contrast, only 10 percent of the smaller domestic banks reported a large effect.

A modest portion of the domestic respondents, 9 percent on net, indicated demand for business loans from larger customers had weakened. This is the first reported decrease since the first quarter of 1996 and partly reverses the increase in loan demand reported in recent surveys. Those respondents reporting weaker loan demand pointed to decreased merger or acquisition activity, decreased customer investment in plant and equipment, and increased funding from nonbank loan sources as significant reasons for the decreased demand. Increased use of internally generated funds and decreased inventory financing needs ranked somewhat lower.

Domestic respondents also reported little change, on net, in credit standards for commercial real estate loans over the last three months, but more than half acknowledged, in special questions, having narrowed interest rate spreads on these loans over the past year. Again, the most common reason cited for the narrower spreads was heightened bank competition, with more aggressive nonbank competition a distant second. A small share of foreign respondents had tightened credit standards on commercial real estate loans. A large majority, 82 percent of domestic and 67 percent of foreign, respondents, on net, reported that competing institutions had eased standards or terms on such loans over the past year.

Lending to Households

A few respondents reported changes in consumer loan standards. On net, 20 percent tightened standards on credit card loans, and 8 percent tightened standards on other consumer loans. Both responses represent a slight increase over the previous survey. Despite the tightening of standards, 10 percent of respondents, on net, expressed greater willingness to make consumer loans. Most banks reported no changes in credit card terms, although about 10 percent cut the size of credit lines and increased interest rate spreads on new or existing accounts. Terms on other consumer loans, which were unchanged on the previous survey, were eased in August: About a fifth of respondents reported narrower spreads on these loans. The demand for consumer loans was reported to be essentially unchanged.

Domestic respondents also reported no change in standards for home mortgage loans since May, but 35 percent, on net, reported increased demand for these loans over the past three months, likely reflecting the robust housing market and the heavy pace of refinancing activity. In special questions, about 10 percent of respondents, on net, reported having eased lending standards and terms on home equity loans over the past six months. Their responses suggested little change in demand for these loans over that period. Those respondents reporting increased demand for home equity loans gave consolidation of other loans as the primary

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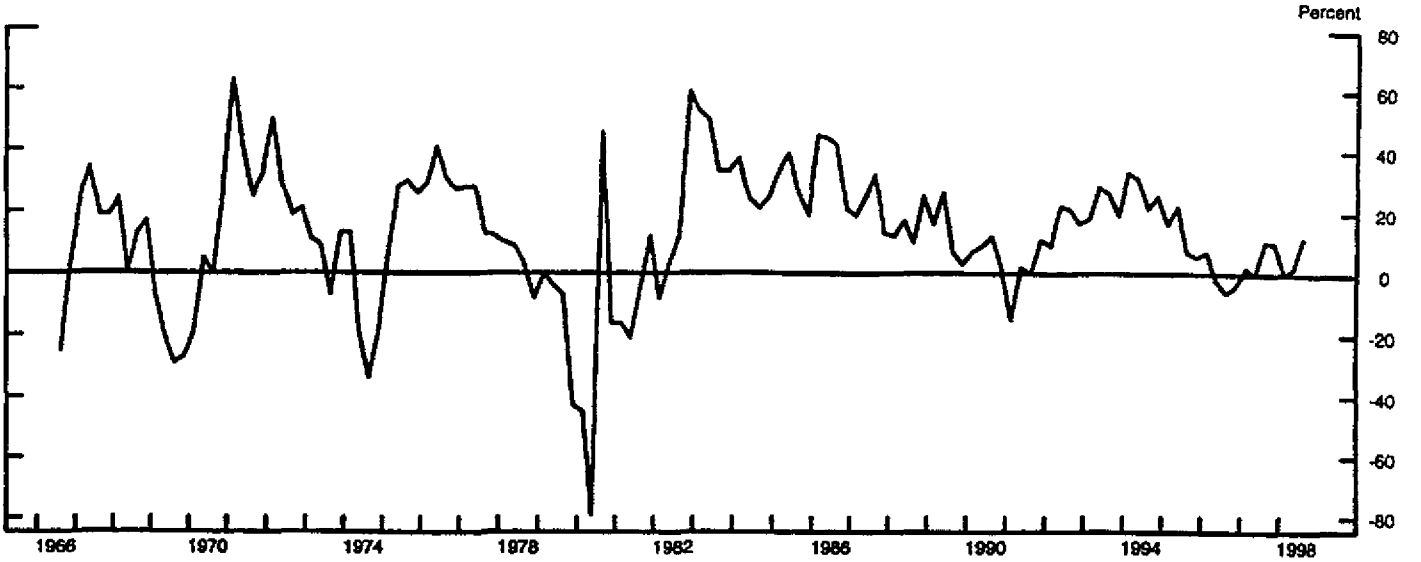
2. Large domestic banks, in this context, are domestic banks with assets exceeding $15 billion.

reason, while those reporting decreased demand gave refinancing of mortgages as the primary reason.

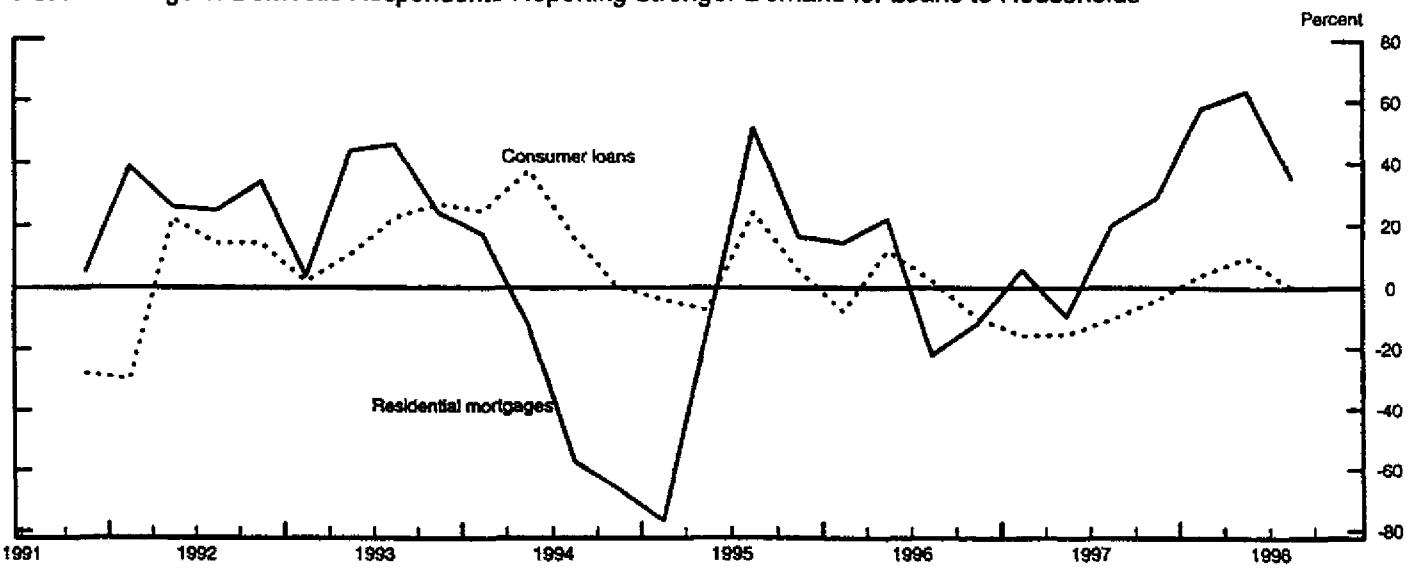
Special questions were asked about the impact of changes in consumer lending standards and terms over the past two years on both loan volume and current terms. Exactly half of the responding banks reported that tighter standards have had a "minimal" or "moderate" effect on the volume of their consumer lending, and 10 percent indicated there had been virtually no effect. About a third of the respondents indicated that they had tightened terms on more than half of their credit card accounts; the majority of banks, however, indicated that only a fairly small share of their credit card accounts had been affected by these changes.

Measures of Supply and Demand for Loans to Households

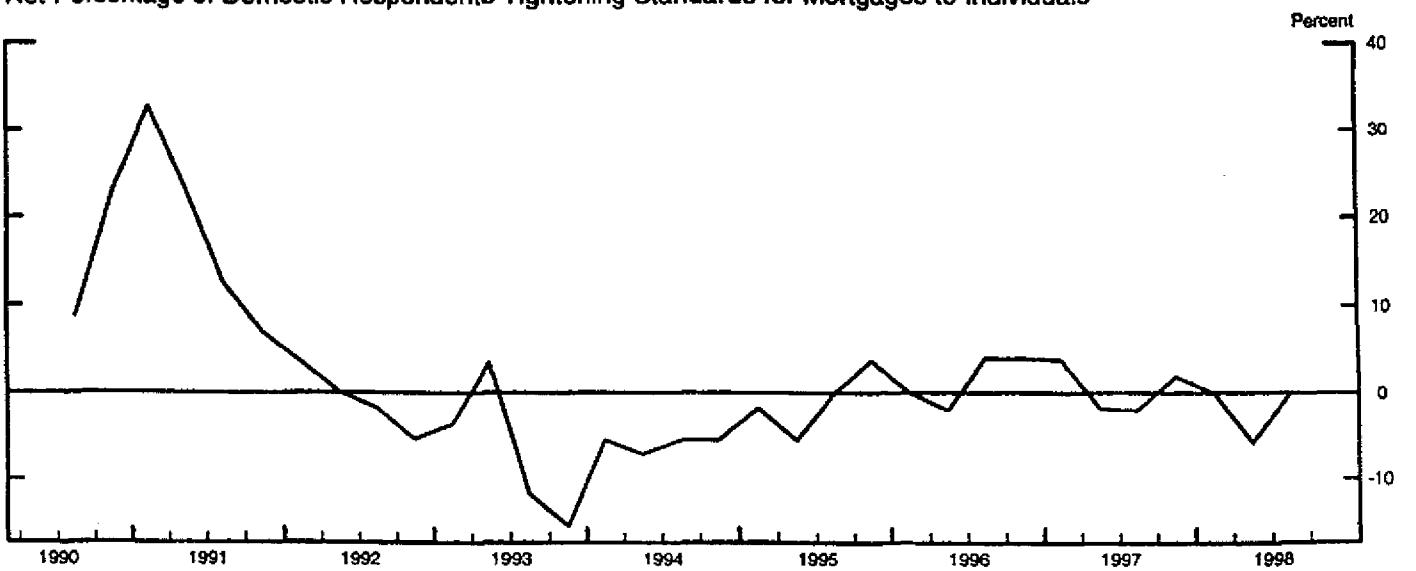
Net Percentage of Domestic Respondents Indicating More Willingness to Make Consumer Installment Loans



Net Percentage of Domestic Respondents Reporting Stronger Demand for Loans to Households

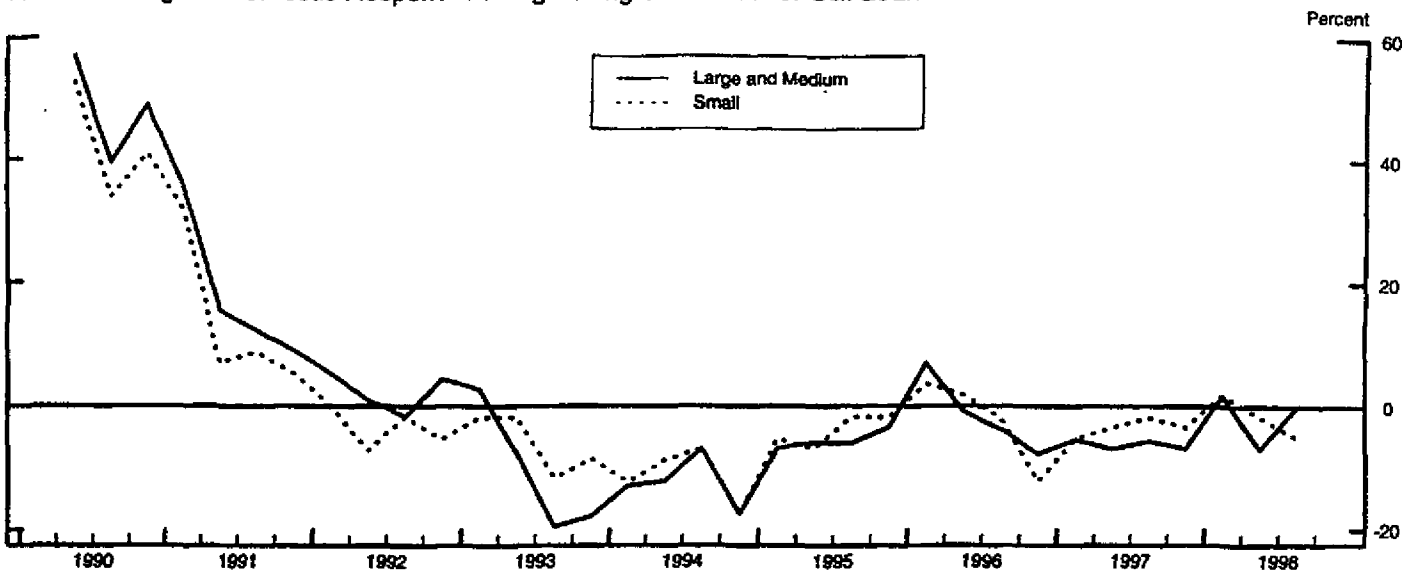


Net Percentage of Domestic Respondents Tightening Standards for Mortgages to Individuals

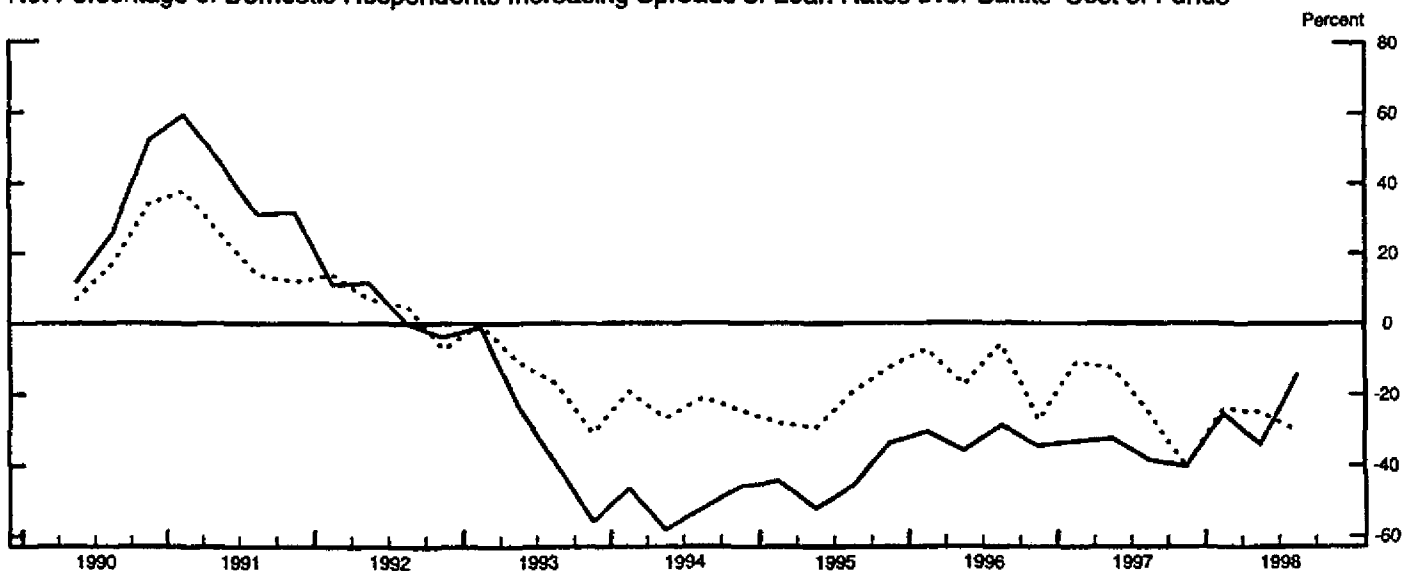


Measures of Supply and Demand for C&I Loans, by Size of Firm Seeking Loans

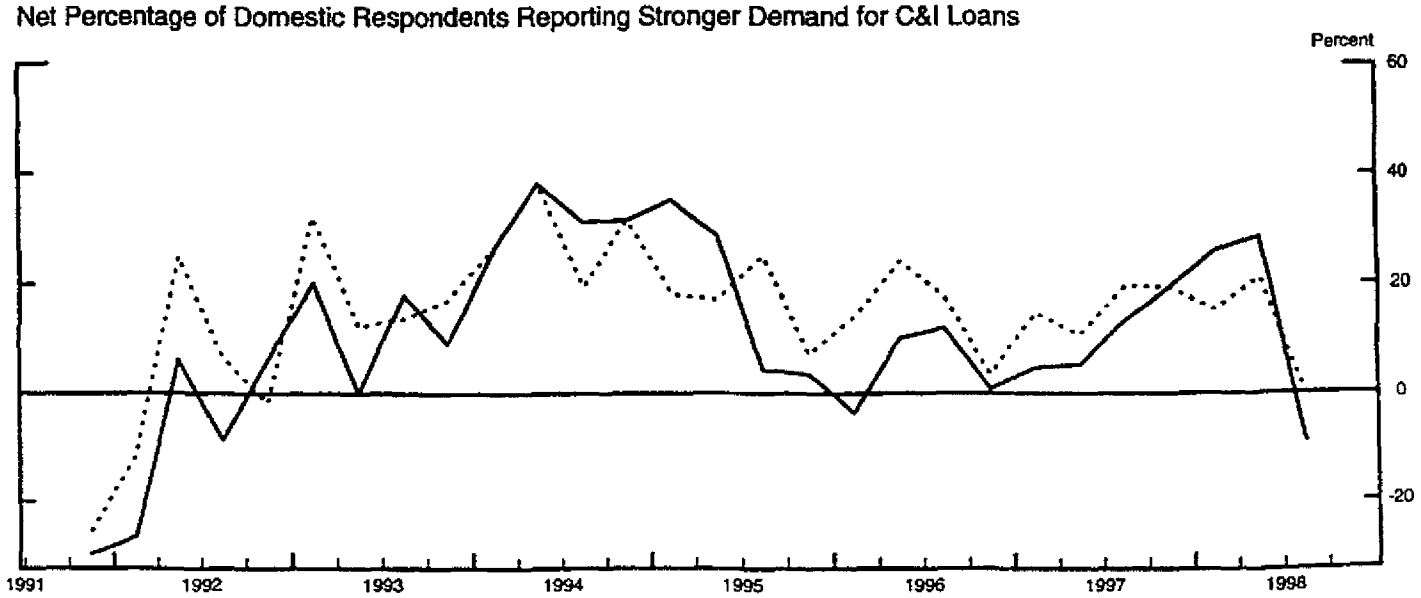
Net Percentage of Domestic Respondents Tightening Standards for C&I Loans



Net Percentage of Domestic Respondents Increasing Spreads of Loan Rates over Banks' Cost of Funds



Net Percentage of Domestic Respondents Reporting Stronger Demand for C&I Loans



INTERNATIONAL DEVELOPMENTS

International Developments

U.S. International Trade in Goods and Services

In May, the U.S. nominal trade deficit in goods and services widened to $15.7 billion, the largest deficit since the series on monthly goods and services was first published in January 1992. For April-May combined (AR), the deficit was substantially larger than in the first quarter. NIPA real net exports fell sharply in the second quarter, yielding a negative contribution to real GDP growth of 2½ percentage points. Trade data for June will be released on August 18.

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

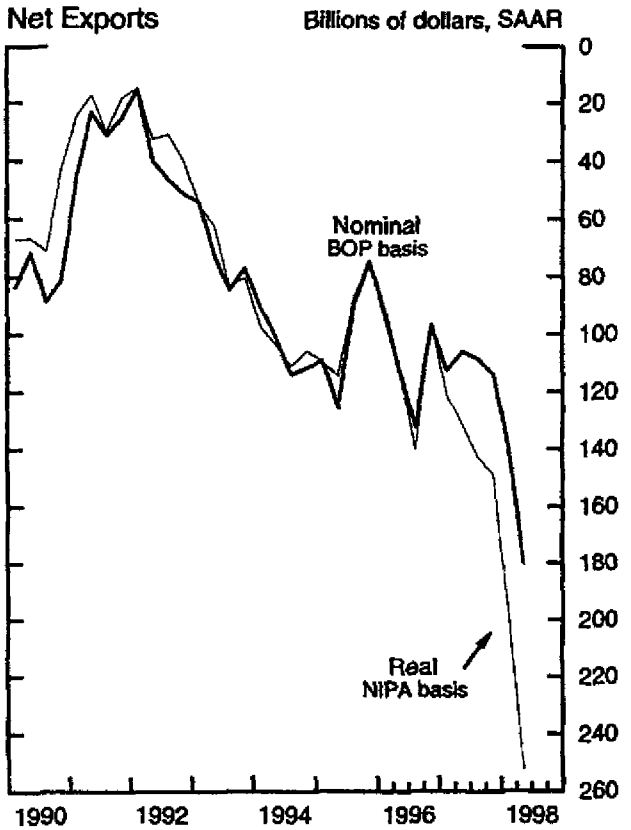
		Annual rates			Monthly rates		
	1997	1997	1998		1998		
		Q4	Q1	Q2e/	Mar	Apr	May
Real NIPA 1/							
Net exports of G&S	-136.1	-149.0	-198.5	-252.9	...	...	...
Nominal BOP							
Net exports of G&S	-113.7	-113.8	-139.5	-180.1	-13.2	-14.3	-15.7
Goods, net	-199.0	-199.4	-222.8	-264.8	-20.5	-21.3	-22.8
Services, net	85.3	85.5	83.3	84.7	7.3	7.1	7.1

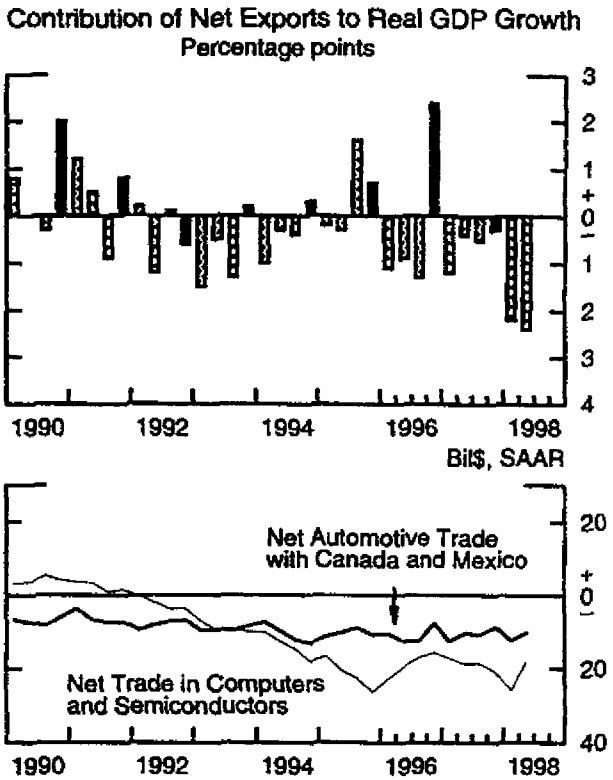
1. In billions of chained (1992) dollars.
e. BOP data are two months at an annual rate.
Source. U.S. Dept. of Commerce, Bureaus of Economic Analysis and Census.

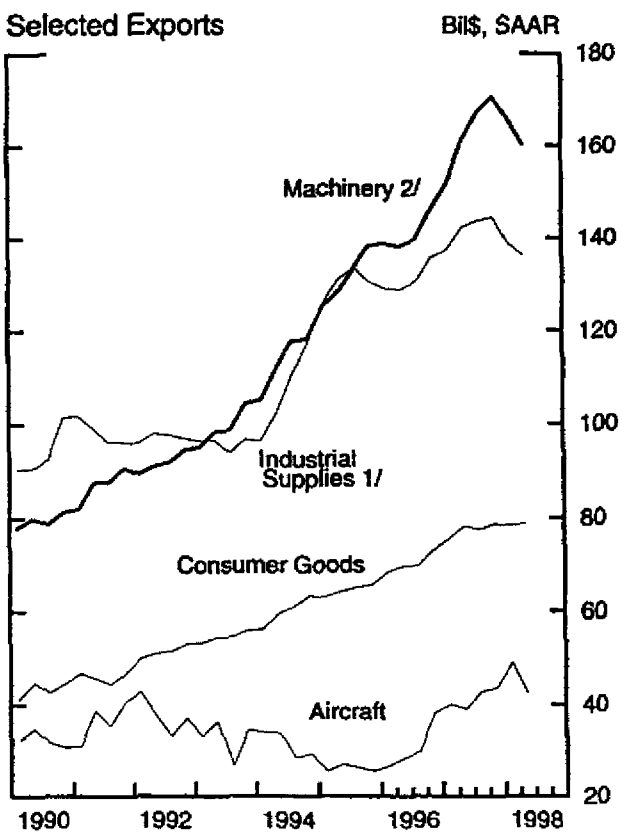
The value of exports declined 1¼ percent in May with much of the decrease in automotive products, machinery, and agricultural products. Exports to most key countries in Asia continued to decline in May. For April-May combined (AR), the value of exports of goods and services was 2½ percent lower than in the first quarter. More than three-fourths of the decline was in capital goods (nearly half from aircraft) and agricultural products. There was also a sharp decline in exports of automotive products to countries other than Canada and Mexico. Overall, exports declined to all major areas except Canada; the largest decreases were to Western Europe and Asia.

The value of imports rose one-half percent in May with the increase spread among all major trade categories except oil and consumer goods (both of which declined). For April-May combined (AR), the value of imports was 1½ percent higher than in the first quarter. Half of the increase was from consumer goods. There were also sharp rises in imports of aircraft and steel. Imports of semiconductors fell.

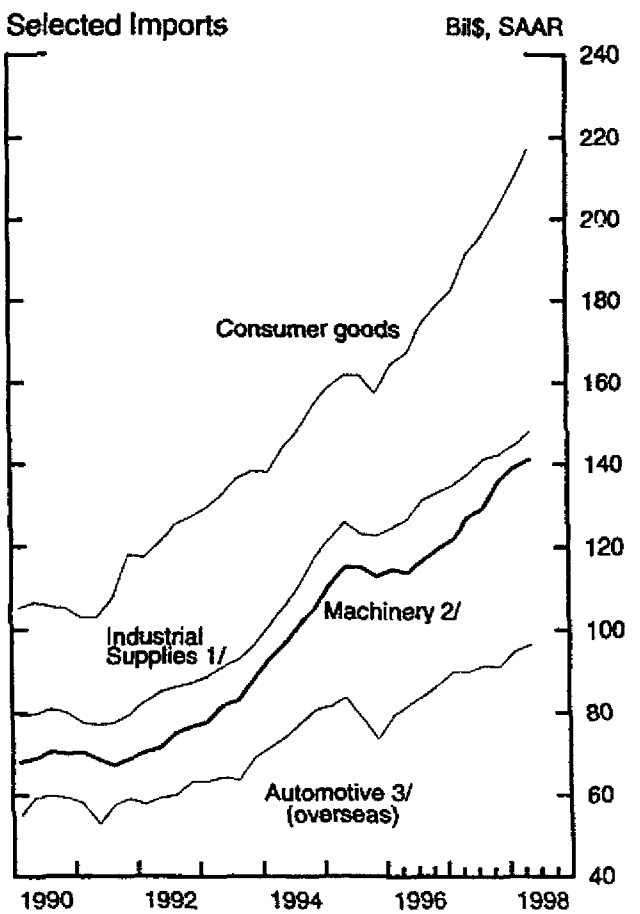
U.S. International Trade in Goods and Services







1/ Excludes agriculture and gold.
2/ Excludes computers and semiconductors.



1/ Excludes oil and gold.
2/ Excludes computers and semiconductors.
3/ Excludes Canada and Mexico.

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

	Levels				Amount Change 1/			
	1998		1998		1998		1998	
	Q1	Q2e/	Apr	May	Q1	Q2e/	Apr	May
Exports of G&S	945.6	920.7	926.6	914.8	-12.2	-24.9	-23.1	-11.9
Goods exports	685.9	658.2	664.0	652.3	-11.3	-27.7	-22.6	-11.7
Agricultural	56.4	51.6	53.1	50.1	-4.1	-4.8	-1.9	-2.9
Gold	5.3	3.9	3.5	4.4	1.9	-1.4	-1.4	0.9
Other goods	624.2	602.6	607.5	597.8	-9.0	-21.6	-19.2	-9.7
Aircraft & pts	48.8	42.4	39.0	45.8	5.3	-6.5	-11.0	6.8
Computers	45.5	44.2	44.3	44.0	-3.6	-1.3	0.9	-0.2
Semiconductors	37.8	35.5	36.3	34.7	-1.0	-2.3	0.1	-1.6
Other cap gds	168.5	162.8	165.9	159.7	-5.1	-5.7	-3.1	-6.2
Automotive	77.7	74.7	77.6	71.8	1.1	-3.0	-1.3	-5.9
to Canada	40.8	41.6	42.0	41.1	-0.5	0.8	-0.6	-0.9
to Mexico	13.2	13.1	14.7	11.6	-0.1	-0.1	0.6	-3.1
to ROW	23.7	20.0	20.9	19.1	1.7	-3.7	-1.3	-1.8
Ind supplies	138.8	136.1	135.3	136.9	-5.7	-2.7	-4.1	1.5
Consumer goods	78.3	78.8	79.1	78.5	-0.4	0.4	0.5	-0.6
All other	28.8	28.2	30.0	26.5	0.4	-0.5	-4.5	-3.5
Services exports	259.7	262.5	262.6	262.5	-1.0	2.8	-0.6	-0.1
Imports of G&S	1085.1	1100.8	1097.9	1103.7	13.4	15.7	-10.4	5.8
Goods imports	908.7	923.0	920.0	925.9	12.2	14.3	-12.6	5.9
Petroleum	54.9	55.8	56.6	54.9	0.8	0.8	5.4	-1.8
Gold	6.7	5.5	5.2	5.7	0.9	-1.2	-2.7	0.6
Other goods	847.1	861.8	858.2	865.3	10.5	14.7	-15.3	7.1
Aircraft & pts	17.9	21.5	19.7	23.3	-0.2	3.6	-1.8	3.5
Computers	72.4	72.7	70.8	74.7	1.5	0.4	-3.5	3.8
Semiconductors	36.9	34.2	34.7	33.6	-0.9	-2.7	-0.6	-1.1
Other cap gds	141.8	143.9	142.5	145.3	3.7	2.1	-3.5	2.9
Automotive	148.0	148.3	146.2	150.4	6.9	0.3	-9.5	4.2
from Canada	53.1	51.8	53.8	49.8	3.1	-1.3	-1.3	-3.9
from Mexico	27.2	29.4	28.8	29.9	-0.7	2.1	-3.5	1.1
from ROW	67.7	67.1	63.6	70.7	4.5	-0.6	-4.6	7.1
Ind supplies	144.5	147.9	146.9	148.9	2.2	3.4	1.8	2.0
Consumer goods	209.1	217.0	219.3	214.7	7.1	7.9	0.7	-4.6
Foods	41.7	41.1	40.8	41.3	1.5	-0.7	-1.8	0.6
All other	34.8	35.3	37.4	33.1	-11.3	0.4	2.8	-4.3
Services imports	176.4	177.8	177.9	177.8	1.2	1.4	2.2	-0.1
Memo:								
Oil qty (mb/d)	10.83	12.05	12.32	11.77	0.13	1.22	1.31	-0.55
Oil price ($/bbl)	13.90	12.67	12.58	12.76	-3.77	-1.23	-0.15	0.18

1. Change from previous quarter or month.
Source. U.S. Dept. of Commerce, Bureaus of Economic Analysis and Census.

Oil imports and prices. The quantity of imported oil declined only slightly in May from high rates in April, and for April-May on average the quantity of imported oil was 12 percent higher than in the first quarter. The strong level of imports primarily reflected an acceleration in stockbuilding and surprisingly strong consumption. Preliminary Department of Energy statistics indicate that oil imports remained strong in June and July, although below the April-May average, as stockbuilding continued and oil consumption moved back toward more usual rates.

The price of imported oil fell 31 percent at an annual rate in the second quarter, about half the rate of decline recorded in the first quarter. The import price rose slightly in April and May following cuts in production by OPEC and non-OPEC countries, and dropped significantly in June and July. After trading in a range of $14.75 to $16.50 per barrel during April and May, the spot price for WTI plunged during June following reports of surprisingly high levels of oil stocks and a sharp downward revision in estimates of Asian oil consumption during the first quarter of 1998 Q1. In July, spot WTI rebounded on news of further cuts in production by major oil producers; prices traded in a range of $13.50 to $14.50 per barrel until early this week, when spot prices dropped below $13 per barrel before rising above $13.50 toward the end of the week.

Prices of non-oil imports and exports. In 1998 Q2, prices of non-oil imports declined just over 3½ percent at an annual rate, with decreases recorded for all major trade categories (particularly computers, semiconductors, other capital goods, industrial supplies, and consumer goods). The price of "core" imports decreased about 2 percent at an annual rate, slightly less than in the first quarter. In July, prices of U.S. non-oil imports declined 0.5 percent, the largest drop since January. For the second consecutive month, prices of non-oil industrial supplies dropped 1 percent; similarly large monthly rates of decline were recorded last December, January and February. Prices of semiconductors also dropped sharply for the second consecutive month; prices of computers also declined. Prices of other capital goods decreased slightly faster than in recent months. Prices of imported consumer goods edged down for the second consecutive month, and prices of imported automotive products were unchanged in July following a slight decrease in the second quarter.

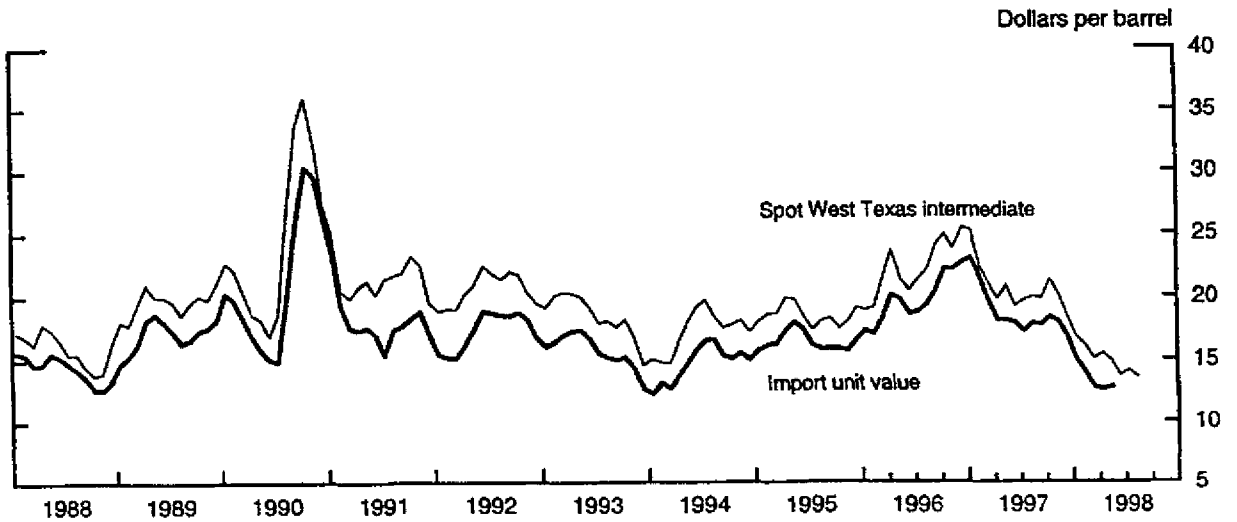
Prices of agricultural exports (BLS) fell 7 percent at an annual rate in the second quarter, about one-half the rate recorded in the first quarter. The price of nonagricultural exports declined 3 percent at an annual rate. There were notable declines in prices of exported industrial supplies and consumer goods, as well as computers and semiconductors. On the other hand, prices of other exported capital goods were

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

	Annual rates			Monthly rates		
	1997	1998		1998		
	Q4	Q1	Q2	May	Jun	Jul
	----------BLS prices (1995=100)----------					
Merchandise imports	-2.0	-11.6	-5.7	-0.1	-0.5	-0.9
Oil	7.1	-61.5	-30.1	0.6	-3.1	-6.8
Non-oil	-2.7	-5.3	-3.6	-0.2	-0.3	-0.5
Core goods*	-0.8	-3.8	-2.5	-0.2	-0.2	-0.4
Foods, feeds, bev.	-4.5	-5.1	-0.1	-1.0	0.7	0.0
Ind supp ex oil	-1.4	-11.1	-3.9	0.1	-1.0	-1.1
Computers	-17.7	-17.3	-19.2	-1.6	-0.9	-0.6
Semiconductors	-15.3	-17.2	-3.2	0.0	-1.2	-2.1
Cap. goods ex comp & semi	-2.1	-3.2	-2.6	-0.1	-0.3	-0.5
Automotive products	1.3	-0.1	-0.8	-0.2	-0.1	0.0
Consumer goods	-0.8	-1.1	-2.5	0.1	-0.2	-0.1
Merchandise exports	-2.9	-5.0	-3.4	0.1	-0.6	-0.1
Agricultural	-6.4	-15.6	-7.0	1.0	0.0	0.2
Nonagricultural	-2.4	-3.7	-2.7	0.0	-0.6	-0.2
Core goods*	-1.0	-3.5	-1.8	0.0	-0.3	-0.2
Ind supp ex ag	-5.2	-9.0	-5.4	-0.3	-0.8	-1.1
Computers	-7.6	-10.5	-11.8	-0.1	-3.4	-0.4
Semiconductors	-14.4	-6.8	-9.7	-0.4	-2.2	0.7
Cap. goods ex comp & semi	-0.3	0.0	-0.1	0.1	-0.3	0.2
Automotive products	0.1	-0.1	0.3	0.0	0.0	0.1
Consumer goods	1.2	-0.5	-1.2	0.2	-0.4	-0.1
	---Prices in the NIPA accounts (1992=100)--					
Chain-weight						
Imports of gds & serv.	-2.3	-10.4	-4.5	...	...	...
Non-oil merchandise	-2.5	-5.6	-3.8	...	...	...
Core goods*	-0.6	-3.3	-1.9	...	...	...
Exports of gds & serv.	-1.6	-3.4	-1.9	...	...	...
Nonag merchandise	-2.4	-3.5	-2.9	...	...	...
Core goods*	-0.8	-2.4	-1.7	...	...	...
Core goods*	-0.8	-2.4	-1.7	...	...	...

*/ Excludes computers and semiconductors.

Oil Prices



unchanged and prices of exported automotive products rose. The price of "core" exports declined 2 percent at an annual rate in the second quarter, slightly less than in the first quarter. In July, prices of nonagricultural exports returned to the average monthly rate of decline recorded during the first five months of the year (0.2 percent) following an unusually sharp decrease in June. In July, the effect of notable decreases in prices of exported industrial supplies (particularly oil, chemicals, and metals) was muted in overall measures of export prices by the small size of changes in other categories of trade. Prices of agricultural exports rose 0.2 percent in July, the third consecutive month without declines.

U.S. International Financial Transactions

Net purchases of U.S. securities by private foreigners were $96.5 billion in the second quarter of 1998, up $20 billion over the first quarter (Summary of U.S. International Transactions table, line 4). The $20 billion gain was more than accounted for by a swing of net private purchases of Treasury obligations from the unusual net sales recorded in the first quarter (line 4a). The shift in private net purchases of Treasuries from the first quarter to the second quarter was mostly accounted for by the large and volatile transactions of Caribbean financial centers. These large net purchases, concentrated in the Treasury bond and note markets, may reflect waning concern about a possible hike in U.S. interest rates. Japanese residents also contributed to this swing. After three quarters of recorded net sales, residents of Japan recorded $6 billion in net purchases of Treasuries in the second quarter, concentrated in April. In June, Japanese residents again sold Treasuries on net. In the rest of Asia, there were small net private purchases of Treasuries in the second quarter.

Net purchases of corporate and other bonds by private foreigners remained very strong in the second quarter (line 4b), owing to a high level of new Eurobond issues by U.S. corporations and government agencies. Agency securities accounted for about one-third of these net purchases. Net purchases of U.S. stocks also remained strong (line 4c), but far below the torrid pace of the first quarter.

U.S. net purchases of foreign securities, primarily from Europe and Latin America, strengthened in the second quarter (line 5). In the same period, there were net sales of Japanese bonds and stocks. There was some pickup in stock purchases of other Asian economies in May and June, after net sales in April.

Foreign official assets held in the United States decreased by $10 billion in the second quarter (line 1). The outflow was more than accounted for by China, Japan, Singapore, Thailand, Spain, and Switzerland.

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

	1996	1997	1997		1998			
			Q3	Q4	Q1	Q2	May	June
Official capital								
1. Change in foreign official assets in U.S. (increase, +)	127.7	19.9	24.0	-26.3	12.4	-10.1	-2.1	-5.4
a. G-10 countries	36.6	1.8	2.1	-12.6	4.0	-10.0	3.2	.2
b. OPEC countries	15.4	13.0	4.7	-.9	-.5	.3	1.2	-.5
c. All other countries	75.7	5.1	17.1	-12.7	8.9	-.4	-6.5	-5.1
2. Change in U.S. official reserve assets (decrease, +)	6.7	-1.0	-.7	-4.5	-.4	-1.9	-1.1	-.7
Private capital								
Banks								
3. Change in net foreign positions of banking offices in the U.S.[1]	-50.1	34.2	-1.2	45.8	-5.3	26.5	-11.8	28.1
Securities[2]								
4. Foreign net purchases of U.S. securities (+)	287.2	343.1	95.5	71.7	76.4	96.5	41.6	25.4
a. Treasury securities[3]	155.6	147.2	35.7	35.5	-1.5	25.9	20.8	2.6
b. Corporate and other bonds[4]	118.9	128.1	36.3	25.8	47.7	55.8	12.7	19.1
c. Corporate stocks	12.7	67.8	23.5	10.4	30.1	14.8	8.1	3.6
5. U.S. net purchases (-) of foreign securities	-110.6	-86.8	-38.6	-7.5	-6.2	-23.3	-5.0	-8.4
6. U.S. direct investment (-) abroad	-81.1	-121.8	-27.5	-35.5	-30.9			n.a
7. Foreign direct investment in U.S.	77.6	93.4	19.0	28.5	25.0		n.a	n.a
8. Foreign holdings of U.S. currency	17.4	24.8	6.6	9.9	.7	n.a	n.a	n.a
9. Other (inflow, +)[5]	-80.3	-50.9	-19.0	14.9	-25.6	n.a	n.a	n.a
U.S. current account balance (s.a.)	-134.9	-155.2	-38.1	-45.0	-47.2	n.a	n.a	n.a
Statistical discrepancy (s.a.)	-59.6	-99.7	-20.0	-52.0	1.1	n.a	n.a	n.a

Note. 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.

1. 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.
2. Includes commissions on securities transactions and therefore does not match exactly the data on U.S. international transactions published by the Department of Commerce.
3. Includes Treasury bills.
4. Includes U.S. government agency bonds.
5. 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.

A net capital inflow was recorded through private banking transactions in the second quarter on a month-end basis (line 3). The net inflow was particularly large in June, more than reversing the net outflow recorded in May.

Foreign Exchange Markets

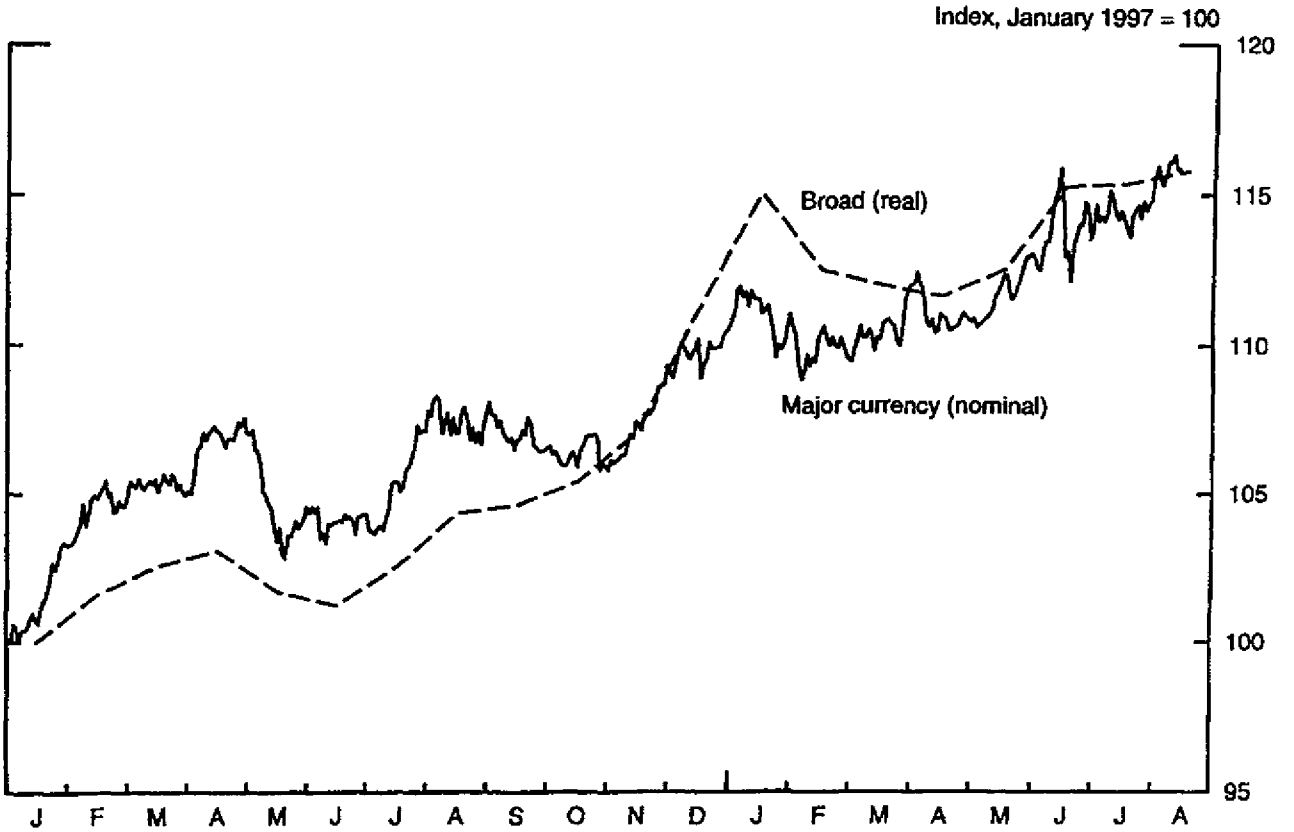
Between the June-July FOMC meeting and mid-August, the foreign exchange value of the dollar rose 2 percent on a weighted average basis against other major currencies (formerly, the narrow index). With respect to individual currencies, the dollar rose against the yen, the Canadian dollar, and sterling, but declined against the mark and other European currencies.

The dollar's overall rise was led by an appreciation of more than 4¾ percent against the yen, as investors viewed the prospects for fiscal stimulus and financial reform in Japan to have faded further during the period. Japan's bridge bank proposal failed to spur market enthusiasm, and doubts remained about how aggressively banks would be closed or merged. The new LDP government appeared to be offering little new by way of fiscal policy stimulus, with the economic program of the new administration containing to a great extent proposals that are merely a repackaging of elements put forth by the previous administration. Statements made in late July by Finance Minister Miyazawa, who seemed to indicate less interest in conducting official intervention operations to support the yen than had been present in the previous administration, also prompted some yen selling. Furthermore, data releases during the period, particularly on employment, continued to show weak or weakening activity. The yield on the Japanese bellwether government bond declined 15 basis points, and equity prices declined more than 2¾ percent.

The dollar rose 3 percent against the Canadian dollar, as market sentiment toward Canadian assets soured. The yield on the ten-year Canadian government bond rose about 20 basis points during the period, even as the yield on the comparable U.S. Treasury security edged down on balance and other G-10 bond yields declined. Equity prices in Canada fell nearly 12 percent.

. The three-month rate on Canadian finance paper rose almost 15 basis points during the period.

Dollar Exchange Rate Indexes



Financial Indicators in Major Industrial Countries

	Three-month rates		Ten-year yields		Equity prices
	Aug. 13	Change	Aug. 13	Change	Change[p]
Canada	5.19	0.14	5.56	0.21	-11.85
Japan	0.70	-0.05	1.24	-0.15	-2.83
Germany	3.41	-0.08	4.48	-0.30	-9.60
United Kingdom	7.60	-0.15	5.63	-0.22	-8.23
France	3.43	-0.04	4.60	-0.25	-7.50
Italy	4.78	-0.21	4.80	-0.27	1.53
Switzerland	1.61	-0.39	2.82	-0.26	-3.96
Australia	5.13	-0.14	5.62	0.05	-4.77
Weighted-average foreign	3.64	-0.03	4.05	-0.08	
United States	5.58	-0.03	5.41[p]	-0.03	-6.06

Note. Change is in percentage points from June 30 to August 13. [p] Preliminary.

The dollar rose more than 2½ percent against the U.K. pound during the period. Data releases showing a weakening in economic activity and the consequent unwinding of expectations for an imminent rate hike by the Bank of England contributed to sterling's decline. The shift in expectations prompted declines in U.K. interest rates across the maturity spectrum.

Confidence in the successful implementation of Stage III of European Economic and Monetary Union may have increased further during the period. The dollar moved down 1 percent against the mark and other euro-area currencies, and long-term bond yields in the region continued to decline, despite news that economic activity appears to be resuming at a healthy pace after a pause in the second quarter. The convergence of short-term interest rates also progressed, with the three-month market interest rate in Italy down another 20 basis points during the period, bringing it to less than 140 basis points of the comparable German rate.

Against a trade-weighted average of the currencies of selected emerging market and newly industrializing economies, the dollar also firmed about ½ percent, as declines of 11 percent against the Indonesian rupiah and 2½ percent against the Korean won were offset by increases of 1 to 4¼ percent against a number of other Asian and Latin American currencies.

The rupiah was supported by an increase of nearly 10 percentage points in the one-month domestic interest rate in Indonesia. Over the same period, equity prices in Indonesia declined more than 9½ percent. Short-term interest rates moved higher in Hong Kong also. Pressures on the Hong Kong dollar developed as concern about the absence of new policy initiatives in Japan prompted speculation that China may choose to devalue the renminbi, taking the Hong Kong dollar with it. As a consequence, the one-month interest rate in Hong Kong moved up 2 percentage points during the period. The higher interest rates, data showing unemployment at a 15-year high, and poor earnings reports sent the Hang Seng stock price index down 22 percent.

In contrast, short-term interest rates in Korea and most of the rest of Asia moved lower, as authorities sought to place more emphasis on providing liquidity and less on maintaining currency values. Only in Korea, however, did the easier monetary conditions correspond to a firming in equity prices, which were up 1¾ percent during the period. Share prices elsewhere in Asia declined, particularly in Malaysia and the Philippines. Contributing to the declines were dimming prospects for Japan, poor corporate earnings reports, downgrades by major ratings agencies of the credit ratings of government and private debt in several Asian economies, and uncertainty about the advisability of softer monetary policy stances. Moody's announcement that it was putting Japan's Aaa sovereign credit rating on review for a possible downgrade also seemed to rattle the neighboring Asian markets.

Financial Indicators in Latin America, Asia, and Russia

	Currency/US dollar		Short-term interest rates		Dollar-denominated bond spread		Equities
	Aug. 13	Change	Aug.12/13	Change	Aug. 12/13	Change	Change
Mexico	9.2225	2.64	21.50	-0.75	7.83[b]	2.03	-16.7
Brazil	1.1715	1.30	20.10	-2.10	9.49[b]	2.31	-13.1
Argentina	.9998	-0.01	6.75	0.30	7.67[b]	1.40	-12.5
Chile	470.85	0.39					-4.9
China	8.3100	0.00			2.46[g]	0.19	-10.1
Korea	1340	-2.62	9.70	-5.10	4.90[g]	-0.33	1.7
Taiwan	34.79	1.22	6.85	-0.65			-2.5
Singapore	1.7485	3.83	4.88	-1.37			-6.8
Hong Kong	7.7500	0.02	11.90	2.02			-22.0
Malaysia	4.1850	1.33	9.90	-1.10	4.98[e]	0.94	-28.3
Thailand	41.80	-0.83	14.00	-9.00	4.33[y]	1.04*	-13.6
Indonesia	12900	-11.03	69.50	9.73	11.50[y]	3.15	-9.6
Philippines	43.25	4.22*			4.37[e]	0.62	-26.0
Russia	6.3450	1.86	38.04	0.90	19.94[b]	9.14	-33.2

Note. Change is in percentage points from June 30 to August 12/13. [b] Stripped Brady bond yield spread over U.S. Treasuries. [g] Global bond yield spread. [e] Eurobond yield spread. [y] Yankee bond yield spread. *Change from June 29.

The Mexican peso declined nearly 2½ percent on balance against the dollar during the period. The downward pressure on the peso prompted the Bank of Mexico to tighten its monetary policy stance on August 10, which drove the one-month interest rate up about 200 basis points from its level immediately preceding the move. (From the beginning of the intermeeting period on June 30, the one-month interest rate showed a net decline, in part reflecting end-of-month and perhaps end-of-quarter money market pressures.) Mexican equity prices declined almost 17 percent.

Asset prices in Russia continued to be pressured, with the ruble falling beyond the limits of its daily band near the end of the period. Russian authorities countered with an announcement on August 12 of the imposition of limitations on domestic banks' purchases of foreign exchange. The announcement of these controls boosted ruble-denominated short-term government bill rates very sharply, with quotes rising as much as 140 percentage points on the morning of August 13. The one-month interbank deposit rate ended the intermeeting period up about 1 percentage point, and the yield spread of Russian Brady-style debt over U.S. Treasury securities rose 9 percentage points. Russian equity prices moved down more than 33 percent.

The Desk did not intervene during the period for the accounts of the System or the Treasury.

Developments in Foreign Industrial Countries

Available data on second-quarter real economic activity indicate that the Japanese economy contracted sharply for a second consecutive quarter, due to an implosion of business fixed investment and a contraction in household consumption. In contrast, real GDP appears to have expanded in the major European economies during the second quarter, albeit at a slower pace than in the first three months of 1998. In most of the European economies, current indicators suggest that strong domestic demand continues to offset relatively poor external performance due to the Asian economic crisis. In contrast, in Canada, domestic as well as foreign demand seems to have slowed from its earlier rapid pace.

Inflationary pressures in most foreign industrial countries remain subdued. One exception is the United Kingdom, where consumer price inflation still remains slightly above the government's 2½ percent target.

Individual country notes. In **Japan,** economic indicators for the second quarter suggest significant weakness in economic activity. Industrial production during the second quarter dropped 5.3 percent (not annualized) from the first-quarter average,

notwithstanding a modest rebound in June. Similarly, total machinery orders during the second quarter were down almost 6.5 percent from their already weak first-quarter pace. Labor market conditions have continued to deteriorate in recent months, with the unemployment rate in June rising to a post-war high and the offers-to-applicants ratio falling to its weakest level in twenty years. Labor market uncertainty appears to be weighing heavily on the household sector, where expenditures fell further during the second quarter and auto registrations continued to decline. In July, the level of consumer prices (net of the September increases in co-payments under the National Health Insurance System) was down about ½ percent from the year-earlier level.

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

	1997	1998					
	Q4	Q1	Q2	Apr	May	Jun	Jul
Industrial Production	-2.3	-1.5	-5.3	-1.6	-2.0	1.3	n.a.
Housing Starts	0.2	1.1	-6.2	-5.7	1.1	-3.1	n.a.
Machinery Orders	-10.2	-4.2	-6.5	-9.8	-5.2	12.5	n.a.
New Car Registrations	-0.0	-7.5	-3.4	-8.5	8.7	-1.8	n.a.
Unemployment Rate (%)	3.5	3.6	4.2	4.1	4.1.	4.3	n.a.
Job Offers Ratio[1]	0.69	0.61	0.53	0.55	0.53	0.51	n.a.
Business Sentiment[2]	-11	-31	-38	...	...	...	...
CPI (Tokyo area)[3]	2.1	2.1	0.6	0.7	0.8	0.4	0.0
Wholesale Prices[3]	1.4	-0.4	-1.6	-2.7	-1.7	-0.3	0.3

1. Level of indicator.
2. Percent of large manufacturing firms having a favorable view of business conditions less those with an unfavorable view (Tankan survey).
3. Percent change from previous year, NSA.

Japan's trade surplus during the first half of the year was $106 billion at an annual rate, well above the $83 billion surplus registered in all of 1997. Exports during the first six months (valued in dollars) were 7½ percent below their 1997 average, while imports dropped a sizable 16 percent. The weakness in exports primarily reflects the impact of the Asian crisis; exports to Korea, Thailand and Indonesia are all down sharply from a year earlier. However, exports to the United States and particularly the European Union

continue to register strong gains. The sharp drop in Japanese imports is due largely to the ongoing contraction in Japanese private domestic demand.

On July 2, the LDP announced a new financial sector restructuring plan. A principal component of the new plan is the establishment of "bridge banks," which would run insolvent banks until the failed banks were merged, sold or liquidated. The bridge bank plan should help ensure that sound borrowers of failed institutions continue to have access to credit. The LDP announcement also included measures to strengthen the Cooperative Credit Purchasing Company, which buys bad assets from solvent banks, and a commitment to dispose aggressively of bad loans held by the government-owned Resolution and Collection Bank. In addition, the LDP called for improved transparency by requiring all banks to report according to "SEC-equivalent" standards, promised an intensive inspection of the nineteen largest banks, and pledged stricter conditionality when public funds are injected into live institutions (including sacking senior management and penalizing shareholders). These measures appear to represent a step forward, but it remains to be seen whether--in practice--the Japanese authorities will actually move decisively to address the financial sector's problems. (The legislation necessary to implement these proposals is being considered in a special Diet session that began on July 30 and is expected to run through early October.)

In Japan's upper-house elections held on July 12, the LDP won only 45 of the 126 seats that were contested. (The LDP entered the election holding 61 of these seats and needed 69 seats to gain a majority in the upper house.) In response to this rebuff, Prime Minister Hashimoto resigned and was replaced by Keizo Obuchi, who had been Hashimoto's foreign minister. Obuchi appointed former Prime Minister Miyazawa as his finance minister and has promised to implement economic reforms, including financial sector restructuring and permanent tax cuts.

Real economic activity in the eleven countries scheduled to enter **European Monetary Union** next year appears to have continued to expand in the second quarter, although at a slower pace than in the first quarter. Partial data suggests that industrial production rose, while both business and consumer confidence remained high. The average unemployment rates continued to fall in most countries, and consumer price inflation remained low across the EMU area.

EURO-11 ECONOMIC INDICATORS[1]
(Percent change from previous period except where noted, SA)

	1996	1997	1997		1998		
			Q3	Q4	Q1	Q2	Jul
GDP	1.9	3.0	0.8	0.5	0.6	n.a.	n.a.
Industrial Production[2]	-0.5	5.4	-0.3	1.0	2.6	n.a.	n.a.
Unemployment Rate[3]	12.0	12.1	12.1	12.1	11.9	n.a.	n.a.
Business Confidence[4]	-16.0	-4.0	-2.0	1.0	2.0	2.0	1.0
Consumer Confidence[4]	-20.0	-15.0	-15.0	-11.0	-8.0	-5.0	-4.0
Consumer Prices[5]	2.0	1.4	1.5	1.4	1.2	1.4	n.a.

1. Weighted by GDP shares, except as otherwise noted.
2. Excludes Austria, Belgium, Luxembourg, Portugal and Spain.
3. Excludes Luxembourg and Portugal.
4. Level of index.
5. Harmonized CPI: percent change from previous year, weighted by shares in private final domestic consumption expenditure.

Real GDP growth in **Germany** is estimated to have dropped back during the second quarter to less than 1 percent at an annual rate from its 3.9 percent pace in the first quarter. Industrial production, after surging in the first quarter, declined 1 percent in the second quarter due primarily to a sharp decline in construction. Production excluding construction fell only slightly in the second quarter. However, total employment rose and capacity utilization remained above 87 percent in the second quarter, its highest level since 1991.[1] Anecdotal reports indicate that the service sector of the economy was relatively strong in the second quarter.

The second-quarter slowdown appears to owe to several temporary factors that shifted growth into the first quarter. First, the increase in the value-added tax by 1 percentage point (to 16 percent) that took effect at the beginning of April shifted consumption expenditure from the second quarter into the first quarter. Second, unusually warm winter weather boosted construction output in the first quarter. Despite the second-quarter slowdown, the German economy appears to be on firm footing. The

1. A significant fraction of this year's decline in unemployment of 250,000 persons (s.a.) owes to schemes that have been re-introduced in the eastern states. In 1997, such schemes were phased-out, resulting in job losses of more than 200,000 in the five states in eastern Germany. The re-introduction of employment programs–including government creation of jobs as well as subsidization and vocational training–is estimated to account for more than one-half of the decline in unemployment this year.

long-awaited rebound in the domestic economy materialized in the fourth quarter of last year and picked up steam in the first quarter, while net exports made a negative contribution to growth in both quarters (primarily reflecting a surge in imports).

Forward-looking indicators are somewhat mixed. Real manufacturing orders were roughly unchanged in the second quarter from their level in the first quarter, and the IFO business confidence survey, which combines current and expected conditions in the manufacturing, retail, wholesale, and construction sectors edged back in the second quarter, but remains at a very high level.

Consumer price inflation remains quiescent. According to preliminary data for the four largest states in western Germany, inflation dropped in July to 0.9 percent from 1.1 percent in June (on a 12-month basis). The drop in July reflects the ending of the transitory effects on the 12-month inflation rate of a revision to the CPI basket in July 1997.

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

	1997	1998					
	Q4	Q1	Q2	Apr	May	Jun	Jul
Industrial Production	0.4	2.1	-1.0	-1.3	1.0	-1.9	n.a.
Orders	0.1	2.4	-0.1	0.7	-0.3	-1.1	n.a.
Unemployment Rate (%)	11.8	11.5	11.2	11.3	11.2	11.0	10.9
Western Germany	9.9	9.6	9.4	9.5	9.4	9.3	9.3
Eastern Germany	19.5	19.2	18.5	19.0	18.5	18.0	17.8
Capacity Utilization[1]	87.0	87.3	87.2	...	...	...	...
Business Climate[1,2]	17.3	18.3	15.3	15.0	16.0	15.0	n.a.
Consumer Prices[3]							
All-Germany	1.8	1.2	1.3	1.4	1.3	1.2	0.9
Western Germany	1.7	1.1	1.3	1.4	1.3	1.1	0.9

1. Western Germany.
2. Percent of firms citing an improvement in business conditions (current and expected over the next six months) less those citing a deterioration.
3. Percent change from previous year.

In **France**, available second-quarter data suggest that domestic demand has remained firm. In April and May, industrial production was up about one percent from its first-quarter average. Consistent with strong second-quarter business confidence, production of capital and semi-finished goods rose. Although auto sales in April were

down slightly, retail sales at large stores were strong, and consumption of manufactured products increased one percent for the quarter as a whole. The quarterly unemployment rate dipped below 12 percent for the first time since the last quarter of 1995. Third-quarter monthly indicators are limited but they point to continued strength in economic activity. In July, consumer sentiment and business confidence remained high and stable, and businesses expected marked improvement in near term production. Consumer price inflation remains stable at record lows.

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

	1997	1998					
	Q4	Q1	Q2	Apr	May	Jun	Jul
Consumption of Manufactured Products	1.4	1.4	1.0	1.3	0.4	0.2	n.a.
Industrial Production	1.3	1.3	n.a.	-0.7	0.6	n.a.	n.a.
Capacity Utilization	81.2	82.5	n.a.	...	...	...	...
Unemployment Rate (%)	12.4	12.2	11.9	11.9	11.9	11.8	n.a.
Business Confidence[1]	17.7	18.0	20.0	18.0	19.0	22.0	19.0
Consumer Prices[2]	1.2	0.7	1.0	1.0	1.0	1.0	n.a.

1. Percent balance of manufacturing firms citing an improvement in the outlook versus those citing a worsening.
2. Percent change from previous year.

On July 22, the government announced the broad outline of its 1999 budget.(Full details will not be available until October when the budget proposal will be presented to parliament.) The plan targets a 2.3 percent central government budget deficit, down from 3 percent this year. However, as in 1998, the government expects to rely on the business cycle for the targeted improvement. In fact, the current budget plan sets a one percent real increase in government spending in order to "boost employment and preserve economic recovery." Overall tax rates are set to decline modestly (due to reductions in some marginal VAT rates), while wealth and capital gains taxes will not be raised, despite such proposals from the left.

In **Italy**, positive calendar effects most likely helped second-quarter economic activity to expand modestly although monthly indicators were mixed.[2] For the quarter as

2. Italian real GDP data, unlike those on industrial production, are not adjusted for the

(continued...)

a whole, consumer confidence rose to reach its highest level since the third quarter of 1990, but business sentiment and industrial production dropped. Related manufacturing data continued to show the negative impact of the phase out of the tax-incentive on new auto purchases as well as that of weaker Asian demand for textile and leather goods. Third-quarter data are scant. In July, consumer confidence declined although it remained above its first-quarter average.

Inflation, which dipped below two percent (year/year) in April 1997, remains low and stable. In July, consumer price inflation was 1.8 percent, unchanged from June and its second-quarter average.

ITALIAN ECONOMIC INDICATORS
(Percent change from previous period except where noted, SA)

	1997	1998					
	Q4	Q1	Q2	Apr	May	Jun	Jul
Industrial Production	1.3	-0.1	-0.2	-0.2	2.5	-2.1	n.a.
Cap. Utilization (%)	79.0	78.2	79.5	...	...	...	...
Unemployment Rate (%)	12.1	12.1	12.3	...	...	...	...
Consumer Confidence[1]	115.3	118.6	122.7	120.5	124.4	123.3	118.9
Bus. Sentiment[2] (%)	17.0	32.0	11.7	21.0	11.0	3.0	n.a.
Consumer Prices[3]	1.6	1.7	1.8	1.8	1.7	1.8	1.8

1. Level of index, NSA.
2. Percent of manufacturing firms having a favorable view of business conditions minus those with an unfavorable outlook.
3. Percent change from previous year.

On July 22, prime minister Prodi narrowly survived a confidence vote in the lower house of the parliament (where the government relies on the support of the Communist Refoundation Party (CR) for an absolute majority). The vote was prompted by CR's refusal to back NATO expansion into Eastern Europe, and the government was bailed out in the last minute by the supporting votes of a small party in the opposing center-right coalition. The latest row is indicative of more political turmoil in the fall when the government will attempt to produce a 1999 budget acceptable to business, the trade unions, and the communists.

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2. (...continued)
number of working days.

In the **United Kingdom,** economic activity continued to expand at a moderate pace in the second quarter. The preliminary estimate showed real GDP growth of 2 percent, little changed from the rate in the first quarter. Growth in service sector output slowed from 3 percent to 2.3 percent, and the average volume of retail sales grew at its slowest quarterly rate in two years. Industrial production expanded 1.0 percent in the quarter, with manufacturing output little changed. Recent survey data suggest that the outlook for manufacturing industries deteriorated further over the summer. Business confidence has declined to its lowest levels since 1992, reflecting a negative outlook for both export and domestic orders.

Conditions in the labor market remain tight and continue to put pressure on wages. The official claimant unemployment rate remained above 4½ percent in July, and average annual earnings growth was 5 percent in May. Retail price inflation remains somewhat above the 2 ½ percent target; the twelve-month rate of British retail price inflation (excluding mortgage interest payments) was 2.8 percent in June.

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

	1997	1998					
	Q4	Q1	Q2	Apr	May	Jun	Jul
Real GDP (AR)	2.5	2.2	2.0	...	...	...	...
Non-oil GDP (AR)	2.9	2.5	1.8	...	...	...	...
Industrial Production	-0.9	-0.3	1.0	1.0	-1.1	0.7	n.a.
Retail Sales	1.4	0.9	0.4	-0.1	1.7	-1.2	n.a.
Unemployment Rate (%)	5.1	4.9	4.8	4.8	4.8	4.8	x.x
Business Confidence[1]	13.0	10.7	-0.7	3.0	-2.0	-3.0	n.a.
Consumer Prices[2]	2.8	2.5	3.0	3.0	3.2	2.8	n.a.
Producer Input Prices	-8.9	-10.0	-8.9	-9.0	-8.6	-8.9	-8.8
Average Earnings[3]	4.6	5.0	n.a.	5.4	x.x	n.a.	n.a.

1. Percent of firms expecting output to increase in the next four months minus those expecting output to decrease.
2. Retail prices excluding mortgage interest payments. Percent change from previous year.
3. Percent change from previous year.

In its August *Inflation Report*, the Monetary Policy Committee of the Bank of England raised its central projection for inflation from its last published forecast in May. The August forecast for the most likely outcome for inflation calls for inflation to remain

above the 2½ percent target for most of the forecast period, but then to fall back so that by the third quarter of 2000 it is "close to the 2½ percent target." The August inflation outlook includes a more inflationary contribution from labor market tightness, reflecting the acceleration in earnings that has occurred since May, and less restraint from import prices.

In **Canada**, recent data indicate a slowing of growth. GDP at factor cost edged down 0.2 percent in May after remaining flat in April, the first time in over two years that the economy has failed to grow for two consecutive months. Manufacturing output continued to decline in May, hurt by reduced demand from Asia. In contrast to recent months, the service sector showed some weakness as well.

Canadian employment has declined on balance since April, after a year and a half of strong growth during which job gains averaged more than 30,000 a month. The GM strike accounted for about 15, 000 persons on temporary layoff in Ontario over the June-July period. The Canadian unemployment rate has remained at 8.4 percent since April, as the labor force has declined in line with the drop in employment.

Canada's trade surplus rebounded to $1.2 billion in May, up from $0.8 billion in April. Imports of machinery and equipment declined, suggesting a slowing in the pace of investment. In contrast, imports of consumer goods remained strong. Exports to Japan rebounded somewhat from their sharp fall in April but were still 19 percent lower than a year ago.

Canadian core consumer prices, which exclude food and energy, fell 0.1 percent in June from the previous month. The only sign of inflation related to the falling Canadian dollar was a 0.7 percent rise in food prices. Relative to a year earlier, the core CPI was up 1.0 percent in June. With inflation at the bottom of its 1 to 3 percent target range, and with some weakening in recent data on economic activity, the Bank of Canada has resisted raising interest rates in the face of a Canadian dollar that has continued to set new lows versus the U.S. dollar.

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

	1997		1998				
	Q4	Q1	Q2	Apr	May	Jun	Jul
GDP at Factor Cost	0.7	0.8	n.a.	0.0	-0.2	n.a.	n.a.
Industrial Production	0.9	-0.2	n.a.	-0.7	-0.4	n.a.	n.a.
Manufacturing Survey: Shipments	0.9	-0.4	n.a.	-0.7	-1.0	n.a.	n.a.
New Orders	1.6	-1.4	n.a.	-0.4	-0.4	n.a.	n.a.
Retail Sales	1.2	0.4	n.a.	1.4	0.5	n.a.	n.a.
Housing Starts	0.1	1.8	n.a.	-8.3	-4.9	n.a.	n.a.
Employment	0.4	0.7	0.7	0.5	-0.0	-0.3	0.2
Unemployment Rate (%)	8.9	8.7	8.4	8.4	8.4	8.4	8.4
Consumer Prices[1]	1.0	1.0	1.0	0.8	1.1	1.0	n.a.
Consumer Attitudes[2]	117.0	118.4	115.8	...	...	...	...
Business Confidence[3]	159.2	155.0	148.9	...	...	...	...

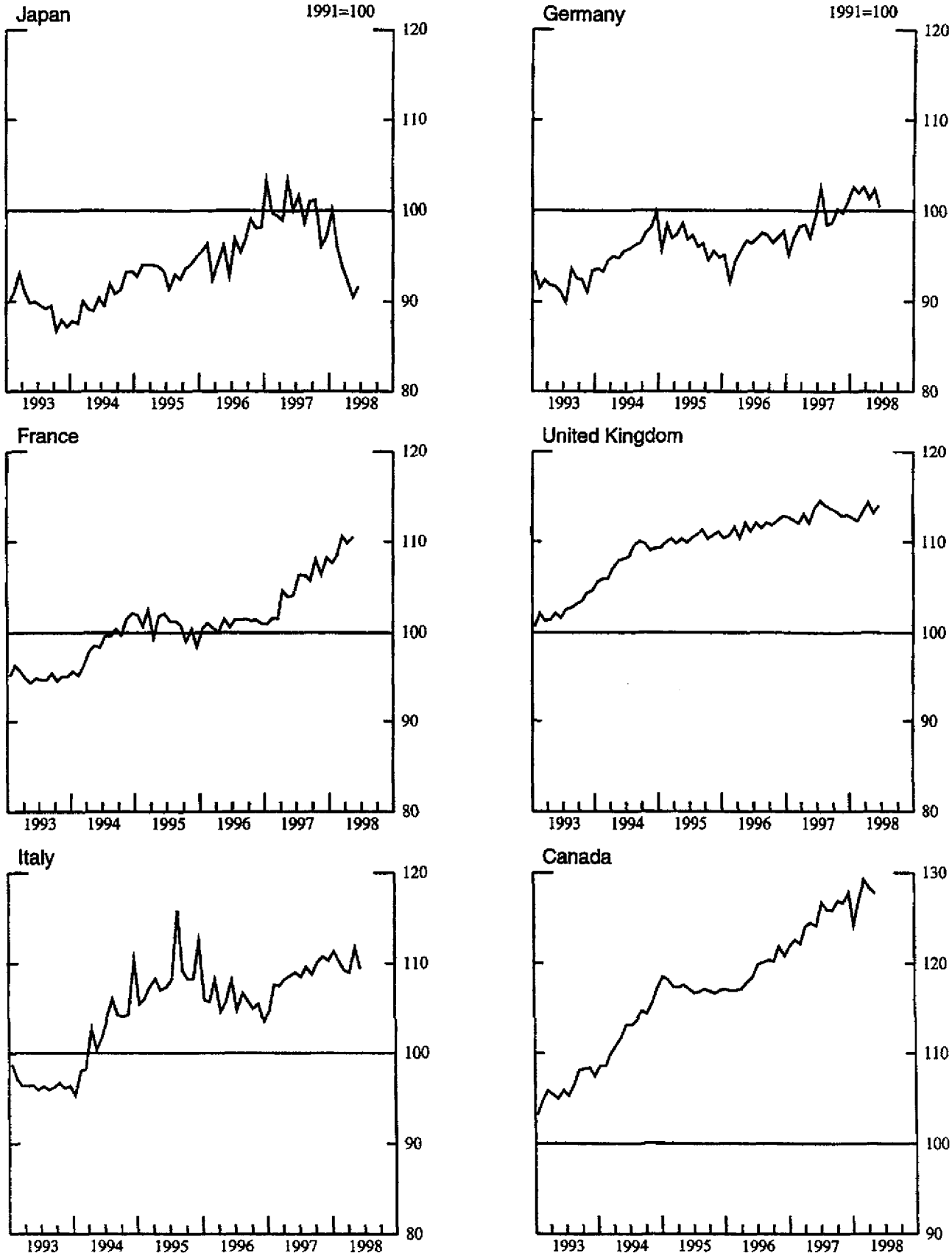
1. Percent change from year earlier.
2. Level of index, 1991 = 100.
3. Level of index, 1977 = 100.

EXTERNAL BALANCES
(Billions of U.S. dollars, SAAR)

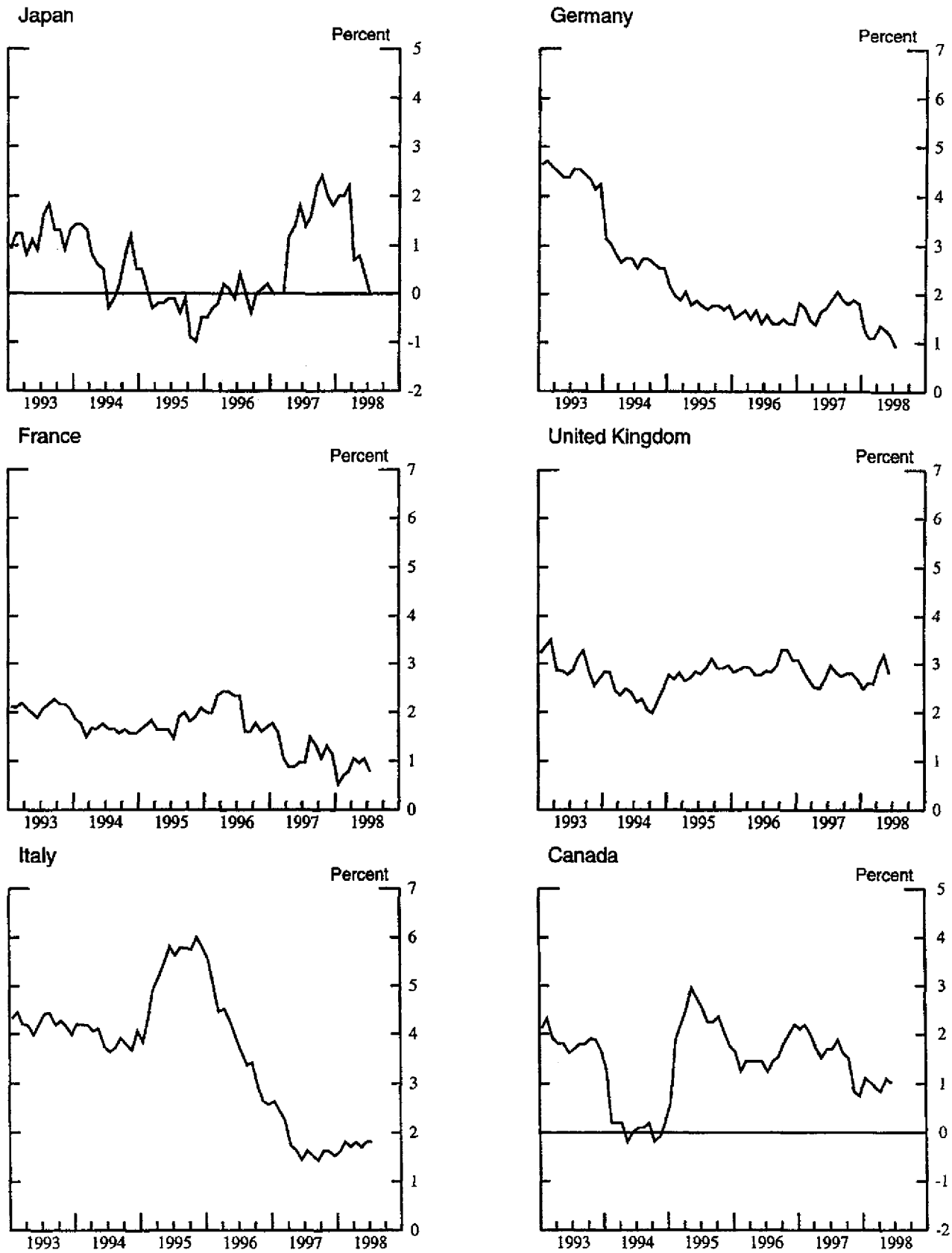
	1997	1998				
	Q4	Q1	Q2	Apr	May	Jun
Japan: trade	98.8	98.0	114.0	111.8	140.2	89.9
current account	112.9	115.9	n.a.	76.5	133.5	125.3
Germany: trade[1]	75.8	67.5	n.a.	77.1	98.0	n.a.
current account[1]	12.8	-14.0	n.a.	15.1	14.4	n.a.
France: trade	31.5	27.0	n.a.	29.5	28.9	n.a.
current account	43.9	35.7	n.a.	41.6	n.a.	n.a.
U.K.: trade	-28.1	-31.5	n.a.	-27.8	-36.5	n.a.
current account	0.3	-21.2	...	...	...	...
Italy: trade	28.9	25.2	n.a.	28.2	34.7	n.a.
current account[1]	37.6	10.3	n.a.	7.6	n.a.	n.a.
Canada: trade	11.2	13.4	n.a.	10.1	13.9	n.a.
current account	-13.2	-10.8	...	...	...	...

1. The current account includes goods, services, and private and official transfers.

Industrial Production in Selected Industrial Countries



Consumer Price Inflation in Selected Industrial Countries
(12-month change)



Economic Situation in Other Countries

In most emerging market economies, economic activity has either been weak (especially in Korea and the ASEAN region) or has slowed. In Russia, the very high interest rates needed to defend the ruble, along with heightened uncertainties, have depressed economic activity. In Brazil, activity picked up in the second quarter, but disappointing economic news in July and August prompted economic stimulus measures.

The general adjustment toward surpluses in external balances in Asia continued. In Latin America, external balances continued to deteriorate, except in Brazil, where the trade balance has narrowed relative to last year.

Progress on economic reform has been mixed. Efforts are underway in several Asian economies to address banking problems. Korea announced it would close five undercapitalized banks and prevent banks from extending credit to non-viable firms. The Brazilian government sold its controlling stake in Telebras in July, but its large fiscal and external imbalances continue to fuel concerns that a devaluation is needed. Russia has initiated a broad array of fiscal measures, but more may be required.

Individual country notes. In **Korea**, activity weakened further in the second quarter. Industrial production in the second quarter was nearly 12 percent below its year-earlier levels, compared with a decline of about 8 percent in the first quarter. The seasonally adjusted unemployment rate rose to 7.7 percent in June, over three times the rate in June of last year. The continued fall in activity prompted the government to announce expansionary fiscal measures, including programs designed to add 500,000 additional jobs. The added spending and tax reductions–adopted with the support of the IMF–are expected to raise this year's government budget deficit to 4 percent of GDP (compared with a 1.7 percent deficit rate envisioned in the original IMF agreement). There have been sporadic but intense outbreaks of labor unrest over proposed layoffs, most prominently at a Hyundai automobile factory, which is attempting to institute the first layoffs under legislation enacted in February allowing employers to make workforce reductions.

Korea's trade surplus increased to $42 billion (annual rate) in the first six months of the year. This rise represents a positive swing of $55 billion from the $13 billion deficit (annual rate) recorded in the corresponding period last year. The won appreciated by about 10 percent against the dollar in July before falling back partially in recent weeks. The appreciation of the won caused some observers (including an IMF official) to express concerns that further won appreciation might begin to reverse some of the trade adjustment achieved since the financial crisis of last fall. The won's strength, along with

the weakness of activity, led the monetary authorities to lower interest rates further, moving the overnight rate down to below 11 percent.

The government has taken additional measures to restructure the financial sector in recent months. At the end of June, the Financial Supervisory Commission (FSC) announced that five under-capitalized banks "whose rehabilitation plans were deemed not feasible" would be closed and their assets and liabilities transferred to five healthier banks. Seven other under-capitalized banks were allowed to remain open but told to submit new rehabilitation plans to the FSC by the end of July. The government also released a list of 55 non-banking firms–including units of the five big chaebols (conglomerates)–that were declared to be non-viable. The firms on the list are to be cut off from all new credit lines and are to enter into proceedings for liquidation or third-party takeover. Finally, in early August, the activities of four life insurance companies were suspended on account of financial shortfalls.

KOREAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1998		1998	
			Q1	Q2	Jun	Jul
Real GDP	6.8	5.5	-3.8	n.a.	...	...
Industrial Production	7.1	6.7	-7.8	-11.7	-13.3	n.a.
Consumer Prices	4.9	4.4	8.9	8.2	7.5	7.3
Trade Balance[1]	-15.0	-3.2	38.2	46.4	41.8	n.a.
Current Account[1]	-23.0	-8.2	42.7	46.2	41.2	n.a.

1. Billions of U.S. dollars, AR, NSA.

In the ASEAN region, weakening domestic demand, tight credit conditions, and Japan's worsening economy continued to dampen economic activity. Indonesia's real GDP is estimated to have fallen 32 percent (SAAR) in the second quarter of 1998. In Malaysia and Singapore, industrial production declined through June.

ASEAN ECONOMIC INDICATORS: GROWTH

	1996	1997	1998		1998	
			Q1	Q2	May	Jun
Real GDP, SAAR						
Indonesia	8.0	4.7	-28.9	-31.6	n.a.	n.a.
Malaysia	8.6	7.8	-22.8	n.a.	n.a.	n.a.
Philippines	5.8	5.2	-1.1	n.a.	n.a.	n.a.
Singapore	6.9	7.7	1.4	-2.6	n.a.	n.a.
Thailand	6.4	-0.4	n.a.	n.a.	n.a.	n.a.
Industrial Production[1]						
Indonesia	6.6	6.2	-7.1	-19.3	n.a.	n.a.
Malaysia	11.0	10.7	-0.8	-6.1	-8.3	-6.0
Philippines	8.4	8.8	6.6	n.a.	n.a.	n.a.
Singapore	3.3	4.6	6.1	-1.1	-4.3	-0.9
Thailand	7.2	-0.4	-16.8	n.a.	-17.4	n.a.

1. Year-over-Year.

Consumer prices, particularly for food, continued to accelerate in Indonesia, in part because of low inventories (reflecting distributors' reluctance to boost them to normal levels) and because the sharp drop in the currency has boosted the prices of traded goods. Elsewhere increases in inflation were moderated by weakening domestic demand.

ASEAN ECONOMIC INDICATORS: INFLATION
(Percent change from year earlier)

	1996	1997	1998		1998		
			Q1	Q2	May	Jun	Jul
Consumer Prices							
Indonesia	8.0	6.5	29.7	52.2	52.2	59.5	72.0
Malaysia	3.5	2.7	4.3	5.7	5.4	6.2	n.a.
Philippines	8.4	5.1	7.1	9.0	9.2	9.9	10.1
Singapore	1.4	2.0	1.0	0.3	0.5	-0.2	n.a.
Thailand	5.8	5.6	9.0	10.3	10.2	10.7	10.0

Trade surpluses widened further in most of the ASEAN countries in May, reflecting the impacts of currency depreciation and sharp declines in domestic demand. Although outpaced in most cases by falling imports, export revenues also declined because of declines in dollar export prices, difficulties in securing credit, a slowdown in global demand for electronics, and a region-wide container shortage.

ASEAN ECONOMIC INDICATORS: TRADE BALANCE[1]

	1996	1997	1998		1998		
			Q1	Q2	Apr	May	Jun
Indonesia	6.9	11.9	20.3	n.a.	22.5	24.1	n.a.
Malaysia	-0.1	-0.2	8.9	13.8	11.5	11.6	18.2
Philippines	-11.9	-10.5	-4.9	n.a.	-2.1	-2.5	n.a.
Singapore[2]	-5.9	-5.8	4.0	9.5	8.2	10.1	10.5
Thailand	-16.1	-4.6	12.1	10.2	7.6	11.4	11.7

1. Billions of U.S. dollars, AR, NSA.
2. Non-oil trade balance.

The implementation of economic reforms varied across the ASEAN region. Indonesia's revised 1998-99 budget reinstated many subsidies for food and fuel to mitigate the impact of the economic crisis on the poor. The IMF acquiesced to this policy change, and on July 15 boosted the stand-by program by $1.3 billion as part of a new multilateral $6 billion package to help Indonesia fund its budget gap. In late July, the Consultative Group for Indonesia[3] pledged an additional $7.9 billion for the same purpose. In August, Indonesia and creditor banks agreed to reschedule $2.6 billion in fixed interbank loans that mature on or before March 1999.[4]

Elsewhere, Malaysia established a bank recapitalization agency, but plans to raise $2 billion for that purpose in international debt markets were shelved after Moody's and S&P lowered Malaysia's sovereign rating in late July. In his first state of the nation speech, Philippine President Estrada promised to quicken the pace of privatization and launch an anti-corruption campaign. Singapore formed a task force on asset securitization to develop means for firms to raise funds. In early August, Thailand floated a proposal to guarantee the minimum value of foreign investors' future equity infusions into Thai banks; industry analysts dismissed the proposal as insufficient to attract capital into the banking industry.

In **Hong Kong,** GDP fell 12.3 percent in the first quarter (SAAR). Unemployment continued to rise, reaching 4.5 percent in the second quarter. Hong Kong's trade deficit has narrowed during 1998, primarily reflecting weak imports; in the first half, exports fell 2 percent from the year-earlier period, while imports fell 6 percent. The yield spread between Hong Kong government securities and comparable U.S.

3. This group consists of 30 donor countries and international organizations and is chaired by the World Bank.

4. The rescheduling agreement also includes derivative contracts whose value is not yet been determined, but which the IMF estimates are likely to amount to an additional $1 billion or more.

Treasuries declined in July to about 300- 400 basis points at maturities of 3 months to 10 years, down about 200 basis points from mid-June, but since early August has risen again. Spreads were in the 450 to 500 basis point range on August 13.

HONG KONG ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1998		1998	
			Q1	Q2	May	Jun
Real GDP[1]	5.0	5.3	-12.3	n.a.	...	...
Consumer Prices[2]	6.5	5.2	4.9	3.9	4.4	3.9
Trade Balance[3]	-17.8	-20.6	-16.8	-18.0	-17.3	-10.2

1. Percent change from previous period, SAAR.
2. End of period.
3. Billions of U.S. dollars, AR, NSA. Imports are c.i.f.

In **China**, real GDP rose 7 percent in the first half of 1998 from the year-earlier period, the lowest rate of growth since 1991. Industrial production continued to slow and consumer prices declined in the second quarter and in July. Net exports remained strong, reflecting weak import growth. In the first seven months, exports rose 7 percent, while imports rose 1 percent. Total reserves less gold, which increased $33 billion in 1997 before stabilizing in the first half of 1998, were $144 billion in June.

CHINESE ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1998		1998	
			Q1	Q2	Jun	Jul
Real GDP[1]	9.7	8.8	7.2	7.0	...	...
Industrial Production	15.6	13.1	10.3	8.9	7.9	7.6
Consumer Prices[2]	7.0	0.4	0.7	-1.3	-1.3	-1.4
Trade Balance[3]	12.2	40.3	42.2	47.4	45.5	50.4

1. Cumulative from beginning of year.
2. End of period.
3. Billions of U.S. dollars, AR, NSA.

In **Taiwan**, industrial production continued to increase from a year ago, but much of the apparent strength reflected growth in the second half of 1997. The trade surplus rose in the second quarter, even though exports (particularly to Asia) fell considerably. Relative to the first quarter, imports fell 2 percent, while exports rose 2 percent. The trade surplus rose sharply in July, with imports down 22 percent from a year earlier, and

exports down 16 percent. Total official reserves less gold stood at $83 billion at the end of June 1998.

TAIWAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted, NSA)

	1996	1997	1998		1998	
			Q1	Q2	Jun	Jul
Real GDP	5.7	6.8	5.9	n.a.	...	...
Industrial Production	1.8	6.8	4.6	4.3	5.4	n.a.
Consumer Prices[1]	2.5	0.2	2.6	1.4	1.4	n.a.
Trade Balance[2]	14.8	7.7	-0.2	5.4	6.2	12.6
Current Account[2]	11.0	7.7	0.9	n.a.	...	...

1. End of period.
2. Billions of U.S. dollars, AR, NSA.

In **Mexico,** economic activity has begun to show signs of decelerating. Industrial production in May was 6 percent above its year-earlier level, which is lower than the recent trend excluding March/April--the period covering the holy week. The slowdown was evident in the construction sector, which has been hard hit by the public sector budget cuts and reduction in government spending on investment. A broader deceleration of activity is anticipated early in the second half of the year as a result of the GM strike.

MEXICAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1998		1998	
			Q1	Q2	Jun	Jul
Real GDP	5.1	7.0	6.6	n.a.	...	...
Industrial Production	10.4	9.2	9.8	n.a.	n.a.	n.a.
Unemployment Rate (%)	5.5	3.7	3.5	3.2	3.4	n.a.
Consumer Prices[1]	27.7	15.7	22.4	12.3	15.1	12.1
Trade Balance[2]	6.5	0.6	-7.2	-4.8	-6.0	n.a.
Imports[2]	89.5	109.8	120.0	124.0	129.6	n.a.
Exports[2]	96.0	110.4	112.8	119.2	123.6	n.a.
Current Account[2]	-1.9	-7.3	-13.6	n.a.	...	...

1. End of period; percentage change from previous period, AR, NSA.
2. Billions of U.S. dollars, AR, NSA.

The trade deficit narrowed in the second quarter despite the decline in oil prices. Inflation declined in July but remained slightly above expectations. Continued price

pressures and volatility in the foreign exchange market prompted the Bank of Mexico to tighten monetary policy in late June and again in early August. In early July, the government announced its third budget cut this year of 9 billion pesos (approximately $1.1 billion) in response to falling oil prices and the consequent loss of government revenue. Nonetheless, events in Asia and their reverberations in international financial markets during the past week have caused sharp declines in the peso and stock market, and increases in 28-day Cetes interest rates and Brady bond spreads.

In **Brazil,** industrial output fell in June after surging in May. The level of industrial production in June was about the same as in October 1997, just before the central bank's overnight interest rate was doubled to over 40 percent to defend the currency, the *real.* Unemployment dropped in June, but the drop reflected mainly a fall in the number of people looking for work. Unemployment in May was at its highest level since records were first kept in the early 1980s. High unemployment plus disappointing news about sales in July and early August prompted the government to enact labor reforms and several stimulative measures. The consumer price index fell in July, bringing year-over-year inflation to 4 percent.

BRAZILIAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1998		1998	
			Q1	Q2	Jun	Jul
Real GDP[1]	2.9	3.0	-4.3	n.a.	...	...
Industrial Production[1]	5.4	2.0	-6.6	10.1	-16.6	n.a.
Open Unemployment Rate (%)	5.4	5.6	7.6	8.0	7.9	n.a.
Consumer Prices[2]	9.4	4.3	7.4	4.1	2.4	-3.6
Trade Balance[3]	-5.5	-8.4	-6.4	-1.6	0.0	-4.6
Current Account[3]	-24.3	-33.8	-24.0	-31.6	-29.8	n.a.

1. Percent-change from previous period, SAAR.
2. INPC, Percentage change from previous period, AR. Annual data are Dec/Dec.
3. Billions of U.S. dollars, AR, NSA.

On July 29, the Brazilian government sold its controlling stake in Telebras for $19 billion, about 60 percent above its asking price. The government indicated that it would use the proceeds of the sale to retire maturing debt, although President Cardoso also indicated that some money would be spent. (Purchasers of Telebras were required to

pay 40 percent of the price of the firms in cash, and the rest in installments over the next couple of years.) Strong interest in the auction was probably boosted by President Cardoso's improved election poll ratings in recent weeks; Cardoso will make his second bid for the presidency in early October, and most observers now expect that he will be reelected in the first round vote. The success of the Telebras auction probably encouraged the central bank's monetary policy committee to reduce its overnight lending rate from 21 percent to 19.7 percent that night (at its regularly scheduled meeting).

Although stock prices rose by about 7 percent over the two days following the Telebras auction, prices since then fell precipitously in response to the problems in Russia and Asia, as well as concern that fiscal and external trends remain incompatible with the government's commitment to limit the depreciation of the *real*. The fiscal and current account deficits total roughly 7 percent of GDP and 3 ½ percent of GDP, respectively, and many observers believe that the *real* is overvalued.

In **Argentina,** the pace of economic growth has slowed somewhat compared with the very impressive rates recorded last year. The growth of industrial production slowed to 5.1 percent (SA) in the second quarter over the same period a year ago and the unemployment rate fell only slightly to 13.2 percent in the May survey from the last survey conducted in October 1997. Inflation continued to be low; 12-month consumer price inflation in July was slightly over 1 percent. Import growth slowed to 8 ½ percent in Q2 over a year ago, compared with a growth rate of nearly 14 percent in the first quarter. Nevertheless, the cumulative trade deficit through June this year was $3.5 billion (AR) compared to a $1 billion deficit (AR) the same period a year ago. The Argentine government met its fiscal targets for the first half of the year agreed upon with the IMF. The government has also announced further spending cuts of about $1 billion for 1998.

President Menem announced in late July that he will not ask Congress to change the law to enable him to seek a third term in office. The announcement halted an unpopular campaign that had threatened to split his Peronist party.

ARGENTINE ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1998		1998	
			Q1	Q2	Jun	Jul
Real GDP	4.3	8.4	6.9	n.a.	...	...
Industrial Production (SA)	3.1	8.6	6.8	5.1	5.8	n.a.
Unemployment Rate (%)[2]	17.2	14.9	...	13.2	...	...
Consumer Prices[1]	0.1	0.3	0.8	1.2	1.2	1.2
Trade Balance[3]	1.6	-3.2	-6.0	-1.2	-1.6	n.a.
Current Account[3]	-3.8	-10.1	n.a.	n.a.	n.a.	n.a.

1. End of period.
2. Unemployment figures available only in May and October of each year. The annual figure is the average of the two surveys.
3. Billions of U.S. dollars, AR, NSA.

The **Venezuelan** economy continues to be plagued by low world oil prices, high interest rates, and political uncertainty surrounding the outcome of the December presidential elections. Faced with substantial oil price declines and oil production cuts resulting from their OPEC commitments, government officials have acknowledged that the oil sector, and the economy as a whole, will contract this year. Oil accounts for about a third of total output, half of government revenues, and three-fourths of exports. Loss of oil revenues have forced major cutbacks in oil investment and raised the government's forecast for the 1998 public sector deficit to 4.6 percent of GDP.

In July, consumer prices rose 38 percent (twelve-month inflation rate), forcing the government to revise upward its 1998 inflation target from 28 percent to 32 percent. Despite high inflation, the government has not allowed the bolivar to depreciate much, creating currency pressures that have led to very sharp increases in interest rates; the loan rate has risen by about 20 percentage points since end-June to about 60 percent, far outpacing inflation. Oil exports were hit hard, with the trade surplus through April this year coming in at a little over $8 billion (AR), compared with nearly $13 billion (AR) over the same period a year ago.

VENEZUELAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1998		1998	
			Q1	Q2	Jun	Jul
Real GDP	-0.4	5.1	...	...	...	...
Unemployment Rate (NSA, %)	11.8	11.8	11.6	11.3	...	...
Consumer Prices[1]	103.3	37.6	31.6	36.4	16.8	28.3
Non-oil Trade Balance[2]	-4.8	-7.3	-6.3	n.a.	n.a.	n.a.
Trade Balance[2]	13.6	11.1	9.1	n.a.	n.a.	n.a.
Current Account[2]	8.8	5.5	...	...	...	...

1. End of period; percentage change from previous period, AR, NSA.
2. Billions of U.S. dollars, AR, NSA.

In **Russia**, a financial crisis erupted beginning in early July. The main underlying market concern was the worsening fiscal situation, involving falling tax revenues, mounting payment arrears, and escalating interest payments on government debt. The focus of immediate market concern was that dwindling foreign exchange reserves would prove inadequate to defend the ruble, which might be forced to depreciate sharply. The central bank raised its money market intervention rate to 80 percent to support the ruble, but market rates surged even higher, moving above 120 percent.

In response to those developments, on July 13, the IMF and World Bank announced that an agreement had been reached that would make substantial funds available to Russia. A total of $22.6 billion was to be provided in the remainder of this year and next year, of which $15.1 billion would come from the IMF, $6 billion from the World Bank, and $1.5 billion from Japan. In return for this support, the Russian government agreed to implement immediately new fiscal measures to increase government revenues by about 3 percent of GDP. In the week following the announcement of the IMF support package, about two-thirds of these promised measures were enacted, either through passage by the parliament or through Presidential degree. However, because of the failure to enact all of the measures, on July 20 the IMF Executive Board voted to reduce by $800 million (to $4.8 billion) the amount that would be immediately released to the Russian government.

In conjunction with the initiation of the support package, Russian authorities indicated that they planned to take measures to extend the maturity of, and reduce the interest costs on, the government's debt. As a first step in this direction, on July 20, it was announced that holders of short-term ruble-denominated Russian Treasury bills

worth $4.4 billion (slightly over 10 percent of the total amount outstanding) had agreed to exchange these bills for 7-year and 20-year dollar-denominated bonds.

Financial markets initially reacted favorably to the announcement of the support package, with the ruble firming, stock prices rising over 10 percent, and market interest rates dropping roughly in half to around 60 percent. However, this initial positive reaction subsequently has been entirely reversed on concerns that promised reform might not be fully implemented and because of adverse spillovers from Japanese and Asian emerging market turmoil. On August 13, stock prices fell 10 percent, short-term treasury bill rates soared to above 200 percent, and the ruble traded well outside its daily trading range set by the central bank. The central bank reacted to this pressure on the ruble and what it termed "a crisis of liquidity" in the banking system by imposing limits on banks' foreign exchange purchases and expanding banks' access to overnight credit.

In recent months it has become increasingly apparent that the high interest rates and economic uncertainty generated by the financial turmoil that has prevailed much of this year is having a depressing effect on the pace of activity. By June, output had fallen about 2 percent below its year-earlier level, and Finance Minister Zadornov recently indicated that he expected output to shrink by up to 1 percent this year and at best to stagnate next year. The most positive macroeconomic development has been the continued decline in inflation, with consumer prices rising less than 5 percent in the 12 months to July.

RUSSIAN ECONOMIC INDICATORS
(Percent change from year earlier except where noted)

	1996	1997	1998		1998	
			Q1	Q2	Jun	Jul
Real GDP	-6.3	0.4	0.0	-0.9	-1.6	n.a.
Industrial Production	-5.2	1.9	1.4	-1.3	-2.5	n.a.
Consumer Prices	52.8	14.8	9.3	7.3	6.4	4.2
Ruble Depreciation	12.5	12.7	6.1	7.0	7.6	7.8
Trade Balance[1]	16.6	13.9	n.a.	n.a.	...	...
Current Account[1]	2.5	-0.4	n.a.	n.a.	...	...

1. Billions of U.S. dollars.