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August 14, 1998

SUPPLEMENT  
CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the  
Federal Open Market Committee

By the Staff  
Board of Governors  
of the Federal Reserve System

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## SUPPLEMENTAL NOTES

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### THE DOMESTIC NONFINANCIAL ECONOMY

#### Business Inventories

The book value of retail inventories fell \$5.3 billion at an annual rate in June. However, excluding motor vehicles, stocks accumulated at a rapid \$27.7 billion annual rate, more than reversing May's decline of \$17.7 billion.<sup>1</sup> With sales at non-auto retailers about unchanged in June, the inventory-sales ratio moved back up to 1.41 months, in the middle of the range recorded over the past year.

The increase in retailers' stocks in June was spread across a wide range of outlets. Notably, stocks held at general merchandisers, apparel outlets, and furniture and appliance stores (the GAF grouping of stores) increased \$11.4 billion at an annual rate, and the inventory-sales ratio for this category moved up to 2.08 months. Still, the inventory-sales ratio in the GAF grouping remained low relative to the levels seen in 1997.

Total manufacturing and trade inventories excluding auto dealers rose \$45.7 billion at an annual rate in June, accelerating from the \$23.9 billion pace registered in May. For the second quarter as a whole, total book-value manufacturing and trade inventories excluding motor vehicles increased \$35.4 billion at an annual rate, about in line with BEA's book-value assumptions underlying the advance GDP estimate. However, the composition of inventory investment differs somewhat from BEA's assumptions, and we estimate that once these book-value stocks are deflated, the second-quarter change in real inventories will be about \$2 billion higher than in the advance GDP release.

#### Industrial Production and Capacity Utilization

The index of industrial production decreased 0.6 percent in July after a revised 1.1 percent fall in June. Some of the downward revision for June was the result of more complete information on production losses associated with the GM strike. The strike lowered assemblies from a seasonally adjusted annual rate of 12.4 million units in May to 8.3 million units in July. We now estimate that the GM strike lowered industrial production by 0.9 percentage point in

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1. The large decline in stocks held at auto dealers was, of course, to be expected as a result of the GM strike. Note, though, that BEA does not use the book-value data on retail inventories at automotive dealers when constructing motor vehicle inventories in the NIPAs.

both June and July; that estimate includes the effects of reduced output at motor vehicle assembly and parts plants and losses at other industries that supply the motor vehicle industry.

Manufacturing output declined 0.7 percent in July following a revised drop of 1.2 percent in June. Stripping away the effects on manufacturing output of the strike, factory production would have been little changed, on balance, over the past few months, after moderate gains in the first quarter. The recent weakness in manufacturing production reduced the factory operating rate to 79.0 percent; excluding the effects of the GM strike, capacity utilization in July would have been a touch below 81 percent, about 1 percentage point below its long-term average. The output of utilities was unchanged in July, remaining at about trend, and the output of mines increased 0.4 percent.

Excluding motor vehicles and parts, manufacturing production edged up 0.1 percent in July after having declined, on average, in the previous two months. The strikes at GM have exacerbated the slowing in this aggregate recently; output of industries that supply the motor vehicle industry declined noticeably in June and July. More generally, the growth in the output of manufacturing excluding motor vehicles and parts has decelerated noticeably this year, in part reflecting the effects of the high dollar and the Asian crisis. The most pronounced weakness has occurred in nondurables and semiconductors.

By major market groups, excluding motor vehicles and parts and energy, the output of business equipment advanced 0.6 percent in July after having accelerated significantly in the second quarter. The information processing equipment group posted widespread gains in July led by increases in the production of computers and photographic equipment; the only exception was a reduction in the output of nondefense communication equipment. The output of industrial equipment retraced a portion of its large increase in June. Transit equipment posted another healthy gain in July, and a surge in the production of farm equipment led the acceleration in other equipment.

Production in other major market groups decelerated sharply in the second quarter and was sluggish in July. The output of consumer goods inched up in July; a rebound in the production of durables, most notably appliances and air conditioners, more than offset the small decrease in nondurable consumer goods. Nonenergy materials declined 0.2 percent in July due

to continuing weakness in basic metals and nondurables; textile, paper, and chemical materials have all decreased over the past three months. The production of construction supplies rose in July after a decline in June, remaining at a very elevated level.

### Consumer Confidence

According to the preliminary report, the Michigan SRC index of consumer sentiment fell a bit in early August but remained in an extremely favorable range. The sub-index of expected conditions moved down to its lowest level this year, reflecting an appreciable decline in respondents' views of business conditions over the next five years. In contrast, the sub-index of current conditions moved up somewhat, as households' appraisals of buying conditions for large appliances rebounded from last month's dip.

Among questions not included in the overall index, responses were generally upbeat in early August. Respondents' views of car buying conditions more than retraced their sharp decline in July, and the reading of home buying conditions remained in its favorable range of late. In addition, respondents' assessments of the expected change in unemployment over the next twelve months receded a touch after running up in July.

The mean value of expected inflation over the next twelve months moved down 0.3 percentage point in early August to 2.8 percent, and the median value ticked down 0.1 percentage point to 2.5 percent. The mean value of expected inflation over the next five to ten years declined 0.2 percentage point to 2.9 percent; the median edged down 0.1 percentage point to 2.6 percent.

### Producer Prices

Producer prices for finished goods rose 0.2 percent in July--pushed up by increases in food and energy prices--while the core PPI increased just 0.1 percent.<sup>2</sup> Over the twelve months ended in July, producer prices declined 0.3 percent; outside of food and energy, the PPI was up 1.1 percent over this period, compared with no change in the preceding twelve months.

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2. Prices of core consumer goods increased 0.3 percent, while the PPI for capital goods was up 0.1 percent. Because the core PPI is made up of these two series, this combination of price increases appears unusual; BLS confirmed that this pattern reflects rounding.

The PPI for food rose 0.4 percent in July. Vegetable prices surged following large declines in the prior two months, and dairy prices continued to climb. Even so, finished food prices have increased just ½ percent over the past twelve months. Finished energy prices increased 0.3 percent in July. Although prices of gasoline and fuel oil fell, those declines were more than offset by increases in prices of natural gas and electricity. According to BLS, the rise in electricity prices reflected, in part, the increase in demand related to hot weather in some parts of the country and the associated switch to higher-cost fuels for generation. Overall, the index for finished energy has dropped 7-1/2 percent over the past year, pulled down by the decline in crude oil prices that began last fall.

Prices of finished consumer goods other than food and energy increased 0.3 percent last month. Prices of passenger cars and light trucks jumped in July, as the Big-Three's coupon incentives expired. Prescription drug prices moved up 1.7 percent further and have increased more than 22 percent over the past year.<sup>3</sup> In contrast to these increases, apparel prices dropped back 0.2 percent in July, and the PPI for tobacco was unchanged. Prices of capital goods were up 0.1 percent in July, as higher prices for motor vehicles were partly offset by a further decline in computer prices.

At earlier stages of processing, the PPI continued to signal little inflationary pressure. The index for intermediate materials other than food and energy was unchanged in July and is down nearly ½ percent since a year ago. Prices for crude materials other than food and energy dropped 1.8 percent in July and are down 7-3/4 percent from a year earlier.

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3. Much of the increase in the past year reflected a 243 percent surge in the price of psychotherapeutic drugs.

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
<u>Book value basis</u>						
Total	39.8	62.7	7.7	21.6	-6.4	7.9
Excluding wholesale and retail motor vehicles	40.2	55.3	35.4	36.6	23.9	45.7
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	-12.1	9.3	-40.3	-5.3
Auto dealers	.9	1.6	-17.6	2.8	-22.6	-33.0
Excluding auto dealers	5.1	20.5	5.5	6.5	-17.7	27.7

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

	<u>Cyclical reference points</u>		<u>Range over preceding 12 months</u>		June 1998
	1990-91 high	1995-96 low	High	Low	
Manufacturing and trade	1.58	1.38	1.39	1.37	1.38
Less wholesale and retail motor vehicles	1.55	1.35	1.36	1.34	1.37
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	1.51	1.45	1.45
Less automotive dealers	1.48	1.43	1.42	1.40	1.41
Automotive dealers	2.22	1.69	1.77	1.60	1.55
General merchandise	2.42	2.20	2.14	2.00	2.02
Apparel	2.53	2.27	2.45	2.32	2.46
GAF	2.42	2.23	2.17	2.06	2.08



TABLE 1  
GROWTH IN SELECTED COMPONENTS OF INDUSTRIAL PRODUCTION  
(Percent change from preceding comparable period)

	Proportion 1997	1998		1998		
		Q1	Q2	May	June	July
		-Annual rate-		--Monthly rate--		
Total index	100.0	1.2	1.9	.4	-1.1	-.6
Previous		1.2	2.5	.3	-.6	
Manufacturing	86.2	2.3	1.1	.1	-1.2	-.7
Durables	46.6	2.6	2.8	.4	-1.5	-1.2
Motor veh. and parts	5.2	-17.7	-12.1	1.4	-14.5	-15.3
Aircraft and parts	2.3	10.8	.0	.6	-.4	1.4
Computer and office eq.	1.8	56.6	58.1	2.7	3.7	3.3
Nondurables	39.6	1.8	-1.1	-.2	-.7	-.2
Manufacturing excluding motor vehicles and parts	81.0	3.7	1.9	.0	-.3	.1
Mining	6.2	9.9	-5.2	.2	-1.9	.4
Utilities	7.6	-16.5	19.1	4.5	.6	.0
IP by market group, excluding motor vehicles and parts and energy						
Consumer goods	22.9	3.3	-.2	.0	-.8	.1
Durables	4.0	10.6	5.2	1.3	-1.1	.9
Nondurables	19.0	1.8	-1.3	-.3	-.8	-.1
Business equipment	12.3	2.9	9.6	-.1	1.6	.6
Information processing	5.5	6.3	15.6	.4	1.3	1.2
Industrial	4.5	-2.0	5.6	-.9	2.4	-.9
Transit	1.1	19.4	5.1	2.0	.5	.7
Other	1.3	-8.8	6.3	-1.1	1.6	3.0
Construction supplies	5.6	8.5	1.0	1.1	-.3	.3
Materials	30.1	4.0	1.1	-.1	-.6	-.2
Durables	21.1	6.0	2.8	.0	-.8	.1
Semiconductors	3.7	30.8	11.1	1.0	.4	1.6
Basic metals	3.3	3.8	-8.5	-.6	-1.5	-.9
Nondurables	9.0	-.8	-3.1	-.6	-.3	-.8

TABLE 2  
CAPACITY UTILIZATION IN INDUSTRY  
(Percent of capacity; seasonally adjusted)

	1967-97	1988-89	1998		1998		
	Avg.	High <sup>1</sup>	Q1	Q2	May	June	July
Total industry	82.1	85.4	82.5	82.0	82.4	81.2	80.5
Manufacturing	81.1	85.7	81.6	80.8	81.1	79.9	79.0
Primary processing	82.4	88.9	85.6	84.8	85.0	84.1	83.6
Textile mill products	85.5	90.4	82.9	82.3	83.7	81.0	81.5
Paper and products	92.4	98.0	92.8	91.3	91.0	90.8	89.0
Chemicals <sup>2</sup>	83.2	92.0	87.7	86.1	86.0	85.2	85.0
Petroleum products	86.6	88.5	97.2	96.9	96.2	96.4	96.9
Rubber and plastics products	84.8	89.6	87.3	87.9	88.0	87.2	87.0
Lumber and products	82.6	93.6	81.3	81.9	81.8	82.1	82.6
Stone, clay, and glass	78.2	83.5	80.8	79.6	79.8	79.3	79.2
Primary metals	81.2	92.7	91.5	88.8	89.0	86.6	85.5
Iron and steel	81.0	95.2	91.3	87.5	87.8	84.9	84.1
Nonferrous metals	81.5	89.3	92.0	90.5	90.6	88.9	87.3
Fabricated metal products	77.9	82.0	78.4	78.1	78.4	77.7	77.0
Advanced processing	80.5	84.2	79.8	79.0	79.5	78.0	76.9
Foods	82.9	85.4	81.3	80.7	81.1	79.8	79.4
Apparel products	81.0	85.1	74.9	74.4	74.1	74.1	73.9
Printing and publishing	85.7	91.7	82.8	81.4	81.6	80.7	81.0
Furniture and fixtures	81.5	86.6	78.2	77.9	77.6	77.9	77.9
Chemicals <sup>3</sup>	76.7	82.2	74.3	74.9	74.8	75.1	74.5
Industrial machinery and computer equipment	81.4	85.4	84.0	85.1	85.0	85.3	84.9
Electrical machinery	81.0	84.0	80.5	78.5	78.5	77.6	77.5
Motor vehicles and parts	76.6	89.1	72.7	69.6	73.5	62.6	52.8
Autos and light trucks <sup>4</sup>		92.3	78.3	74.8	79.7	66.1	53.2
Aerospace and misc. transportation equipment	75.2	87.3	80.7	80.1	80.3	80.1	80.6
Instruments	81.7	81.4	80.1	79.9	80.0	79.5	80.0
Miscellaneous manufactures	75.4	79.0	80.5	79.5	79.2	78.8	78.5
Mining	87.5	88.0	91.6	90.1	90.8	89.0	89.3
Utilities	87.3	92.6	86.6	90.3	91.4	91.9	91.8

1. The historical highs shown are specific to each series and did not occur in the same month.

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

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

4. Series begins in 1977.

UNIVERSITY OF MICHIGAN SURVEY RESEARCH CENTER: SURVEY OF CONSUMER ATTITUDES  
(Not seasonally adjusted)

	1997 Dec	1998 Jan	1998 Feb	1998 Mar	1998 Apr	1998 May	1998 Jun	1998 Jul	1998 Aug (p)
Indexes of consumer sentiment (Feb. 1966=100)									
Composite of current and expected conditions	102.1	106.6	110.4	106.5	108.7	106.5	105.6	105.2	104.5
Current conditions	111.4	113.5	120.0	113.7	115.5	113.9	115.4	113.3	115.7
Expected conditions	96.1	102.2	104.2	101.9	104.3	101.7	99.3	100.0	97.3
-----									
Personal financial situation									
Now compared with 12 months ago*	123	124	142	128	131	130	130	132	132
Expected in 12 months*	136	141	145	134	138	134	134	139	137
Expected business conditions									
Next 12 months*	142	148	155	158	162	158	150	145	146
Next 5 years*	109	123	121	119	121	118	116	119	109
Appraisal of buying conditions									
Cars	135	145	149	146	145	148	152	139	153
Large household appliances*	166	171	170	167	169	166	170	162	168
Houses	161	172	170	176	178	172	171	169	170
Willingness to use credit									
Willingness to use credit	39	55	56	49	51	54	50	54	49
Willingness to use savings									
Willingness to use savings	75	74	78	82	70	78	68	82	78
Expected unemployment change - next 12 months									
Expected unemployment change - next 12 months	114	106	99	100	97	102	105	111	109
Expected inflation - next 12 months									
Mean	3.4	2.8	2.6	2.9	2.7	3.1	3.2	3.1	2.8
Median	2.8	2.3	2.4	2.5	2.4	2.6	2.7	2.6	2.5
Expected inflation - next 5 to 10 years									
Mean	3.9	3.4	3.2	3.3	3.2	3.3	3.3	3.1	2.9
Median	3.1	2.9	2.9	2.8	2.7	2.8	2.9	2.7	2.6

\* -- Indicates the question is one of the five equally-weighted components of the index of sentiment.

(p) -- Preliminary

(f) -- Final

Note: Figures on financial, business, and buying conditions are the percent reporting 'good times' (or 'better') minus the percent reporting 'bad times' (or 'worse'), plus 100. Expected change in unemployment is the fraction expecting unemployment to rise minus the fraction expecting unemployment to fall, plus 100.

RECENT CHANGES IN PRODUCER PRICES  
(Percent change)

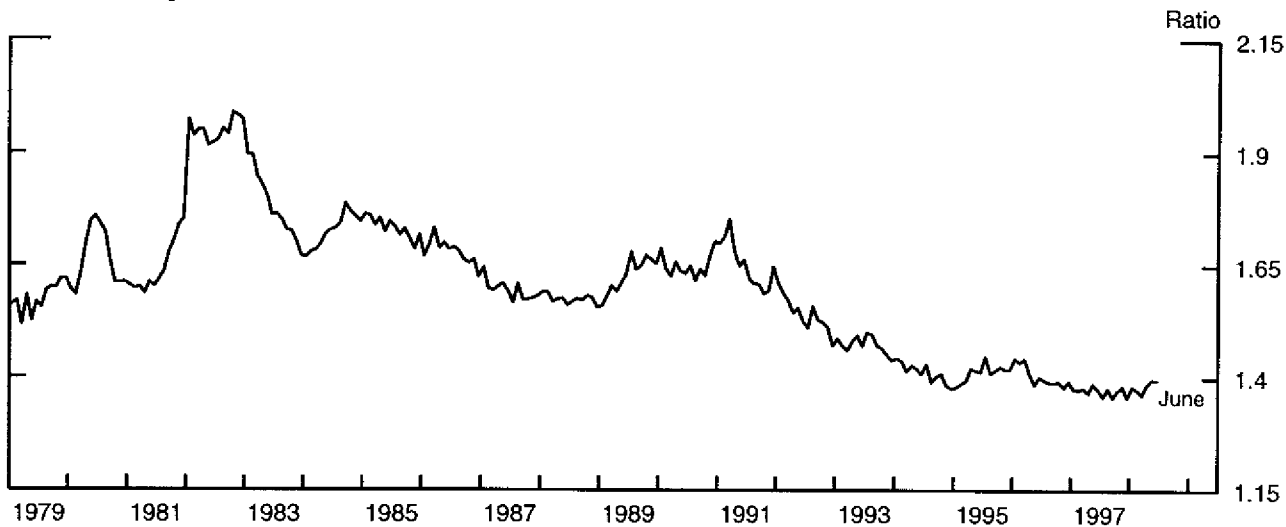
	Relative importance Dec. 1997	1996	1997	1997			1998	
				Q4	Q1	Q2	June	July
				-----Annual rate-----			-Monthly rate-	
Finished goods	100.0	2.8	-1.2	-1.2	-3.0	.0	-.1	.2
Consumer foods	23.2	3.4	-.8	1.5	-1.8	.6	.1	.4
Consumer energy	13.6	11.7	-6.4	-5.7	-27.0	-3.1	-1.7	.3
Other finished goods	63.2	.6	.0	-.8	2.3	.6	.2	.1
Consumer goods	38.0	.8	.3	-.3	3.9	1.4	.3	.3
Capital equipment	25.2	.4	-.6	-2.0	.0	-.9	.0	.1
Intermediate materials <sup>1</sup>	94.9	.7	-.8	-.6	-4.4	-1.6	-.3	.0
Excluding food and energy	81.8	-.9	.3	.0	-.9	-1.2	-.1	.0
Crude food materials	42.1	-1.0	-4.0	4.1	-14.3	-3.0	.1	-2.8
Crude energy	36.4	51.2	-23.1	5.4	-53.5	-2.3	-3.9	-.6
Other crude materials	21.5	-5.5	.0	-8.2	-13.6	-5.0	-.5	-1.8

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

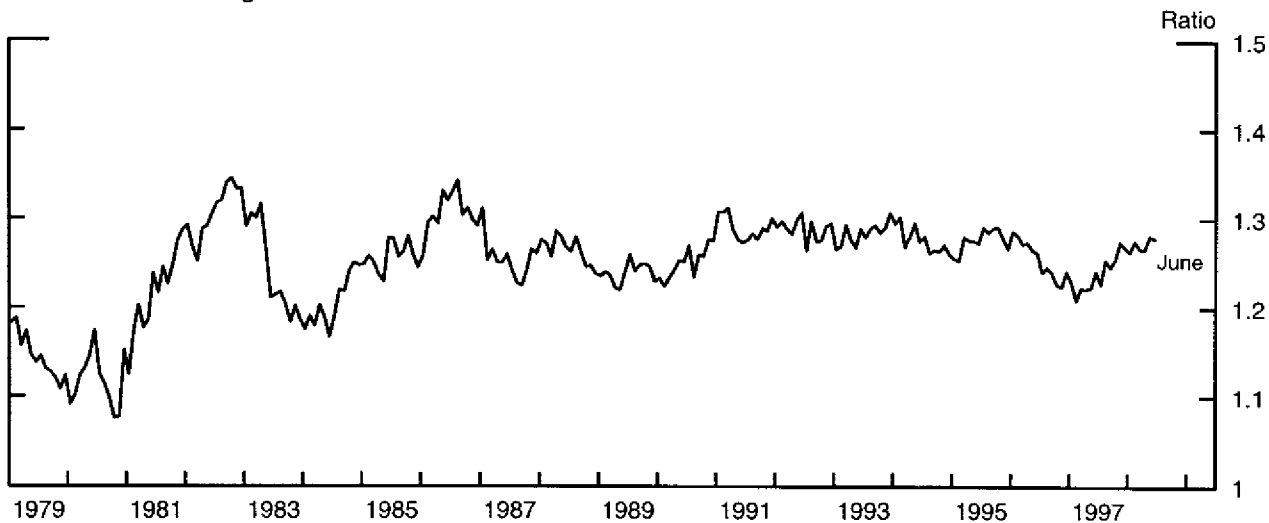
### Inventory-Sales Ratios, by Major Sector

(Book value)

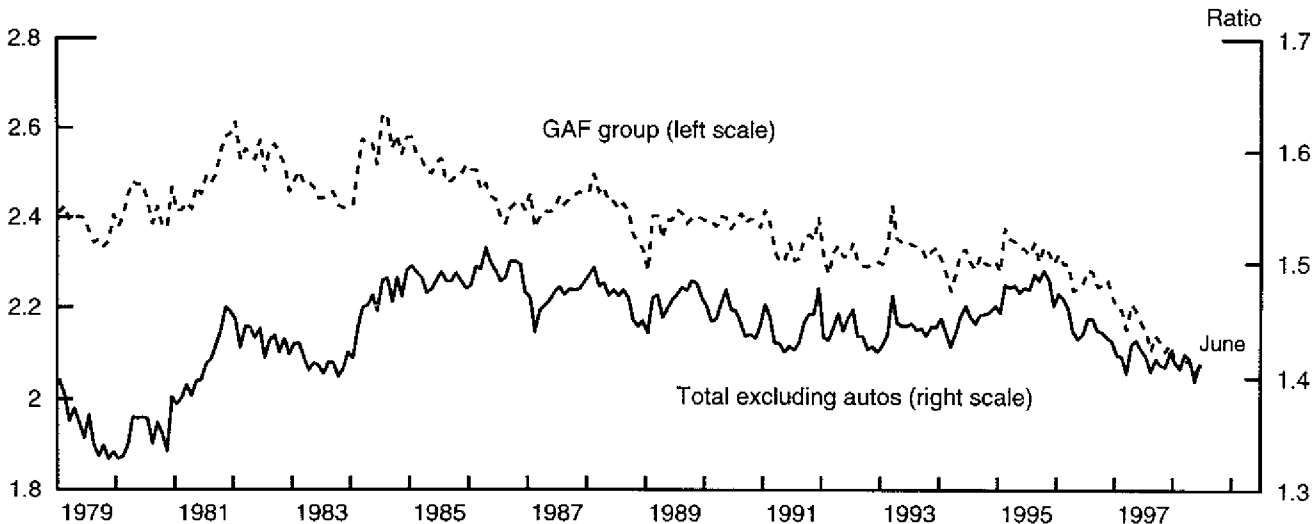
Manufacturing



Wholesale Excluding Motor Vehicles



Retail



**Selected Financial Market Quotations<sup>1</sup>**  
(Percent except as noted)

Instrument	1997	1998			Change to Aug. 13, from:			
	Sep. 30	Feb. 24	FOMC * July 1	Aug. 13	Sep. 30	Feb. 24	FOMC * July 1	
<b>Short-term rates</b>								
Federal funds								
intended rate <sup>2</sup>	5.50	5.50	5.50	5.50	0.00	0.00	0.00	
realized rate <sup>3</sup>	5.51	5.48	5.51	5.55	0.04	0.07	0.04	
Treasury bills <sup>4</sup>								
3-month	4.93	5.13	4.97	4.91	-0.02	-0.22	-0.06	
6-month	5.08	5.11	5.04	4.97	-0.11	-0.14	-0.07	
1-year	5.18	5.18	5.10	4.99	-0.19	-0.19	-0.11	
Commercial paper								
1-month	5.51	5.47	5.54	5.50	-0.01	0.03	-0.04	
3-month	5.48	5.44	5.47	5.47	-0.01	0.03	0.00	
Large negotiable CDs <sup>4</sup>								
1-month	5.59	5.54	5.60	5.55	-0.04	0.01	-0.05	
3-month	5.67	5.54	5.61	5.58	-0.09	0.04	-0.03	
6-month	5.72	5.56	5.68	5.61	-0.11	0.05	-0.07	
Eurodollar deposits <sup>5</sup>								
1-month	5.56	5.50	5.56	5.53	-0.03	0.03	-0.03	
3-month	5.63	5.53	5.59	5.56	-0.07	0.03	-0.03	
Bank prime rate	8.50	8.50	8.50	8.50	0.00	0.00	0.00	
<b>Intermediate- and long-term rates</b>								
U.S. Treasury (constant maturity)								
2-year	5.80	5.57	5.49	5.37	-0.43	-0.20	-0.12	
10-year	6.12	5.69	5.44	5.44	-0.68	-0.25	0.00	
30-year	6.41	5.97	5.62	5.60	-0.81	-0.37	-0.02	
U.S. Treasury 10-year indexed note	3.61	3.68	3.76	3.80	0.19	0.12	0.04	
Municipal revenue (Bond Buyer) <sup>6</sup>	5.63	5.29	5.36	5.34	-0.29	0.05	-0.02	
Corporate bonds, Moody's seasoned Baa	7.66	7.30	7.11	7.17	-0.49	-0.13	0.06	
High-yield corporate <sup>7</sup>	9.02	8.93	9.20	9.49	0.47	0.56	0.29	
Home mortgages <sup>8</sup>								
FHLMC 30-yr fixed rate	7.28	6.99	6.96	6.91	-0.37	-0.08	-0.05	
FHLMC 1-yr adjustable rate	5.51	5.59	5.68	5.60	0.09	0.01	-0.08	
<b>Stock exchange index</b>								
	Record high		1998			Percentage change to Aug. 13, from:		
	Level	Date	Feb. 24	FOMC * July 1	Aug. 13	Record high	Feb. 24	FOMC * July 1
Dow-Jones Industrial	9337.97	7/17/98	8370.10	8952.02	8459.50	-9.41	1.07	-5.50
S&P 500 Composite	1186.75	7/17/98	1030.56	1133.84	1074.91	-9.42	4.30	-5.20
NASDAQ (OTC)	2014.25	7/20/98	1738.71	1894.74	1802.54	-10.51	3.67	-4.87
Russell 2000	491.41	4/21/98	454.30	457.39	403.83	-17.82	-11.11	-11.71
Wilshire	11106.10	7/17/98	9834.35	10663.62	10003.82	-9.93	1.72	-6.19

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.