
*73rd Annual
Report
1986*



Board of Governors of the Federal Reserve System

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., May 18, 1987

THE SPEAKER OF
THE HOUSE OF REPRESENTATIVES

Pursuant to the requirements of section 10 of the Federal Reserve Act, I am pleased to submit the Seventy-Third Annual Report of the Board of Governors of the Federal Reserve System.

This report covers operations of the Board during calendar year 1986.

Sincerely,

Paul A. Volcker, *Chairman*

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Part 1
Monetary Policy and
the U.S. Economy in 1986

Introduction

Economic activity continued to expand moderately in 1986, at about the average pace prevailing since mid-1984. This growth was sufficient to create a substantial number of new jobs and to produce another small decline in the unemployment rate. Further progress also was made toward the objective of overall price stability. Wage and price behavior continued to be influenced by the anti-inflationary thrust of policies put in place earlier and by the adjustment of expectations to the new environment. Thus, while the plunge in world crude oil prices contributed importantly to the marked slowing in inflation in 1986, prices outside the energy area also decelerated on average. Labor cost pressures remained subdued, with nominal wage gains across a broad range of occupations and industries continuing to move toward rates more consistent with trends in labor productivity.

The Federal Reserve encouraged continued economic expansion by supplying ample reserves for the banking system and reducing the discount rate four times, by a total of 2 percentage points. A large portion of the reserves provided were aimed at accommodating the strong demand for M1-type deposits. M1 grew in excess of 15 percent in 1986, and its velocity declined more than 9

percent, a rate unprecedented during the postwar years. In part, this rapid money growth reflected the public's response to changes in interest rates that made holding NOW accounts and demand deposits more attractive. However, the growth in M1 was well in excess of what would be expected based on past relationships among money, interest rates, and income. Growth in the broader aggregates was more in line with past experience, taking account of interest rate movements. Both M2 and M3 expanded almost 9 percent and ended the year just within the upper bound of their annual target ranges.

In the credit markets, short-term interest rates declined about 2 percentage points through the first three quarters of 1986, before backing up somewhat in response to pressure around the end of the year from a huge volume of tax-related financial transactions. Longer-term bond rates fell more than 2 percentage points in 1986; most of the decline occurred in the first four months of the year in response to an improved inflation outlook and sluggish growth in economic activity. After mid-April, Treasury bond rates fluctuated in a relatively narrow range, but corporate and municipal bond rates trended down and reached their lowest levels since the late 1970s.

The declines in interest rates contributed to the vigorous pace of household spending last year by reducing borrowing costs and boosting asset values. Housing starts, which are particularly sensitive to interest rate developments, rose a bit despite the drag of a depressed economy in

NOTE. This discussion of economic and financial developments in 1986 is adapted from the *Monetary Policy Report to the Congress Pursuant to the Full Employment and Balanced Growth Act of 1978* (Board of Governors, February 1987).

regions heavily dependent on oil and agriculture. In contrast, capital spending declined over the course of the year, largely because of the substantial cutback in oil drilling; more broadly, investment was restrained by an overhang of office and other commercial space and the weak pace of activity in major segments of the manufacturing sector.

The disparity between household spending and business investment is indicative of the imbalances that characterized the U.S. economy in 1986. Indeed, economic performance throughout the expansion has varied considerably across industries and regions of the country. In some cases, such as agriculture, special circumstances have played a role. But more fundamentally, the imbalances are rooted in the enormous—and partly related—deficits in the country's external accounts and in the federal budget.

Although the foreign exchange value of the dollar fell sharply through early 1987 from its peak in early 1985, the nation's trade deficit deepened. The increased price competitiveness of U.S. producers contributed to a sizable improvement in the growth of exports in 1986, but the pickup was limited by the sluggishness of economic activity in many

other countries. At the same time, the volume of imports continued to rise rapidly through most of the year, in part because the pass-through into import prices of the dollar's depreciation against major foreign currencies was limited by the ability of foreign exporters and U.S. distributors to absorb much of the swing in exchange rates in their profit margins. Also, an increasing amount of imports was coming from the newly industrialized and developing countries whose currencies, as a group, did not appreciate against the dollar. With import penetration remaining on an uptrend, domestic production continued to expand less rapidly than domestic demand.

The federal budget deficit also remained huge, despite substantial deficit-reducing actions taken by the administration and the Congress. Official estimates suggest a deficit for fiscal 1987 of around \$175 billion, a good deal less than the record 1986 figure but still equal to a historically high 4 percent of the gross national product. Further cuts in the federal deficit are essential, in the context of movement toward better external balance, to ensure that an adequate flow of domestic saving is available to support needed domestic investment.

The Economy in 1986

The economy completed a fourth consecutive year of expansion in 1986, with real gross national product increasing about 2 percent. The rise in overall activity resulted in 2½ million new payroll jobs. The jobless rate for civilians continued to edge down and was 6¾ percent at year-end.

Inflation slowed sharply in 1986: virtually all broad measures of price trends showed their smallest increases in many years. Although the sharpness of the deceleration owed much to specific developments in the markets for oil and other commodities, the favorable inflation performance also represented at a fundamental level the continuation of trends in wage and price behavior fostered by policies in place since the early part of the decade.

While output continued to grow in 1986, the economy still was characterized by pronounced imbalances. These were reflected in marked disparities in economic performance across industries and geographic areas. In particular, domestic oil exploration and investment were cut back severely, and only massive federal subsidies sustained many farm enterprises faced with sharply lower crop prices. In addition, major segments of the industrial sector continued to struggle with intense foreign competition, and relatively low rates of capacity utilization, along with a glut of office space, depressed capital spending.

The most serious imbalances continued to be in the external sector and in the federal budget. Despite the decline of roughly 40 percent

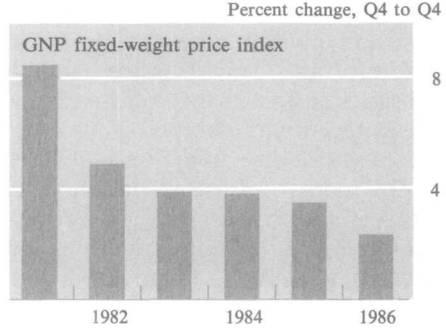
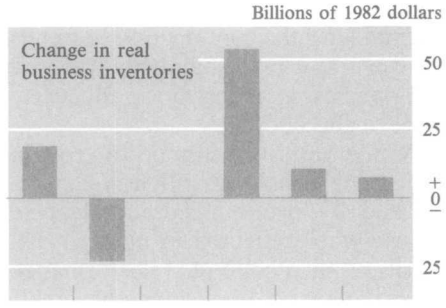
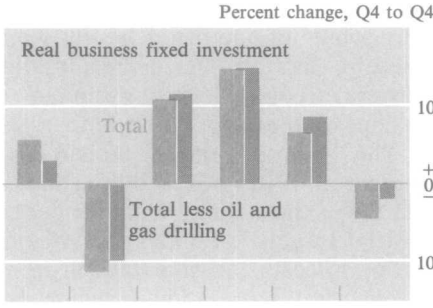
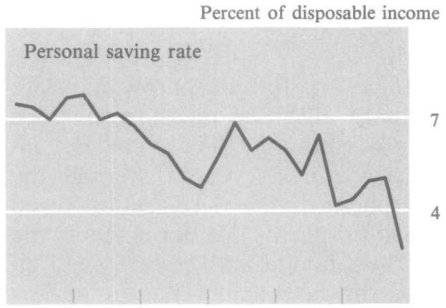
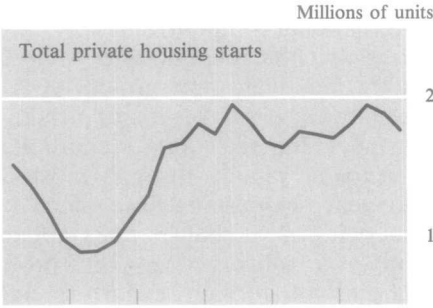
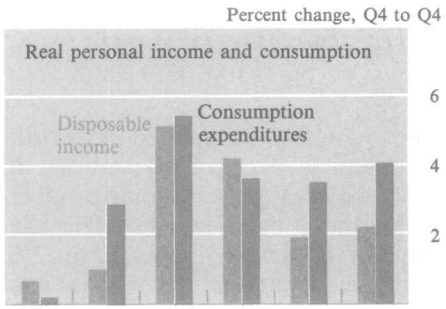
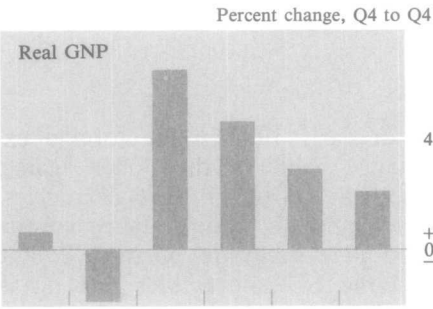
after early 1985 in the foreign exchange value of the dollar against the other Group of Ten currencies, the country's trade balance continued to deteriorate. Growth in the volume of exports did pick up in 1986 in response to the enhanced international competitiveness of U.S. firms, but the rebound was damped by the relatively slow growth of the economies of U.S. major trading partners. Import volumes continued to expand rapidly through most of the year, in part because much of the swing in exchange rates apparently was absorbed in the profit margins of foreign exporters and U.S. distributors, and increases in the prices of imported goods were thereby limited. As a result, the current account deficit continued to widen, to about \$150 billion in 1986.

The federal budget deficit also increased, hitting \$221 billion in fiscal 1986; the deficit vastly exceeded official targets, as underestimates of program costs and shortfalls in revenues offset the deficit-reducing actions taken by the administration and the Congress. The much smaller estimated deficit in the area of \$175 billion for fiscal year 1987 is still considerably above the Gramm-Rudman-Hollings target of \$144 billion.

Prices

The GNP fixed-weight price index increased about 2½ percent in 1986. This was the smallest yearly increase in more than two decades and followed a rise of 3½ percent in 1985. Some other popular measures of

Indicators of Economic Performance



All data are seasonally adjusted, and those that involve dollar amounts are in 1982 dollars. The unemployment data are from the U.S. Department of

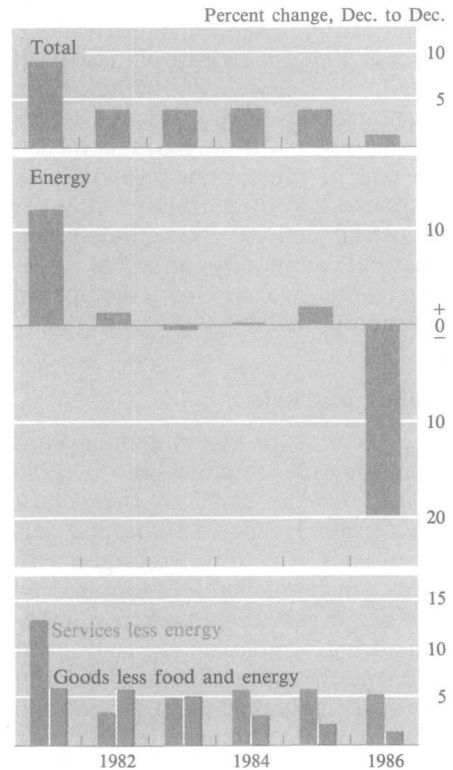
Labor; the other data are from the U.S. Department of Commerce.

prices decelerated even more. The consumer price index for goods and services rose only about 1 percent, and the producer price index for finished goods actually fell 2½ percent.

The greater deceleration in the consumer and producer price indexes than in the GNP price measure reflects the greater importance of energy prices in those indexes. The movements in energy prices over the past year or so have been striking. World crude oil prices dropped from \$26 per barrel in late 1985 to about \$11 per barrel around midyear; they trended up over the second half of 1986 and rose to around \$18 per barrel in early 1987 in the wake of the agreement on production limits reached by the Organization of Petroleum Exporting Countries in late December. The drop in crude oil prices in the first half of 1986 was reflected promptly in prices of gasoline and home heating oil, which fell around 30 percent over the course of the year. Charges for electricity and natural gas also declined, but much less than those for refined petroleum products. On balance, retail energy prices declined 20 percent over the year.

Price increases outside the energy area generally remained moderate in 1986. Retail food prices rose 4 percent, a bit more than in 1985, reflecting the effects of the summer's heat wave in the Southeast. However, prices of retail goods excluding food and energy continued to slow and, on balance, were up only 1½ percent. The influence of the depreciating dollar on consumer goods prices was highly variable across sectors and relatively small overall. Sizable increases occurred in dockside prices for foreign cars and for some types

Consumer Prices



The data are from the U.S. Department of Labor.

of home electronic and photographic equipment, and retail prices of such goods accelerated. But there was little evidence of any significant aggregate impact on other consumer goods. Prices for nonenergy services also slowed somewhat, but they still rose around 5 percent, boosted by continued large increases for medical services and higher premiums for various types of insurance.

Prices for many basic industrial commodities continued to decline over most of the first three quarters of 1986. Excess capacity in some basic industries and the generally abundant world supplies of many

primary commodities contributed significantly to the weakness in these prices. Sluggish industrial activity in the United States and other large economies also was a factor. Prices in a number of these markets turned up late in the summer, possibly in response to the firming in U.S. industrial activity. Nonetheless, industrial commodity prices at year-end were well below the peaks reached in mid-1984.

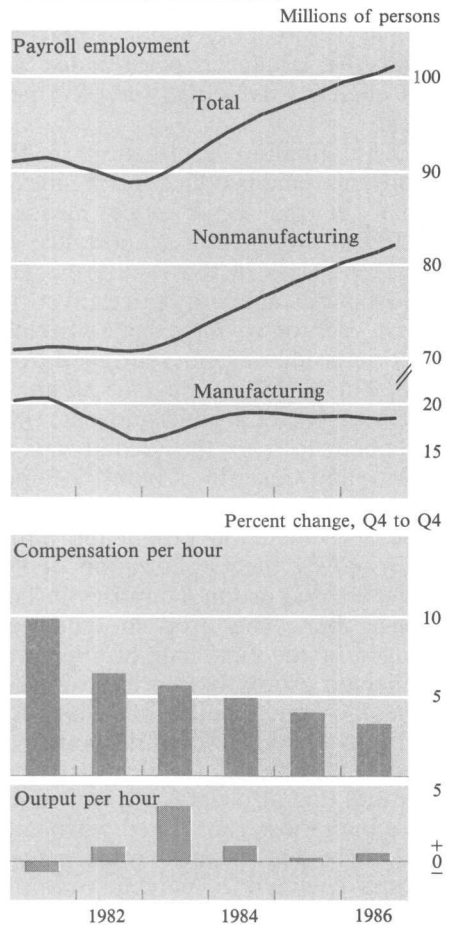
Labor Markets

The increase of 2½ million in non-farm payroll employment in 1986 was about the same as the robust 1985 pace. Hiring in trade and services again was quite vigorous, with especially large increases for business and health services. In contrast, manufacturing employment contracted over the first three quarters of 1986. However, it picked up in the autumn in response to an apparent firming in industrial activity; in nondurable goods industries, where output had risen steadily, employment gains were widespread, but hiring at firms producing durable goods remained spotty.

The growth in the number of jobs in 1986 slightly exceeded the rise in the labor force. As a result, the civilian unemployment rate edged down, to 6¾ percent at year-end. Labor force participation maintained its upward trend: women continued to enter the workforce in large numbers, in part responding to expanding job opportunities; and participation rates for adult men held steady. Overall, the number of persons employed relative to the working-age civilian population reached 61 percent, a new high.

Wages continued on a path of moderation in 1986. Hourly compensation in the nonfarm private sector,

Labor Market Conditions



Payroll employment covers the total nonfarm sector; hourly compensation and output cover the nonfarm business sector. All data are from the U.S. Department of Labor.

as measured by the employment cost index, rose about 3¼ percent, ¾ percentage point less than in 1985. The deceleration in wages reflected the continued slack in labor markets as well as the reduction in price inflation, and was widespread across industries and occupations. In the unionized sector, wage increases were especially small, and a number of alternative, more flexible compensa-

tion arrangements were adopted, including the substitution of lump-sum payments for general wage increases. The advance in compensation for white-collar workers also moderated, although it remained more rapid than that for other groups.

Unit labor costs in the nonfarm business sector were well contained in 1986, because of the relatively moderate increase in wages. Gains in output per hour, however, have averaged less than 1 percent per year since 1984; through 1986 the underlying trend in productivity for the business sector as a whole improved only slightly from the very low pace of the 1970s, and it remains well below the pace of earlier years in the postwar period. In contrast, productivity in manufacturing has increased about 3½ percent a year over the past three years, in part because intense foreign competition has induced many producers to modernize their factories and streamline their operations.

Household Sector

The household sector was the major contributor to overall growth again in 1986. Consumer spending increased a robust 4 percent in real terms, even though income growth was only moderate on average for the second year in a row. Real disposable income soared in the first half of the year because of the plunge in energy prices, but it dropped after midyear as wage and salary gains remained sluggish and farm and interest income declined. Consequently, the personal saving rate fell to around 4 percent, the lowest annual average in nearly 40 years.

The growth in consumption last year was paced by strong gains in purchases of durable goods, while

spending on nondurable goods and services increased at about the same rate as in the preceding few years. Among durable goods, sales of new cars rose to around 11½ million units. Effective prices of new cars were held down by incentive programs of below-market financing for domestic makes and by the introduction of low-priced imports from Korea and Yugoslavia. At the same time, sales of Japanese and European models remained brisk, despite sizable increases in their sticker prices. Total outlays for other durable goods also rose substantially, as consumers greatly increased their purchases of home electronics products, and sales of furniture and appliances were supported in part by the robust pace of home sales in recent years.

Housing activity continued to expand in 1986. Total housing starts edged up to 1.8 million units for the year as a whole, their highest level since the late 1970s. Single-family homebuilding increased about 10 percent, bolstered not only by a sizable decline in mortgage rates—which brought rates on fixed-rate loans back to single digits for the first time since 1978—but also by continuing favorable demographic trends. In contrast, multifamily activity dropped off considerably over the course of the year; an important factor in the decline was the restraining influence of record-high vacancy rates on rental units, especially in key markets in the South. In addition, several provisions of 1986 tax legislation have reduced the profitability of building rental housing.

Business Sector

Business spending on plant and equipment declined 4½ percent in

real terms in 1986. Much of the drop was attributable to the sharp cutback in oil and gas well drilling, which fell almost 50 percent over the year. But investment outside of the energy sector also was generally lackluster as many firms, especially in the tradable goods sector, trimmed expansion plans in light of relatively low rates of capacity utilization and continuing uncertainty about future sales trends. Investment in computers and other office machines remained on the path of reduced growth evident since the fading of the high-tech spending boom in 1985, in part because of concerns about the productivity-enhancing potential of some of these products. More generally, the widely anticipated elimination of the investment tax credit prompted many firms to accelerate spending in late 1985; despite another tax-related speedup late last year, the net effect of tax changes in 1986 appears to have been to depress equipment spending. Outlays for nonresidential structures outside of the energy area, which had risen exceptionally fast over the first few years of the expansion, fell in 1986. The decline in office construction, where vacancy rates reached extraordinarily high levels, was especially sharp.

Inventory investment generally remained subdued in 1986. Faced with sluggish orders and stable or falling prices, manufacturers continued to trim their stocks. In the retail and wholesale trade sector, inventories of goods other than automobiles increased moderately for the second year in a row; however, at year-end such stocks appeared to be roughly in line with near-term sales prospects. At auto dealers, stocks fluctuated widely but showed little net

change over the course of the year; drops in inventories coincided mainly with the special incentive programs that pushed sales to record levels, and also with a burst in sales in December in anticipation of tax changes in 1987.

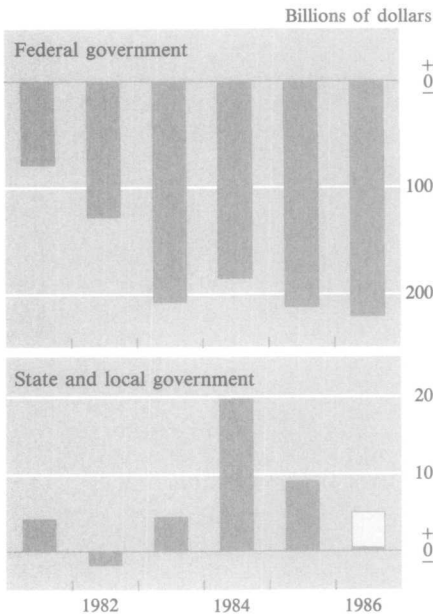
After-tax economic profits in the nonfinancial corporate sector, although at fairly high levels relative to GNP, were essentially unchanged overall from 1985. There was considerable diversity in the performance of individual industries: the petroleum industry experienced a marked decline in profits associated with the fall in oil prices, while petroleum-using industries such as chemicals and plastics fared relatively well.

Government Sector

Even though the administration and the Congress have taken significant action in the past few years to reduce it, the federal budget deficit has remained huge. In fiscal year 1986 the imbalance hit a record \$221 billion, exceeding the previous year's deficit by more than \$8 billion. Revenue growth in 1986 was restrained by the relatively moderate rise in nominal income, while demands on some programs were strong, especially in the areas of agriculture and health. Although the budgetary program put in place for fiscal year 1987 was nominally consistent with the Gramm-Rudman-Hollings deficit target of \$144 billion by January 1987, the published estimates of the administration and the Congressional Budget Office were around \$175 billion, equal to about 4 percent of GNP—still a high ratio historically.

Excluding changes in farm inventories held by the Commodity Credit

Government Surpluses and Deficits



The data on the federal government deficit are for fiscal years and are on a budget basis; they are from the U.S. Department of the Treasury.

The data on state and local governments are for operating budgets. They are on a national income accounts basis, and they come from the U.S. Department of Commerce.

The total 1986 surplus of \$5.0 billion for state and local governments contained about \$4.7 billion of nonrecurring inflows from settlements involving oil company overcharges, Outer Continental Shelf rents, and stripper-well charges, as well as shifting of some revenue-sharing payments to fiscal 1986.

Corporation (CCC), federal purchases of goods and services rose appreciably in 1986. Over the course of the year defense purchases in real terms grew about 7 percent, similar to the increases recorded since the early 1980s. Excluding CCC purchases, real nondefense outlays, which have shown little net change in recent years, were essentially flat.

Purchases of goods and services by state and local governments rose briskly in 1986, mainly because of a surge in construction activity. An upswing in the school-age population in recent years has led to a step-up in school building, and numerous programs are under way to expand and improve the infrastructure. The growth in overall outlays has been sustained despite concerns about the financial condition of the sector. Excluding some special one-time inflows, such as previously escrowed oil-lease payments, the combined surplus of operating and capital accounts for the sector as a whole fell to near zero in 1986. Many states, including most of those in the energy and agricultural regions, responded to budgetary pressures by raising taxes and cutting spending.

Monetary Policy and Financial Markets

The Federal Reserve faced continuing challenges in 1986, not only in discerning the underlying trends in a complex domestic and international economic setting, but also in specifying appropriate policy actions in a financial environment marked by rapid structural change. As in previous years, and in keeping with the Full Employment and Balanced Growth Act, the Federal Reserve used money and credit aggregates as a means of assessing and characterizing policy. At the same time, in targeting these aggregates and in reaching operational decisions with respect to the degree of reserve pressures and the discount rate, the evaluation of signals provided by a broad range of economic and financial indicators played a large role.

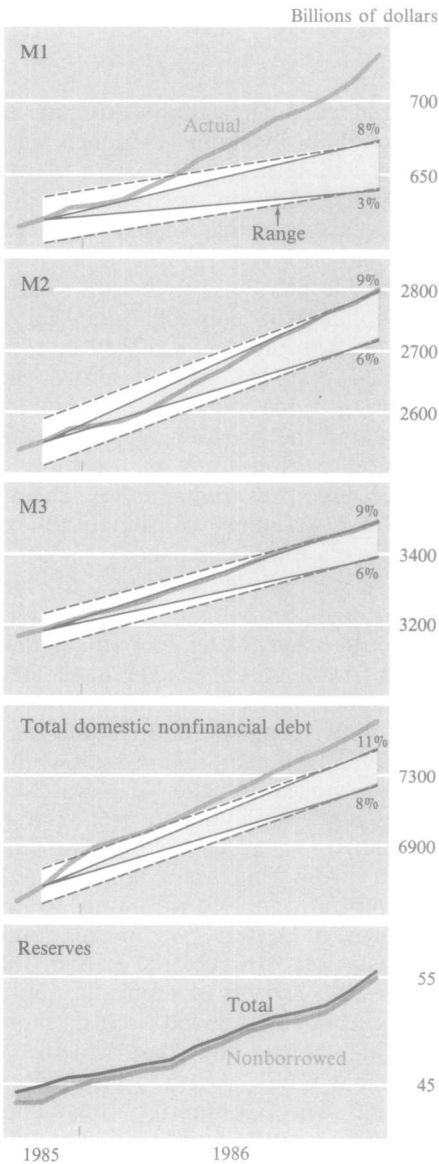
At its meeting in February 1986, the Federal Open Market Committee established target growth ranges, measured from the fourth quarter of 1985 to the fourth quarter of 1986, of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3. The associated monitoring range for growth of domestic nonfinancial debt was set at 8 to 11 percent. In light of the experience of recent years, the Committee recognized that the relationship between M1 and economic activity was subject to especially great uncertainty. Accordingly, the FOMC agreed to evaluate movements in M1 in light of their consistency with the patterns in other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures.

M1 was well above its annual

target range when the FOMC met in July. The available evidence suggested that the rapid growth of M1 reflected shifts in portfolios toward liquid assets in the context of declining market interest rates, rather than excessive money growth with potential inflationary consequence. Against this background, the Committee concluded that M1 growth above the existing range would be acceptable, provided the broader aggregates expanded within their target ranges, price pressures remained in check, and the economy continued to expand at a moderate pace.

The Committee reaffirmed the target ranges for M2 and M3 at its July meeting. According to data at that time, both of these aggregates had expanded at rates near the midpoints of their ranges, and Committee members believed that growth within those ranges for the year was still consistent with the overall policy objectives of reducing inflation further, promoting sustainable growth in output, and contributing to an improved pattern of international transactions. In the first half of the year, the growth of domestic nonfinancial debt exceeded both its monitoring range and the growth of nominal GNP, as it had in previous years. The Committee was concerned about the burdens and potential instabilities associated with the persistence of rapid debt growth, and it felt that raising the monitoring range for debt would create an inappropriate benchmark for evaluating long-term trends. The existing range was maintained, but the FOMC

Monetary Aggregates, Nonfinancial Sector Debt, and Reserves



The ranges adopted by the FOMC for the monetary aggregates and for total debt of the domestic nonfinancial sector were for the period from 1985:4 to 1986:4.

The reserve aggregates have been adjusted to remove discontinuities associated with changes in reserve requirements. Nonborrowed reserves include extended credit. The shaded area is adjustment and seasonal borrowing.

thought that debt growth could well exceed its upper bound.

The growth of M2 quickened in the second half of the year, and M3 expanded at a somewhat faster pace as well. Nevertheless, both of the broader aggregates ended the year within their target ranges, although near the upper bounds. M1 accelerated further in the second half of the year, resulting in a record postwar decline in velocity for 1986. The growth of nonfinancial debt slowed slightly in the second half of the year, but still exceeded its monitoring range by nearly 2 percentage points.

Pressure on reserve positions of depository institutions changed little over the course of 1986, as evidenced by a relatively low volume of borrowing at Federal Reserve Banks. The broadly accommodative thrust of policy also was manifest in the four reductions in the discount rate between March and August. In part, these cuts were intended to keep this rate in line with the yields on short-term market instruments, but they also were taken in the context of hesitant worldwide economic growth, an improved inflation outlook, and growth of the broader monetary aggregates within their annual target ranges.

In setting monetary policy the FOMC paid considerable attention to the country's trade deficit and the foreign exchange value of the dollar. The Committee members generally viewed the narrowing in the trade deficit as a key to achieving a sustainable and smooth expansion of activity across the economy. At the same time, the Committee was concerned that an unduly precipitous decline of the dollar against the currencies of the country's major trading partners could contribute to

inflationary pressures here. To help limit the effect on the value of the dollar, the first reduction in the discount rate was coordinated with action by other major central banks; similarly, the reduction in April was accompanied by a cut in the Bank of Japan's discount rate.

Monetary Aggregates

M2 expanded almost 9 percent in 1986, placing this aggregate near the upper bound of its annual growth target. Although in recent years M2 has exhibited a tighter relationship with nominal GNP than M1 has, the velocity of M2 still registered a decline of 4 percent last year and reached its lowest level in decades. The buildup of M2 balances relative to income probably reflected incentives to place savings in various components of the aggregate whose offering rates were falling more slowly than market interest rates were.

Among rates on retail deposits, the slowest to adjust in 1986 were those on short-term accounts. Depository institutions were reluctant to reduce rates on savings deposits because many of these accounts had represented a stable, profitable source of funds for many years. Rates on NOW accounts also fell only slightly. Much larger declines were registered on time deposits, reflecting not only quicker adjustment to market rates but also the pattern of rate movements in the credit markets, where long-term rates fell much more than short-term rates in late 1985 and early 1986. The changing structure of deposit rates at banks and thrift institutions led to a pronounced shift in the composition of M2: inflows to transaction deposits, savings deposits, money market deposit accounts, and money market mutual fund shares

were very strong while small time deposits ran off, marking the second consecutive year of zero or negative growth.

The weakness in small time deposits in 1985 and 1986 also could have reflected "rate shock." As existing time deposits matured, savers with high-yielding deposits acquired several years earlier were unable to reinvest the funds at comparable returns. A sizable portion of maturing deposits evidently was placed in liquid instruments in M2 while savers searched for other investment opportunities. Yield-conscious investors also may have been lured from time deposits by attractive returns on some nondeposit instruments. For example, stock and bond mutual funds grew rapidly in 1985 and 1986 after stagnating during most of the 1970s and early 1980s, and the issuance of savings bonds was strong in the summer and fall before their minimum yield was lowered from 7½ to 6 percent.

M3 also ended 1986 near the upper bound of its annual target range, increasing 8¾ percent over the year. Growth of M3 close to that of M2 is not surprising, inasmuch as M2 constitutes four-fifths of the larger aggregate. (The remaining share is dominated by large time deposits and certain other managed liabilities of depository institutions.) Credit growth at banks and thrift institutions remained quite strong last year; but, with the exception of the first quarter, the use of managed liabilities in M3 was light as growth of core deposits was largely sufficient to fund asset expansion. Large certificates of deposit expanded only 3 percent on balance, with commercial banks paying down their outstanding CDs during much of the year and thrift institutions also doing so in the

16 Monetary Policy and Financial Markets

Reserves, Money Stock, and Debt Aggregates

Annual rate of change based on seasonally adjusted data unless otherwise noted, in percent¹

Item	1984	1985	1986	1985	1986				
				Q4	Q1	Q2	Q3	Q4	
Depository institution reserves²									
Total	7.6	15.2	20.4	12.4	13.1	18.1	23.5	21.5	
Nonborrowed	-2.9	26.6	22.5	10.3	19.1	17.9	23.8	22.4	
Required	7.3	15.1	20.3	11.5	12.3	19.8	23.9	19.9	
Monetary base ³	7.3	8.8	9.7	8.2	8.3	9.0	10.1	10.3	
Concepts of money⁴									
M1	5.4	12.1	15.3	10.9	8.8	15.5	16.5	17.0	
Currency and travelers checks	7.1	8.0	7.5	7.2	7.3	6.7	7.5	7.8	
Demand deposits	1.6	8.9	11.6	8.5	4.6	14.6	12.6	12.8	
Other checkable deposits	10.5	22.2	28.6	18.1	16.8	25.5	30.6	31.1	
M2	7.9	8.8	8.9	6.6	5.3	9.4	10.6	9.1	
Non-M1 component	8.6	7.8	6.8	5.3	4.2	7.4	8.6	6.4	
MMDAs (n.s.a.), savings, and small-denomination time deposits	8.0	7.3	5.5	4.5	5.2	5.7	6.1	4.7	
General-purpose and broker/dealer money market mutual fund assets (n.s.a.)	17.0	9.2	17.3	0.5	11.3	27.3	14.0	12.7	
Overnight RPs and Eurodollars (n.s.a.)	4.7	20.0	13.4	27.3	5.3	-2.3	30.7	18.1	
M3	10.7	7.7	8.8	7.1	7.7	8.7	9.7	7.9	
Non-M2 component	23.3	3.4	8.5	8.9	17.3	6.1	6.4	3.4	
Large-denomination time deposits	29.2	4.8	3.0	10.0	12.6	1.6	-0.1	-2.2	
Institution-only money market mutual fund assets (n.s.a.)	33.6	12.1	30.3	3.1	22.9	39.2	30.9	16.8	
Large-denomination term RPs (n.s.a.)	36.7	-4.0	27.3	40.6	47.0	18.8	13.6	21.0	
Term Eurodollars (n.s.a.)	-8.5	-5.0	4.9	-3.1	8.2	6.1	-4.5	9.6	
Domestic nonfinancial sector debt	13.9	13.5	12.9	13.6	15.4	10.3	12.0	11.5	
Federal	16.0	15.2	14.6	13.7	17.0	11.6	14.5	12.6	
Nonfederal	13.3	12.9	12.3	13.5	15.0	9.8	11.2	11.1	

1. Changes are calculated from the average amounts outstanding in each quarter. Annual changes are measured from Q4 to Q4.

2. Data on reserves and the monetary base incorporate adjustments for discontinuities associated with the implementation of the Monetary Control Act and other regulatory changes to reserve requirements.

3. The monetary base consists of total reserves plus the currency component of the money stock (less the amount of vault cash holdings of thrift institutions that is included in the currency component of the money stock) plus, for institutions not having required reserve balances, the excess of current vault cash over the amount applied to satisfy current reserve requirements.

4. M1 consists of currency in circulation; travelers checks of nonbank issuers; demand deposits at all commercial banks other than those due to domestic banks, the U.S. government, and foreign banks and official institutions, less cash items in the process of collection and Federal Reserve float; and other checkable deposits, which consist of negotiable orders of

withdrawal and automatic transfer service accounts at depository institutions, credit union share draft accounts, and demand deposits at thrift institutions. M2 is M1 plus money market deposit accounts (MMDAs); savings and small-denomination time deposits at all depository institutions (including retail repurchase agreements), from which have been subtracted all individual retirement accounts (IRAs) and Keogh accounts at commercial banks and thrift institutions; taxable and tax-exempt general-purpose and broker/dealer money market mutual funds, excluding IRAs and Keogh accounts; overnight and continuing-contract RPs issued by commercial banks; and overnight Eurodollars issued to U.S. residents by foreign branches of U.S. banks worldwide. M3 is M2 plus large-denomination time deposits at all depository institutions; assets of institution-only money market mutual funds; large-denomination term RPs issued by commercial banks and thrift institutions; and term Eurodollars held by U.S. residents in Canada and the United Kingdom and at foreign branches of U.S. banks elsewhere.

fourth quarter. The weakness in CDs was widespread as institutions relied more on other managed liabilities, such as term repurchase agreements (included in M3) and advances from Federal Home Loan Banks (not included in M3).

The broad shift to liquid assets greatly affected the behavior of M1. The narrow monetary aggregate expanded more than 15 percent in 1986, marking the second consecutive year of double-digit growth. Its velocity fell $9\frac{1}{2}$ percent compared with a decline of $5\frac{1}{4}$ percent in 1985. Since 1981, the velocity of M1 has declined 16 percent, a remarkable development in view of its tendency to climb about 3 percent a year in the previous two decades.

Much of the rapid growth in narrow money over the past two years appears to have been related to the way the sharp decline in market interest rates affected incentives to hold NOW accounts and demand deposits. Short-term market interest rates fell about 5 percentage points from their peak in the latter part of 1984 to their lowest levels since 1977, while NOW account rates changed much less. Although more rapid money growth generally would be expected in an environment of declining rates, the expansion of M1 in 1985 and 1986 was in excess of that implied by the historical relationships among money, interest rates, and income.

About half of the growth of M1 in both years occurred in interest-bearing checkable deposits. Because depository institutions were slow in adjusting the rates paid on NOW accounts, the spreads between those rates and rates on substitutes narrowed substantially. For example,

between the first quarter of 1986, when interest rates on NOW accounts were fully deregulated, and the fourth quarter of the year, the spread between the rate on three-month Treasury bills and the average rate on NOW accounts at commercial banks shrank from 135 basis points to 53 basis points. Similarly, the average rate on NOW accounts in late 1986 was not far below that on six-month small time deposits.

Demand deposits also accelerated; they grew nearly 12 percent from the fourth quarter of 1985 to the fourth quarter of 1986. As with other checkable deposits, lower short-term interest rates are an important influence on the growth of demand deposits because they reduce incentives to economize on transaction balances. Also, some demand deposits are held by business firms in exchange for services provided by banks, and these compensating-balance requirements typically are enlarged as market rates decline. Although these effects were important to the expansion of demand deposits throughout 1986, the apparent response to declining interest rates was much larger than would be expected from historical experience.

Another element in the growth of demand deposits apparently was the large volume of financial transactions in 1986. For example, because of certain payment procedures—such as transferring funds held in escrow accounts by officer's check rather than by wire—the massive volume of mortgage originations and prepayments could have influenced the movement of demand deposits. In addition, a flurry of financial transactions around year-end induced in part by impending changes in the tax

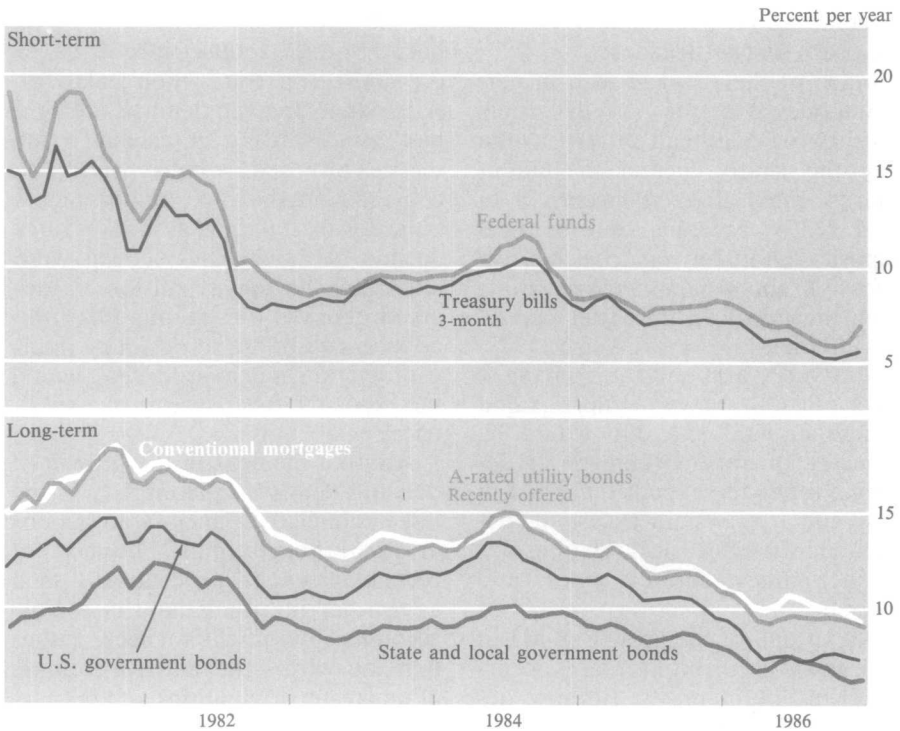
law temporarily boosted demand deposits sharply.

In implementing monetary policy in 1986, the FOMC generally accommodated through open market operations the strong demand for reserves associated with the rapid growth of transaction balances. In the context of prospects for slow growth of real economic activity, disinflationary trends in wages and prices, and growth of the broader monetary aggregates within their target ranges, four reductions in the

discount rate were implemented between March and August.

Early in the year, all the monetary aggregates slowed sharply, with M2 dropping below its annual target range. Also, evidence suggested that the economy was growing sluggishly, and the outlook for inflation improved as oil prices fell. In this environment, market interest rates began to decline in mid-February, and the Federal Reserve reduced the discount rate $\frac{1}{2}$ percentage point to 7 percent in early March. At the

Interest Rates



All the data are monthly averages. Their descriptions and sources are as follows: Federal funds, from the Federal Reserve; three-month Treasury bills, market rate on three-month issues, on a discounted basis, from the U.S. Department of the Treasury; conventional mortgages, weighted averages of 30-year, fixed-rate, level-payment mortgages at savings and loan associations, from the Federal Home Loan Mort-

gage Corporation; A-rated utility bonds, weighted averages of recently offered, 30-year investment-grade bonds adjusted to an A-rated basis by the Federal Reserve; U.S. government bonds, market yields adjusted to 30-year constant maturity by the U.S. Treasury; state and local government bonds, index based on 25 issues of 30-year revenue bonds of mixed quality, from the *Bond Buyer*.

time, there was concern that unilateral action to lower interest rates might cause an excessive reaction in the foreign exchange market, where the dollar had been under downward pressure. Accordingly, the reduction was timed to correspond with similar actions by the central banks of West Germany, Japan, and several other industrialized nations.

With the economy expanding slowly and underlying price pressures continuing to moderate, interest rates fell further throughout March and into April. By mid-April, most market interest rates had reached their lowest levels since the late 1970s, and the Federal Reserve instituted another reduction in the discount rate to catch up with and to ratify the declines in market rates.

After mid-April, interest rates rose for a short time as market participants focused on an upturn in oil prices, an acceleration in the growth of the monetary aggregates, and a further decline in the foreign exchange value of the dollar. By the end of June, however, a steady flow of weak statistics began to reveal anemic growth in real economic activity in the second quarter. The FOMC had expected an improvement in activity in the second half of the year, but the rebound now appeared likely to be less vigorous than previously anticipated and perhaps delayed because of continued disappointing movements in the U.S. trade position and the effects of pending tax reform legislation on business investment. Accordingly, shortly after the July FOMC meeting, the Board approved another cut of a half point in the discount rate to 6 percent.

The final reduction in the discount rate last year took place after the August FOMC meeting. The last two reductions in 1986 were adopted

without similar action by foreign central banks. Unilateral action to lower interest rates carried the risk of adding to the downward pressure on the dollar and possibly feeding a source of inflationary pressure. However, the Federal Reserve thought that prevailing economic and financial conditions warranted taking such a risk, realizing that the provision of reserves could be tightened through open market operations if adverse developments were to arise.

Although the value of the dollar fluctuated considerably after the reduction in the discount rate in August, it showed no distinct downward movement until around year-end. Short-term interest rates declined about 1 percentage point over the summer months, moving either in anticipation of, or in response to, the reductions in the discount rate. Long-term rates were about unchanged on balance over the summer, but more concern about interest rate prospects developed in early fall. Economic indicators began signaling a pickup in the pace of economic activity, and rising prices of oil and precious metals, along with the potential effects of the cumulative decline in the value of the dollar, seemed to raise concerns about the outlook for inflation. Through the remainder of the year, the FOMC attempted to keep a steady degree of reserve pressure, and market interest rates fluctuated within a fairly narrow range.

Even so, short-term interest rates moved higher as the end of the year approached, in part because of the exceptional volume of tax-related transactions. As firms rushed to complete mergers and buyouts, and households stepped up their sales of assets to realize capital gains, the demand for business loans and trans-

action balances surged. This heavy volume of financing also was reflected in unusually strong demand for reserves by depository institutions. The System added reserves freely to accommodate this demand, but the pressure nevertheless showed through short-term rates. Shortly after the turn of the year, short-term rates moved down toward their earlier levels. The dollar, however, was under substantial downward pressure in early 1987; disappointing figures on the U.S. trade deficit prompted selling of the dollar on exchange markets, and this pressure intensified with reported suggestions by some U.S. policymakers that, particularly in the absence of more growth-oriented policies abroad, the dollar might need to depreciate further to correct the nation's external imbalance.

Aggregate Credit Flows

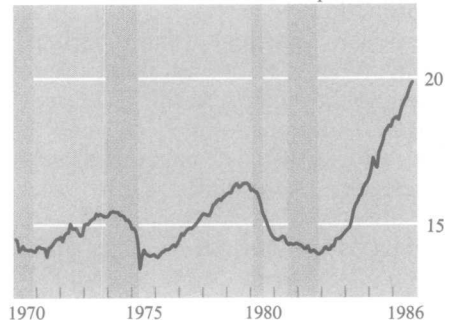
Domestic nonfinancial debt expanded almost 13 percent in 1986, a slightly slower pace than that in the two previous years but still above both the Committee's monitoring range and the growth of nominal GNP.¹ Debt issuance by the state and local sector dropped off substantially from the pace set in 1985, when it was boosted by borrowing in anticipation of tax reform restrictions. In the household sector, mortgage borrowing strengthened, but a marked decrease in the expansion of consumer installment credit contributed

to a slowing in the overall growth of household indebtedness. A continuation of corporate financial restructurings buoyed expansion of business debt, despite the maintenance of a moderate gap between capital spending and internal funds. Growth of federal sector debt remained strong.

Growth of consumer installment credit receded last year to about 12 percent from the 15 to 20 percent pace of recent years. Nevertheless, installment debt continued to grow faster than income, and the ratio of such debt to income established another record. With mortgage debt expanding rapidly, the ratio of overall household debt to income also reached a new high.

Assets of the household sector have increased sharply in recent years; rising stock prices alone added several hundred billions of dollars to household wealth in 1986. At the same time, many families, especially in parts of the country hard hit by economic adversities, have experienced difficulty in meeting their financial commitments. The number of personal bankruptcies accelerated dramatically in 1985 and 1986, surg-

Consumer Installment Debt
Percent of disposable income



Based on data from the Federal Reserve and from the U.S. Department of Commerce.

1. When measured from the end of December to the end of December, domestic nonfinancial debt expanded 11½ percent. The growth from fourth quarter to fourth quarter cited in the text is higher because of the surge in debt at the end of 1985 and the arithmetical effects of quarterly averaging.

ing last year well beyond the historical experience. Strains in managing credit card debt were particularly evident as delinquency rates on revolving-balance accounts increased appreciably. Delinquency rates on other categories of installment debt and on mortgage loans fell some last year, although they were much higher than in previous expansions. For some households, debt-servicing burdens were reduced by the refinancing of high-rate mortgages or the decline in interest payments on their adjustable-rate mortgages.

Internal funds in the aggregate were nearly sufficient to meet the basic financing needs of nonfinancial corporations in 1986. However, some firms continued to borrow heavily to fund massive retirements of equity in association with mergers, buyouts, and share repurchases. At the same time, the drop in long-term interest rates afforded businesses the opportunity to improve their financial positions.

As long-term interest rates declined in the spring of 1986 to their lowest levels in eight years, corporate bond issuance surged to record levels. Indeed, the volume of domestic corporate bonds sold last year was nearly twice the previous record set in 1985. Much of the proceeds from bond issuance in 1986 was used to refund higher-cost long-term debt or to pay down short-term debt. As the stock market continued to register impressive gains, new equity issuance also reached record levels; of the gross proceeds from issues sold last year, about 30 percent was raised by firms issuing stock in the public market for the first time.

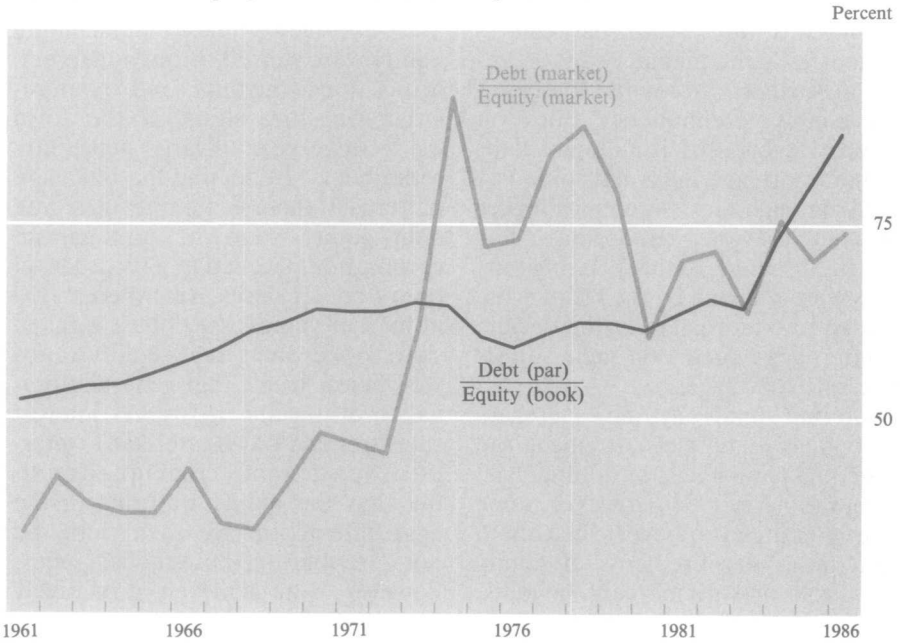
The retirement of high-coupon bonds, the reduced dependence on short-term credit, and the issuance of new equity shares tended to im-

prove conventional measures of corporate balance-sheet strength. However, massive volumes of outstanding equity were retired through mergers, acquisitions, buyouts, and other restructurings, resulting in the third consecutive year of large net equity retirements. Reflecting the financing patterns in these years, the aggregate debt-equity ratio of nonfinancial corporations swelled to a record level on a "book" basis. But when stated at market values, the robust gains in share prices kept debt-equity ratios well below levels that generally prevailed during the 1970s. As interest rates trended down after 1981, interest-coverage ratios crept up, suggesting that the ability of firms in the aggregate to service their debt did not deteriorate. These modest gains, however, were achieved in relatively benign market and economic circumstances.

The large paydown of equity reduced the ability of some corporations to weather economic shocks. The weak financial structures of some firms, along with strains in certain industries, led to more than \$3 billion of corporate bond defaults in 1986, an amount that dwarfs experience in nearly every other year of the post-war period. Concern that other firms also might have problems in meeting their financial obligations was reflected in the pace of bond downgradings, which in 1986 were more than three times as numerous as in the late 1970s.

Firms with downgraded debt typically find their securities trading at higher interest rates in the market. In general, however, quality spreads between private debt securities of different grades have been relatively stable in recent years, suggesting that investors have not been alarmed about the credit quality of corpora-

Ratio of Debt to Equity for Nonfinancial Corporations



Federal Reserve flow of funds accounts.

The market value of debt is based on market prices of bonds traded on the New York Stock Exchange

and par values of loans and short-term paper; the market value of equity is based on market prices of outstanding shares.

tions in the aggregate and have not attempted to limit their portfolios to higher-rated issues.² During the first half of 1986, spreads between the yields on corporate bonds and Treasury securities widened considerably, but this widening appeared to be related to the heavy volume of corporate issues and to a revaluation of call and refunding provisions on long-

term obligations. A narrowing of these spreads early in 1987 reversed much of the earlier increase.

While the economy had grown continuously for more than four years by the end of 1986, the expansion was uneven and it left certain sectors under severe strains. The well-known problems faced by firms in the mining, energy, agricultural, and many manufacturing industries, and by a number of heavily indebted developing countries, were feeding through to the financial intermediaries supplying them credit. For example, 136 commercial banks failed in 1986, compared with only 7 in 1981. Many of these institutions had heavy credit exposures to the oil industry, while more than 40 percent of them held relatively large amounts of agricultural loans.

2. The interest rate spreads between investment-grade and speculative issues widened about 50 basis points for a short time after the bankruptcy filing by LTV Corporation in July 1986. Low-rated or unrated bonds also experienced substantial yield increases for a time later in the year, further widening the spread, when concerns about the liquidity of that market segment surfaced in connection with the insider-trading scandal. That widening was re-

The impact of the distress in the farm sector also has been severe for the Farm Credit System, the government-sponsored agency that holds about 25 percent of outstanding farm debt in the United States. The losses of the banks in the System totaled nearly \$2 billion in 1986, largely reflecting provisions for loan losses, and the System's capital surplus soon will be exhausted if losses do not abate. The Congress approved regulatory accounting procedures for the Farm Credit System in the fall of 1986 that will allow the banks to report higher net income than generally accepted accounting principles would permit. The higher reported income may ease some of the problems within the System relating to the preservation of capital and help to justify charging borrowers more competitive rates. By themselves, however, the accounting procedures do not provide substantive relief.

The financial condition of the thrift industry as a whole has improved markedly since the early part of the decade, but the difficulties of many institutions have intensified. As interest rates fell from the elevated levels of 1981 and 1982, the average cost of funds at thrift institutions declined much more rapidly than the average yield on their assets. The industry as a whole returned to profitability in 1983, and aggregate earnings jumped thereafter. Net income for the industry in 1986 probably was strong again, but lower than in 1985.

At the same time, problems of

asset quality have become increasingly important for a sizable number of these institutions. While some of these problems are associated with the economic distress in some regions of the country, overly aggressive investment strategies of some institutions certainly have contributed heavily. For 1986, about one-quarter of the thrift industry will report negative net income, and the long-term prospects for many of these institutions are unfavorable. Moreover, the resources of the Federal Savings and Loan Insurance Corporation are inadequate to manage these problems effectively.

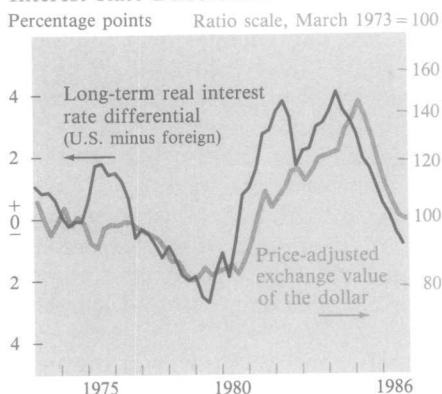
While the many stresses and financial vulnerabilities are not amenable to correction through general monetary policy, they do influence the economic environment and represent a potentially disruptive and destabilizing element in financial markets. The Federal Reserve has been called upon to play a positive role through its regulatory and supervisory functions. For example, steps have been taken to reduce the risks associated with large payments made by wire transfer, and several proposals have been made to ensure the capital adequacy of commercial banks. Many of the financial and sectoral stresses will take considerable time to alleviate, and will require a stable monetary environment, redress of the imbalances in the nation's federal budget and international trade positions, and prudent private behavior, encouraged as necessary by sound regulation.

International Developments

The international scene in 1986 brought a further substantial decline in the dollar against the currencies of major foreign industrial countries, and some evidence emerged that the process of adjustment of external balances among major industrial countries may be under way. Although domestic demand abroad accelerated, exceeding for the first time since 1982 the rate of growth of real domestic demand in the United States, growth in real GNP in nearly all industrial countries remained sluggish and turned out to be below official forecasts at the start of the year. The United States again posted record trade and current account deficits for the year as a whole; but accelerating import prices during the course of the year and an upturn in real net exports in the fourth quarter suggested that the effects of the dollar's decline since February 1985 were beginning to show through. The sharp drop in oil prices through the first three quarters of 1986 were a factor in the low rates of increase in general price levels in major industrial countries. Although economic growth varied widely among non-OPEC developing countries, it continued at a moderate pace for the group as a whole.

The dollar's foreign exchange value dropped another 15½ percent against a weighted average of 10 currencies of major foreign industrial countries, bringing its decline between February 1985 and December 1986 to 33 percent. (Over this period the German mark appreciated 66 percent and the Japanese yen 61 percent

Exchange Value of the Dollar and Interest Rate Differential



Exchange value of the U.S. dollar is its weighted average exchange value against currencies of the other G-10 countries using 1972-76 total trade weights adjusted by relative consumer prices.

Differential is rate on long-term U.S. government bonds minus rate on comparable foreign securities, both adjusted for expected inflation estimated by a 36-month centered moving average of actual inflation or staff forecasts where needed.

against the dollar.) The dollar's decline was associated with a further drop in the long-term real interest rate differential, as U.S. rates fell more than foreign rates. Indeed, one measure of this differential showed that it became negative during 1986, after having been as high as around 4 percentage points in favor of the dollar in mid-1984. Major foreign central banks purchased a total of \$11½ billion in exchange market intervention in 1986, as contrasted with sales of \$17½ billion in 1985. U.S. monetary authorities did not intervene in foreign exchange markets at all in 1986.

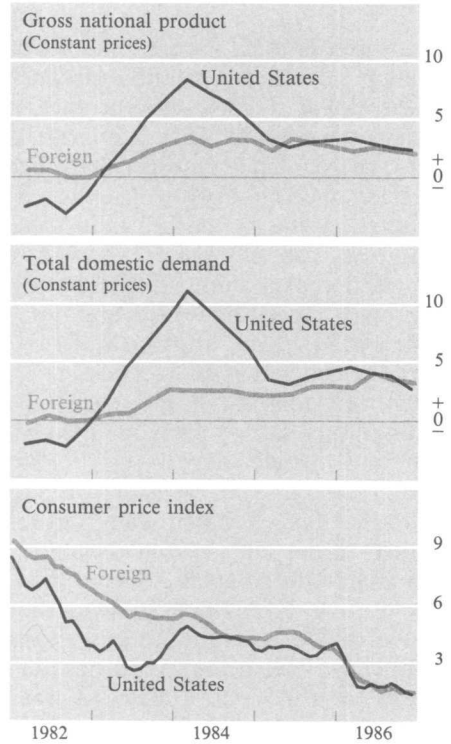
After a further drop of 6½ percent in the dollar in early 1987, monetary authorities of the United States and

five other major countries met in Paris on February 22 to conduct multilateral surveillance of their economies in the framework of the May 1986 Tokyo summit. In their communiqué, they stated that the exchange rate changes over the past two years "have now brought their currencies within ranges broadly consistent with underlying economic fundamentals" and that further substantial exchange rate changes "could damage growth and adjustment prospects." Therefore, they "agreed to co-operate closely to foster stability of exchange rates around current levels."

Real economic growth in the major foreign industrial countries was somewhat disappointing in 1986. In the first quarter, real GNP declined in several European economies and in Japan, partly as a result of unusually severe weather. A strong rebound of activity in the second quarter was followed by substantially slower growth during the remainder of the year. Weakness was particularly evident in the manufacturing sector. In the final quarter of 1986, industrial production in Germany was only slightly above its level at the end of 1985; Japan's industrial production declined during the second half of 1986 to an average level in the fourth quarter below that of a year earlier. In contrast to the slowing in real GNP, domestic demand expanded somewhat faster abroad in 1986 than had been the case in 1985. In the European economies especially, demand strength shifted to the domestic sectors of the economy from the export sector.

The pace of growth abroad was generally insufficient to lower unemployment rates. In both Japan and France the unemployment rate at the end of the year was somewhat

GNP, Demand, and Prices
Percent change from previous year



Foreign data are multilaterally weighted averages for the Group of Ten (G-10) industrial countries, using 1972-76 total trade weights, and are from foreign official sources.

Data for the United States are from the U.S. Departments of Commerce and Labor.

above its level at the beginning of 1986; in Germany the rate was slightly lower, and in the United Kingdom it was about the same.

The rate of inflation in the major foreign industrial countries dropped sharply in 1986, on average, from its already low 1985 level. In Japan consumer prices were essentially unchanged during 1986, while in Germany consumer prices fell slightly. Wholesale prices declined significantly in most foreign industrial countries. Weakness in world oil prices early in the year and further

appreciation relative to the dollar in the currencies of most of these countries were the principal factors working to lower inflation rates abroad.

In several major foreign countries, rates of money growth rose in 1986. Target ranges announced for the growth of specific aggregates were exceeded in Germany and the United Kingdom. In Japan, money growth remained fairly rapid, whereas growth of the monetary aggregates in France slowed from its 1985 pace. Fiscal policy abroad was again generally restrained, and government deficits as a fraction of GNP were either about the same or down further in most of the foreign industrial countries.

The aggregate current account surplus of the major foreign industrial countries rose more than \$60 billion in 1986. The largest gains were experienced by Japan, whose surplus rose more than \$35 billion to reach \$86 billion, and by Germany, where the gain of about \$22 billion brought the total surplus to \$36 billion. In contrast, in both the United Kingdom and Canada the current account declined in 1986, to near balance and a significant deficit, respectively.

Increases in the dollar value of these current account surpluses masked the adjustment of trade volumes that did occur in 1986 in several of the major foreign economies. In Japan the volume of exports declined more than 4 percent from the fourth quarter of 1985 to the fourth quarter of 1986, while the volume of imports rose more than 14 percent. German export volume in the final quarter of 1986 was about unchanged from its level one year earlier, while import volume was more than 6 percent higher than at the end of 1985.

Declining oil revenues induced a further \$10 billion contraction of

imports by OPEC countries, whose merchandise imports have now declined about \$60 billion (or 40 percent) since 1981. However, the even sharper decline in the oil export revenue of OPEC countries resulted in a net \$30 billion increase in the aggregate current account deficit of those countries during 1986.

The exchange rate competitiveness on world markets of most non-OPEC developing countries continued to improve during 1986. The value of their currencies again declined significantly in real terms, reflecting the large declines against the Japanese and European currencies and only little change against the U.S. dollar. In most East Asian developing countries, the continuing rapid growth of manufactured exports combined with declining costs of oil imports to produce strong increases in trade surpluses. In the case of the highly indebted countries of Latin America, external interest payments continued to fall in 1986, reflecting the downward trend of world interest rates. However, declining oil and commodity prices along with domestic developments led to reemergence in 1986 of an overall current account deficit which, for Latin America, had almost been eliminated in 1984-85. Nevertheless, in some of these countries, particularly Mexico, Colombia, and Ecuador, the shifts toward markedly more competitive exchange rates in 1985 and 1986 aided a strong expansion of nontraditional exports during 1986.

Efforts to provide additional financing for the heavily indebted developing countries faced growing difficulties during 1986. The World Bank helped several of these countries devise programs of structural reform. In doing so, it contributed significantly both to the resolution of

economic distortions affecting those countries and to sustainable economic growth. World Bank financial commitments for sectoral-adjustment programs also rose sharply. For Mexico and Nigeria, the international bank creditors assembled parallel new-money packages that were linked to the borrowing countries' performance under World Bank and IMF-approved adjustment programs.

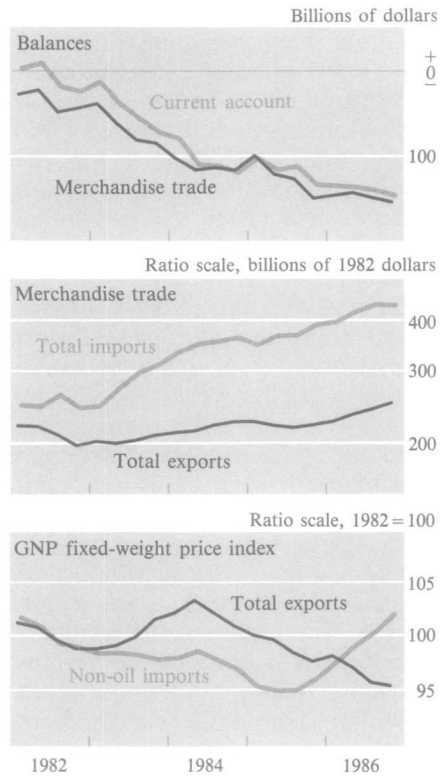
However, by the end of 1986, bank creditors collectively were unable to complete action on the proposed new loans for Mexico—a failure representative of the tendency of the banks to act less rapidly and uniformly than during 1983–85 in the provision of new resources to heavily indebted countries. On a net basis, banks based in the industrial countries appear to have provided no new lending in 1986 to the 15 heavily indebted countries that were identified in connection with the Program for Sustained Growth put forth by the U.S. Secretary of the Treasury in late 1985.

U.S. International Transactions

The U.S. merchandise trade and current account deficits widened further in 1986. A \$7 billion increase in exports and a \$31 billion increase in imports yielded a trade deficit of \$148 billion; the deficit was \$124 billion in 1985. The current account deficit was \$141 billion in 1986, compared with \$118 billion in 1985.

The rise in the value of exports in 1986 reflected a strong increase in the volume of nonagricultural exports, which rose 14 percent from the fourth quarter to the fourth quarter, after having been flat in 1985. This strong recovery of exports came despite a slowing of economic growth in the rest of the world. The

U.S. International Trade



Data are seasonally adjusted at annual rates and are from the U.S. Department of Commerce.

improvement in the price competitiveness of U.S. products resulting from the decline in the dollar appears to have contributed heavily to this rise in export volume. The growth, spread over most major categories of trade, was concentrated in sales of industrial supplies and capital goods, primarily to other industrial countries but also to developing countries in Asia.

The value of agricultural exports fell by \$3 billion in 1986, a drop due almost entirely to falling prices. Lower support prices introduced during the year for major crops resulted in some increase in price competitiveness.

While ample foreign supplies have made marketing abroad increasingly difficult for many commodities, fourth-quarter demand for U.S. exports of soybeans was augmented as the result of a drought in Brazil, a major world supplier.

The increase in the value of imports for 1986 as a whole reflected mainly a rise in volume that covered most trade categories. Increases were particularly pronounced in consumer goods and business machines. The

continued strength in imports of consumer goods reflected in part the strength of competition from abroad as import prices were slow to adjust, and in part the relative strength of U.S. domestic consumption over this period. Forty-five percent of U.S. consumer goods imports come from developing countries in Asia whose currencies have not appreciated against the dollar in real terms. Nonetheless, the average price of non-oil imports turned up during

U.S. International Transactions¹

Billions of dollars, seasonally adjusted

Transaction	Year		Quarter				
	1985	1986	1985	1986			
			Q4	Q1	Q2	Q3	Q4
Current account	-118	-141	-34	-34	-34	-35	-37
Merchandise trade balance	-124	-148	-37	-36	-36	-37	-38
Exports	214	222	53	54	55	56	57
Imports	-339	-369	-90	-90	-91	-93	-96
Investment income (net)	25	23	9	7	5	6	5
Direct investment, net	26	33	10	8	8	8	8
Portfolio investment, net	-1	-10	-1	-2	-2	-2	-3
Other services (including military transactions)	-3	-1	-1	-1	*	*	1
Unilateral transfers, private and government	-15	-15	-4	-3	-4	-4	-4
Private capital flows	103	82	34	22	7	27	26
Bank-reported capital, net (outflows, -)	40	20	12	15	-11	11	5
U.S. net purchases (-) of foreign securities	-8	-5	-1	-6	-2	*	3
Foreign net purchases (+) of U.S. Treasury securities	21	9	6	8	4	1	-3
Foreign net purchases of U.S. corporate bonds	46	53	18	13	16	13	12
Foreign net purchases of U.S. corporate stocks	5	17	4	6	7	4	*
U.S. direct investment abroad	-19	-32	-10	-10	-8	-8	-6
Foreign direct investment in United States	18	26	2	1	4	6	14
Other corporate capital flows, net	*	-7	3	-5	-3	*	n.a.
Foreign official assets in United States (increase, +)	-1	33	-1	2	15	15	1
U.S. official reserve assets, net (increase, -)	-4	*	-3	*	*	*	*
U.S. government foreign credits and other claims, net	-3	-2	-1	*	*	-1	*
Seasonal adjustment discrepancy .....	...	...	4	1	-1	-4	4
Statistical discrepancy	23	27	5	10	13	-6	10

*Less than ±\$500 million.

1. Details may not add to totals because of round-

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

1986 after nearly five years of decline. Prices of most major import categories showed a significant acceleration during 1986. This general trend suggests that in aggregate terms the price competitiveness of domestically produced products has improved somewhat.

The value of oil imports dropped sharply in 1986. A nearly 50 percent drop in price (year over year) was only partly offset by a 25 percent increase in volume. The volume rose sharply, if irregularly, during much of 1986, partly to rebuild stocks and partly in response to the break in oil prices as OPEC oil production increased during the year. In anticipation of the announcement in December of an agreement by OPEC to limit production, oil prices rebounded and the volume of oil imports fell in the fourth quarter.

Among nontrade components of the current account, net payments on foreign portfolio holdings in the United States increased noticeably, reflecting the growing stock of U.S. portfolio liabilities to foreigners. This increase was partly offset by higher net income receipts on U.S. direct investments abroad.

The recorded \$141 billion current account deficit for 1986 was balanced by recorded net capital inflows of \$114 billion and a statistical discrepancy of \$27 billion. Unlike the case in earlier years of current account deficits, official reserve holders accounted for a significant part of the recorded capital inflow in 1986 (almost \$32 billion). A large part of the official inflow was associated with foreign exchange market intervention by the G-10 countries, especially Japan, to slow the depreciation of the dollar. Several newly industrialized countries in Asia, particularly

Taiwan, also added substantially to their official holdings in the United States, while the OPEC countries continued to draw down their assets.

Private capital flows were again dominated by securities transactions. Attracted by expected gains in U.S. stock prices, foreigners purchased, net, a record \$17 billion of U.S. stocks. Foreign purchases of corporate bonds remained strong, as U.S. corporations continued to take advantage of relatively low long-term interest rates to restructure their balance sheets, issuing a large volume of bonds in both the domestic and Eurobond markets. However, the share of Eurobonds in new publicly offered bond issues by U.S. corporations fell sharply in 1986. Recorded net purchases of U.S. Treasury securities by private foreigners declined as well, but purchases of Treasuries by foreign official reserve holders increased as foreign monetary authorities invested the bulk of their intervention purchases of dollars in these instruments.

Foreign direct investment in the United States reached record levels in 1986, swelled by mergers and takeovers bunched at the end of the year, before the effective dates of the new tax law. Direct investment abroad by U.S. residents was up sharply in 1986, largely because of the accounting effects of the sharp depreciation of the dollar.

Inflows reported by banks were moderate in 1986, down substantially from 1985. Growth of liabilities to Latin American institutions other than banks dropped sharply from the high 1984 and 1985 rates, and the large 1985 decline in bankers acceptances was followed by only a small decline in 1986.

Foreign Exchange Operations

U.S. monetary authorities did not intervene in foreign exchange markets in 1986. Because of the substantial further appreciations of major foreign currencies against the dollar in 1986, the Federal Reserve System experienced valuation gains of \$1,971 million on its holdings of foreign currency reserve assets. At year-end, System holdings of foreign currencies were valued at \$9,475 million. Essentially all of these holdings consisted of marks, yen, and Swiss francs.

The only activity on the Federal Reserve swap network involved a \$210 million drawing by the Bank of Mexico in August. This was part of an official bridge-financing package provided by the monetary authorities of the United States and 14 other countries, pending drawings by Mexico on more permanent financing facilities provided by the International Monetary Fund and the World Bank. This drawing on the Federal Reserve was completely repaid by February 1987.

Monetary Policy Reports to the Congress

Given below are reports submitted to the Congress by the Federal Reserve on February 19 and July 18, 1986, pursuant to the Full Employment and Balanced Growth Act of 1978.

Report on February 19, 1986

Monetary Policy and the Economic Outlook for 1986

While there are unusual uncertainties surrounding prospects for prices and economic activity in 1986—stemming in part from questions about the timing and dimension of domestic adjustments to the weaker dollar on exchange markets, about oil price declines, and about the process of fiscal restraint—the overall economic outlook for the year appears generally favorable. Real economic growth probably will pick up somewhat from last year's pace, and inflationary pressures should remain contained. The recent weakness in oil prices, though it has the potential for causing dislocations in energy markets and adding to the strains on some heavily indebted oil-producing countries, should enhance real growth and work to offset the upward impact on the price level this year from the drop of the dollar on exchange markets. Over the course of the year, the prospective movement toward fiscal restraint, and also the more competitive exchange rate, should help correct imbalances that in recent years have threatened the sustainability of economic expansion and affected domestic and international financial markets.

Economic and Financial Background

The past year was one of further progress in the national economy. Although growth in economic activity was slower than that in the earlier phase of the expansion, increases in output were great enough to reduce the unemployment rate to its lowest level since 1980. Moreover, even as the economic upswing moved into its fourth year, inflationary pressures remained in check. In 1985, prices generally rose less than they had the year before and wage gains were restrained.

Continued economic growth last year was supported by a generally accommodative monetary policy. The demand for narrow money was strong, partly in lagged response to earlier interest rate declines and partly perhaps in response to more conservative cash management practices. M1 expanded relatively rapidly throughout the year, growing about 12 percent, and its velocity exhibited an unusual and large drop of 5½ percent; growth exceeded both the original target range set in February and the wider, rebased range for the second half set in July. However, the broader monetary aggregates behaved more normally and ended the year within their target ranges. M2 expanded about 8½ percent as compared with its range of 6 to 9 percent, and M3 grew around 7½ percent compared with its range of 6 to 9½ percent.

In credit markets, most short-term interest rates declined about a percentage point over last year, while

longer-term rates dropped approximately 2 percentage points, partly reflecting an improved outlook for inflation and expectations of greater fiscal restraint. Stock prices also rose substantially during the year. Meanwhile, debt growth was strong, with expansion of domestic nonfinancial debt for the year of 13½ percent, above the monitoring range of 9 to 12 percent set by the Committee. The rapidity of debt creation reflected, in part, borrowings to finance retirements of corporate stock associated with mergers, buy-outs, and share repurchases and the acceleration of state and local debt issues in response to proposed tax law changes.

While output of the U.S. economy, measured by real gross national product, expanded moderately in 1985, domestic sectors increased their purchases of goods and services more rapidly. The difference was reflected in an increasing volume of imports as the volume of exports declined. Thus, all segments of the economy did not share equally in the expansion. Key sectors such as manufacturing, mining, and agriculture continued to face strong competition from foreign producers. Sluggish growth abroad also limited export markets for U.S. producers. In financial markets, a number of institutions had to cope with loan problems associated with the economic pressures and large debt burdens of certain borrowers, including less developed countries and energy and agricultural borrowers in the United States.

Adjustments are in process that should help correct the imbalances that have emerged in recent years. The resolve demonstrated by the Congress and the administration in

passing the Balanced Budget and Emergency Deficit Control Act of 1985 has had salutary effects on expectation in financial markets. As budgetary deficits are reduced, more and more domestic saving can be channeled into investment in the plant and equipment needed to improve productivity and sustain economic growth over the long term. The decline in the dollar should help bring about an environment in which U.S. producers will be able to compete more effectively in world markets. The efforts of many banks and other financial intermediaries to bolster capital and reserves, together with lower interest rates, should help financial institutions to strengthen their ability to cope with financial strain. Questions remain, however, about other factors affecting the U.S. economy—including the strength of economic expansion abroad, the impact of a declining dollar on inflation here, and the effect of reduced oil prices on the financial health of domestic energy producers and of a number of oil-exporting developing countries.

Monetary Policy for 1986

The Federal Open Market Committee framed its monetary policy plans for 1986 in light of the fundamental objectives of maintaining sustainable growth of economic activity, making continued progress over time toward price stability, and working toward better balance in the nation's external transactions. As shown in the accompanying table, the Committee set ranges for the monetary aggregates for the period from the fourth quarter of 1985 to the fourth quarter of 1986 of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3;

Ranges of Growth for Monetary and Credit Aggregates

Percent change, fourth quarter to fourth quarter

Money or credit aggregate	1986	1985
M1	3 to 8	3 to 8 ¹
M2	6 to 9	6 to 9
M3	6 to 9	6 to 9½
Debt	8 to 11	9 to 12

1. Annual rate, applied to period from second to fourth quarter.

it established a monitoring range of 8 to 11 percent for debt. These are the same ranges that had been tentatively set for 1986 in July of last year, except that the M1 range has been widened to reflect the uncertainties about the behavior of that aggregate, as noted below.

Compared with ranges that had most recently been in effect for 1985, the new ranges involve a reduced upper limit for M3 and a generally lower range for debt. The ranges for M1 and M2 are unchanged. The width of the M1 range reflects continuing uncertainties about the behavior of M1 under varying economic and financial circumstances, given recent experience and the changed composition of the aggregate over the past few years. In particular, the availability of interest-bearing checking accounts that serve both transaction and savings functions may have increased the sensitivity of this aggregate to changes in market rates as well as to other factors influencing the public's allocation of its savings among various financial assets. While the range for M1 is wide enough to allow for some variation in behavior of the aggregate's income velocity in response to changing conditions, the range was set on the assumption that there would not be a large drop in velocity, such as occurred in 1985. In that connection, the Committee

will evaluate behavior of M1 in light of its consistency with the other monetary aggregates, economic and financial developments, and the potential for inflationary pressures. In sum, policy implementation will involve continuing appraisal of the relationships among the various measures of money and credit, their velocity trends, and indicators of economic activity and prices, as well as conditions in domestic credit and foreign exchange markets.

The growth of the broader aggregates in 1986 is not expected to be far different from last year, when their velocities declined somewhat. Last year's velocity experience was closer to the norm for these aggregates than was the case for M1. The final phase of deposit deregulation this year—the removal of minimum balance requirements on money market deposit accounts at the beginning of the year and the elimination of ceiling rates on savings and regular NOW accounts at the end of March—is expected to have only minimal effects on the broad aggregates as well as on M1. Other ceiling-free accounts have been widely available for a number of years, and minimum balance requirements already have been reduced to a relatively low level.

The Committee for some years has had a monitoring range for the total debt of domestic nonfinancial sectors. Historically, debt has expanded about as rapidly as GNP, but in recent years debt has grown more rapidly than the economy, raising some concern about the increasing debt burden. The growth of debt is expected to moderate somewhat in 1986. A diminution of debt financing for purposes of stock retirement is anticipated, and growth of state and

local government debt is expected to slow from last year's exceptional pace, absent further changes in the proposed tax law that might prompt a renewed acceleration in borrowing. While the federal deficit is expected to remain at a high level for much of 1986, it should begin declining in the course of the year as greater fiscal restraint takes hold and helps to curb the rate of increase in U.S. government debt.

Economic Projections

The Committee felt that its monetary objectives were consistent with expectations for continued growth in output, further reductions in unemployment, and muted inflation in 1986. While there clearly are a good many uncertainties and risks in the present environment—for instance, the actual outcome for the budget, behavior of the dollar, and oil prices—the Committee members and non-voting Reserve Bank Presidents generally believe that prospects for the economy in the year ahead are reasonably favorable. As indicated in the table, their expectations center on real GNP growth of 3 to 3½ percent and on inflation in the range of 3 to 4 percent. The expanding job opportunities associated with the in-

crease in output are expected to lower the unemployment rate gradually, although sluggish productivity performance, if it should continue, would limit the nation's growth potential.

Two key factors in the positive economic outlook are the recent developments in energy and financial markets. The decline in energy prices can be expected to raise the growth of real disposable income and to bolster consumer spending in the months ahead. The marked increase in household financial wealth associated with the rise in stock and bond prices also should provide the basis for continued gains in consumer outlays. This should work to offset the restraint in spending that could be exerted by the runup in household indebtedness and the associated decline in the personal saving rate during the past year. Nevertheless, the high level of debt remains a risk in the outlook for consumer spending.

The rise in stock prices and the decline in interest rates have improved prospects for domestic investment in plant, equipment, and housing. Moreover, while the federal deficit is not likely to drop significantly for some months, as noted earlier, greater fiscal restraint, as it

Economic Projections for 1986

Percent

Measure	FOMC Members and other FRB Presidents		Adminis- tration	Congressional Budget Office
	Range	Central tendency		
<i>Change, fourth quarter to fourth quarter</i>				
Nominal GNP	5 to 8½	6½ to 7¼	8.0	7.6
Real GNP	2¾ to 4¼	3 to 3½	4.0	3.6
GNP implicit deflator	2½ to 4½	3 to 4	3.8	3.9
Average unemployment rate in the fourth quarter ..	6¼ to 6¾	About 6½	6.7	6.7 ¹

¹ Civilian unemployment rate.

develops, should enhance the availability of domestic saving for private investment and reduce the need to rely on foreign saving. Mortgage rates are at their lowest levels since 1979, and the greater affordability of housing can be expected to buoy residential construction even in the face of some evident overbuilding in the multifamily sector. Similarly, lower costs of capital should—along with some improvement in the competitiveness of U.S. industry owing to the dollar's decline—help to support business investment despite likely weakness in the energy and office building sectors. In the near term, the leanness of manufacturers' stocks suggests the likelihood of some pickup in the rate of inventory accumulation.

The outlook for the external sector is quite uncertain. The response of U.S. industry, as well as of foreign producers, to the decline of the dollar will take place only over time and will depend on a number of factors, such as the extent to which it is believed the exchange rate change is "permanent" and the strategies firms pursue with respect to the potential trade-off between profit margin and market share. Perhaps more important in the short run, our trade and current account position also will depend on the pace of economic growth abroad: if growth in other countries is relatively slow, that would tend to limit near-term improvement.

With regard to the outlook for inflation, wages in the aggregate have shown no tendency toward acceleration, and recent settlements in major collective bargaining agreements indicate wage gains in manufacturing, construction, and transportation are likely to continue at the moderate pace registered in re-

cent years, even though the unemployment rate is declining. Disappointing productivity performance does raise questions about pressures from the labor cost side, although some pickup in productivity improvement is assumed this year. A decline in oil prices also should be a constructive influence. Nevertheless, it was recognized that a weaker dollar poses a clear risk of greater inflationary pressures.

The projections by FOMC members and nonvoting Reserve Bank Presidents of real GNP and prices over 1986 generally are somewhat lower than the administration's projections, although the full range of expectations does encompass the latter. In any event, differences are not large and economic growth at the pace the administration anticipates can be accommodated by the FOMC's targets.

The Performance of the Economy during the Past Year

The economy completed a third successive year of expansion in 1985, with real gross national product increasing 2½ percent over the year. The rise in economic activity was sufficient to create 3 million new payroll jobs and the unemployment rate edged down; with a further strong increase in employment in January of this year, the jobless rate for civilians reached a six-year low of 6.7 percent. Meanwhile, most broad measures of price increase indicate that inflation slowed to about a 3½ to 3¾ percent rate in 1985, somewhat less than the pace registered over the previous two years.

Though output and employment continued to grow in 1985, the rate of expansion was slower than some had anticipated, raising some con-

cerns about the sustainability of the recovery. Furthermore, the pattern of developments in the past year had some disturbing aspects: domestic and foreign demands continued to be diverted away from goods and services produced in the United States, draining income from our households and businesses and exacerbating an inventory correction by U.S. firms as their sales lagged; meanwhile, consumers continued to increase their spending at a substantial clip, but only by borrowing at a pace that pushed household debt burdens to still higher levels.

Although the nation as a whole experienced continued growth, the serious sectoral imbalances that had emerged earlier during the recovery became more apparent when gains in activity moderated. Industrial output grew slowly in 1985, and manufacturing and mining employment posted outright declines during much of the year. The agricultural sector remained under acute pressure, as shrinking export markets and abundant harvests pushed prices sharply lower. As a result, farmers continued to face mounting difficulties in servicing the large volume of debt that had accumulated in the 1970s.

To a considerable extent, these imbalances and stresses are related to fundamental disequilibria in the nation's finances: the continuing huge federal budget deficit and the growing deterioration in the U.S. current account. During the past year, however, policymakers took important steps to address these problems. The Balanced Budget and Emergency Deficit Control Act was passed, establishing a mechanism for deficit reduction and signaling the resolve of the Congress and the administration to achieve meaningful progress on this front. And the financial

authorities of the G-5 nations agreed that exchange rates should better reflect underlying economic relationships, which would enhance the prospects for some improvement in our external balance.

The federal budget deficit was of record magnitude in fiscal year 1985. The large federal deficit not only absorbed a significant portion of the saving available to the domestic economy, but also continued to be a source of concern to investors with respect to longer-range potential for inflationary pressures. Not surprisingly, the prospect for some reduction in the deficit contributed to the downward trend in interest rates late last year.

The importance of international economic developments for the performance of the U.S. economy has become increasingly apparent during the current economic expansion. Although the foreign exchange value of the dollar declined over most of the year—encouraged at times by coordinated official intervention activity—changes in spending patterns, which typically lag movements in exchange rates, were not yet evident and imports made further inroads into domestic markets. Meanwhile, slow growth, on average, in much of the rest of the world has failed to provide strong markets for U.S. exports. The net result has been that domestic demands have increased more rapidly than domestic production throughout the course of the expansion.

An important achievement of the current recovery has been the sustained expansion of economic activity without any relinquishing of progress toward the goal of price stability. The containment of inflation has been aided by the high exchange value of the dollar and excess world

supplies of many basic materials, which have left prices unchanged or lower for a wide range of imported goods, industrial commodities, agricultural products, and petroleum. More fundamentally, wage increases in the aggregate have been restrained, limiting upward pressure on costs.

The Household Sector

Spending in the household sector remained strong in 1985, despite a sharp slowing in income growth. Growth in real disposable income rose about 1½ percent, much less than the increase of 4 percent of the previous year. Income growth was limited as wage and salary gains decelerated, interest income weakened, and farm income plummeted. Meanwhile, real personal consumption expenditures advanced 3 percent last year—only a little less than in 1984—buoyed by continued high levels of borrowing. As a result, the personal saving rate fell to an average of about 4½ percent last year, well below historical norms.

The strength in household spending last year reflected further gains in outlays for consumer durables, especially purchases of new automobiles. Sales of new cars totaled more than 11 million units, the strongest selling pace since 1978. Sales of domestic autos picked up to 8¼ million units in response to the general downtrend in interest rates, several rounds of price and financing concessions offered by manufacturers, and increased availability of some models that had been in short supply in 1984. Sales of foreign cars climbed to a record level of more than 2¾ million units for the year; a greater volume of exports to the United States was permitted under the Japanese voluntary restraint pro-

gram for 1985–86, and this accounted for most of the pickup.

Activity in the housing sector was flat in 1985. The number of new homes started last year remained at about the same rate of 1¼ million units posted in the preceding two years. Construction of single-family housing showed no new strength, despite a decline in mortgage rates to their lowest level in six years and favorable demographic trends. In part, some of the effect of lower mortgage rates may have been offset by a tightening of qualification standards by lenders and mortgage insurers and higher mortgage insurance premiums. Construction of multifamily housing remained at the relatively high level of the two previous years, notwithstanding high and rising vacancy rates for rental units. Rental housing construction was supported by heavy issuance of debt by state and local authorities, partly in anticipation of constraints imposed by tax reform legislation.

Recent trends in consumer balance sheets continued last year. Consumer installment debt, which had climbed sharply in 1984, did so again in 1985, and the ratio of debt to disposable income reached a record high. Growth in financial assets of households has, however, more than kept pace with the rapid rise in debt over the past two years. In particular, the strong gains posted by the stock and bond markets in 1985 provided a substantial boost to household wealth.

Indications of debt-servicing difficulties in the household sector have mounted. Delinquency rates on consumer installment loans have been on the rise since mid-1984, and for some categories—such as bank credit cards—have reached relatively high levels. Moreover, mortgage loan delinquencies persist at the historically

high levels that have prevailed since the 1981–82 recession, associated with the influence of lingering high rates of unemployment in some communities, slow income growth, and weak housing prices in certain areas of the country. However, surveys of households continue to show favorable readings on attitudes concerning financial positions, suggesting that these financial strains are currently limited to a small part of the population.

The Business Sector

Economic conditions in the business sector also were mixed last year. After-tax economic profits of nonfinancial corporations as a group increased sharply for a third consecutive year and as a percent of GNP stood at their highest level since the late 1960s. Many firms in manufacturing and mining industries, however, have encountered significant difficulties brought about by the high value of the dollar. In addition to the influence of the exchange rate, downward pressures on prices and profits in the agricultural and energy sectors have been exacerbated by ample supplies in world markets.

Business spending for equipment and structures advanced 6 percent in real terms in 1985, supported by falling interest rates, declining relative prices for capital equipment, and continued efforts to modernize facilities in order to meet intensified competition. Nevertheless, the growth in business fixed investment was well below the extraordinary pace of the preceding two years. Furthermore, the slowdown in capital outlays was widespread, including many categories of high technology equipment, heavy industrial machinery, and structures. Some deceleration of investment spending may be expected

as an expansion progresses and the growth of sales subsides to more sustainable levels. However, the reduced pace of investment last year was reinforced by declining capacity utilization rates in the industrial sector. Moreover, rising vacancy rates for office buildings contributed to slower growth in expenditures for nonresidential structures.

Businesses accumulated inventories at a much reduced pace in 1985, particularly in the manufacturing sector. In real terms, nonfarm business inventories rose \$10 billion last year, after the sharp \$56 billion investment that occurred in 1984. In the manufacturing sector, sluggish orders and stable or falling prices have induced businesses to adopt a cautious approach to inventory accumulation; factory inventories declined over the second half of 1985 and were little changed on net for the year as a whole. In the trade sector, stocks increased over the year, boosted by a large rise in auto inventories in the fourth quarter. Excluding autos, inventories at retail establishments increased about in line with the moderate rise in sales over 1985.

Financial strains have remained evident in several important sectors of the economy. The decline in the exchange value of the dollar has yet to ease significantly the international trading problems of many industrial firms. Moreover, the activity and earnings of the domestic energy sector have been affected adversely by the weakening of petroleum prices on world markets. The financial condition of U.S. agriculture worsened further in 1985. A large portion of the agricultural sector has continued to struggle with sharply lower prices, diminished export markets, and depressed land values. With farm incomes plunging, debt-servicing prob-

lems have created serious strains on both farmers and farm lenders.

The Government Sector

The federal budget deficit rose to \$212 billion in fiscal year 1985. Although the expanding economy continued to boost receipts, outlays rose even faster, with large increases registered for agricultural support payments, interest outlays, and defense purchases. As a percent of GNP, the deficit remained at a historically high level of 5 percent, absorbing a large share of the net saving available to the domestic economy.

Federal government purchases of goods and services, which add directly to GNP and constitute a third of total federal expenditures, posted another strong advance last year. Federal purchases, excluding changes in farm inventories held by the Commodity Credit Corporation (CCC), were up more than 3³/₄ percent over the year, after adjustment for inflation. Defense outlays continued to provide a major boost to federal purchases, rising 6¹/₂ percent over the year. Purchases by the CCC rose sharply, as low market prices encouraged farmers to shift massive inventories of grain to the federal government.

State and local governments increased purchases of goods and services about 3 percent in 1985, after a similar increase in the preceding year. Most of the growth in expenditures last year reflected strong increases in construction outlays as states and localities continued efforts to improve and expand basic infrastructure. With the rise in expenditures exceeding the growth in receipts, the fiscal position of state and local governments weakened throughout the year; aggregate operating and capital account surpluses, which had

risen to substantial levels in 1984, were virtually eliminated by the end of last year.

The Foreign Sector

After registering particularly sharp gains toward the end of 1984 and in the first two months of 1985, the dollar generally fell in international currency trading throughout the remainder of last year. By the end of 1985, the trade-weighted foreign exchange value of the dollar had fallen nearly 25 percent from its peak in February. This decline occurred against the backdrop of a narrowing of the differential between inflation-adjusted, long-term interest rates in the United States and other industrial countries, which at least in part reflected the slowing of economic growth in the United States relative to growth abroad.

It will take some time before the effects of the dollar's depreciation manifest themselves in the external position of the United States, which continued to deteriorate last year. The widening gap between imports and exports boosted the current account deficit to about \$120 billion, up from \$107 billion in 1984.

Merchandise imports continued to rise in 1985, increasing about 3¹/₂ percent in real terms over the year. Consumer goods, capital equipment, and industrial materials posted moderate increases. Although prices of imported goods fell for the year as a whole, some firming in the prices of manufactured imports became apparent toward the end of the year, in part attributable to the decline in the value of the dollar.

The volume of merchandise exports declined in 1985; agricultural exports fell abruptly, while exports of nonagricultural goods were essentially unchanged. The failure of

growth in other industrial countries, on average, to pick up has limited the expansion of markets for U.S. products. Furthermore, economic growth in developing nations slowed a bit in 1985, as many countries continued to face difficult debt-servicing problems externally and strong inflationary pressures at home.

In this context, the Secretary of the Treasury in October addressed the economic and financial problems confronted by many of these countries. He urged the borrowing countries to undertake comprehensive programs of economic adjustment designed to promote efficiency and economic growth. At the same time, he called upon the international banking community, the World Bank, and the other multilateral development banks, working with the International Monetary Fund, to provide the assurance that adequate external financing would be available to support such programs during the next several years. The initial response to these proposals has been positive; all parties generally accept that the proposals represent a constructive framework for dealing with the international debt problems of individual countries and for promoting the growth and stability of the world economy.

Labor Markets

With the economy continuing to expand, developments in labor markets remained generally favorable in 1985. The unemployment rate drifted down over the year, as gains in employment exceeded the growth of the labor force. Labor force participation has maintained its upward trend; women continued to enter the workforce in large numbers, in part responding to expanding job opportunities. Overall, the number of per-

sons employed relative to the population rose to a record level.

Nonfarm payrolls expanded 3 million in 1985, somewhat below the unprecedented hiring rate posted during the first two years of the recovery. Although growth in employment in the aggregate continued, the composition of the gains reflected the unevenness of current expansion. Employment in the trade and service sectors accounted for more than two-thirds of the growth in payrolls last year. Government employment rose nearly one-half million, reflecting primarily increased payrolls of state and local governments. In contrast, the weak expansion of output in the manufacturing sector resulted in some trimming of employment over the first three quarters of the year. Although an upturn in manufacturing jobs began in the fall, employment was down about 170,000 over the year.

Wage increases remained restrained in most segments of the labor market last year, despite a further reduction in the unemployment rate. Hourly compensation in the private sector, as measured by the employment cost index, rose about 4 percent in 1985, 1 percentage point less than in the preceding year. Nearly all of the deceleration of compensation per hour last year reflected a slowing in the growth of fringe benefits; wage rates increased at about the same pace posted in 1984. To a large extent, the recent slowing in the growth of benefits has resulted from lower health care expenses for employers, as cost-sharing arrangements shifted greater responsibilities to employees and programs for hospital cost containment became more widespread.

Meanwhile, labor productivity was nearly unchanged in 1985, after in-

creasing substantially earlier in the recovery. When viewed over a longer period, the underlying trend in productivity in recent years appears to have improved a little from the very low pace of the 1970s, but remains well below the pace earlier in the postwar period. Management and workers have responded to a more competitive environment by modernizing plant and equipment, improving operational efficiency, and making work rules more flexible. Unit labor costs in the nonfarm business sector rose $3\frac{3}{4}$ percent in 1985, higher than the increase during the previous two years but well under the pace registered in the early 1980s.

Price Developments

Most broad measures of prices indicate that inflation was unchanged or perhaps moved a bit lower in 1985, even as the economy was passing through a third year of expanding activity. The consumer price index advanced $3\frac{3}{4}$ percent over 1985, somewhat less than the 4 percent increase posted the previous year. The GNP fixed-weight price index, which includes production for businesses, government, and export, as well as for consumers, increased $3\frac{1}{2}$ percent, about $\frac{1}{2}$ percentage point less than the average increase over the preceding two years. Producer prices of finished goods advanced $1\frac{3}{4}$ percent last year, and prices of intermediate materials were essentially flat.

Progress toward price stability has been sustained by several factors, the most important of which have been subdued inflation expectations, moderate wage increases, and the influence of the high value of the dollar on the prices of imports and goods that compete with imports. In addition, developments in the food and

energy markets continued to restrain the overall rate of inflation in 1985. Energy prices showed little change last year; however, a substantial margin of unutilized productive capacity, continued conservation efforts, and the debt-servicing problems of several important oil producers have all contributed to a situation of surplus availability of oil and to a sharp break in oil prices on world markets at the end of the year. Crop prices at the farm have remained depressed by diminished export demand and high levels of production. Lower prices for crude foods and small increases in processing costs held food prices at the retail level to an increase of $2\frac{3}{4}$ percent last year.

Prices for many basic industrial commodities fell during 1985. Weak expansion of industrial production in the United States and in other major industrial countries has limited the growth in demand for raw and semi-processed materials. Furthermore, the high prices for many raw commodities that prevailed over the 1970s and early 1980s induced a rapid expansion of capacity, particularly in developing countries. With productive capacity in place and with many of these countries facing massive debt-servicing requirements, supplies of commodities on world markets have remained plentiful.

On balance, price increases outside the food and energy area held steady last year. Consumer prices other than food and energy increased about $4\frac{1}{2}$ percent, a bit less than in 1984. The prices of retail goods excluding food and energy were held to a gain of 2 percent in 1985, at least in part by small increases or declines in the prices of products in markets in which import competition is substantial. Price increases for

nonenergy services remained at an annual rate of about 5³/₄ percent last year. Capital equipment prices rose 2³/₄ percent in 1985, somewhat more than in 1984.

Monetary Policy and Financial Markets in 1985

At its meeting in February 1985, the Federal Open Market Committee established ranges for money and credit growth during the year, measured from the fourth quarter of 1984 to the fourth quarter of 1985, of 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9¹/₂ percent for M3. The associated monitoring range for the debt of domestic nonfinancial sectors was set at 9 to 12 percent.

In July, the Committee reaffirmed the ranges for M2, M3, and debt, but established a new M1 growth range of 3 to 8 percent, measured at an annual rate, from the second to the fourth quarter of the year. Over the first half of the year, M1 had grown well above the upper end of its range and velocity had registered an unusually steep decline, apparently reflecting substantial additions to money balances, especially interest-earning transaction balances, spurred by the sharp drop in interest rates since mid-1984. The M1 objective for the second half of the year anticipated a considerable slowing of growth, on the assumption that historically more normal behavior in the velocity of M1 would reemerge. Continued uncertainty about the behavior of the aggregate, however, was signaled in widening the M1 range 2 percentage points.

The unusual pattern of M1 behavior in fact persisted over the second half of the year; growth in the

aggregate did not slow, and its velocity registered an even steeper decline. At the same time, the broader monetary aggregates were growing generally within their ranges, while economic growth had slowed to well below the pace of the year before and upward price pressures remained muted. In the fall, the FOMC determined that, under these circumstances, growth in M1 above its range for the second half of the year would be acceptable.

In general, the FOMC last year emphasized the need to evaluate growth in all the aggregates in light of developments in the economy and prices, as well as conditions in financial and foreign exchange markets. Throughout the year, monetary policy remained generally accommodative to emerging demands for money. Pressures on bank reserve positions were varied in a narrow range over the year, and the discount rate was reduced once, by ¹/₂ percentage point.

Money, Credit, and Monetary Policy
M1 increased at an annual rate of 12.7 percent from the second to the fourth quarter of the year, compared with its range of 3 to 8 percent for this period; growth for the year as a whole came to 11.9 percent. Much of the unusually strong growth in M1 in 1985 and the accompanying decline in velocity seemed to be attributable to lower interest rates, though expansion in the aggregate was stronger, particularly in the second half of the year, than historical evidence on its relationship to income and interest rates would have suggested.¹ The behavior of this aggregate

1. Appendix A reviews the behavior of velocity in recent years.

gate may have become more sensitive to changes in market rates in recent years owing to the deregulation of certain transaction accounts. By reducing the opportunity cost of holding transaction balances, the creation of NOW and Super NOW accounts has made M1 a much more attractive savings vehicle for households. Moreover, with the rates on NOW accounts fixed and those on Super NOWs being adjusted sluggishly to changing conditions, falling interest rates have led to relatively substantial reductions in incentives to economize on M1 balances, with accompanying declines in velocity. However, considerable uncertainty about the response of M1 to variations in interest rates or income unavoidably persists, as both money holders and depository institutions adapt to the elimination of important regulatory constraints.²

In 1985, the interaction of lower market interest rates with deregulated transaction deposit rates seemed to induce especially heavy inflows to interest-bearing checkable accounts. Spreads between offering rates on these deposits and interest rates on time deposits and market instruments, low by the standards of recent decades, apparently diminished the incentives to keep savings in longer-term instruments, as well as to separate savings from transaction balances. Demand deposits also contributed to the increase in M1 last year, registering unusually rapid growth, especially in the second half. Business demand balances paced the rise,

likely reflecting the cumulative effect of lower interest rates on incentives to economize on demand deposits and on compensating balance requirements, as well as generally more cautious cash management practices, possibly in part because banks and corporations sought to reduce risk in response to financial problems that had developed in certain areas of the market.

M2 recorded growth of 8.6 percent in 1985, in the upper part of its range, as its nontransaction component increased 7.6 percent. The shift toward more liquid assets evident in the rapid rise of M1 also affected the distribution of deposits within the nontransaction portion of M2. Small time deposits declined last year, while some very liquid components, such as money market deposit accounts, posted very large increases, and even

Growth of Money and Credit¹

Percentage change

Period	M1	M2	M3	Domestic non-financial sector debt
<i>Fourth quarter to fourth quarter</i>				
1979	7.5	8.1	10.3	12.4
1980	7.3	9.0	9.6	9.6
1981	5.2	9.3	12.3	9.8
	(2.5) ²			
1982	8.7	9.1	10.0	9.1
1983	10.4	12.2	9.9	11.2
1984	5.4	8.0	10.5	14.1
1985	11.9	8.6	7.4	13.5
	(12.7) ³			
<i>Quarterly growth rates</i>				
1985:1	10.1	11.7	10.1	13.5
2	10.5	6.3	5.6	11.9
3	14.5	9.5	7.6	12.2
4	10.6	5.9	5.7	13.7

1. M1, M2, and M3 incorporate effects of benchmark and seasonal adjustments made in February 1986.

2. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.

3. M1 figure in parentheses is the annualized growth rate from the second to the fourth quarter of 1985.

2. Experimental alternative measures of money, which attempt to allow for the varying degree of "moneyness" in components of the monetary aggregates, are discussed in appendix B.

savings deposits rose 4 percent after several years of declines. However, growth of M2 appears to have been restrained to an extent by some redirection of household portfolios toward such non-M2 instruments as shares in stock and bond mutual funds.

M3 growth slowed to 7.4 percent last year—close to the midpoint of its range—reflecting in part a slower pace of credit expansion at depository institutions and consequently a reduced need to raise funds through managed liability issuance. Thrift institutions, in particular, greatly reduced their net acquisition of assets, partly in response to new Federal Home Loan Bank Board regulations that raised capital requirements for rapidly growing thrifts. The growth of large time deposits issued by thrift institutions slowed to less than 7 percent in 1985, down sharply from the pace of nearly 50 percent recorded in the preceding year.

Expansion in debt of domestic nonfinancial sectors moderated only a little from its elevated 1984 pace and, at 13.5 percent, exceeded its monitoring range of 9 to 12 percent. Last year was the fourth consecutive year in which debt expanded more rapidly than GNP, after more than 20 years in which the ratio of debt to GNP had been generally stable. One factor boosting debt growth relative to spending has been the extraordinary pace of corporate borrowing to retire equity in mergers, buyouts, and stock repurchases. The volume of such borrowing appears to have been as large in 1985 as in 1984. In addition, borrowing surged late last year in the tax-exempt market, when issuance was accelerated in anticipation of possible tax law changes. Even after allowance for

these two factors, which together may have accounted for roughly 2 percentage points of debt growth in 1985, the expansion of the debt of domestic nonfinancial sectors remained very strong. An important element in the continued rapid growth of debt and the rise in its ratio to GNP has been the huge size of federal deficits. Although federal debt growth has slowed since 1982, it continued to run at more than 15 percent last year.

In implementing policy during 1985, the Federal Reserve basically accommodated the strong demands for reserves by depository institutions. In the early part of the year—when M1 expansion was very rapid, and M2 and M3 growth was also strong—interest rates backed up somewhat. However, these increases were more than reversed later in the first half, influenced in part by a cut of $\frac{1}{2}$ percentage point in the discount rate from 8 to $7\frac{1}{2}$ percent in May, as economic activity appeared more sluggish, partly reflecting the drag from the relatively high value of the dollar on exchange markets. Growth of the broader aggregates had slowed appreciably after the early part of the year, though M1 remained well above its range. On balance over the first six months of the year, most market interest rates fell about 1 percentage point, leaving them about 3 to 4 percentage points below their mid-1984 levels. On exchange markets, the dollar, which had risen sharply through February, declined thereafter and by midyear was 9 percent below its February peak on a trade-weighted basis, leaving it just under its level at the end of 1984.

When, at its July meeting, the FOMC reaffirmed its ranges for M2, M3, and debt, and widened and

rebased the M1 range, the members anticipated that these ranges would be consistent with continued subdued inflation and some pickup in economic growth from the sluggish first-half pace. As the summer progressed, however, it became clear that the demand for M1 remained strong. After slowing somewhat in July, M1 spurted again in August and continued to rise at a double-digit annual rate in September. M2 growth also picked up during the summer, climbing above its range in this period.

In the summer, market interest rates reversed a portion of their earlier declines. With both M1 and M2 growing relatively rapidly, economic activity apparently picking up, and the dollar having declined further, the Federal Reserve provided reserves a bit more cautiously for a time. But beginning around mid-autumn, the Federal Reserve was seeking a slight easing in bank reserve conditions, as incoming data suggested that relatively moderate increases in economic activity continued to be in prospect and upward price pressures remained subdued. Meanwhile, M1 growth was continuing strong on balance, but growth in the broader aggregates was slowing.

On balance over the second half of the year, most short-term rates were little changed, ending the year just slightly above their midyear lows and about a percentage point below their levels when 1985 began. However, on exchange markets, the dollar declined more than 15 percent over the second half, impelled in large part by the G-5 announcement in September indicating the desirability of some appreciation of other currencies relative to the dollar and

by the ensuing coordinated intervention by the United States and other key industrial countries.

In long-term debt markets, interest rates generally fell a percentage point or more on balance over the second half, with most of the decline occurring during a fourth-quarter rally that accelerated as the year drew to a close. The downward movement in long-term rates and simultaneous surge in stock market prices were fueled in part by legislative initiatives to mandate reductions in the federal deficit and to pare the government's demands on credit markets. Declining world oil prices and the continued softness in markets for other commodities promoted expectations of lower inflation among market participants, also contributing to the rally.

Other Developments in Financial Markets

Corporations were able to reduce their demands on credit markets in 1985 as strengthening profits and weaker capital expenditures narrowed the sector's financing gap. Nevertheless, business borrowing to finance stock retirements remained high—perhaps \$70 billion in each of the past two years. Spurred by the drop in long-term rates, to six-year lows, corporate credit demands focused on the bond markets. Record amounts of securities were offered publicly by nonfinancial firms in both the domestic and the Eurobond markets last year. On the other hand, short-term borrowing slowed, with bank lending to businesses relatively weak.

Tax-exempt borrowing was extraordinarily strong last year; a surge in bond offerings late in the year lifted 1985 volume to a record high. While more favorable interest rates

stimulated borrowing generally, efforts to finance in advance of possible restrictions under a proposed tax law scheduled to take effect after year-end boosted advance refunding and private purpose issues in particular.

Households continued to borrow heavily in 1985. Their debt-servicing burden rose sharply as they continued to add to debt at a double-digit rate at the same time that growth of disposable income slowed. Signs of potential strain appeared, as the delinquency rate for consumer installment loans rose, although most measures of debt quality remained well within past experience. Consumer credit remained especially strong, growing at nearly the 20 percent rate recorded in 1984. But the growth of home mortgage borrowing, while near its 1983–84 average, was probably restrained somewhat by the tightening of lending standards that accompanied the rise of mortgage loan delinquency rates to record levels.

Strains were evident in financial markets at times in 1985 but did not cause major disruptions in overall market conditions. Financial market concern over credit-quality issues was not severe enough to be reflected in a broad-based widening of yield spreads between corporate and Treasury debt or between private-sector securities of different risk classes. Nevertheless, the agricultural sector of the economy continued to experience serious financial distress and there were pressures on some segments of the financial community at times last year.

Early in the year, privately insured savings and loans in Ohio and, then, in Maryland were closed or limited to small withdrawals after depositor runs in both states. The problem in Ohio was triggered by news of losses

at one large thrift institution. Problems developed in Maryland when heightened depositor anxiety in the aftermath of the Ohio crisis combined with news of difficulties at a savings and loan in Maryland. As the difficulties emerged, the Federal Reserve advanced funds at the discount window to the affected institutions to bolster their liquidity. Such lending—whose expansive reserve effect was offset through open market operations—has been repaid in Ohio, where the troubled institutions have been restructured and reopened, but remains outstanding at a number of Maryland thrift institutions.

The thrift industry as a whole showed some improvement in earnings and capital positions last year, although many institutions remained heavily burdened with low-quality or low-yielding assets. Lower interest rates lifted profits from their depressed 1984 levels by reducing the cost of funds and generating capital gains on asset sales. The profitability of commercial banks also appears to have increased in 1985, breaking the downtrend of recent years. Asset quality remained a concern for some institutions, however, and was a major factor in the sharp increase in the number of bank failures. Banks apparently again increased the rates at which they charged off bad loans and added to loan-loss reserves, reflecting continued financial strains in such industries as agriculture, energy, and real estate. Higher profits along with the rallies in stock and bond markets helped many banks improve their capital positions in 1985, facilitating efforts to comply with more stringent capital adequacy guidelines. As part of its efforts to ensure the continued safety and soundness of the financial system,

the Federal Reserve also initiated a program to strengthen supervision of commercial banking operations.

Agricultural finances drew special attention last year. Farm income remained depressed, and falling prices for agricultural products left many farmers unable to meet their debt-servicing requirements. Moreover, declining land prices eroded the value of collateral behind many agricultural loans. Consequently, failures of banks with relatively high proportions of agricultural loans in their portfolios rose to 68 in 1985, from 32 in 1984 and an average of just 6 in each of the preceding three years. The Farm Credit System, which holds about one-third of U.S. agriculture's debt, experienced mounting losses and requested federal aid. Farm Credit securities, which had been priced very close to Treasury issues of comparable maturity, yielded as much as 100 basic points more than Treasury debt at one point in the fall. Rate spreads narrowed in December, after passage of legislation enabling the Farm Credit System to mobilize its resources more readily and providing for the possibility of a backup source of assistance once internal sources of funds are exhausted.

To ease possible constraints on the availability of credit at agricultural banks over the 1985 growing season, the Federal Reserve in March liberalized its regular seasonal borrowing program and initiated a temporary special seasonal program aimed at making liquidity available to agricultural banks that might experience strong loan demand. Although total seasonal borrowing fell short of the unusually high level in 1984, evidence suggests that these actions increased access to seasonal credit, boosting borrowing somewhat above

what would otherwise have been expected, given money market conditions and overall slack loan demand by farmers. In early 1986, the Federal Reserve renewed the temporary seasonal program to assure that agricultural banks would not face liquidity constraints in accommodating the needs of their farm borrowers this year.

Appendix A: Velocities of the Monetary Aggregates in the 1980s

In 1985, the relationship between M1 and nominal GNP diverged substantially from historical patterns as M1 velocity registered a sharp drop of 5½ percent. In contrast to the increases that had doubled velocity over the course of the 1960s and 1970s, last year's decrease left M1 velocity about 8 percent below its 1981 peak level. Velocities of the broader monetary aggregates also declined in 1985, but these declines were not so far off their historical norms.

The downward trend of M1 velocity so far in the 1980s differs markedly from the annual rate of increase of 3¼ percent averaged during the preceding two decades. Two developments in recent years appear especially pertinent to explaining the changed relationship between M1 and income. First, interest rates at the end of last year were substantially below their peak levels in 1981. With such a decline, the earnings forgone in holding money, with its liquidity advantage, were considerably reduced, and preferences for money relative to other financial assets would be expected to increase in response. As this occurred, the velocity of M1 would be expected to decline.

Second, deposit rate deregulation

has changed the pricing behavior and yield comparisons between some M1 deposits and other deposits and financial instruments. Whereas earlier only non-interest-bearing assets—demand deposits and currency—directly served transaction needs, in the 1980s individuals have had available for transaction purposes first NOW accounts with a $5\frac{1}{4}$ percent ceiling and subsequently Super NOW accounts with higher, competitively set rates.

These institutional changes have reduced pressures for innovations that would enable depositors to conserve on M1 holdings or use them more intensively to support spending. Such innovations had contributed to the previous uptrend in M1 velocity. But also, the proliferation of interest-bearing checkable deposits for individuals, nonprofit organizations, and governmental units has altered the balance of motives for holding M1 deposits, making them more attractive repositories for savings as well as transaction funds and probably increasing the sensitivity of M1 demand to changes in market interest rates. This effect has grown in importance as interest-bearing checkable deposits have grown. Such accounts have proven enormously popular; at the end of last year, almost \$180 billion in interest-bearing checkable accounts was outstanding, including more than \$60 billion in Super NOWs, which have been available for only three years. The total figure compares with outstanding balances of less than \$30 billion when NOW accounts were first authorized on a nationwide basis at the end of 1980. By the end of 1985 interest-bearing checkable deposits had grown to about 30 percent of M1 and 40 percent of the deposit component of that aggregate.

The resulting higher interest rate sensitivity of the public's demand for M1 relates to the fact that when market rates decline, the opportunity cost—the gap between those rates and the fixed ceiling on NOWs—declines in percentage terms much more than do market rates themselves. And the tendency of offering rates on Super NOWs to lag changes in market rates has made their opportunity costs also move like those on fixed-rate accounts in the short run. Recent trends at depository institutions toward applying higher interest rates or lower fees to transaction accounts with higher balances have probably further changed opportunity cost calculations. This “tiering” can have the effect of providing a very high rate of return—and thus a low opportunity cost—on funds added to an account because, for example, per-check charges or other fees may cease to apply at the new larger balance.

Not only does the responsiveness of M1 to interest rates and income seem to have changed in the 1980s, but the behavior of M1 also appears to have become less predictable on other grounds. In part, the increased unpredictability of M1 demand is due to the larger share of savings balances in M1, which has made general portfolio-balance considerations a more important influence. Over the past several years, deposit rate deregulation has given institutions vastly increased freedom to set deposit rates and has provided their customers with a larger menu of assets paying market-related rates. With regulations progressively changing and depositors and depository institutions continually adapting to the changes, uncertainty has increased concerning the impact on money demand of variations in eco-

conomic and financial conditions, including changes in wealth of money holders. Moreover, since the process of deposit rate deregulation has occurred alongside a general decline in inflation and market interest rates, the reasons for permanence of apparent shifts in M1 behavior often have been obscured.

The declines in the velocities of M2 and M3 last year were neither as large as in that of M1, nor as far from their longer-term trends. The velocity of M2 has declined in recent years, but on balance has shown little change over recent decades. While last year's drop in the velocity of M2 was about twice the average of the past several years, its size was within historical experience. The decline of M3 velocity was somewhat smaller than in recent years and continued a long-term downtrend in that measure. Nevertheless, the behavior of the broader aggregates probably has been altered by developments in the 1980s. For example, the interest rate responsiveness of M2 probably has declined with deregulation, which has permitted the yields on many of its components to vary with market rates. While this aggregate continues to show strong responses to rates over short periods, over intervals of a half year or more it has been far less affected than M1.

Appendix B: Experimental Money Stock Indexes

Financial deregulation and innovation since the mid-1970s have blurred distinctions between transaction and nontransaction balances. As businesses and consumers have changed their payment practices and portfolios of financial assets, uncertainty about the behavior of conventional monetary aggregates and their ability

to foreshadow movements in GNP has intensified. The narrow aggregate M1 has been affected most noticeably. This aggregate consists of currency, demand deposits, and checkable deposits paying interest, mainly NOW accounts. The share of M1 balances paying interest has grown substantially and is held partly for savings purposes. In 1982-83 and again in 1985, growth of M1 was unusually strong relative to GNP. Old M1-A, which includes only currency and demand deposits, was less affected in those years, but because it excludes NOWs, it understates transaction money. In 1981, M1-A was considerably distorted as demand deposits were shifted into NOWs, which had been newly authorized nationwide.

In light of these developments, the Board's staff has investigated several alternative measures of money. This appendix focuses mainly on the transaction money stock measure, MQ. Its components encompass currency and all checkable instruments that serve as means of payment, including money market deposit accounts (MMDAs) and certain money market funds, both of which have limited check-writing features. In contrast to the conventional aggregates, though, MQ is an index number. In general, index numbers are used to combine items that have dissimilar characteristics; an example would be the differing economic values of the various items in the industrial production index. In MQ, components are treated conceptually as differing in the volume of "GNP transactions" each finances per dollar, notwithstanding their common unit of account of one dollar.

MQ and conventional narrow monetary aggregates are alike in that the growth rate of either can be

thought of as a weighted average of the growth rates of its components. But the weights applied to the growth rates of components are not equal for these different monetary aggregates. In conventional M1 and M1-A, the implied weights are simply dollar shares of each component in the total. In MQ, the weights on the growth rates of components reflect not only differences in dollar amounts among components but also differences in the estimated intensity with which the various components are used in carrying out GNP transactions. Thus, instead of dollar quantity shares, MQ uses as weights the estimated share of GNP spending financed by each component.

The implied quantity-share weight on the growth rate of other checkable deposits in M1 growth was about 26 percent in 1985, meaning that the 22 percent growth in this component last year contributed about $5\frac{3}{4}$ percentage points ($26 \text{ percent} \times 22 \text{ percent} = 5\frac{3}{4} \text{ percent}$) to the growth rate of M1. Because they are excluded from M1-A, these deposits receive a zero weight in M1-A growth. The weight on the growth of other checkable deposits in MQ growth was about $12\frac{1}{2}$ percent in 1985, so the rapid growth in this component contributed only about $2\frac{3}{4}$ percentage points to MQ's growth rate over last year.

When applied to the component growth rates, these weights produce the growth rates for MQ and the conventional narrow aggregates. MQ grew somewhat faster in the mid-1970s than M1. Over that period, demand deposit growth, which was relatively weak, received a lower weight in MQ, and currency growth a higher weight, than in M1. Since then, MQ growth has been between

growth of M1-A and M1. Although, in principle, MQ tends to adjust automatically for changes in payments practices, the experience in 1981 with major shifts from demand deposits to nationwide NOWs exemplifies the practical difficulties in developing appropriate weighting procedures. Still, M1-A was even more distorted than MQ in 1981. Over 1985, MQ growth was about $1\frac{3}{4}$ percentage points slower than conventional M1 growth but around 2 percentage points faster than M1-A growth.

In 1983, M2 growth was distorted upward by the introduction of MMDAs, but otherwise it has been rather steady since the late 1970s.

Annual velocity growth for MQ, has been between the growth rates of V1 and V1-A since the late 1970s. Over 1985, as over 1982, all three velocities fell, with V1 registering the steepest declines in both years. Velocities of the broader conventional aggregates declined at about the same rate as V1 in 1982 but by less than V1 in 1985.

The predictability of MQ's demand, given interest rate spreads and GNP, has been roughly comparable with that of M1 and M1-A demand on average over the 1980s, with all three narrow aggregates exhibiting unexpectedly large increases in 1985 relative to econometric predictions. In 1982-83, however, MQ's demand was more predictable than either M1 or M1-A. None of the three has been appreciably superior in its ability to presage movements in nominal GNP so far in the 1980s, on the basis of statistical relations that held on average over the 1970s; each signaled considerably more nominal GNP growth than actually occurred in 1982-83 and

again in 1985. The broader conventional measures performed better than MQ, as well as conventional narrow measures, in these relatively simple tests of their demand and indicator properties for the 1980s, but they were less reliable indicators of GNP in the previous decade.

Research is continuing on the development of MQ and the assessment of its demand and indicator properties. Efforts are under way to refine the procedures used to estimate MQ's weights, as well as to improve the basic method of weighting major outflows from particular accounts, such as those distorting MQ in 1981. At this time, however, understanding the significance of movements in MQ is hampered not only by limited experience with the aggregate but also by unresolved conceptual and measurement questions.

In addition to MQ, several other monetary indexes have been constructed experimentally. The transaction money stock index, MT, is similar in concept to MQ but focuses on the way money is used for all transactions, including payments associated with financial trading, intermediate output, and so forth, instead of just GNP spending. In a different approach to monetary indexes, these monetary services indexes have been constructed to reflect a broader view of money as providing a range of services, such as liquidity, that goes beyond the means of payment, and these indexes correspondingly encompass broader collections of component assets; such indexes distinguish components by the estimated opportunity cost of holding each monetary asset rather than investing in the highest-yielding alternative financial asset. As with MQ, conceptual and measurement problems re-

main to be solved for these other experimental indexes, which thus far do not appear to perform as well as conventional aggregates.

Report on July 18, 1986

Monetary Policy and the Economic Outlook for 1986 and 1987

Sharp contrasts among sectors and regions of the economy characterized economic developments during the first half of 1986. Reflecting in substantial part continuing strong competitive pressures from abroad and large spending cutbacks in the oil industry in response to sharply declining prices, industrial and investment activity were restrained. In contrast, activity continued to expand rather strongly in housing, the financial sector, and the broad service area of the economy. On balance, real gross national product remained on a rather sluggish growth path.

Although there are substantial uncertainties about the degree and timing of a pickup in economic activity, a number of positive economic and financial developments have occurred that should provide the basis for somewhat faster economic growth and some reduction in unemployment over the year ahead. Interest rates have moved lower, and, reflecting the decline of the dollar on foreign exchange markets, U.S. industry is in a stronger competitive position internationally. Also, inflation has remained subdued, reflecting not only declines in the prices of energy and other basic commodities but also continued restraint on wages in many sectors. Much of the uncertainty about a pickup in growth turns

on the strength of economic performance in other industrialized countries, and there is also some concern over the transitional effects of tax reform legislation.

What monetary policy has been able to do, during a period of greater overall price stability and adequate capacity relative to the demands actually placed upon it, is to accommodate demands for money and credit, helping to facilitate further declines in interest rates. Monetary policy by itself cannot eliminate or deal with the sectoral imbalances that are still troubling the economy. A reduction of the large deficit in the nation's external accounts is of critical importance over time, and this reduction will be difficult to achieve in an orderly way without faster growth in key foreign economies. Agreement on tax reform also would remove a major source of uncertainty that probably has inhibited growth in the first half of the year; over time, substantial progress toward eliminating federal budget deficits is essential to achieving better balance in the U.S. and world economies. Overall, prospects for the economy appear to be favorable, but much will depend on the evolution of policy, both in this country and abroad.

Economic and Financial Background

The first half of this year saw a continuation of the reduced pace of economic growth that has prevailed since the middle of 1984. Although the service industries have been strong, manufacturing activity has been relatively sluggish in the face of strong foreign competition, and some sectors, such as energy and agriculture, are under strong pressure. The economy has generated a

substantial number of new jobs this year, but the labor force also has grown rapidly and the unemployment rate has remained around 7 percent.

Perhaps the most significant economic event in the first half of 1986 was the plunge in world crude oil prices. Despite the potential longer-term benefits from this development, the initial impact on the U.S. economy was negative as, with less of an incentive to search for new sources of supply, oil exploration activity was cut back sharply. However, falling crude oil prices have been translated quickly into lower rates of inflation for a time, and in addition, they have damped expectations about future price increases. Consumer confidence has been high, and with purchasing power boosted by the decline in energy prices, consumer spending has been strong. By damping inflation expectations, the drop in world oil prices also spurred a rally in credit markets, further extending the decline in interest rates that began in mid-1984.

Against the background of relatively slow economic growth and little overall price pressure, monetary policy basically has accommodated strong demands for reserves to back deposits thus far in 1986, while responding to and facilitating the drop in market interest rates with three half-point cuts in the discount rate. At the same time, with the dollar under downward pressure in foreign exchange markets during most of the period and the economies of other key industrial countries somewhat weak early in the year, international economic and financial developments remained an important consideration in the conduct of monetary policy. Similar official changes in interest rates in several major

foreign countries, where growth also has been slower than expected, took place around the time of the first two discount rate reductions by the Federal Reserve this spring. The coordinated cuts helped avoid the potential for disturbing exchange market conditions.

Reductions in other short-term rates were generally in line with the total decline of $1\frac{1}{2}$ percentage points in the discount rate since the end of last year. Yields on long-term credit market instruments fell as much as $2\frac{1}{4}$ percentage points, encouraged not only by the revision of inflation expectations that seemed to be keyed to falling energy prices but also by the sluggish performance of the economy and, early in the year, by the restraining effect of the Gramm-Rudman-Hollings legislation on expected federal budget deficits.

These and earlier declines in market rates had a particularly strong effect on the narrow monetary aggregate. By June, M1 had grown at an annual rate of $12\frac{3}{4}$ percent from its fourth-quarter 1985 level, well in excess both of its target range of 3 to 8 percent and of the growth in the economy. Over the first half of the year, the velocity of the aggregate appears to have declined at a faster rate than the postwar record decline in 1985. The interaction of lower interest rates with the changed composition of M1 since deposit deregulation explains a good portion of this rapid decline of velocity. The public apparently has been shifting a considerable amount of its savings into the negotiable order of withdrawal (NOW) account component of the aggregate in response to relatively large declines in rates on competitive outlets for liquid funds. Growth in demand deposits also has been quite strong, likely related to the effect of

lower interest rates on the balances that businesses must hold to compensate for banking services, as well as to a surge in financial market activity. Even after taking account of these factors, however, the strength of M1 appeared extraordinary in the first half.

The broader aggregates grew more moderately, ending the first half near the middle of their respective target growth ranges of 6 to 9 percent. Nevertheless, the strong demand for liquid assets, generated by the relatively large declines in long-term rates, was evident not only in soaring M1 balances but also in the composition of the broader aggregates. For example, the more liquid components of M2 grew rapidly, while its time-deposit component increased only marginally. Over the same period, the debt of domestic nonfinancial sectors is estimated to have remained somewhat above its monitoring range, growing well in excess of GNP.

The substantial decline in long-term interest rates since the middle of last year has helped buoy interest-sensitive sectors of the economy. Activity in the housing market was quite strong in the first half of 1986, supported by the lowest level of mortgage rates in more than seven years. The reduction in interest rates also was a factor in the strength of consumer spending, both by reducing the overall cost of credit and by raising the value of the household sector's security holdings.

Although the foreign exchange value of the dollar has fallen a third from its 1985 peak, the depreciation apparently has not yet produced a substantial increase in the volume of exports or a reduction in the volume of imports. Adjustments of trading patterns to exchange rate movements

take place over a number of years, and it is not surprising that a dramatic improvement in our large merchandise trade deficit has yet to occur. However, progress has been somewhat slower than might have been expected, partly because of the slow growth in other major industrialized countries. The continuing appreciation of the dollar against the currencies of many developing nations also has been a factor.

The influence of strong foreign competition remains pervasive. Agricultural products are in ample supply worldwide, reducing the export opportunities of our producers. In manufacturing, many industries continue to face weak foreign orders, while an increasing portion of domestic demand has been met from abroad in spite of price increases on some competing foreign products. With little observed pickup in demand, many firms have scaled back their expenditure plans, and capital spending remains weak as a result.

Ranges for Money and Debt Growth in 1986 and 1987

The FOMC reaffirmed the 1986 ranges of 6 to 9 percent that had been established in February for M2 and M3; as noted above, the broader monetary aggregates ended the first half of the year near the middle of those target ranges. For 1987, the Committee tentatively decided that, consistent with its intention to achieve money growth at a rate consistent with maintaining reasonable price stability and sustainable economic expansion, the target growth ranges for both M2 and M3 would be lowered $\frac{1}{2}$ percentage point, to $5\frac{1}{2}$ to $8\frac{1}{2}$ percent, measured from the fourth quarter of 1986 to the fourth

quarter of 1987. Those ranges were felt to be consistent with a pickup in economic growth.

The rapid rise in M1 over the first half of the year underscored the degree of uncertainty surrounding the behavior of the aggregate and, in particular, about its behavior relative to GNP. The nature of the relationship among M1, income, and interest rates appears to have been significantly altered by the changed composition of the aggregate in recent years, as well as by the prospects for greater price stability. The precise implications of these developments for the future are not yet clear, given the limited experience to date. In these circumstances, the Committee decided that growth of M1 in excess of the previously established range of 3 to 8 percent for 1986 would be acceptable and growth in that aggregate over the balance of the year would continue to be evaluated in light of the behavior of the other monetary aggregates. Developments in all the aggregates will be judged against the background of developments in the economy and financial markets and potential price pressures.

With respect to 1987, the Committee expressed the preliminary view that the current range for M1—3 to 8 percent—should provide for adequate money growth to support continued economic expansion, assuming that a greater stability reemerges in the link between M1 and income in a more stable economic, price, and interest rate environment than has existed in recent years. However, in the context of the experience of the past several years and keeping in mind the exceptional uncertainties in predicting the behavior of M1, the Committee at the end of this year

Ranges of Growth for Monetary and Debt Aggregates

Percent change, fourth quarter to fourth quarter

Aggregate	1986	Tentative for 1987
M1	[3 to 8] ¹	[3 to 8] ²
M2	6 to 9	5½ to 8½
M3	6 to 9	5½ to 8½
Debt	8 to 11	8 to 11

1. While no new range was specified for 1986, growth in excess of the established range would be acceptable.

2. Indicative of likely range if more stable velocity behavior shows signs of reemerging.

will review with particular care the appropriate range and weight to be placed on M1 in 1987.

As shown in the accompanying table, the FOMC did not change the 1986 "monitoring" range for the credit market debt of domestic non-financial sectors and tentatively retained the same range for next year. It was anticipated that the debt aggregate might exceed the monitoring range of 8 to 11 percent for 1986 as a whole, given its rapid growth around the beginning of the year, but as in the past, the Committee felt that raising the target would create an inappropriate benchmark for evaluating longer-term trends in debt growth.

Economic Projections

The Committee believes that the monetary objectives it has set are supportive of a strengthening of economic activity in the second half of the year. However, the uncertainties associated with the economic outlook appear to be quite large, and continued vigilance and flexibility in the conduct of policy clearly are needed. As summarized in the table on economic projections, the central-tendency forecast of Committee members and nonvoting Reserve Bank Presi-

dents is for growth of 2½ to 3 percent in real GNP this year. Such an increase in output would be expected to generate appreciable further gains in employment, but the unemployment rate might not drop below 7 percent before year-end. With the decline in energy prices more than offsetting effects from the depreciation of the dollar and with pressure from domestic labor and product markets restrained, the inflation rate for the year is generally projected at between 2¼ and 2¾ percent, as measured by the implicit deflator for GNP.

In 1987, which would be the fifth year of the current expansion, real

Economic Projections for 1986 and 1987¹

Percent

Measure	FOMC Members and other FRB Presidents	
	Range	Central tendency
	1986	
<i>Change, fourth quarter to fourth quarter</i>		
Nominal GNP	3¼ to 6½	4¾ to 5¾
Real GNP	2¼ to 3½	2½ to 3
GNP implicit deflator ...	1½ to 3¼	2¼ to 2¾
<i>Average level in the fourth quarter</i>		
Civilian unemployment rate	6.9 to 7.2	7
	1987	
<i>Change, fourth quarter to fourth quarter</i>		
Nominal GNP	5 to 8¼	6 to 7½
Real GNP	2 to 4¼	3 to 3½
GNP implicit deflator ...	1½ to 4¼	3 to 4
<i>Average level in the fourth quarter</i>		
Civilian unemployment rate	6½ to 7	Around 6¾

1. The administration has yet to publish its mid-session budget review document, but spokesmen have indicated that there will be revisions to earlier forecasts. As a consequence, the customary comparison of FOMC forecasts and administration economic goals has not been included in this report.

GNP is projected by most participants to increase 3 to 3½ percent, and unemployment is expected to decline moderately. A significant portion of the increase in production next year is expected to come from the external sector, with the lower value of the dollar expected to restrain the growth of imports and to stimulate exports. However, with energy prices leveling off, exchange-rate-related increases in import prices are expected to cause an acceleration in inflation to a range of 3 to 4 percent next year.

The forecasts of the Committee members and nonvoting Reserve Bank Presidents assume that the Congress will seek to achieve the Gramm–Rudman–Hollings deficit reduction targets. Progress in reducing the federal deficit is seen as crucial in maintaining financial conditions conducive to balanced growth and to an improved pattern of international transactions.

A number of factors point toward a reacceleration in growth, although the exact degree and timing remain uncertain. Despite their initial effects on investment, lower energy prices should help support economic activity, primarily by bolstering real consumer income. The lower level of interest rates also is expected to give some impetus to consumption while, at the same time, maintaining the strength in the housing market. Business spending on new plant and equipment is projected to pick up somewhat over time, but the degree of improvement will depend in part on the character of tax reform legislation.

A critical element in the expected improvement in economic performance is progress toward reducing the size of the merchandise trade deficit. As previously noted, with import

prices rising as a result of the depreciation of the dollar, the growth in imports is expected to slow, and the increased price competitiveness of U.S. goods should bolster export growth. However, a substantial improvement in our trade performance will require satisfactory growth of demand in other countries. Moreover, such an improvement will require open access to foreign markets, which underscores the critical importance of avoiding protectionist measures here and abroad.

The Performance of the Economy During the First Half of 1986

The economy continued to expand in the first half of 1986, but apparently no more rapidly than in 1985. The overall increase in output during the first six months of the year generated slightly more than 1 million new jobs, and the civilian unemployment rate held near 7 percent. At the same time, the dramatic decline in world crude oil prices caused a substantial slowing in inflation.

The combination of the lingering effects of the high foreign exchange value of the dollar during 1984 and 1985, the slow growth abroad, and the initial impact of lower crude oil prices played a key role in inhibiting any acceleration in overall economic activity. Industrial output declined noticeably over the first half, with activity reflecting the continuing intense competition from foreign producers in the manufacturing sector and also the sharp cutbacks in energy-related investment. U.S. agriculture confronts growing world supplies of many farm products, and many farmers continue to be squeezed by a heavy debt-servicing burden and

falling land values. The drop in oil prices has caused substantial adjustment problems in the short run. Oil drilling has been reduced drastically, and a number of high-cost wells have been capped. More than 100,000 jobs have been lost in the oil industry since the beginning of the year.

At the same time, however, some of the benefits from the drop in oil prices did begin to emerge in the first half. The lower price of crude oil was reflected fairly quickly in the prices of finished energy products, which caused consumer prices to register their largest three-month decline since the beginning of 1949. This lower price level has given a substantial boost to the purchasing power of consumers and has helped to support higher levels of spending. Although the volume of oil imports will rise, the sharper decline in price is an aid in reducing the large deficit in our trade account.

A potentially more significant longer-term influence on our balance of trade is the lower value of the dollar. The prices of foreign goods are rising in dollar terms and should begin to shift expenditures from imports to domestic products. At the same time, U.S. goods are more competitive on world markets, although we have yet to experience a sustained improvement in exports. The rather moderate improvement in export volume to date reflects, in part, the effects of the dollar's earlier rise and the slow pace of economic activity abroad. Growth in the major industrialized nations was particularly weak in the first quarter of 1986, although there appears to have been some rebound in the second quarter. Meanwhile, the drop in oil revenues reduced import demand in some developing countries, most importantly Mexico.

Another factor affecting the economy this year has been the changing fiscal-policy environment. It now appears that the deficit in the current fiscal year may exceed earlier plans, but the Congress has moved to implement the spirit of the deficit targets contained in the Gramm-Rudman-Hollings legislation in acting on its fiscal 1987 budget. The prospect of lower federal budget deficits in the years ahead, coupled with the drop in oil prices, encouraged sizable reductions in long-term interest rates at the beginning of 1986, which have begun to stimulate the interest-sensitive sectors of the economy. The most notable result has been in the housing sector in which lower mortgage rates have led to substantial gains in building activity. Investment in new plant and equipment has not shown a similarly positive response to lower interest rates, however; apart from the negative effects of the oil drilling decline, business spending has been damped by the existence of a sizable overhang of office and factory space and by continuing uncertainties about sales trends and tax reform.

With the decline in energy prices, further progress has been made in reducing the inflation rate. Continued moderation in wage increases and abundant supplies of agriculture commodities and industrial raw materials also were important factors in restraining price increases in the first half of 1986. These favorable developments worked to offset the inflationary tendencies associated with the depreciation of the dollar and the continued rapid rise in the prices of services.

The Household Sector

Consumer expenditures were quite strong in the first half of 1986,

supported in part by rapid income growth. Real disposable income increased at about 5½ percent at an annual rate, boosted by high levels of farm subsidy payments and the energy-related slowdown in inflation. In addition, survey information indicates that consumer confidence remains high, and many households consider it to be a good time to purchase big-ticket items such as a car or a new home. Under these circumstances, consumers have been willing to spend the bulk of their income gains, and the personal saving rate has remained at a historically low level.

The increase in consumer spending was widespread. Purchases of non-durable goods, such as apparel, were particularly strong in the first quarter, while outlays for services also grew briskly. The demand for new automobiles also remained quite high after the large sales increase in 1985. New cars sold at an annual rate of 11 million units in the first six months of this year, with important support coming from a series of below-market finance incentive programs for many domestic models. Foreign automobiles continued to sell at a fast pace even though sticker prices generally have increased more than 10 percent in response to the exchange rate changes.

Activity in the housing sector also has been strong this year. Stimulated by the decline in mortgage rates, sales of new single-family homes hit a record high in March and remained generally strong throughout the second quarter. Production responded to this increase in demand, and during the first half, single-family units were begun at a rate of 1¼ million units, the highest since 1979. Despite elevated rental vacancy rates, construction apparently was main-

tained in the multifamily sector by the large volume of mortgage revenue bonds issued by many state and local governments at the end of last year. However, as these tax-exempt funds were depleted, activity in the multifamily market began to taper off in the spring. In addition, concerns about the treatment of income properties under tax reform may have begun to restrain the construction of multifamily dwellings.

Indicators of the financial position of the household sector were mixed in the first half of the year. Although the growth in consumer credit slowed from its rapid pace in 1985, the ratio of consumer installment debt to disposable income edged up to a new high. The rallies in the stock and bond markets strengthened the asset side of the household sector balance sheet, and many homeowners took the opportunity presented by the decline in interest rates to ease their debt-servicing burdens by refinancing mortgage loans. However, increased strains also were evident, as personal bankruptcies rose to record levels and mortgage delinquency rates remained historically high.

The Business Sector

The financial position of the business sector improved a bit in the aggregate during the early part of 1986, albeit with considerable diversity across industries. Economic profits in the corporate sector rose at an \$11 billion annual rate in the first quarter, and the share of after-tax economic profits in GNP remained at the highest level since the late-1960s. Financial conditions in agriculture and manufacturing remained weak, however. Agriculture continued to be hurt by excess supply conditions worldwide, and farm loan delinquencies rose to a postwar high.

In manufacturing, intense price competition from foreign sources squeezed profit margins, and with little growth in demand, capacity utilization moved lower.

Business spending on plant and equipment was weak in the first half of the year. This poor performance partly reflected a "payback" after very strong capital spending in the fourth quarter of 1985. Firms apparently accelerated their spending at the end of last year to take advantage of investment incentives that were targeted for scaling back or elimination under proposed tax reform legislation; expenditures then dropped off in the first quarter of 1986. In addition to these tax-anticipation effects, the demand for computers and other high-technology equipment remained subdued, after increasing rapidly in the first two years of the recovery. Spending on nonresidential structures was down substantially, partly as a result of the cutback in oil and gas well drilling, which was large enough to reduce real GNP growth $\frac{1}{2}$ percentage point in the first quarter and perhaps more in the second quarter. However, a correction also began in the construction of office buildings in response to past overbuilding and high vacancy rates.

Much of the change in business inventories in the first half of this year was associated with fluctuations in automobile dealers' stocks. Domestic car production outpaced sales in the first quarter, and this resulted in a substantial buildup of auto inventories. Assembly schedules were scaled back in the spring, which helped dealers reduce their excess inventories, although stocks remained high. Outside the auto area, inventory investment remained moderate overall, but the pattern differed markedly between manufacturing and

trade. Manufacturers continued to trim their stocks, preferring to keep inventories lean until there was firm evidence of a resurgence in demand. In contrast, inventory investment picked up at trade establishments, even though merchants continued to hold a historically high level of stocks relative to sales.

With the declines in capital spending and the slow pace of inventory investment, internal funds in the aggregate were adequate to meet almost all of the basic financing needs of nonfinancial corporations. However, the drop in long-term interest rates to the lowest levels since 1978 prompted businesses to issue massive amounts of bonds; the proceeds were used not only to finance new investment but also to retire outstanding bonds and stocks and to pay down short-term debt.

The Government Sector

Despite congressional action to slow the growth of spending, the size of the federal budget deficit in fiscal 1986 may match or exceed the record \$212 billion of fiscal 1985. Revenue growth has slackened in association with the slower pace of nominal income growth. Expansion of corporate tax receipts has slowed significantly, while excise tax revenues also are down as lower oil prices virtually have eliminated the receipts from the "windfall profits" tax.

Federal purchases of goods and services fluctuated widely in the first half of 1986. They dropped substantially in the first quarter, in part reflecting a slowing in the purchases of farm products by the Commodity Credit Corporation (CCC), after a record increase in the fourth quarter of 1985. Excluding CCC purchases, real federal outlays were down

slightly, as a result of lower defense spending.

Purchases of goods and services by state and local governments in real terms increased at an annual rate of 2.8 percent in the first quarter of 1986, about the same pace as in 1985. After a large increase in the first quarter, construction spending remained strong in the spring, while employment rose further. However, a number of states, particularly those dependent on agriculture and the oil industry, continued to experience a substantial deterioration in their financial condition. A significant portion of tax revenues in many oil-producing states are tied directly to the value of oil output, and the drop in oil prices has induced a concomitant decline in receipts. In addition, the secondary effects on energy-related businesses are tending to reduce revenues further. To restore fiscal balance, many states have announced expenditure cuts or tax increases.

The External Sector

Continuing the decline that began early last year, the dollar depreciated further against the currencies of foreign industrial countries during the first half of 1986. On balance, the trade-weighted value of the dollar has fallen more than 30 percent from its February 1985 peak, about one-third of which has occurred this year. Associated with the depreciation was a narrowing in inflation-adjusted interest rate differentials between the United States and the other major industrialized countries, as interest rates declined both here and abroad.

Although a substantial correction has occurred in the dollar's value, at least against the currencies of the major industrialized countries, the

nation's current account deficit was unchanged in the first quarter from the high rate of \$135 billion in the fourth quarter of 1985. This lack of improvement was the result of large increases in nonpetroleum imports while exports grew more slowly. The failure to date of the dollar's decline to slow import growth reflects, in part, the relatively slow pass-through of the depreciation into import prices. Because profit margins of foreign exporters expanded during the period of dollar appreciation, they are able, for a time, to absorb the reduced receipts without raising prices; slack markets at home also have held down price increases. In addition, the dollar has continued to rise against the currencies of many developing countries, which account for about one-quarter of U.S. non-petroleum imports. However, non-petroleum import prices now are increasing, led by large increases for automobiles, other consumer items, and capital equipment.

The decline in the dollar also improved the price competitiveness of U.S. goods in foreign markets. However, exports have been slow to pick up, in important part because of the sluggish pace of foreign economic activity. Real gross national product declined in both Japan and West Germany in the first quarter, but economic growth appears to have been somewhat stronger in the spring.

Economic growth also has been sluggish among many of our major trading partners in the developing world. Like other oil-producing countries, Mexico is adjusting its spending to lower oil revenues, and this adjustment has reduced the demand for U.S. products. Falling world commodity prices also have aggravated the financial difficulties of other developing nations, including

members of the Organization of Petroleum Exporting Countries.

Reflecting these influences, the volume of U.S. merchandise imports rose 1½ percent in the first quarter of 1986, as nonpetroleum imports continued to grow rapidly while oil imports declined. The largest increases were in machinery, with smaller advances registered for some consumer goods. The volume of merchandise exports was up somewhat in the first quarter, with a decline of 3½ percent in exports of agricultural products offset by increased U.S. nonagricultural exports.

Labor Markets

Nonfarm payroll employment expanded in the first half at an average pace of roughly 175,000 per month on a strike-adjusted basis, down from 230,000 in 1985. Continuing the trend of the past few years, gains at trade and service establishments were quite strong and accounted for most of the overall employment increase. Hiring also was brisk at construction sites through much of the period, buoyed by the strength in homebuilding. However, manufacturing payrolls contracted somewhat, with weakness in the motor vehicle, metals, and machinery industries.

The civilian unemployment rate averaged somewhat higher over the first half of the year than at the end of 1985. The continued expansion of job opportunities about matched the rise in the number of individuals entering or reentering the workforce, and labor force participation reached a new high by midyear. However, the weakness in the industrial sector was reflected in a rise in the number of workers separated from their last job.

In view of the continued slack in labor markets as well as lower price inflation, wage growth remained moderate. The employment cost index, a broad measure of overall compensation trends, rose 3¾ percent in the 12 months ending in March, down from 4½ percent over the year ended in March 1985. Most of the slowing was the result of smaller increases in the cost of employee benefit programs, reflecting in part efforts to contain medical insurance expenses, while wages and salaries rose at about the rate of 4 percent experienced in 1985. Continued moderation in union wage gains also was evident in the collective bargaining agreements reached in the first half of 1986.

After declining at the end of 1985, labor productivity in the nonfarm business sector rebounded in the first quarter of 1986. However, the gain largely reflected erratic movements in hours worked by self-employed workers, and productivity has been essentially flat over the past year after rising substantially early in the recovery. Productivity in manufacturing has increased somewhat faster during this expansion, as intense import competition has forced many producers to modernize their factories and streamline work rules. As a result of the first-quarter bounce back in productivity, unit labor costs in the nonfarm business sector fell during that period, but they were still up about 3 percent from a year earlier.

Price Developments

Falling energy prices were largely responsible for a significant slowing in measures of aggregate inflation during the first half of 1986. A broad measure of prices—the fixed-weighted

price index for GNP—increased at a $2\frac{1}{2}$ percent annual rate in the first quarter, down from a rise of $3\frac{1}{2}$ percent in 1985. Consumer prices actually declined over the February-to-April period, but they still were up $1\frac{1}{2}$ percent over the 12-month period ended in May. The drop in prices was greater at the wholesale level, where weakness in the industrial sector added to the downward pressure from energy prices.

The speed and magnitude of the decline in world crude oil prices this winter were dramatic. Over the January-to-April period, crude oil prices fell more than \$15 per barrel to their lowest level since 1978. Prices of refined petroleum products responded quickly to the drop in crude oil prices, and retail gasoline prices fell 25 percent, or about 28 cents a gallon, over the January-to-May period. Charges for electricity and natural gas, which compete with fuel oil as a power source, responded more slowly to the lower crude oil prices but by the end of May had fallen about 1 percent.

The prices of industrial raw materials continued to decline in the first half. Prices were depressed by abundant world supplies of many primary commodities; debt-servicing obligations led many developing countries to maintain or expand their output. Sluggish industrial activity in the United States and other large economies contributed to the softness of commodity markets.

Outside the energy area, further progress was made in reducing the inflation rate during the first half of the year. Retail food prices rose at an annual pace of only 1 percent through May, held down by falling meat prices. A small decline in the prices of consumer goods was responsible for the slowdown in the

consumer price index (CPI), excluding food and energy, to an annual rate of increase of $3\frac{1}{2}$ percent from its $4\frac{1}{2}$ percent rise during 1985. In contrast, the prices of nonenergy services continued to increase at an annual rate of 6 percent, boosted by rising housing costs and by higher premiums for most types of insurance.

Monetary Policy and Financial Markets in the First Half of 1986

The Federal Open Market Committee at its meeting in February of this year established target growth ranges, measured from the fourth quarter of 1985 to the fourth quarter of 1986, of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3. The associated monitoring range for growth of the debt of domestic non-financial sectors was set at 8 to 11 percent. As compared with the ranges for 1985, the M2 target was unchanged, the upper limit for M3 was reduced $\frac{1}{2}$ percentage point, and the debt range was lowered 1 full percentage point; the M1 target remained the same as that set last July for the second half of 1985. It was expected that growth of money and credit within these ranges would be adequate to encourage sustainable economic expansion consistent with progress over time toward reasonable price stability and an improved pattern of international transactions.

In retaining the comparatively wide target range for M1, the FOMC recognized continuing uncertainties about the behavior of that aggregate. Moreover, the Committee agreed that, in view of these uncertainties and the unexpectedly rapid growth of M1 relative to GNP in recent years, the behavior of the narrow money stock would be evaluated in

light of growth in the broader monetary aggregates, developments in the economy and financial markets, and the potential for inflationary pressures.

In the event, rapid M1 growth reemerged early this spring, and by June the aggregate was far above its range. M2 and M3, however, ended the first half near the middle of their 1986 target ranges. This disparate pattern of money growth, as well as the modest expansion in economic output, ebbing inflation, and continuing downward pressure on the dollar in foreign exchange markets, provided the setting for policy during the first six months of this year. In general, monetary policy was accommodative. As an operational matter, the degree of pressure on reserve positions of depository institutions remained limited, and the discount rate was lowered twice in the first half of the year, $\frac{1}{2}$ percentage point each time, in the context of sizable declines in market interest rates and similar actions by some other industrial countries. In early July, the discount rate was cut another $\frac{1}{2}$ point, to 6 percent.

Money, Credit, and Monetary Policy

In 1985, M1 grew at a rate substantially above its target growth range in the first half, and it continued to do so over the remainder of the year, even after the range had been re-based and widened in July. Instead of the return to more normal behavior that the FOMC had looked for, M1 velocity—the ratio of nominal GNP to M1 balances—fell even more rapidly in the second half of the year than it had in the first. Taking the prevailing economic and financial conditions into account, the Committee decided in the latter part

of 1985 that above-target M1 growth would be acceptable.

In light of the uncertainties surrounding the behavior of M1, in February of this year the FOMC set a 1986 target range for the aggregate that, while not providing for a drop in velocity as large as the 6 percent decline posted in 1985, was wide enough to allow for appreciable variation in velocity relative to historical trends. Nevertheless, the Committee recognized that the relationship of M1 to income had become increasingly difficult to predict, owing importantly to the changing composition of M1. An important share of the aggregate now consists of interest-bearing deposits, which are potentially an attractive repository for savings as well as transaction balances, introducing an additional source of sensitivity to changes in

Growth of Money and Credit

Percentage change at annual rate

Period	M1	M2	M3	Domestic non-financial sector debt
1985:4 to 1986:2	11.9	7.3	7.9	13.0 ^c
1985:4 to June 1986	12.8	7.8	7.8	12.7 ^c
<i>Fourth quarter to fourth quarter</i>				
1979	7.5	8.1	10.3	12.3
1980	7.3	9.0	9.6	9.6
1981	5.2	9.3	12.3	9.8
	(2.5) ¹			
1982	8.7	9.1	10.0	9.0
1983	10.4	12.2	9.9	11.2
1984	5.4	8.0	10.5	14.3
1985	11.9	8.6	7.6	14.0
<i>Quarterly average</i>				
1985:1	10.1	11.7	10.2	13.6
2	10.5	6.3	5.5	12.0
3	14.5	9.5	7.6	12.9
4	10.7	6.0	6.5	14.6
1986:1	7.7	4.3	7.4	16.1
2	15.8	10.3	8.3	9.6 ^c

1. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.

^c Estimated.

interest rates and other economic variables. In these circumstances, the Committee emphasized that policy implementation would involve a continuing appraisal of trends in all of the money and credit measures, as well as of indicators of economic activity and prices, and conditions in credit and foreign exchange markets. Within this framework for policy and against a background of incoming data indicating moderation of inflationary pressures and a relatively slow pace of economic expansion—including weakness in some important goods-producing sectors—the Federal Reserve basically accommodated the demands for reserves associated with strong M1 growth over the first half of 1986.

Early in the year, reserves were provided slightly more freely, continuing the trend toward easier reserve conditions that had developed late last year. In the initial months of 1986, growth of M1 dropped off sharply from its rapid 1985 pace, and growth of M2 also slowed substantially, to a rate below its annual target range. There were signs of some sluggishness in economic activity, and steep declines in oil prices, which were improving the outlook for inflation, contributed importantly to a rally in long-term credit markets that picked up momentum in mid-February. At the same time, short-term interest rates edged a little lower, but the federal funds rate remained significantly above the Federal Reserve's discount rate.

In this context, a cut in the discount rate would complement the thrust of open-market operations and would accommodate the market tendency toward lower interest rates. However, an important consideration in the timing and extent of any rate cut was the risk posed by an

excessive reaction in the foreign exchange markets, when the dollar remained under downward pressure during much of the period. Ultimately, on March 7, the Federal Reserve cut the interest rate charged for discount window borrowings $\frac{1}{2}$ percentage point to 7 percent, and the central banks of Japan, Germany, and several other industrial nations took similar actions around that time.

Short-term rates in U.S. markets fell throughout March and much of April. Interest rates in long-term markets continued to benefit from the favorable effect of slumping oil prices on inflation expectations, as well as improvements in the federal budget outlook, with the Gramm-Rudman-Hollings legislation beginning to bite and official projections of the deficit being revised sharply downward. To an extent, declining rates also reflected the optimism present in the markets that, with economic growth remaining moderate, there was potential for a further easing of monetary policy. M1 accelerated markedly—moving above its target range in March—apparently in response to lower interest rates, but M2 and M3 growth were rather restrained, with M2 remaining below the lower end of its range throughout the first quarter.

On April 18, the Federal Reserve announced another reduction in the discount rate, to $6\frac{1}{2}$ percent. This change served primarily to catch up with and validate declines that already had taken place in market rates. Exchange rates and international interest rate considerations again played a role, and our discount rate cut coincided with a rate cut by the Bank of Japan.

By this time, market interest rates in the United States had fallen 1 to

2 percentage points since December, to their lowest levels in eight or nine years. Both short- and long-term rates then turned higher for a time, as some indications of stronger economic growth seemed to be developing and prospects for a further easing of monetary policy receded. Supporting the market's changed outlook were an acceleration in the monetary aggregates, strength in some incoming economic indicators, and the dollar's slide on foreign exchange markets, which continued through mid-May. The dollar subsequently recovered a bit, but most of the increase both in the exchange rate and in U.S. market interest rates was reversed before the first half ended, as indications of an expected strengthening of economic activity failed to materialize. With market interest rates falling, price pressures remaining subdued, and the economies of the United States and other industrial countries growing relatively slowly, the Federal Reserve again reduced the discount rate $\frac{1}{2}$ percentage point, to 6 percent, effective July 11.

On balance since the end of 1985, the dollar has declined more than 10 percent, and short-term rates, about $1\frac{1}{2}$ percentage points. Long-term Treasury yields fell as much as $2\frac{1}{4}$ percentage points, but yields on other long-term securities fell less; corporate and tax-exempt bond yields dropped about 1 point, and fixed-rate mortgages fell just $\frac{1}{2}$ percentage point. The smaller declines in these other markets were due in part to the massive issuance of these obligations (including a large volume of refinancings) elicited by the drop in rates over recent quarters, to investor desires for call protection, and in the case of tax-exempt securities, to concerns about tax reform.

Lower market interest rates have been an important factor in the rapid growth of M1 this year. The strong response of M1 to the decline in rates has reflected in part the cumulative effect of the deposit deregulation of recent years. In the first half of 1986, the final two installments of deregulation—the removal of minimum balance requirements on money market deposit accounts and Super NOWs on January 1 and the lifting of the ceiling on passbook savings rates on April 1—appear to have had little immediate effect on the growth of M1 or the other aggregates because relatively few institutions actually changed their deposit pricing practices. But the advent and expansion of interest-bearing checking accounts over the years have attracted more savings-type balances and have increased the responsiveness of M1 to interest rate changes. Since rates on the interest-bearing M1 accounts have adjusted sluggishly to changes in market rates, relatively wide swings in the incentives to hold these deposits have resulted.

Growth in NOW accounts surged in the first half of 1986, reaching an annual rate of around 25 percent in the second quarter, as it responded to the lower overall level of market interest rates and the narrower spread between long- and short-term rates. The latter development seemed to spur shifts of funds from time deposits into shorter-term accounts, including NOW accounts. Demand deposit growth also strengthened as interest rates declined. In part, lower rates prompted increases in the compensating balances that businesses needed to hold in the form of demand deposits to pay for bank services. In addition, deposit levels may have been boosted to an extent by a sizable increase in financial transac-

tions in the first half of the year, especially soaring mortgage prepayments and originations, which was stimulated by lower rates.

The velocity of M1 fell only moderately in the first quarter, but as money growth picked up and nominal GNP apparently failed to accelerate, velocity dropped at an extraordinary pace in the second quarter, resulting in a first-half rate of decline in M1 velocity that probably was somewhat faster than the average over 1985. Although the rapid M1 growth and falling velocity stemmed in large measure from interest rate declines, the size of the M1 increase was distinctly larger than what would have been expected based on historical relationships among money, income, and interest rates.

In contrast to M1, which grew at an annual rate of 12³/₄ percent through June and exceeded its target by a large margin, both M2 and M3 grew moderately in the first half of the year and in June were near the middle of their respective ranges. Some of the more liquid components of the broader monetary aggregates, however, increased very rapidly, as part of the larger shift in investor portfolios toward short-term assets. This shift had much less effect on M2 or M3 than on M1, because the reallocation of funds took place largely within these broader aggregates. In addition to transaction deposits, money market deposit accounts, money market mutual funds, and ordinary savings deposits all expanded strongly during the first half of the year, while small time deposits grew only slightly.

Investors looked not only to the shorter-term components of the monetary aggregates, but also to stock and bond mutual funds (not included in the aggregates), which

posted very attractive returns as a result of ongoing market rallies. Flows into such funds probably depressed M2 growth somewhat in the first half of this year, as they had in 1985. Even so, lower market interest rates and strong demands for short-term assets lifted M2 in excess of income, leading to an appreciable further decline in M2 velocity over the first two quarters of 1986. While M2 showed a fair amount of volatility in the first half, growth of M3 was comparatively steady from month to month, as banks varied their issuance of managed liabilities to compensate for fluctuations in core deposit inflows.

The debt of domestic nonfinancial sectors is estimated to have expanded at a more moderate rate over the first six months of 1986 than it had in some time, although still well in excess of the growth in income.¹ Bond issuance had surged in December in advance of the possible effective date of some provisions of tax-reform legislation, lifting the first-quarter level of the debt aggregate. Hence, when measured from its fourth-quarter-average base, the growth of domestic nonfinancial sector debt has remained above its monitoring range, coming in at an annual rate of 12³/₄ percent through June. Measured from its level at the end of December, however, debt grew at an annual rate of 10¹/₄ percent through the end of June.

To an extent, the lower rate of debt growth since the end of December represented a reaction to the inflated borrowing just before the end of last year, when special factors applying to particular sectors com-

1. The appendix reviews some aspects of the recent behavior of the debt aggregate.

bined to boost debt issuance tremendously, far in excess of normal credit needs. For example, the pronounced slowdown of federal borrowing in the first quarter reflected the draw-down of substantial cash balances built up by the government before year-end. Indeed, federal borrowing picked up again in the second quarter, and, for the year as a whole, the huge federal deficit is likely to make a strong contribution to aggregate debt growth, as it has for the past several years.

Following the surge in their borrowing late last year, state and local governments showed a sharp drop in debt growth. This earlier borrowing and continued uncertainty about tax reform restrained tax-exempt debt growth in early 1986. Beginning in March, however, public-purpose and refunding issues increased again as rates declined further and views changed about the likely form and effective date of restrictions proposed in tax-reform legislation.

Borrowing by the household sector also eased somewhat from the heavy pace of recent years. After a surprising slowdown early in the year, net residential mortgage borrowing apparently expanded rapidly in the second quarter. Over the entire period, lower mortgage rates spurred a substantial pickup in total mortgage originations, but the high volume of refinancings reportedly strained the ability of lenders to process real estate transactions. Consumer credit growth rates this year have been substantially below those of last year, though still outpacing the growth of income. An increasing number of consumers seem to be experiencing difficulty in making timely payments on outstanding credit; delinquencies on consumer loans other than credit cards have risen moderately, but

those on bank credit cards have surged in the past two years, and personal bankruptcy rates have soared.

The smallest degree of deceleration occurred in the debt of the nonfinancial business sector, which continued to be boosted by the wave of corporate mergers, acquisitions, and share repurchases. While the stock market rally helped spur a substantial rise in gross equity issuance, net stock issuance remained decidedly negative because of the mergers and restructurings. Most notable so far this year, however, was the strength of long-term debt issuance by businesses in response to steeply falling long-term rates; gross issuance of corporate bonds, especially strong in March and April, ran far in excess of previous records. Nonfinancial firms increased their short-term debt only slightly, however, and this was reflected in a decline in their commercial paper outstanding, as well as in slow business loan growth at banks.

The stresses evident in many parts of the economy left their mark on the books of banks and other financial institutions. Asset quality deteriorated as a consequence of the sharp drop in oil prices and associated dislocations in the energy sector, overbuilding in commercial real estate, and the continuing distress in agriculture. Banks with relatively large amounts of farm loans outstanding, as well as other agricultural lenders, have been particularly hard hit recently; loan losses at these institutions have soared and their profitability has continued to slide. While banks in regions with economies heavily dependent on energy production were among the most strongly capitalized and profitable earlier, their financial position has eroded under

pressure of surrounding economic difficulties. Bank failures in the first half of this year continued to run at about the rapid pace of 1985, with agricultural banks again accounting for a disproportionate share.

Overall bank earnings began to improve in 1985, and the industry has added significantly to its capital and loss reserves, although the explosion in off-balance-sheet commitments and the clouded outlook surrounding the repayment of many bank loans may have made it more difficult to assess the level of risk in the banking industry. At savings and loan associations, overall profitability appears to be improving as interest rates have declined and mortgage origination activity has surged. However, a substantial number of these institutions continue to have severe problems owing primarily to losses on weak assets, prompting proposals to add to the financial resources of the Federal Savings and Loan Insurance Corporation.

Concerns over loans to certain developing countries came to the forefront again this year as Mexico began to grapple with the additional economic and financial problems brought on in large part by dramatically lower oil prices. Banks have remained cautious lenders in the face of ongoing concerns about the economic and financial prospects of these countries. However, despite the weakness of global demand, some progress has been made in implementing appropriate macroeconomic policies and policies of internal structural reform. Financial support for such policies both from multilateral lending institutions and private creditors has been provided or is being negotiated along the lines proposed

by Secretary of the Treasury Baker in Seoul last fall.

Appendix: Some Aspects of the Behavior of Domestic Nonfinancial Sector Debt

After moving in rather close alignment for about a quarter of a century, debt growth in recent years has far outpaced expansion of nominal GNP. The ratio of debt outstanding to GNP began climbing late in 1981 and subsequently soared well above the range that had prevailed since the early 1950s, a development that extended through the first half of 1986.

The debt aggregate is derived from the Federal Reserve's Flow of Funds accounts. It contains the credit market debt of domestic nonfinancial sectors—households, nonfinancial businesses, state and local governments, and the federal government—whose spending accounts for the vast bulk of income and production. It excludes debt of the financial sector because funds raised by financial intermediaries are already counted in the debt aggregate at the point they are channeled to nonfinancial sectors. To include financial sector debt would lead to double counting.

Nonfinancial sectors also behave to a degree as financial intermediaries, raising funds in credit markets and using the proceeds, at least for a while, to acquire credit market claims on other nonfinancial units. In such cases, "double counting" may be said to exist, because the initial borrowing appears as debt of a domestic nonfinancial unit, and the financial asset acquired has as its counterpart, either directly or indirectly, debt of another nonfinancial

unit. For example, a substantial portion of the funds raised by state and local governments in 1985 was used to acquire claims on the federal government or mortgage claims on households. The federal government also issues debt and uses the proceeds to extend loans to private borrowers—obligations that appear elsewhere in the debt aggregate.

While nonfinancial sectors engage to some degree in these intermediary functions on a regular basis, a marked increase in such activity can act to boost measured growth in the debt aggregate. This was the case last year, when the proceeds of a large volume of debt issued by state and local governments with the intention of retiring outstanding obligations at a later time were placed largely in special nonmarketable securities of the federal government. In addition, debt growth has been lifted in recent years by a wave of corporate mergers, acquisitions, and share repurchases that has resulted in a massive retirement of equity, financed with credit.

To assess the degree to which this double counting and corporate substitution of debt for equity have acted to boost debt growth, the behavior of an adjusted debt measure and of an equity-augmented measure was examined. The adjusted debt measure excludes readily identifiable double counting—in particular, that associated with the aforementioned state and local and federal government borrowing as well as with credit extended by nonfinancial businesses to the household sector. The resulting measure of adjusted debt is noticeably smaller in relation to GNP, but it has behaved quite similarly to the regular debt measure, rising

sharply relative to GNP in recent years to well above the range prevailing since the 1950s.

The adjusted debt measure can be augmented by the accumulated net issuance of equity so that it encompasses funds raised in all markets. Although increasing less rapidly than debt or adjusted debt—for example, it rose 12½ percent in 1985 on an end-of-period basis, as compared with 14½ percent for adjusted debt and 15 percent for debt—the augmented measure also has risen rapidly in recent years in relation to GNP, indicating that borrowing to retire equity explains only a small portion of the increase in the debt-GNP ratio. From a longer perspective, this measure has remained within its historical range, and its recent rise returns it, in relation to GNP, to the levels prevailing in the 1950s and early 1960s.

The evidence thus suggests that unusual behavior of the debt aggregate relative to GNP in recent years is related more to changes in underlying behavior than to the special factors just discussed. The unusual rise in debt relative to GNP in recent years has been in both the federal and nonfederal components of the aggregate. Growth in federal debt strengthened in the early 1980s and soared in 1982 with the widening of the budget deficit. After 1982, growth of federal debt slowed a bit in percentage terms while continuing to increase in dollar amounts and relative to GNP. Rising federal budget deficits have been associated with rising current account deficits and a growing gap between domestic purchases and output as net exports have contracted sharply. From one perspective, the growing federal def-

icit can be viewed as being financed by an inflow of funds from abroad—the counterpart to our current account deficit—which has enabled the federal government to increase its borrowing without curbing private spending and credit use to the extent that would be necessary in the absence of those external funds.² However, the erosion of our international competitive position, which is reflected in the current account deficit, certainly has greatly affected individual industries.

Debt of each of the nonfederal sectors—households, nonfinancial businesses, and state and local governments—also has increased relative to economic activity, even after removing the types of double counting mentioned above. In the case of households, the exceptional growth of debt has been evident in both mortgage and consumer debt and has been accompanied by a spectacular buildup of financial assets and a low personal saving rate. In other words, the household sector has been “grossing up” its balance sheet in recent years by heavy financial asset accumulation and borrowing. Financial deregulation and competition for household assets likely have contributed to this process by expanding access to market-related yields on deposits and other financial assets, while growing competition among lenders for market share and the trend toward securitization have added to sources of credit and put downward pressure on household

borrowing costs. The corresponding narrowing of the spread between borrowing and deposit rates adds to the willingness of households to borrow rather than draw down liquid assets when spending rises relative to income. Demographic factors also appear to have contributed to household debt growth as the baby boom generation has moved further into the age bracket in which spending on housing and durables and borrowing tend to be high. In addition, households have benefited from the runup in stock market prices in recent years, and this boost to their net worth may have encouraged more borrowing. Even so, household debt growth has outstripped increases in net worth.

For nonfinancial corporations, most of the advance in indebtedness relative to output in recent years stems from the substitution of debt for equity, previously discussed. The unevenness of the current economic expansion also appears to have boosted corporate borrowing because some industries—especially those dependent on export markets and those competing with imports—have experienced protracted weakness, even though overall cash flows have been strong; thus, working capital and investment needs have been less closely matched with cash flows among firms than is typical, contributing to more rechanneling of funds through credit markets and more corporate borrowing. Finally, state and local government borrowing was especially heavy in 1985, even after removing the double-counting factors already mentioned, as lower interest rates and the anticipation of tax reform also fueled a surge in tax-exempt bond issuance for purposes other than advance refunding and mortgage acquisitions.

2. Not shown in the charts to the appendix is the relation between debt measures and domestic spending (GNP less net exports). In recent years, debt growth has been somewhat more in line with growth in domestic purchases than output, but this ratio, too, has risen sharply.

Part 2
Records, Operations,
and Organization

Record of Policy Actions of the Board of Governors

Regulation D (Reserve Requirements of Depository Institutions) and Regulation Q (Interest on Deposits)

March 12, 1986—Amendments

The Board amended Regulations D and Q in connection with the expiration of its authority to set interest rate ceilings and reserve requirements for deposit instruments.

Votes for these actions: Messrs. Volcker, Martin, Wallich, Rice, Ms. Seger, Messrs. Angell, and Johnson. Governor Seger dissented from the Board's decision to establish early withdrawal penalties for small institutions.

The Depository Institutions De-regulation Act of 1980 called for phasing out over a six-year period interest rate ceilings on all deposit accounts except demand deposits. The Board's authority under the act to set interest rate ceilings expires March 31, 1986, leaving only the prohibition on the payment of interest on demand deposits as a constraint on deposit interest rates. Statutory authority for money market deposit accounts (MMDAs) also expires on that date, as does the Board's authority to set penalties for early withdrawal of time deposits.

The Board amended Regulations D and Q to continue the existing exemptions of savings deposits and MMDAs from reserve requirements and from the prohibition against the payment of interest on demand deposits. Thus savings accounts con-

tinue to qualify for the zero or 3 percent reserve requirement if no more than three transfers are allowed each month; MMDAs qualify if no more than six transfers are allowed each month.

Previously, businesses had been permitted to hold savings accounts up to a maximum of \$150,000. The amendments remove the \$150,000 limitation on business savings accounts, making their treatment similar to that of MMDAs. Any business account from which more than three telephone transfers are permitted per month, however, is considered a demand deposit and is subject to the interest rate limitation and reserve requirement appropriate for demand deposits.

The Board also decided to continue some early withdrawal penalties to help preserve for reserve requirement purposes the distinctions between transaction accounts and time deposits and among non-personal time deposits of differing maturities. In addition, the Board decided to extend the applicability of early withdrawal penalties to certain small institutions—primarily credit unions—that had not had such penalties under the 1980 act. The Board agreed to allow these institutions a longer period for compliance with this provision. Governor Seger dissented from the Board's decision to apply early withdrawal penalties to small institutions.

Most of the amendments are effective April 1, 1986. Credit unions and other small institutions that had not

been subject to the early withdrawal penalties have until January 1, 1987, to begin imposing penalties on time deposits opened, added to, or renewed after that date.

Regulation D (Reserve Requirements of Depository Institutions)

November 24, 1986—
Amendment

The Board amended Regulation D, effective December 31, 1986 (1) to increase the amount of transaction account balances to which the lower reserve requirement applies; and (2) to increase the amount of reservable liabilities subject to a zero percent reserve requirement.

Votes for these actions: Messrs. Volcker, Johnson, Ms. Seger, Messrs. Angell, and Heller. Absent and not voting: Messrs. Wallich and Rice.

Under the Monetary Control Act of 1980, depository institutions, Edge and agreement corporations, and U.S. agencies and branches of foreign banks are subject to reserve requirements set by the Board. Initially, reserve requirements were set at 3 percent of an institution's first \$25 million in transaction balances and 12 percent on balances above that level. The act directs the Board to adjust the amount subject to the lower reserve requirement to reflect changes in the amount of transaction balances nationwide. By the beginning of 1986, this amount had been raised to \$31.7 million. Recent growth in such balances indicated that a further increase of \$5 million was warranted. The Board, therefore, amended Regulation D to increase to \$36.7 million the amount to which

the lower reserve requirement applies.

The Garn–St Germain Depository Institutions Act of 1982 established a zero percent reserve requirement on the first \$2 million of an institution's reservable liabilities. It also provided for annual adjustments to that exemption based on deposit growth nationwide. Recent growth in deposits indicated that the amount subject to a zero percent reserve requirement should be increased from \$2.6 million to \$2.9 million, and the Board amended Regulation D accordingly.

Regulation G (Securities Credit by Persons Other than Banks, Brokers, or Dealers)

January 8, 1986—Interpretation

The Board issued an interpretation of Regulation G, effective January 10, 1986, that clarifies the need for margin requirements for certain debt securities issued by a company seeking to acquire another.

Votes for this action: Messrs. Volcker, Partee, and Rice. Votes against this action: Mr. Martin and Ms. Seger. Absent and not voting: Mr. Wallich.¹

The interpretation addresses debt securities issued by a shell corporation in a takeover attempt. (A shell corporation is a firm that has no significant business operations, functions primarily as a vehicle for acquiring the stock of the target company, and has virtually no assets other than the margin stock.) The

1. On this and subsequent pages, footnote 1 indicates that there was a vacancy on the Board when this action was taken.

interpretation states that debt securities issued by such a shell company are presumed to be indirectly secured by the stock of the company being acquired and, therefore, are subject to the margin requirements of Regulation G. If specific evidence exists of collateral other than the margin stock or of a guarantee by the parent of the shell company, then the securities are not covered by the interpretation.

Governors Martin and Seger believed that adoption of the interpretation was unnecessary. They noted that a process already exists whereby the staff provides advice on margin stock matters, and they saw no reason for the Board to be involved in such determinations. In addition, they preferred a longer comment period.

Regulation J (Collection of Checks and Other Items and Wire Transfers of Funds)

May 28, 1986—Amendments

The Board amended Regulation J, effective January 1, 1987, to reduce and reallocate check float, to permit Reserve Banks to collect checks drawn on banks in foreign countries, and to make other technical changes. The Board also modified its automated clearinghouse (ACH) procedures and adopted a standard holiday schedule for the Reserve Banks.

Votes for these actions: Messrs. Volcker, Wallich, Rice, Ms. Seger, Messrs. Angell and Johnson.¹

The Board changed the procedures for recovering check float arising from the local or regional observance of a holiday not observed nationally. Effective January 1, 1987, a paying bank that closes voluntarily on a

nonstandard holiday must pay for checks made available to it on that day or reimburse the Reserve Bank for the value of the resultant float. The Board also modified its ACH procedures, effective April 1, 1987, to reduce and reallocate float that results from nonstandard holidays. In addition, the Board adopted a schedule for Reserve Bank observance of the 10 national holidays, effective January 1, 1987.

In other amendments, the Board established two-year limits for bringing actions against a Reserve Bank for mishandling a payment item (beginning January 1, 1990) and for bringing action against a paying bank for failing to comply with the regulation's notification requirements (beginning August 1, 1986). The Board also authorized the Reserve Banks to collect instruments drawn on payors in foreign countries.

Regulation K (International Banking Operations)

June 23, 1986—Amendment

Effective July 8, 1986, the Board revised the procedures governing international investments by U.S. banking organizations.

Votes for this action: Messrs. Volcker, Wallich, Rice, Ms. Seger, Messrs. Angell and Johnson.¹

Previously, the regulation's provisions on foreign investment had required a banking organization to obtain the Board's consent to invest more than 10 percent of its capital and surplus in a foreign company. The amendment removes that requirement and permits such an investment with written notice to the Federal Reserve 45 days in advance.

Regulation Y (Bank Holding Companies and Change in Bank Control)

June 25, 1986—Amendments

The Board amended Regulation Y, effective December 15, 1986, to add six activities to the list of nonbanking activities permissible for bank holding companies.

Votes for this action: Messrs. Volcker, Wallich, Rice, Ms. Seger, Messrs. Angell and Johnson.¹

The Board also revised the portion of the regulation governing insurance activities.

Votes for this action: Messrs. Volcker, Rice, Ms. Seger, Messrs. Angell, and Johnson. Abstaining: Mr. Wallich.¹

The amendments to Regulation Y permit bank holding companies to engage in the following nonbanking activities: consumer financial counseling; tax preparation and planning; commodity trading and futures commission merchant advisory services; check guarantee services; credit bureau and collection agency services; and personal property appraisal. The regulation stipulates the conditions under which holding companies may engage in these activities.

The Board eliminated a requirement that holding companies that underwrite credit-related insurance provide rate reductions or other policy benefits to customers. The requirement had stipulated that holding companies must charge premiums lower than the maximum established by state rules. The Board found that this requirement put holding companies at a competitive disadvantage and that other safeguards exist to address the possibility of adverse effects on the public.

The Board also redefined the scope of insurance activities permitted under the Garn–St Germain Depository Institutions Act of 1982. The act prohibited some insurance activities that had been permissible under Regulation Y and permitted expansion of other activities. The act generally prohibited agency and underwriting activities, except as specifically exempted. The Board revised Regulation Y to incorporate exemptions that permit the following activities: (1) selling credit-related life, accident, and health insurance and insurance for involuntary unemployment; (2) selling, through finance-company subsidiaries, property insurance on collateral of \$10,000 or less (or \$25,000 for manufactured homes); (3) continuing and expanding certain agency activities authorized before specified grandfather dates; (4) acting as a managing general agent for group insurance for the holding company; (5) acting as a general insurance agent if the holding company has \$50 million in assets or less; and (6) acting as a general insurance agent in towns with inadequate insurance agency facilities or with fewer than 5,000 residents. The Board determined that a bank holding company's authority to operate a general insurance agency in small towns should be confined to those towns in which the company has lending offices.

Regulation Z (Truth in Lending)

December 10, 1986—
Amendment

The Board amended Regulation Z, effective December 16, 1986, to redefine what constitutes an advance of new money in a refinancing and,

thereby, to expand the exemptions from the right of rescission.

Votes for this action: Messrs. Volcker, Johnson, Ms. Seger, Messrs. Angell and Heller. Absent and not voting: Messrs. Wallich and Rice.

Under the Truth in Lending Act, consumers who use their homes as collateral for a loan have three days within which to rescind the transaction. Creditors are required to provide borrowers with a written notice of their right to rescind such a transaction, and creditors cannot disburse funds or otherwise perform services until the three-day rescission period has expired. Regulation Z exempts refinancings from the right of rescission if the new credit is extended by the same creditor who made the original loan and if the transaction does not involve an advance of new money. Regulation Z had defined new money as the difference between the new "amount being financed" and the outstanding balance plus any earned unpaid finance charges. The Board amended the regulation to redefine what constitutes a new advance of money so that the right of rescission would not be triggered if a consumer finances charges such as attorney's fees, title search fees, and insurance premiums. The Board found that these charges generally are not substantial relative to the principal amount refinanced and do not put the borrower's home at a significantly higher risk of loss.

The Board decided to withdraw one other proposed amendment to the right of rescission that had been published for comment. The amendment had pertained to refinancings by creditors other than those who made the original mortgage loans. The Board's decision reflected the limited nature of the exemption pro-

posed, the complexity of an implementing rule, and several adverse comments received on the proposal.

Rules Regarding Delegation of Authority

December 15, 1986— Amendment

The Board amended its rules, effective immediately, to permit certain System officials to waive the requirements to publish notice and seek public comment on a proposed change in the control of a bank, if such disclosures would seriously threaten the bank.

Votes for this action: Messrs. Volcker, Johnson, Ms. Seger, Messrs. Angell, and Heller. Absent and not voting: Messrs. Wallich and Rice.

Recent legislation amended the Change in Bank Control Act to require that public comment be sought on any proposed change in bank ownership. That legislation, however, permits a federal bank regulator to dispense with the publication and comment requirements if the regulator determines that such disclosure would seriously threaten the safety or soundness of the bank being acquired. The amendment to the Board's rules delegates authority to determine whether to waive the notice requirements either to the Board's Director of the Division of Banking Supervision and Regulation, with the concurrence of the General Counsel, or to the appropriate Reserve Bank, with the concurrence of the Board's Director of Banking Supervision and the General Counsel. A waiver of these requirements would be appropriate, for instance, when prompt action is necessary to prevent the bank's failure. These System officials

already have comparable delegated authority for applications filed under the Bank Holding Company Act.

against: Ms. Seger. Absent and not voting: Messrs. Wallich and Rice.

Policy Statements

July 11, 1986—Revisions to Capital Adequacy Guidelines

The Board revised its guidelines for capital adequacy to permit bank holding companies to count perpetual debt as primary capital and to limit the inclusion of certain sources of equity as primary capital.

Votes for this action: Messrs. Volcker, Wallich, Rice, Ms. Seger, Messrs. Angell and Johnson.¹

The revised guidelines establish criteria for determining whether a perpetual debt instrument qualifies as primary capital. The guidelines now permit qualifying perpetual debt, perpetual preferred stock, and mandatory convertible stock to compose up to one-third of an institution's primary capital. Also, 20 percent of an institution's primary capital may be in the form of mandatory convertible securities and perpetual debt. Perpetual debt securities issued or in the process of being issued on November 20, 1985, when the proposed revisions were published for comment, are grandfathered and excluded from the limitations.

November 3, 1986—Basic Financial Services

The Board authorized issuance of a policy statement on the types of basic services that financial institutions should be encouraged to offer.

Votes for this action: Messrs. Volcker, Johnson, Angell and Heller. Vote

The Board's Consumer Advisory Council had become concerned that changes in the financial services market might have an adverse effect on lower-income households. After careful study, the Council recommended that the Board issue a policy statement encouraging state member banks to offer the types of services most needed by low- and moderate-income households. The Board agreed with the need for such a statement but believed that the policy should have broader applicability. The Board recommended that the Federal Financial Institutions Examination Council propose such a statement for all financial institutions.

After review, the council approved a joint policy statement to be issued by its member agencies that encourages efforts by trade associations and individual financial institutions to make basic banking services available to all customers. Rather than identify particular accounts or services that should be offered, the statement broadly defines the types of services that institutions should endeavor to provide and encourages trade associations and financial institutions to ensure availability of certain basic services, such as a safe and accessible place to keep money; a way to obtain cash, including the cashing of government checks; and a means for making third-party payments. The Board adopted the policy statement. Ms. Seger objected to issuance of the policy statement because she believed that actions by certain trade associations adequately addressed the concerns in the statement and that Board action, therefore, was not necessary.

1986 Discount Rates

The Board approved four reductions of $\frac{1}{2}$ percentage point in the basic discount rate during 1986. Those reductions served to lower the rate from $7\frac{1}{2}$ percent in early March to $5\frac{1}{2}$ percent in the latter half of August. There were no increases in the discount rate during the year.

The reasons for the Board's decisions are reviewed below. Those decisions were made in the context of the policy actions of the Federal Open Market Committee and of general economic and financial developments that are covered in more detail elsewhere in this REPORT. A listing of the Board's actions on the discount rate during 1986, including the votes on those actions, follows this review.

Actions on the Basic Discount Rate

January–February: No Change

During the early weeks of the year, the Board discussed but took no action on a number of requests by individual Federal Reserve Banks to reduce the basic discount rate by $\frac{1}{4}$ or $\frac{1}{2}$ percentage point. A rate of $7\frac{1}{2}$ percent had been in effect since mid-May 1985. The Board's ongoing review of economic and financial developments, including the behavior of the monetary aggregates, resulted in decisions to defer action rather than to approve or deny the pending rate cuts. The Board also took account of developments in foreign exchange markets and noted the risks to the dollar of a reduction under the prevailing circumstances, particularly if a lower discount rate were not accompanied by cuts in the lending rates of key central banks abroad.

By the latter part of February a majority of the Board Members believed that, on balance, the latest available information pointed to a more sluggish expansion of business activity than they had anticipated earlier in the year. They also called attention to the disinflationary effects of falling oil prices, to declining interest rates, and to recent evidence of slower monetary growth. Other Members observed that the weakening in some business indicators was relatively recent and did not necessarily portend a slower economic expansion. Moreover, the recent moderation in monetary growth came after an extended period of generally rapid expansion. These Members also expressed concern about the potentially adverse influence that a reduction in the discount rate might have on the foreign exchange value of the dollar unless it was associated with movements toward ease by at least some of the leading industrial countries abroad.

At a meeting held on February 24, the Board by a vote of 4 to 3 approved a reduction of $\frac{1}{2}$ percentage point in the basic discount rate to 7 percent. On the same day, the Board rescinded that action by unanimous vote following a review of prospective actions by key central banks abroad to reduce their lending rates. Members who favored a reduction in the discount rate on domestic grounds decided that a delay of limited duration would be acceptable, given the outlook for easing actions by at least some other major central banks during the next couple of weeks, if not within the next few days.

March–August: Basic Rate Reduced
On March 6, by unanimous vote, the

Board approved a reduction from $7\frac{1}{2}$ to 7 percent in the basic discount rate. This action was taken in the context of similar actions announced or expected by central banks in a number of other major industrial countries and in light of sizable further declines in most domestic interest rates in recent weeks. The Members also noted that the expansion of the monetary aggregates had been more limited thus far in 1986 than earlier, and the latest business information tended to confirm previous indications of more sluggish economic growth. In addition, a relatively favorable outlook for prices had been enhanced by the continuing decline in oil prices.

On April 18, the Board approved another reduction of $\frac{1}{2}$ percentage point in the basic discount rate. Most of the members believed that such an action was desirable to bring the rate into better alignment with short-term market rates, which had continued to decline since March 6. A reduction was also thought to be consistent with prospective policy easing in one or more of the major industrial nations abroad. Members noted that the latest indicators of business activity suggested on balance that economic growth would be relatively sluggish in the second quarter, especially reflecting weakness in business investment. Among other factors an important influence on such investment was the adverse effect of lower oil prices on the energy industry.

Governor Rice dissented from this action. In his view the economic outlook remained favorable despite indications of slower expansion in the current quarter. He stressed that consumer spending was being well maintained, and he believed that some turnaround in business spend-

ing was likely and would contribute to faster economic growth during the second half of the year. The outlook for net exports also appeared to be more positive. He concluded that a further cut in the discount rate was not warranted in these circumstances.

On July 10, the Board unanimously approved another reduction in the basic discount rate to 6 percent. Such an action was judged to be consistent with the accommodative monetary policy that had been implemented for some time through open market operations, and it took account of recent declines in a number of market interest rates. A lower discount rate also was deemed appropriate in the context of relatively slow growth in overall business activity, relatively low prices for a number of important commodities, and reduced pressures on the prices of goods fostered by an economy that was operating comfortably within capacity limits and subject to strong competition from abroad. Members noted that while M1 had been growing rapidly in recent months, the broader aggregates, M2 and M3, were currently near the midpoints of their target ranges for 1986. The Federal Open Market Committee had established those ranges in February and had reaffirmed them at its meeting on July 8-9. Some Members commented on the risks to the dollar of reducing the discount rate when few, if any, of the major central banks abroad were likely to ease their policies, at least over the near term. In this situation the dollar might remain under downward pressure in the foreign exchange market. But it was noted that a reduction in the System's rate might encourage easing measures abroad later, if not immediately.

The last reduction in the discount rate during 1986, to 5½ percent, was approved by unanimous vote on August 20. The Members agreed that such an action was consistent with the policy decision reached by the Federal Open Market Committee at its meeting on August 19 and with the System's broad objective of sustaining orderly economic growth within a framework of progress toward price stability. The Members recognized that there were risks of downward pressures on the dollar in the foreign exchange market, given the prospect that key industrial nations abroad were not likely to lower their discount rates in the near future. However, those risks were felt to be manageable and to be acceptable in light of prevailing and prospective economic and financial conditions.

September–December: No Change

During the closing months of the year, the Board made no further changes in the discount rate. The Members took account of a pickup in the growth of economic activity from the very sluggish pace in the second quarter. Prices tended to rise somewhat faster during the summer and fall months, reflecting developments in food and energy markets, but overall pressures on prices remained limited during this period.

Renewal of Temporary Seasonal Credit Program

On February 14, 1986, the Board approved the renewal for 1986 of its temporary, simplified seasonal credit program. This program was originally approved and implemented in 1985 as a means of making funds available at the discount window to agricultural banks experiencing un-

sually strong loan demands. The program was intended to complement the longstanding regular seasonal credit program and thereby to help assure that small- and medium-sized banks did not face liquidity constraints in accommodating their farm borrowers over the 1986 planting and production cycle. Under this temporary program, eligible banks could borrow at the discount window to fund one-half of their loan growth in excess of 2 percent over a base level; such borrowing could not exceed 5 percent of their deposits.

For 1986, the Board modified the temporary program slightly to enhance the program's usefulness to potential borrowers. The modifications (1) gave banks the option of borrowing at a fixed rate of ½ percentage point over the basic discount rate or at a variable rate that is the basic discount rate itself, and (2) permitted banks added flexibility in determining the base from which loan growth would be measured. Banks were allowed to borrow under either the regular or the temporary seasonal programs, but not under both at the same time.

New Policy on Large Borrowings from the Discount Window

On May 19, 1986, the Board approved a new policy to deal with exceptionally large borrowings from the discount window that arise from computer breakdowns or other operating problems. Under the new policy, a rate higher than the basic discount rate is applied to loans of unusual size that result from a major operating problem at the borrower's facility unless the problem clearly is beyond the reasonable control of the borrowing institution. The rate to be charged is the highest rate estab-

lished for loans to depository institutions. The Board's objective was to ensure that, in such circumstances, credit extended by the Federal Reserve would be at rates as high as or higher than those for short-term accommodation in the open market. The Board also wanted to encourage institutions to maintain or install appropriate measures and precautions to reduce the chances that major problems might develop.

Structure of Discount Rates

The basic discount rate noted in this report is the rate charged on loans to depository institutions for short-term adjustment credit. The basic rate also applies to most seasonal credit, including the regular seasonal program; under that program, credit may be provided for periods longer than those permitted under adjustment credit to assist smaller institutions in meeting regular needs for funds arising from certain expected seasonal movements in their deposits and loans. As noted above, credit is also provided at the basic discount rate under the variable-rate option of the temporary seasonal program and at a rate $\frac{1}{2}$ percentage point above the basic rate under the fixed-rate option of the temporary seasonal program.

Another category of discount-window credit relates to loans made over extended periods to depository institutions that are under sustained liquidity pressure. Such extended credit may also be provided when exceptional circumstances or practices adversely affect a particular depository institution. The interest rate on extended credit rises relative to the basic rate as the period of borrowing lengthens. For loans that have been outstanding for more than 150 days,

or for a shorter period if they are expected to be outstanding for an unusually long time and in relatively large amounts, the Reserve Banks may charge a flexible rate. The flexible rate, which has a floor that is 1 percentage point above the basic discount rate, takes account of the rates on market sources of funds. The Board approved reductions in the flexible rate periodically during the year, from $8\frac{1}{2}$ percent in mid-March to $6\frac{1}{2}$ percent in early September.

As of December 31, 1986, the structure of discount rates was as follows: a basic rate of $5\frac{1}{2}$ percent for short-term adjustment credit and for credit under the regular seasonal program. No loans were outstanding under the temporary seasonal program at year-end. Rates on extended credit ranged from the basic rate of $5\frac{1}{2}$ percent for the first 60 days of borrowing, to $6\frac{1}{2}$ percent for the next 90 days of borrowing, and to $7\frac{1}{2}$ percent after 150 days. The flexible rate on extended credit was $6\frac{1}{2}$ percent at year-end and was authorized for the Federal Reserve Banks of Richmond, Atlanta, Chicago, Kansas City, Dallas, and San Francisco.

Votes on Reserve Bank Requests to Change the Discount Rate

Under the provisions of the Federal Reserve Act, the boards of directors of the Federal Reserve Banks are required to establish rates on loans to depository institutions at least every 14 days and to submit such rates to the Board of Governors for review and determination. The Board votes listed below are those that involved changes in the basic discount rate. Votes involving the re-

establishment of existing rates are not shown. All of the latter were unanimous.

February 24, 1986

Effective February 25, 1986, the Board approved actions taken by the directors of the Federal Reserve Banks of Dallas and San Francisco to reduce the basic discount rate from 7½ percent to 7 percent.

Votes for this action: Mr. Martin, Ms. Seger, and Messrs. Angell and Johnson. Votes against this action: Messrs. Volcker, Wallich, and Rice.

February 24, 1986

The Board rescinded its approval of a reduction in the basic discount rate from 7½ percent to 7 percent at the Federal Reserve Banks of Dallas and San Francisco.

Votes for this action: Messrs. Volcker, Martin, Wallich, Rice, Ms. Seger, and Messrs. Angell and Johnson. Votes against this action: None.

March 6, 1986

Effective March 7, 1986, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco to reduce the basic discount rate to 7 percent.

Votes for this action: Messrs. Volcker, Martin, Wallich, Rice, Angell, and Johnson. Votes against this action: None. Absent and not voting: Ms. Seger.

The Board subsequently approved a similar action taken by the directors of the Federal Reserve Bank of Cleveland, effective March 10, 1986.

April 18, 1986

Effective April 21, 1986, the Board

approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Cleveland, Richmond, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to reduce the basic discount rate to 6½ percent.

Votes for this action: Messrs. Volcker, Martin, Wallich, Ms. Seger, and Messrs. Angell and Johnson. Vote against this action: Mr. Rice.

The Board subsequently approved similar actions taken by the directors of the Federal Reserve Banks of Atlanta and St. Louis, effective April 22, and Philadelphia, effective April 23, 1986.

July 10, 1986

Effective July 11, 1986, the Board approved actions taken by the directors of the 12 Federal Reserve Banks to reduce the basic discount rate to 6 percent.

Votes for this action: Messrs. Volcker, Wallich, Rice, Ms. Seger, Messrs. Angell and Johnson. Votes against this action: None.¹

August 20, 1986

Effective August 21, 1986, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to reduce the basic discount rate to 5½ percent.

Votes for this action: Messrs. Volcker, Wallich, Rice, Ms. Seger, and Messrs. Angell, Johnson, and Heller. Votes against this action: None.

The Board subsequently approved similar actions taken by the directors of the Federal Reserve Banks of Philadelphia and St. Louis, effective August 22, 1986.

Record of Policy Actions of the Federal Open Market Committee

The record of policy actions of the Federal Open Market Committee is presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each such action, and that it shall include in its ANNUAL REPORT to the Congress a full account of such actions.

In the pages that follow, there are entries with respect to the policy actions taken at the meetings of the Federal Open Market Committee held during the calendar year 1986, including the votes on the policy decisions made at those meetings as well as a résumé of the basis for the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings, rather than on data as they may have been revised later.

It will be noted from the record of policy actions that in some cases the decisions were made by unanimous vote and that in other cases dissents were recorded. The fact that a decision in favor of a general policy was

by a large majority, or even that it was by unanimous vote, does not necessarily mean that all members of the Committee were equally agreed as to the reasons for the particular decision or as to the precise operations in the open market that were called for to implement the general policy.

During 1986 the policy record for each meeting was released a few days after the next regularly scheduled meeting and was subsequently published in the *Federal Reserve Bulletin*.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market activities, the Federal Reserve Bank of New York operates under two separate directives from the Open Market Committee: an Authorization for Domestic Open Market Operations and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, it operates under an Authorization for Foreign Currency Operations and a Foreign Currency Directive. These four instruments are shown below in the form in which they were in effect at the beginning of 1986. Changes in the instruments during the year are reported in the records for the individual meetings.

Authorization for Domestic Open Market Operations

In Effect January 1, 1986

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than \$6.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) When appropriate, to buy or sell in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates, prime bankers acceptances with maturities of up to nine months at the time of acceptance that (1) arise out of the current shipment of goods between countries or within the United States, or (2) arise out of the storage within the United States of goods under contract of sale or expected to move into the channels of trade within a reasonable time and that are secured throughout their life by a

warehouse receipt or similar document conveying title to the underlying goods; provided that the aggregate amount of bankers acceptances held at any one time shall not exceed \$100 million;

(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers acceptances of the types authorized for purchase under 1(b) above, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such

accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(c), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

Domestic Policy Directive

In Effect January 1, 1986¹

The information reviewed at this meeting suggests that economic activity is expanding at a relatively modest pace in the current quarter. Total nonfarm payroll employment increased further in November, though less than in October, and the civilian unemployment rate edged down to 7.0 percent. Retail sales and industrial production picked up in November after declining in October. After strengthening in October, housing starts fell appreciably in November. Incoming information generally suggests relatively sluggish business capital spending. Revised merchandise trade data for the third quarter confirm that the deficit widened further, as non-oil imports continued to increase and exports fell somewhat. Broad measures of prices and wages appear to be rising at rates close to those recorded earlier in the year.

After declining in October, M1 grew substantially in November while growth in M2 and M3 continued quite moderate. Expansion in total domestic nonfinancial debt has remained rapid. Through November, M1 expanded at a rate well above the long-run range set by the Committee, M2 grew at a rate a bit below the upper

end of its range for the year, and M3 expanded at a rate near the mid-point of its range for 1985. Treasury bill rates have fallen somewhat while other short-term market interest rates have changed little on balance since the November meeting of the Committee; long-term rates have moved appreciably lower over the period. The trade-weighted value of the dollar against major foreign currencies has declined on balance since the Committee's meeting in early November, though the dollar has tended to stabilize more recently.

The Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation further, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee at the July meeting reaffirmed ranges for the year of 6 to 9 percent for M2 and 6 to 9½ percent for M3. The associated range for total domestic nonfinancial debt was reaffirmed at 9 to 12 percent. With respect to M1, the base was moved forward to the second quarter of 1985 and a range was established at an annual growth rate of 3 to 8 percent. The range takes account of expectations of a return of velocity growth toward more usual patterns, following the sharp decline in velocity during the first half of the year, while also recognizing a higher degree of uncertainty regarding that behavior. The appropriateness of the new range will continue to be reexamined in the light of evidence with respect to economic and financial developments including developments in foreign exchange markets. More generally, the Committee agreed that growth in the aggregates may be in the upper parts of their ranges, depending on continuing developments with respect to velocity and provided that inflationary pressures remain subdued.

For 1986 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1985 to the fourth quarter of 1986, of 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9 percent for M3. The associated range for growth in total domestic nonfinancial debt was provisionally set at 8 to 11 percent for 1986. With respect to M1 particularly, the Committee recognized that uncertainties surrounding recent behavior of

1. Adopted by the Committee at its meeting on Dec. 16–17, 1985.

velocity would require careful reappraisal of the target range at the beginning of 1986. Moreover, in establishing ranges for next year, the Committee also recognized that account would need to be taken of experience with institutional and depositary behavior in response to the completion of deposit rate deregulation early in the year.

In the implementation of policy for the immediate future, the Committee seeks to decrease somewhat the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in M2 and M3 over the period from November to March at annual rates of about 6 to 8 percent; while the behavior of M1 continues to be subject to unusual uncertainty, growth at an annual rate of 7 to 9 percent over the period is anticipated. Somewhat greater reserve restraint might, and somewhat lesser reserve restraint would, be acceptable depending on behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 6 to 10 percent.

Authorization for Foreign Currency Operations

In Effect January 1, 1986

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward trans-

actions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Austrian schillings	Italian lire
Belgian francs	Japanese yen
Canadian dollars	Mexican pesos
Danish kroner	Netherlands guilders
Pounds sterling	Norwegian kroner
French francs	Swedish kronor
German marks	Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding \$10.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the

Committee to renew such arrangements on maturity:

Foreign bank	Amount (millions of dollars equivalent)
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	700
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1(A) above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested insofar as practicable, considering needs for minimum working balances. Such investments shall be in liquid form, and generally have no more than 12 months remaining to maturity. When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board Members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager for Foreign Operations, for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

Foreign Currency Directive

In Effect January 1, 1986

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks and with the Bank for International Settlements.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Meeting Held on February 11–12, 1986

Domestic Policy Directive

The information reviewed at this meeting suggested that economic activity was expanding at a moderate pace. A number of major indicators of production and spending had shown improvement in late 1985 and early 1986. Underlying inflationary pressures appeared to be generally well contained. Prices in the latter part of the year were boosted by developments in markets for food and energy, but oil prices declined substantially in early 1986.

The labor market, one of the few areas for which data for early 1986 were available at the time of this meeting, showed exceptional strength in January. Total nonfarm payroll employment rose 566,000—about twice the average monthly increase in the fourth quarter of 1985—and the unemployment rate declined to 6.7 percent, its lowest rate in six years. Hiring remained brisk at trade establishments and in finance and service industries, with those sectors accounting for about two-thirds of the rise. Employment gains in the construction industry were also strong, apparently due in part to unusually good weather throughout most of the country during the month. In the manufacturing sector, employment increased for the fourth consecutive month, and the average number of hours in the factory workweek remained at a high level.

The index of industrial production rose an estimated 0.7 percent further in December, after no change on balance over the preceding two months. Available information for January suggested some additional rise in that month. The index of

capacity utilization for total industry rose in December for the second consecutive month, increasing 0.4 percentage point to 80.5 percent. Nevertheless, the year-end rate remained below the most recent peak of 82.0 percent recorded in the summer of 1984.

Total retail sales rose 1.9 percent in December, after having declined on balance over the previous two months. Sales increased for all major categories, but most of the rise was attributable to sizable gains in outlays for durable goods. Boosted by an expanded round of financing incentive programs, sales of domestic automobiles registered a strong rebound toward the end of December and were at an annual rate of 7.9 million units for the month as a whole—about 1½ million units above the rate in each of the preceding two months. Sales advanced further in January to a rate of 8.6 million units.

Total private housing starts rose sharply in December, more than offsetting the appreciable decline in the previous month, and newly issued permits for residential building also increased substantially. The strength in housing activity during the month was apparent in both the single-family and the multifamily sectors. For the fourth quarter as a whole, both housing starts and permits were at annual rates of nearly 1¾ million units—close to the pace recorded in earlier quarters and for the year 1985. Sales of new homes improved a bit around year-end, and sales of existing homes in the final quarter of 1985 registered their fifth consecutive quarterly increase.

Business capital spending strengthened somewhat in the fourth quarter. Growth in expenditures for producers' durable equipment was especially rapid, possibly reflecting firms'

attempts to realize tax benefits that might be eliminated for equipment installed after 1985. New orders for nondefense capital goods grew appreciably in December but were essentially flat over the fourth quarter as a whole. Shipments of such goods, however, rose about 3½ percent in the quarter. Outlays for nonresidential construction rose about 5 percent in December after having changed little on balance since August.

In the final months of 1985, the rates of increase in consumer and producer prices were somewhat higher than in the spring and summer, reflecting mainly what appeared to be a temporary spurt in prices for food and energy-related items. In the agricultural component, prices of domestically produced crude foods had leveled off in December and apparently fell in January. In the energy sector, prices of crude oil and other petroleum products tumbled dramatically in early 1986, and the effects of these declines were likely to show through at the consumer level in coming months. Excluding the food and energy sectors, consumer prices rose in November and December at a pace close to that for the year as a whole, and producer prices changed little on balance over the two-month period. For the year 1985 consumer prices rose about 3¾ percent, compared with 4 percent in 1984; producer prices rose about 1¾ percent in both years. The index of average hourly earnings of nonfarm production workers increased 3 percent last year, about the same as in 1984.

The trade-weighted value of the dollar against major foreign currencies had declined about 4 percent further since the Committee's meeting in mid-December. Throughout the period, and particularly around the time of the January meeting of

the G-5 countries, exchange market movements reflected varying assessments of official attitudes toward the dollar and differing views about the likely effects of sharply declining oil prices on various industrial and developing countries. Preliminary data on merchandise trade for the fourth quarter suggested that the deficit widened further from the already high third-quarter level. Both oil and non-oil imports rose, and exports were little changed. For the year 1985 the deficit was estimated at about \$120 billion, up from \$107 billion in 1984.

At its meeting on December 16-17, 1985, the Committee had adopted a directive that called for some limited decrease in the degree of pressure on reserve positions. The members expected such an approach to policy implementation to be consistent with growth of M2 and M3 at annual rates of about 6 to 8 percent over the period from November to March. Although the behavior of M1 continued to be subject to unusual uncertainty, the members expected expansion of that aggregate to slow to an annual rate of 7 to 9 percent over the four-month period.¹ It was agreed that somewhat greater restraint might, and somewhat lesser restraint would, be acceptable over

1. These growth rates and all subsequent data on the monetary aggregates reflect annual benchmarks and seasonal factors as published on February 13, 1986.

The monetary aggregates are defined as follows: M1 comprises demand deposits at commercial banks and thrift institutions, currency in circulation, travelers checks of nonbank issuers, negotiable order of withdrawal (NOW) and automatic transfer service (ATS) accounts at banks and thrift institutions, and credit union share draft accounts. M2 contains M1 and savings and small-denomination time deposits (including money market deposit accounts

the intermeeting period, depending on the growth of the monetary aggregates, the strength of the business expansion, the performance of the dollar on foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The intermeeting range for the federal funds rate was retained at 6 to 10 percent.

With respect to the Committee's longer-run ranges for monetary growth during 1985, M1 expanded at a rate well above the range of 3 to 8 percent, at an annual rate, set for the second half of the year; M2 grew at a rate somewhat below the upper end of its range of 6 to 9 percent for the year; and M3 expanded at a rate near the midpoint of its range of 6 to 9½ percent for 1985. Expansion in total domestic nonfinancial debt was above the upper end of its monitoring range of 9 to 12 percent for the year. In early 1986, there was evidence of a marked overall slowing in the monetary aggregates. M1, which had increased at an annual rate of about 12½ percent in December, grew only a little in January; on average over the two months, expansion in M1 was running near the lower end of the short-run range anticipated by the Committee at its previous meeting. M2, which had

expanded moderately in December, decelerated markedly in January, reflecting both the slowdown in M1 and quite low growth in its nontransaction component. Expansion in M3 picked up somewhat in January as banks issued a substantial volume of large time deposits to support a further robust increase in bank credit; its growth over the two-month period was in line with the Committee's expectations.

Open market operations during the intermeeting period were directed toward achieving a slight decrease in pressures on reserve positions. Seasonal plus adjustment borrowing from the discount window, while rising sharply around year-end when excess reserves were particularly large, averaged only about \$260 million during the two full maintenance periods ending in January. Open market operations were undertaken in an environment of large seasonal fluctuations in reserve needs, unusually high Treasury balances, a weakening tendency for the dollar in foreign exchange markets, incoming economic data that were somewhat stronger than had generally been anticipated and, as the period progressed, sharp further declines in oil prices. Under these conditions the federal funds rate generally hovered around the 8 percent level during much of the intermeeting interval and was considerably above that level for a few days around year-end. More recently, the rate moved down to a range of 7¾ to 7⅞ percent. Other short-term rates rose a little over the period, and intermediate- and long-term rates were unchanged to somewhat lower.

The staff projections presented at this meeting suggested that economic activity and employment would be somewhat stronger over the near

(MMDAs) at all depository institutions, overnight repurchase agreements (RPs) at commercial banks, overnight Eurodollars held at foreign branches of U.S. banks by U.S. residents other than banks, and money market mutual fund shares other than those restricted to institutions). M3 is M2 plus large-denomination time deposits at all depository institutions, large-denomination term RPs at commercial banks and savings and loan associations, institution-only money market mutual funds, and term Eurodollars held by U.S. residents in Canada and the United Kingdom and at foreign branches of U.S. banks elsewhere.

term than had been anticipated at the time of the previous meeting. For the year 1985, the third successive year of economic expansion, real GNP was estimated to have increased about $2\frac{1}{2}$ percent, and broad measures of inflation generally had risen at rates of around $3\frac{1}{2}$ to $3\frac{3}{4}$ percent—close to, or somewhat below, those recorded in the preceding two years. Real GNP was expected to grow a little more this year than in 1985 and the average unemployment rate was projected to decline somewhat from the rate recorded last year. The rate of increase in prices over the coming year was expected to be little changed from that experienced in 1985. It was noted, however, that the sharp further declines in oil prices in the days before this meeting had not been incorporated in the projections.

In the Committee's discussion of the economic situation and outlook the members differed somewhat in their assessments of the prospects for business activity, but they generally agreed that further expansion at a somewhat faster pace than in 1985 was a reasonable expectation for 1986. At the same time, several members commented that the outlook remained subject to substantial uncertainties. Changes in the international prices of crude oil were so large and so recent that they were particularly difficult to evaluate. Members also referred to uncertainties surrounding prospects for fiscal policy stemming from the legal challenge to the Gramm–Rudman–Hollings legislation, the problems for business investors associated with pending tax reform legislation, and the difficulties of predicting and assessing changes in the foreign exchange value of the dollar.

While they recognized the limitations of any forecasts under present circumstances, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members presented at this meeting specific projections of economic activity, average prices, and the rate of unemployment. For the period from the fourth quarter of 1985 to the fourth quarter of 1986, forecasts for growth of real GNP centered on a range of 3 to $3\frac{1}{2}$ percent, with a full range of $2\frac{3}{4}$ to $4\frac{1}{4}$ percent. Forecasts of growth in nominal GNP had a central tendency of $6\frac{1}{2}$ to $7\frac{1}{4}$ percent and an overall range of 5 to $8\frac{1}{2}$ percent. With regard to the rate of inflation, as indexed by the GNP deflator, the projections centered on rates of 3 to 4 percent and the range was $2\frac{1}{2}$ to $4\frac{1}{2}$ percent. Estimates of the rate of unemployment in the fourth quarter of 1986 varied from about $6\frac{1}{4}$ to $6\frac{3}{4}$ percent, with several in the area of $6\frac{1}{2}$ percent. These forecasts were based on the Committee's objectives for growth in money and credit that were established at this meeting. It was also assumed that federal budget deficits would be on a declining trend and that the foreign exchange value of the dollar would not change enough after its substantial fall during 1985 to exert a significant further impact on economic activity and prices during 1986.

In the course of the Committee's discussion, members referred to the recent improvement in several key indicators of business activity. In themselves these indicators augured well for continuing economic growth over the year ahead. On the other hand some members commented that the current and prospective performance of several important sectors of the economy—such as agriculture

and business fixed investment—did not suggest a strengthening expansion. However, the actual performance of those sectors among others would be influenced to an important extent by a number of broad, over-riding factors.

Among the positive factors cited by the members were the recent decline in oil prices, lower interest rates, and higher stock prices. These developments generally had favorable implications for consumer spending, housing, and many types of business investment. Some members also referred to the rapid growth in M1 and to the ample availability of liquidity as factors that would tend to support the expansion over the year ahead. The decline in the foreign exchange value of the dollar, while exerting upward pressures on prices, was seen as another positive development in terms of its impact on economic activity, although views differed considerably with regard to the timing and extent of that impact.

On the negative side, members mentioned the downside risks inherent in the debt problems faced by many consumers and a number of industries, including agriculture, and the associated financial strains on some of their institutional lenders. The recent decline in oil prices, while a favorable development in terms of its overall impact on the economy, nonetheless had negative consequences for energy producers and therefore for important parts of the country. Several members also stressed the adverse repercussions of lower oil prices on a number of developing countries that were heavily dependent on oil exports to service their large debts to international lending institutions, including major U.S. banks.

The fiscal policy outlook, despite current legal complications, was seen as pointing to declining budgetary deficits. Members commented that the better prospects for action on the federal budget had already helped to reduce inflationary expectations and had exerted a quite favorable impact on domestic financial markets. The actual implementation of deficit-reducing measures—in terms of their direct effects on government spending—would tend to restrain the growth of income and economic activity. However, those effects might well be offset, at least in part, by increased private spending that would tend to be stimulated by downward adjustments in interest rates as markets anticipated or responded to reduced federal credit demands.

In their discussion of the outlook for inflation, the members expressed somewhat differing views. These ranged from expectations of little change, or perhaps some improvement, from the recent trend to the anticipation of some deterioration. In the context of the sizable decline in unemployment and poor productivity performance, some members commented that the economy's growth potential might be more limited than they had thought earlier and that relatively rapid business expansion might at some point, though not over the quarters immediately ahead, be associated with increasing inflationary pressures. Other members, while also troubled by productivity trends, nonetheless felt that the rate of unemployment was still sufficiently high and capacity utilization rates sufficiently low to rule out such a concern for the conduct of policy for the time being. Views also differed in emphasis with regard to the inflationary impact of the decline in

the foreign exchange value of the dollar. The depreciation of the dollar, especially if it were to continue substantially further, could involve significant upward pressures on import prices at some point. Some members emphasized their view that the inflationary impact of the dollar decline would be greatly dampened by efforts of foreign business firms to retain market shares. Others, while recognizing that the effects of the dollar's decline could be delayed and in the short run offset by reduced oil prices, felt that the inflationary potential would be significant over time, depending in part on other economic policy developments. The members generally agreed that, in addition to oil price and federal budgetary developments, the strong price competition in many markets and restrained labor settlements were factors currently tending to curb inflationary pressures.

At this meeting the Committee reviewed the 1986 growth ranges for the monetary and credit aggregates that it had tentatively set in July 1985 within the framework of the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act). Those tentative ranges included growth, measured from the fourth quarter of 1985 to the fourth quarter of 1986, of 4 to 7 percent for M1 and 6 to 9 percent for both M2 and M3. The associated range for total domestic nonfinancial debt had been provisionally set at 8 to 11 percent for 1986.

Discussion of the tentative range for M1 focused on its appropriate width and level in light of the economic and financial circumstances that appeared to be in prospect for the year ahead and on its unusual behavior in recent years. While the members expressed some differing

preferences regarding an appropriate range for M1, the differences were not very large. All of the members contemplated a marked slowing in M1 growth from that experienced in 1985 as a likely development despite their expectations of some pickup in the expansion of nominal GNP. Nonetheless, the members gave considerable emphasis to the uncertainties that continued to surround the outlook for the velocity of M1—the relationship between M1 and GNP. The sharp decline in M1 velocity during 1985 was unexpected although after the fact it could be explained to a considerable extent, though not entirely, by historical relationships of money to income and interest rates. Still, the changing composition of M1, involving a growing share of interest-bearing components, had increased the proportion of M1 that served both a transaction and a savings function and appeared to have made the behavior of this aggregate less predictable in comparison to earlier experience. Moreover, demand deposits had grown much more in 1985 than might have been anticipated and it was not clear whether that growth reflected more cautious cash management practices on the part of businesses or other perhaps transitory factors.

In the view of most, but not all, of the members it was desirable to widen the tentative M1 range in order to take account of the uncertainty in the relationship between M1 and economic activity and prices, but in general the suggested ranges involved approximately the same midpoints. The upper limits that were proposed generally assumed there would not be as large a drop in velocity this year as had occurred in 1985. But it was noted that in the absence of some reversal in the sharp

1985 drop in M1 velocity, growth toward the upper end of the range might well prove to be consistent with satisfactory economic performance. It might even be appropriate for M1 to run above the upper bound of its range should recent velocity trends persist. On the other hand, more moderate growth in M1 could be indicated to the extent that its velocity proved to be stronger than expected. In general, there was agreement that the behavior of M1 should be evaluated in light of its consistency with M2 and M3 and also in the context of broader economic and financial developments and the potential for inflationary pressures.

With regard to the broader monetary aggregates, the members indicated that the tentative ranges established in July for 1986 were still appropriate. Growth last year was generally in line with expectations, and on balance over the past few years, the behavior of M2 and M3 seemed to have been less affected than M1 by institutional and interest rate changes. In part that development reflected the fact that the broader aggregates include an array of deposit and money market instruments that often exhibit offsetting movements.

In the course of the Committee's discussion, consideration was given to the appropriate degree of emphasis to be given to M1 in policy implementation, at least until there was more evidence that the behavior of M1 velocity could be anticipated with a greater degree of confidence. Most of the members felt that the Committee's current procedures remained appropriate, taking account of the considerations underlying the range adopted and its interpretation. **Some emphasized that M1 was likely**

to prove again to be a more useful guide for policy implementation in a variety of potential economic settings. One member commented that over time M1 would probably serve as a better indicator of future GNP than the broader measures of money. Alternatively, it was suggested that while M1 might have become a less reliable guide, at least under recently prevailing circumstances, it continued to have significant value as a policy indicator when considered in the context of the behavior of the broader aggregates. Collectively, the aggregates used by the Committee appeared to have more significance than any one of them viewed separately.

With respect to the monitoring range for total domestic nonfinancial debt, a majority of the members favored adopting the range of 8 to 11 percent for 1986 that had been tentatively established in July. A number of other members preferred somewhat higher ranges in the expectation that debt expansion, while decreasing from its actual pace in 1985, might still be around—or perhaps a bit above—the upper limit of the tentative range. In the course of the discussion, it was suggested that the Committee drop its monitoring range for debt, perhaps substituting another measure such as total liquid assets. It was pointed out, among other things, that the debt aggregate was subject to serious measurement problems, including a large amount of double counting—related for example to financial activities such as advance refundings and mortgage financing by state and local governments—and distortions arising from an extraordinary pace of share retirements financed by borrowing. It was also noted that the debt measure had been deviating substantially in recent

years from past historical relationships to GNP. A majority of the members, while acknowledging the difficulties with this aggregate and agreeing that further study was needed, continued to feel that it served as a useful benchmark for evaluating the growth of debt in the economy and that its behavior should continue to be monitored, particularly in light of the Committee's concern about the increasing debt burden in the economy.

At the conclusion of the Committee's consideration of the long-run ranges, all of the members indicated that they favored or found acceptable monetary growth ranges for 1986 of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3. A monitoring range of 8 to 11 percent was also accepted for total domestic nonfinancial debt. In keeping with the Committee's usual procedures under the Humphrey-Hawkins Act, the ranges would be reviewed at midyear, or sooner if deemed necessary, in the light of their behavior in relation to economic and financial developments.

The following paragraph relating to the long-run ranges was approved for the domestic policy directive:

The Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation further, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed to establish the following ranges for monetary growth, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate was subject to substantial uncertainties in relationship to economic activity and prices, depending among other things on its re-

sponsiveness to changes in interest rates. It agreed that an appropriate target range under existing circumstances would be 3 to 8 percent, but it intends to evaluate movements in M1 in the light of its consistency with the other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures. It adopted a range of 6 to 9 percent for M2 and 6 to 9 percent for M3. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent for the year 1986.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Black, Forrester, Johnson, Keehn, Martin, Parry, Rice, Ms. Seger, and Mr. Wallich. Votes against this action: None.

In the Committee's discussion of policy implementation for the weeks immediately ahead, a number of members referred to the difficulty of clearly appraising the significance of the most recent economic and financial developments. While monetary expansion had slowed in recent weeks, the period of reduced growth was brief and it followed a period of substantial expansion. Strong employment growth did not appear to be fully matched by other current economic indicators. The needed correction of the value of the dollar entailed risks of a more fundamental change in market attitudes and a cumulating decline in the exchange rate that might discourage willingness to hold dollars at declining interest rates. In these circumstances, nearly all participants agreed that little or no change in reserve availability was warranted. In that connection, members also noted that the recent slowing of the monetary aggregates was reasonably in line with the Committee's expectations at the time of the December meeting for the November-to-March period.

In the course of the Committee's

discussion it was noted that while monetary policy had been relatively accommodative for some time, short-term rates had shown little tendency to decline and the Federal funds rate remained significantly above the discount rate even though borrowing at the discount window had dropped to rather low levels last month. Moreover, long-term rates had declined substantially since early fall. In that context, and against the already accommodative mode of open market operations, the point was made that the discount rate might need to be reduced to permit or accommodate a market tendency toward lower rates and that such a move would be a desirable complement to open market operations in the light of the risks of a slower rate of business expansion. More generally, in prevailing circumstances, the members wished to conduct open market operations in a manner that would not in itself signal or encourage higher interest rates or impede the tendency for some market rates to decline. At the same time, there was concern that policy implementation be sensitive to a situation in which a decline in the dollar might tend to feed upon itself, leading to an exaggerated fall with disturbing implications for inflation, financial markets, and the economy over time. In that connection it was noted that the desirability of a discount rate action would depend on evolving economic and financial circumstances; among other factors, in the light of the risks for the dollar in foreign exchange markets, such action would need to take account of the willingness of major central banks abroad to take broadly similar actions.

In the Committee's discussion of possible intermeeting adjustments in

policy implementation, the members agreed that the appropriate degree of pressure on reserve positions should continue to be determined in light of the growth of the monetary aggregates judged in the context of incoming information about the economy, the outlook for prices, and conditions in domestic and international financial markets, including the value of the dollar in the foreign exchange markets. A majority of the members agreed with the suggestion that there should be no presumptions about the likely direction of any intermeeting adjustments, given the many uncertainties about prospective economic and financial developments and the behavior of the monetary aggregates. However, some members believed that policy implementation should remain especially alert to developments that might call for some easing of reserve conditions in light of the considerable risks that they saw of some weakening in the economic expansion.

At the conclusion of the Committee's discussion a majority of the members indicated their acceptance of a directive that called for maintaining unchanged conditions of reserve availability. The members expected such an approach to policy implementation to be consistent with growth in M2 and M3 at annual rates of about 6 percent and 7 percent respectively for the period from November to March. Over the same period they expected M1 to expand at an annual rate of around 7 percent, although the behavior of M1 was seen as still subject to unusual uncertainty. The Committee indicated that it might find somewhat greater or somewhat lesser reserve restraint acceptable over the intermeeting period depending on the

growth of the monetary aggregates, the strength of the business expansion, the performance of the dollar on foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The members agreed that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 6 to 10 percent.

At the conclusion of the meeting, the following domestic policy directive, embodying the Committee's long-run ranges and its short-run operating instructions, was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that economic activity is currently expanding at a moderate pace. Total nonfarm payroll employment increased substantially further in January, and the civilian unemployment rate declined to 6.7 percent. In December industrial production rose further, and available information suggests some additional rise in January. Retail sales increased considerably in December after declining on balance over the previous two months, and housing starts rebounded from their October–November pace. Business capital spending strengthened somewhat in the fourth quarter. Merchandise trade data for the fourth quarter suggest that the deficit widened further from the very high third-quarter level. In late 1985 consumer and producer prices rose somewhat more than earlier, but for the year as a whole broad measures of prices and wages increased at rates close to those recorded in 1984.

With respect to the Committee's ranges for longer-term monetary growth, M1 expanded at a rate well above the range set for the second half of 1985; M2 grew at a rate somewhat below the upper end of its range for the year; and M3 expanded at a rate near the midpoint of its range for 1985. Expansion in total domestic nonfinancial debt was above the upper end of its monitoring range for the year. In January growth in M1 and M2 slowed

markedly, while growth in M3 picked up as banks issued a substantial volume of large time deposits to support further robust growth in bank credit. Interest rates have fluctuated considerably since the December meeting of the Committee; on balance, short-term interest rates have risen a little while longer-term rates are unchanged to somewhat lower. The trade-weighted value of the dollar against major foreign currencies has declined further.

The Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation further, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed to establish the following ranges for monetary growth, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate was subject to substantial uncertainties in relationship to economic activity and prices, depending among other things on its responsiveness to changes in interest rates. It agreed that an appropriate target range under existing circumstances would be 3 to 8 percent, but it intends to evaluate movements in M1 in the light of its consistency with the other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures. It adopted a range of 6 to 9 percent for M2 and 6 to 9 percent for M3. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent for the year 1986.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in M2 and M3 over the period from November to March at annual rates of about 6 percent and 7 percent, respectively; while the behavior of M1 continues to be subject to unusual uncertainty, growth at an annual rate of about 7 percent over the period is anticipated. Somewhat greater reserve restraint or somewhat lesser reserve restraint might be acceptable depending on behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit

markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 6 to 10 percent.

Votes for the short-run operational paragraph: Messrs. Volcker, Corrigan, Angell, Black, Forrestal, Johnson, Keehn, Parry, Rice, and Wallich. Votes against this action: Mr. Martin and Ms. Seger.

Mr. Martin and Ms. Seger dissented because they preferred some easing of reserve conditions given the risks they saw of unacceptably sluggish economic expansion. Such risks would be reduced in their view by lower short-term interest rates, which had not declined in line with recent reductions in long-term interest rates and in inflation expectations. They also believed some modest easing could lead to market conditions that would facilitate a reduction in the discount rate.

Meeting Held on April 1, 1986

Domestic Policy Directive

The information reviewed at this meeting indicated a mixed pattern of developments. On balance it appeared that economic activity had picked up from the reduced fourth-quarter pace, although spending remained sluggish in some key sectors. Price developments thus far in 1986 had been dominated by sharp declines in oil prices. Energy prices fell substantially over the first two months of the year and food prices also declined somewhat, while prices of most other goods and services rose at a moderate pace.

Total nonfarm payroll employment, which had increased substan-

tially in January, rose further in February, but employment in manufacturing fell after four months of gains. The average monthly rise in employment for the two months was about 325,000, somewhat higher than the average in the fourth quarter of 1985. Hiring was exceptionally brisk at retail trade and service establishments in both months. In contrast to the employment gains reported in the payroll survey, employment as measured by the household survey fell almost 400,000 in February, about offsetting the increase in January, and the civilian unemployment rate rose 0.6 percentage point to 7.3 percent. A sharp drop in agricultural employment, not measured by the payroll survey, accounted for about half of the decline; job losses in energy-related industries apparently also contributed to the decline.

The index of industrial production fell an estimated 0.6 percent in February after edging up only slightly in January. Although output of automotive goods was higher in February, production cutbacks were widespread for most other categories of goods. In particular, petroleum drilling activity was curtailed sharply in response to the dramatic declines in oil prices. Limited information available for March, including reported cutbacks in motor vehicle assemblies and steel production and a further decline in drilling activity, suggested continued sluggishness in production. The index of capacity utilization for total industry declined 0.6 percent to 80.0 percent; over the past year the index generally had fluctuated in a range of 80 to 81 percent.

Although retail sales changed little in January and February, they remained about 1.0 percent above the average in the fourth quarter, owing to a spurt in December. The rise

relative to the level of the fourth quarter was attributable to gains in outlays for durable goods, particularly automobiles and furniture and appliances. Sales of domestic automobiles, boosted by additional financing incentive programs, rose to an average annual rate of 8.3 million units over the January–February period, about 1½ million units above the depressed fourth-quarter rate. However, sales slipped during the first 20 days of March to a rate of 7 million units.

Total private housing starts surged in the January–February period to an annual rate of more than 2 million units, compared with an average of about 1¾ million units for the fourth quarter and for the year 1985. The increase was concentrated in the single-family sector, though construction of multifamily structures remained at a relatively brisk pace despite continued high rental vacancy rates. Sales of new homes declined somewhat in February to a level about equal to the fourth-quarter average, while sales of existing homes remained at about their January pace and a little lower than in the fourth quarter. Over the period since the FOMC meeting in February, the average rate on commitments at savings and loan associations for conventional fixed-rate home mortgage loans had declined nearly 1 percentage point to about 10 percent, the lowest level since 1978.

Business capital spending apparently weakened somewhat in early 1986 after a surge around the end of last year. Shipments of nondefense capital goods from domestic producers rose 5 percent in February but remained well below the average in the fourth quarter. New orders for nondefense capital goods, after hav-

ing been essentially flat in the fourth quarter, declined sharply in January but turned up in February. Outlays for nonresidential structures probably fell in early 1986, as spending on petroleum drilling activity reportedly plummeted.

Largely reflecting declines in energy prices, the producer price index for finished goods fell substantially in January and February, dropping 0.7 percent and 1.6 percent respectively. Producer prices for consumer foods and for crude food materials also declined appreciably over the two months. The consumer price index declined 0.4 percent in February—its first decline in more than three years—more than offsetting a rise in January. A sharp drop in prices for gasoline and fuel oil accounted for most of the February decline, but food prices also fell. Prices of other goods and services generally rose moderately. The index of average hourly earnings edged up on balance over the first two months of the year.

The trade-weighted value of the dollar against major foreign currencies continued to fall through about mid-March but recently rose somewhat; on balance the dollar had declined about 1¾ percent over the period since the February meeting. Disappointment among market participants about data released on U.S. economic activity and concerns about potential adverse effects of the sharp declines in oil prices on U.S. banks holding sizable loans to energy-related businesses and to oil-producing developing countries exerted downward pressure on the dollar, offset to some extent by views that foreign authorities, especially the Japanese, were reluctant to see further appreciation of their currencies. The merchandise trade deficit in January

appeared to have been only slightly smaller than in December; preliminary data for February suggested that exports increased and that the price and quantity of oil imports declined.

At its meeting on February 11–12, 1986, the Committee had adopted a directive that called for maintaining unchanged conditions of reserve availability. The members expected such an approach to policy implementation to be consistent with growth in M2 and M3 at annual rates of about 6 percent and 7 percent respectively for the period from November to March. Over the same period they expected M1 to expand at an annual rate of around 7 percent, though the behavior of M1 was viewed as still subject to unusual uncertainty. The Committee agreed that somewhat greater or somewhat lesser reserve restraint might be acceptable over the intermeeting period, depending on the behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The intermeeting range for the federal funds rate was retained at 6 to 10 percent.

After growing little in January, M1 expanded at an annual rate of about 7 $\frac{1}{4}$ percent in February and was expected to grow at a rate of about 14 percent in March—leaving this aggregate at a level somewhat above the upper end of the Committee's range for the year. On the other hand, growth of M2 was generally sluggish over the first three months of the year, and expansion in M3 remained moderate. As a result, M2 was running below its long-run range while M3 was near the midpoint of its range for 1986. The expansion in total domestic nonfinancial debt appeared to

have slowed appreciably over the first quarter, after extraordinarily rapid growth around the end of last year.

Open market operations during the intermeeting period were directed at maintaining about the prevailing degree of pressure on reserve positions. Seasonal plus adjustment borrowing from the discount window averaged about \$350 million during the three full reserve maintenance periods after the February FOMC meeting. That level was inflated a bit by technical problems associated with wire transfers early in the interval; more recently, borrowing was running in the area of \$225 million to \$250 million.

Federal funds generally traded in the 7 $\frac{3}{4}$ to 8 percent area during the first half of the intermeeting period. After the announcement by the Federal Reserve on March 7 of a reduction in the discount rate from 7 $\frac{1}{2}$ to 7 percent, the federal funds rate fell to around 7 $\frac{3}{8}$ percent and generally fluctuated around that level throughout the remainder of the period. Other short-term interest rates declined about $\frac{1}{2}$ to $\frac{7}{8}$ percentage point over the intermeeting interval. Long-term rates dropped more sharply, falling by 1 to nearly 1 $\frac{3}{4}$ percentage points, against a background of further weakness in oil prices, mixed economic news, and declines in some aggregate measures of prices.

During the Committee's discussion of the economic situation and outlook, several members commented on the contrast between current indications of some sluggishness in economic activity and a number of underlying developments that pointed to stronger expansion later in the year and perhaps in 1987 as well. The incoming information on business activity was mixed, but it was thought that on balance such information suggested a pickup in eco-

conomic growth in the first half of this year from the very slow pace in the fourth quarter. Several members observed, though, that the near-term outlook remained relatively weak, particularly taking account of substantial cutbacks in oil company investments associated with declining oil prices. At the same time a combination of developments—including reduced interest rates, higher stock prices, lower oil prices, and a decline in the dollar on exchange markets—was likely to exert an increasingly stimulative impact on the economy as the year progressed. The staff projection presented at this meeting had suggested that the expansion in real GNP would strengthen by the second half of the year, after relatively modest growth in the first half.

In evaluating the economic outlook, some members referred to the apparent improvement in business confidence over the course of recent weeks as the cost of capital declined and international competitiveness improved. It was thought that substantial declines in interest rates would have a stimulative impact on interest-sensitive sectors of the economy; indeed, that impact was already being felt in the housing sector. Members also reported that lower interest rates were leading to a large volume of mortgage debt refinancings. The latter would reduce monthly servicing costs and would therefore tend to support consumer spending over time. The rise in stock market prices and the decline in oil prices also were viewed as favorable for consumer spending. Taking account of these various factors, a few members commented that potential deviations from the staff projection were likely to be in the direction of more rapid growth.

Other members, while seeing some improvement as a likely prospect for the second half of the year, nonetheless emphasized the uncertainties—both domestic and international—that continued to trouble the business outlook and that could portend more restrained expansion than was currently anticipated. Consumer debt burdens remained large and one member observed that sales of new automobiles currently appeared to be inhibited to some extent by a reduced willingness or capacity of some consumers to borrow. In the business sector, while investment spending was likely to benefit considerably from the reduced cost of capital, its overall growth might well be restrained by weak demands for business equipment in important sectors of the economy such as agriculture and energy, and by the impact over time of apparent overbuilding, notably of office structures, in some parts of the country. One member also noted that uncertainties relating to tax reform legislation were continuing to inhibit business investment spending. Members also indicated that the improved conditions in financial markets stemmed to a large extent from expectations of future reductions in federal budget deficits and a failure to implement such reductions could have highly adverse consequences for financial markets and the economy.

With respect to exchange market developments, the decline in the dollar was viewed as implying upward pressures on domestic prices over time, but also as likely to stimulate business activity. While there were few actual indications to date of directly induced increases in export sales, contacts with business suggested that export markets were

improving. The members continued to differ in their assessment of when and to what extent a lower dollar would exert its favorable effects on overall domestic economic activity or begin to show through significantly in prices. One emphasized that efforts by foreign firms to retain market shares, especially in the absence of strong economic growth abroad, would tend to reduce the expansionary and price effects of the dollar's depreciation.

Some members commented that the strength of the expansion in the U.S. economy over the next few quarters would depend to an important extent on the rate of economic growth in key industrial nations abroad and the resulting increase in their demands for U.S. exports. It was noted, however, that stronger expansion in some major foreign countries might well be contingent on their pursuit of more stimulative economic policies, and there was question about the willingness of some key countries to undertake such policies at this time. A member also commented on the importance of world commodity prices in maintaining the international purchasing power of many developing countries, in addition to those that exported oil, and the potentially adverse repercussions of lower commodity prices on world trade and U.S. export industries.

In their comments about the outlook for inflation the members gave considerable emphasis to the favorable impact of declining oil prices, but it was also noted that those prices remained vulnerable to a reversal. In the staff's economic projections, the rate of increase in prices was projected to slow over the near term, largely because of the favora-

ble, one-time effects of lower oil prices. Members noted that the current downward pressures on prices provided an opportunity for the more effective pursuit of policies designed to foster a continuing reduction in the rate of inflation. It was observed in this connection that while considerable progress had been made in curbing inflation in key industries such as manufacturing and construction, the services industries appeared to be particularly resistant to further anti-inflationary progress. Partly for that reason but also in light of the recent weakness in productivity, the depreciation of the dollar, federal budget uncertainties, and the possibility of a reversal in oil prices, some members expressed concern about the underlying inflationary potential in the economy. They also cited recent price increases by a major automobile manufacturer as a worrisome development in terms of its broader implications for inflationary attitudes and future inflation.

At its meeting in February the Committee had agreed on policy objectives for monetary growth for the period from the fourth quarter of 1985 to the fourth quarter of 1986 that included ranges of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3. The associated range for total domestic nonfinancial debt was set at 8 to 11 percent. In keeping with the Committee's usual procedures under the Humphrey-Hawkins Act, these ranges would be reviewed at the July meeting or sooner if warranted by unanticipated developments.

In the Committee's discussion of policy implementation for the weeks immediately ahead, all of the members favored directing open market operations at least initially toward

maintaining essentially unchanged conditions of reserve availability. However, some shadings of opinion were expressed. A few preferred to tilt the provision of reserves toward slightly easier reserve conditions or at least to retain flexibility in that direction, depending on emerging market conditions. Others expressed the view that current reserve pressures should be well maintained, recognizing the possibility that such an approach to policy implementation might involve some little tightening of market conditions since market participants might be anticipating some easing. More generally, a number of members commented that policy implementation needed to take account of the already accommodative posture of monetary policy and the favorable, though somewhat uncertain, prospects for stronger expansion over the intermediate term, if not in the period immediately ahead.

The members anticipated that, with little or no change in reserve conditions, the monetary aggregates would tend to grow at rates that were broadly consistent with the Committee's target ranges for the year. M1 might remain on the high side in the weeks ahead, but it was emphasized that the behavior of M1 remained subject to considerable uncertainty. According to an analysis prepared for this meeting, M1 growth over the next three months might be close to that experienced over the December-to-March period, assuming unchanged conditions of reserve availability, somewhat slower expansion in nominal GNP, and no further declines in short-term market rates. However, demands for M1 balances were likely to be boosted, possibly substantially, if interest rates should decline further during the period

ahead. Some members also stressed the desirability of focusing on the tendency for the velocity of M1 to remain relatively weak and the associated possibility that relatively rapid growth in M1 and in reserves might be needed to help sustain the expansion. In general, the members agreed that the behavior of M1 should continue to be evaluated in light of its consistency with M2 and M3 and also in the context of broader economic and financial developments, the potential for inflationary pressures, and exchange market conditions. Over the next three months M2 was expected to strengthen from its reduced pace in the first quarter, while M3 was likely to continue to expand at a moderate rate.

With regard to possible intermeeting adjustments in policy implementation, the members could foresee potential developments that might call for either some easing or some tightening, given the uncertainties about prospective economic and financial developments and the behavior of the monetary aggregates. In these circumstances, most of the members felt that there should be no presumptions about the likely direction of any intermeeting adjustments. However, some members believed that policy implementation should remain especially alert to developments that might call for some easing of reserve conditions, given the risks that the expansion might prove to be significantly weaker than expected over the period immediately ahead. It was noted that a further reduction in the discount rate, should market conditions here and policy developments abroad make such an action desirable, could have implications for monetary policy implementation and, depending on the circumstances, might require a con-

sultation of the Committee prior to the next scheduled meeting on May 20.

At the conclusion of the Committee's discussion, all of the members indicated their acceptance of a directive that called for maintaining about the existing degree of pressure on reserve conditions. The members expected such an approach to policy implementation to be consistent with growth of both M2 and M3 at an annual rate of about 7 percent for the period from March to June. Over the same period, M1 was expected to expand at an annual rate of about 7 to 8 percent, but the members recognized that the behavior of M1 remained subject to unusual uncertainty. The Committee indicated that it might find somewhat lesser or somewhat greater reserve availability acceptable over the intermeeting period depending on the growth of the monetary aggregates, the strength of the business expansion, the performance of the dollar on foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Committee agreed that the current intermeeting range of 6 to 10 percent for the federal funds rate should be retained, although some members suggested that the current range might be lowered as a technical adjustment that would bring the present trading level of the federal funds rate closer to the midpoint of the range.

At the conclusion of the meeting the following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates a mixed pattern of developments with evidence of a pickup in economic activity from the reduced fourth-

quarter pace but with spending sluggish in some key sectors. Total nonfarm payroll employment increased appreciably further in February following a large rise in January, but employment in manufacturing fell after four months of gains and industrial production declined. The civilian unemployment rate rose sharply to 7.3 percent. Retail sales were little changed in January and February after rising over the previous two months, while housing starts were well above their pace in late 1985. Business capital spending apparently weakened somewhat in early 1986. The merchandise trade deficit for January appears to have been only slightly smaller than in December; preliminary data for February suggest that exports increased and that the price and quantity of oil imports declined. Largely reflecting declines in energy prices, consumer prices edged down on balance over the first two months of 1986 and producer prices fell substantially.

Growth in M1 picked up considerably over the course of the first quarter, leaving this aggregate by March somewhat above the upper end of its range for the year. On the other hand, growth of M2 was generally sluggish over the past 3 months and was running below its long-run range. Expansion of M3 was moderate during the winter months, with growth around the midpoint of its range for 1986. Interest rates have declined considerably since the February meeting of the Committee. On March 6, the Federal Reserve Board approved a reduction in the discount rate from $7\frac{1}{2}$ to 7 percent. The trade-weighted value of the dollar against major foreign currencies continued to decline through mid-March but has risen somewhat more recently; on balance the dollar has declined slightly since the February meeting.

The Federal Open Market Committee seeks monetary and financial conditions that will foster reasonable price stability over time, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at its February meeting to establish the following ranges for monetary growth, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate was subject to substantial

uncertainties in relationship to economic activity and prices, depending among other things on its responsiveness to changes in interest rates. It agreed that an appropriate target range under existing circumstances would be 3 to 8 percent, but it intends to evaluate movements in M1 in the light of its consistency with the other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures. It adopted a range of 6 to 9 percent for M2 and 6 to 9 percent for M3. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent for the year 1986.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in M2 and M3 over the period from March to June at annual rates of about 7 percent; while the behavior of M1 continues to be subject to unusual uncertainty, growth at an annual rate of about 7 to 8 percent over the period is anticipated. Somewhat lesser reserve restraint or somewhat greater reserve restraint might be acceptable depending on behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 6 to 10 percent.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Horn, Johnson, Melzer, Morris, Rice, Ms. Seger, and Mr. Wallich. Votes against this action: None. Absent and not voting: Mr. Martin.

On April 21, the Committee held a conference by telephone after the announcement of a reduction in the discount rate from 7 to 6½ percent effective on that date. The members reviewed recent economic and financial developments, including the behavior of the monetary aggregates

and technical factors affecting the provision of reserves. At the conclusion of the discussion the members agreed that no changes were needed in the current directive adopted at the meeting on April 1. It was understood that in carrying out open market operations within the framework of that directive, and recognizing that partial data suggested a strengthening in all the monetary aggregates in recent weeks, a degree of caution should be exercised to avoid an impression that a further change in the discount rate was sought over the period immediately ahead.

Meeting Held on May 20, 1986

1. Domestic Policy Directive

The information reviewed at this meeting indicated a mixed pattern of economic developments. On balance, growth in real GNP, estimated by the Commerce Department to have picked up in the first quarter to an annual rate of 3.7 percent, appeared to be expanding at a relatively modest pace in the current quarter. Thus far in 1986, broad measures of prices, heavily influenced by sharp reductions in petroleum prices, had shown declines in energy and food prices and moderate increases in prices of most other goods and services.

Total nonfarm payroll employment rose 200,000 further in April, after increasing about ¾ million in the first quarter, but employment trends continued to be unbalanced across industries. Employment in finance and service industries remained strong, and hiring at construction sites picked up substantially after changing little in the first quarter. In manufacturing, however, job losses

were recorded for the third consecutive month, and the length of the average factory workweek slipped from the high levels registered at the end of last year. Employment in the oil and gas industry plummeted during the first four months of the year, as firms curtailed drilling activity in response to lower oil prices. The civilian unemployment rate edged down to 7.1 percent in April, close to the level that had prevailed throughout 1985.

The index of industrial production rose an estimated 0.2 percent in April after steep declines in the preceding two months. The increase was attributable mainly to a rebound in motor vehicle assemblies, but there were also some gains in steel output and in production of equipment for business and for defense and space; these developments offset a further plunge in oil and gas well drilling. The index of capacity utilization for total industry dropped 0.7 percent further in March to 79.3 percent, its lowest level since December 1983, and apparently changed little in April.

Total retail sales rose $\frac{1}{2}$ percent in April, primarily reflecting a substantial increase in spending for automotive products and continued gains in outlays for general merchandise. Sales of domestic automobiles, sparked by a new series of sales and financing incentives, strengthened to an annual rate of 8.0 million units from their sluggish pace of 6.9 million units in March. Sales rose even further in early May to a rate of 8.8 million units.

Total private housing starts increased about 4 percent in April from a relatively high level. During the first four months of 1986, starts averaged nearly 2 million units at an annual rate, well above levels of

about $1\frac{3}{4}$ million units in each of the previous three years. Issuance of residential building permits also rose somewhat in April, with the increase concentrated in the single-family sector. Permits for multifamily structures fell, apparently in response to high rental vacancy rates, particularly in the South, and perhaps to heightened uncertainties about the prospects for changes in tax legislation relating to certain types of real estate investment.

Weakness in the energy sector has contributed to a slowing in business capital spending in recent months. Outlays for nonresidential structures fell sharply as spending on petroleum drilling activity plummeted. Expenditures for capital equipment dropped substantially, about reversing the rise in the previous quarter that was attributed to purchases of equipment in advance of potentially adverse tax law changes. New orders for nondefense capital goods, which had been flat in the fourth quarter, remained lackluster through March. Recent surveys of capital spending plans point to no more than modest growth in outlays for the year as a whole.

Largely reflecting declines in energy prices, the producer price index fell 0.6 percent in April, its fourth consecutive monthly decline, and over the first four months of the year the index was down about 11 percent at an annual rate. The consumer price index had fallen 0.4 percent in March for the second month in a row, and had declined at an annual rate of about 2 percent over the first three months of the year. Though movements in these indexes were dominated by the sharp drop in prices of petroleum products, declines in food prices at both the producer and consumer levels also helped to hold down inflation in the first quarter.

On the other hand, prices of goods other than food and energy items generally have been rising in recent months at about the same pace that prevailed last year, while prices of services have been increasing a little faster than in 1985.

The trade-weighted value of the dollar against major foreign currencies rose somewhat in the week before this meeting but on balance it had declined about $4\frac{3}{4}$ percent further over the period since the Committee's meeting on April 1; the largest decline was against the Japanese yen. There was little net change over the period in the differential between U.S. and a weighted average of foreign interest rates. Throughout the period, but especially around the time of the Tokyo Summit in early May, statements of U.S. and foreign officials appeared to influence trading behavior. The U.S. merchandise trade deficit appeared to have decreased somewhat in the first quarter, as both the volume and average price of oil imports fell and nonagricultural exports picked up.

At its meeting on April 1, 1986, the Committee had adopted a directive that called for maintaining about the existing degree of pressure on reserve positions. The members expected such an approach to policy implementation to be consistent with growth of both M2 and M3 at an annual rate of about 7 percent for the period from March to June. Over the same period, M1 was expected to expand at an annual rate of about 7 to 8 percent, but the members recognized that the behavior of M1 remained subject to unusual uncertainty. The Committee agreed that somewhat lesser or somewhat greater reserve restraint might be acceptable

over the intermeeting period depending on the behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The intermeeting range for the federal funds rate was retained at 6 to 10 percent.

M1 grew at an annual rate of $14\frac{1}{2}$ percent in April, close to its rapid pace in March, and data available thus far for early May indicated further strong expansion. M1 has expanded more rapidly than the Committee expected at the time of its April 1 meeting, and for the year to date has grown at a rate well above the 8 percent upper limit of the Committee's range for 1986. M2 and M3 expanded in April at annual rates of about $13\frac{3}{4}$ percent and $10\frac{1}{2}$ percent respectively, also outpacing the growth paths previously expected for the second quarter. However, given its earlier weakness, M2 moved only into the lower part of its long-run range in April, while M3 rose to a level slightly above the midpoint of its range for 1986. Expansion of total domestic nonfinancial debt, which had slowed appreciably over the first quarter, appeared to be continuing at a relatively moderate pace.

Open market operations during the intermeeting period were directed at maintaining about the prevailing degree of pressure on reserve positions. During the three full reserve maintenance periods after the April 1 meeting, seasonal plus adjustment borrowing from the discount window averaged about \$275 million. Borrowing was exceptionally light in the days immediately preceding the announcement on April 18

of a reduction in the discount rate from 7 to $6\frac{1}{2}$ percent, but has averaged a little more than \$300 million since then.

Federal funds generally traded in the $6\frac{3}{4}$ to 7 percent area over most of the intermeeting period, down about $\frac{1}{2}$ percentage point from the rate prevailing around the time of the previous meeting. Most other short-term rates also declined on balance, though by less than the federal funds and discount rates, while long-term rates moved somewhat higher. After declining early in the intermeeting period, interest rates subsequently rose against the background of an upturn in oil prices, strong money supply growth, further depreciation of the dollar, and emerging views among market participants that the scope for further easing in monetary policy was reduced.

The staff projections presented at this meeting suggested that expansion in real GNP, though relatively modest in the current quarter, would likely strengthen over the second half of 1986 and would be at a moderate pace in 1987. The rate of unemployment was expected to decline marginally over the projection horizon. The general level of prices, as measured by the GNP implicit deflator, was projected to rise relatively slowly in the near term, but to pick up later as the favorable effects of declining oil prices dissipated and upward pressures on prices from the dollar's depreciation tended to intensify.

In the Committee's discussion of the economic situation and outlook, members commented that stronger economic expansion in line with the staff forecast was a reasonable expectation for the second half of the

year, but several members also stressed the risks of a different outcome. It was generally noted that there was no firm evidence to date of a pickup from the currently sluggish rate of expansion in overall economic activity and that weaknesses remained in key sectors of the economy such as energy and agriculture. However, a number of fundamental factors pointed to faster growth later, though there was considerable uncertainty about both the timing and the magnitude of the prospective strengthening. These factors included substantially reduced interest rates, higher prices in equity markets, lower oil prices, and the favorable effects of the dollar's depreciation on the international competitiveness of U.S. products. At the same time, some members observed that inflationary pressures could increase over the next several quarters, particularly if domestic demands for goods and services proved to be quite strong at a time when the lagged price effects of the dollar's depreciation were being felt. It was noted in this connection that progress toward reducing federal budget deficits was urgently needed to improve prospects for balanced economic growth and help protect against renewed inflation.

With regard to specific indications of prospective strengthening in economic activity, members referred among other developments to the apparent improvement in business confidence in many parts of the country. Housing activity was described as strong in most areas, and some members cited evidence of a pickup in sales of consumer durables related to housing. And although activity in manufacturing industries tended to remain sluggish, the service industries generally were experiencing considerable growth, includ-

ing notably the financial services and tourism. While the staff forecast had indicated continuing growth of consumer spending and modest expansion in business fixed investment and inventories, one member referred to the possibility that expansion in these key sectors might gather momentum as uncertainties about the actual strength of business were resolved favorably, contributing to a greater acceleration in real economic growth. Another member commented that the buildup of liquidity was seen by many observers as a positive factor for the expansion, especially in the context of what was viewed as an accommodative monetary policy. While broad measures of liquidity had not shown particular strength in recent quarters, holdings of cash balances had been expanding rapidly and were available to support a considerable pickup in spending at some point in the future.

On the other hand, several members indicated that the possibility of the expansion remaining weak could not be ruled out. In this regard, a number of members indicated that they viewed business fixed investment as a major uncertainty in the overall economic outlook, noting that current indicators of future investment remained weak and that there was considerable reluctance to undertake some investment activities pending the passage of tax reform legislation. Moreover, the apparent overbuilding of commercial and other facilities in some parts of the country and weak investment demand in depressed sectors of the economy would tend to inhibit investment spending over the quarters ahead. Members also referred to shortfalls in revenues of state and local governments in depressed areas of the country as a negative factor. Finally,

one member referred to the possibility of an inventory correction should the currently positive business mood begin to deteriorate.

A number of members expressed the view that the performance of the economy during the second half of the year would hinge to a considerable extent on foreign developments. Some felt that the main downside risks in the nearer-term business outlook were on the foreign trade side. To an important degree, rising demands for U.S. exports would depend on faster growth in key foreign industrial nations, and it was observed that such growth had been disappointing and a pickup might not occur in the absence of more stimulative economic policies in at least some of those countries. And while a depreciated dollar could be expected to have a favorable impact on U.S. foreign trade over time, that impact might well be delayed and muted in an environment of slow growth abroad and of highly competitive markets for internationally traded goods. Further growth in protectionism in the United States might likewise have a strongly inhibiting effect on U.S. export markets as foreign nations retaliated.

A number of members raised questions about the outlook for inflation. It was pointed out that the recently favorable behavior of overall prices was the result of price declines in the energy and food sectors. Those declines would soon be in the past, and upward pressures on overall prices would reemerge, stimulated in part by the lagged inflationary effects of the dollar's depreciation. Indeed, prices of nonfuel imports were already indicated to have turned up. Even if oil prices were to stabilize near current levels, their favorable impact on overall prices would tend

to wane over the quarters ahead, and the possibility of a reversal in oil prices could not be dismissed. Agricultural prices also could not be expected to continue trending downward, and indeed some firming had occurred recently. On the more favorable side, members referred to the intense competition in many markets and to restrained wage settlements in a number of industries. Basic cost pressures appeared to be well contained so far in manufacturing industries although price and wage pressures in the service industries remained disturbing. In one view any intensification of inflationary pressures might well be delayed until well into 1987.

At its meeting in February the Committee had agreed on policy objectives for monetary growth for the period from the fourth quarter of 1985 to the fourth quarter of 1986 that included ranges of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3. The associated range for total domestic nonfinancial debt was set at 8 to 11 percent. In keeping with the Committee's usual procedures under the Humphrey-Hawkins Act, these ranges would be reviewed at the July meeting when provisional ranges would also be established for 1987.

The Committee's policy discussion focused to a considerable extent on the members' evaluation of the recent behavior of the monetary aggregates, particularly M1. With varying degrees of emphasis, members questioned the reliability of M1 developments as a guide for the conduct of monetary policy under prevailing circumstances. It was noted in this connection that the rapid growth in M1 and the associated weakness in its velocity appeared to reflect to a considerable but nonetheless uncer-

tain extent the earlier declines that had occurred in market interest rates in the context of subsiding inflationary expectations and softness in final demands. From this viewpoint, the relatively rapid growth in the demand for money balances needed to be accommodated in order to assure a satisfactory performance of the economy. On the other hand, rapid monetary growth also might imply an excessive buildup in liquidity, with inflationary implications for the future. In that context, several members emphasized the need to gauge the performance of M1 in light of whether behavior of other, broader, monetary aggregates provided confirming evidence of a rapid growth in liquid assets.

Members noted that expansion of the broader aggregates, despite the more rapid growth in recent weeks, was well within the Committee's ranges for 1986, and indeed near the lower end of the range in the case of M2. The more moderate growth of the broader aggregates this year, along with relatively moderate growth of L, an even more encompassing measure of the public's liquid asset holdings, raised questions as to whether the growth of M1 really represented a potentially excessive buildup in liquidity or was more of a shift in the composition of liquid holdings in response to relative movements in interest rates. However, continuing growth in M2 and M3 at the relatively rapid rates experienced recently could be a matter of increasing concern. One member expressed a somewhat differing assessment of the behavior of the broader aggregates this year in that the contingent liabilities of banks, most of which back instruments that are not included in M2 and M3, also seemed to have grown rapidly. More-

over, growth of M2 and M3 appeared to have been held back by investor portfolio shifts into bonds and equities, including mutual funds, and the unwinding of such shifts could result in faster growth later. In this view, therefore, less comfort could be taken from the relatively restrained growth of the broader aggregates for the year to date.

According to an analysis prepared for this meeting, the maintenance of the current degree of pressure on reserve positions could be expected to be associated with slower monetary growth over the balance of the quarter. Even so, because of the substantial expansion in April and early May, growth for the quarter as a whole would be considerably faster than was expected at the time of the previous meeting, notably in the case of M1. According to this analysis, the unusual surge in demand deposits was likely to subside over the course of coming weeks, while some moderation could also be expected in the growth of NOW accounts as both depositors and depository institutions completed their adjustments to the lower market interest rates that had emerged. Members indicated broad agreement with this analysis, but they questioned the timing and extent of the slower growth. In light of the uncertainties that were involved, some proposed omitting numerical references in the directive to the Committee's expectations for monetary growth in the second quarter. However, despite the greater than usual uncertainties, a majority of the members preferred to retain the customary procedure of specifying numerical growth expectations in the directive.

In the Committee's discussion of policy implementation for the period immediately ahead, most of the

members indicated that they were in favor of continuing to direct open market operations at least initially toward maintaining the existing degree of reserve availability. In support of this view, members commented that the rapid growth of the monetary aggregates and the favorable conditions for a pickup in business activity had to be weighed against the currently sluggish growth in overall business activity and the consequent uncertainties surrounding the economic outlook. One member felt, however, that the rapid growth in M1 and the potential for increased inflationary pressures later in the year and in 1987 argued for some firming.

With regard to possible adjustments during the intermeeting period, a majority of the members felt that policy implementation should be alert to the potential need for some firming of reserve conditions, especially if business indicators gave a clear signal of a pickup in the rate of economic expansion and monetary growth did not slow in line with expectations. Generally, these members did not want to rule out the possibility of some easing in the weeks immediately ahead, but they foresaw the potential desirability of such a course only in the context of appreciably more sluggish economic performance than was now expected. In this connection, one member emphasized that continuing declines in the velocity of money in combination with a sluggish economic performance might warrant some easing of reserve conditions. Other members believed that there should be no presumptions about the likely direction of any intermeeting adjustments, given the prevailing uncertainties about the performance of the economy, possible developments in

domestic and international financial markets, and the behavior of the monetary aggregates. Some members also expressed the view that the Committee should be tolerant of a shortfall of M1 growth below current expectations in light of the rapid expansion of M1 recently and for the year-to-date. It was noted that account needed to be taken of the behavior of the dollar on foreign exchange markets in any intermeeting adjustments.

At the conclusion of the Committee's discussion, all but one member indicated their acceptance of a directive that called for no change in the existing degree of pressure on reserve positions. The members expected such an action to be associated with a deceleration in monetary growth over the balance of the second quarter. Because such growth had been rapid thus far in the quarter, the members anticipated faster growth of the monetary aggregates, especially M1, than was expected at the time of the April 1 meeting. The members recognized that the behavior of M1 remained subject to unusual uncertainty, but they agreed that its growth might be in the area of 12 to 14 percent for the period from March to June, assuming some decline over the balance of the quarter. For the same period, M2 and M3 were now expected to expand at annual rates of around 8 to 10 percent. The members agreed that if the anticipated slowing in monetary growth did not occur, somewhat greater reserve pressure would be acceptable in the context of a pickup in the expansion of economic activity, with account being taken of conditions in domestic and international financial markets and the behavior of the dollar on foreign exchange markets. On the other hand,

somewhat lesser reserve restraint might be acceptable in the event of pronounced sluggishness in the performance of the economy in association with a marked slowing in monetary growth.

The Committee agreed that the current intermeeting range for the federal funds rate should be reduced by 1 percentage point to 5 to 9 percent. The reduction was intended as a purely technical adjustment in the context of an unchanged degree of reserve availability and its purpose was to provide a more symmetrical range around the lower federal funds rate that had prevailed for some time. The members regard the federal funds range as a mechanism for initiating Committee consultation when its boundaries are persistently exceeded.

At the conclusion of the meeting the following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates a mixed pattern of developments but suggests on balance that economic activity is expanding at a relatively modest pace in the current quarter. Total nonfarm payroll employment increased moderately further in April following a considerable rise in the first quarter, but employment in manufacturing fell for the third consecutive month. The civilian unemployment rate edged down to 7.1 percent. Industrial production and total retail sales turned up in April following earlier declines, while housing starts rose somewhat further from a relatively high level. Weakness in the energy sector has contributed to a slowing of business capital spending. The merchandise trade deficit appears to have decreased somewhat in the first quarter, as the volume and average price of oil imports fell. Largely reflecting declines in energy prices, consumer prices have declined somewhat since late 1985 and producer prices have fallen substantially.

In April M1 continued to grow at a rapid pace, leaving this aggregate above the up-

per end of its range for the year. Growth of the broader aggregates, especially of M2, strengthened considerably in April, bringing M2 into the lower part of its long-run range and M3 slightly above the midpoint of its range for 1986. Most short-term interest rates have declined on balance since the April 1 meeting of the Committee, while long-term rates are somewhat higher. On April 18, the Federal Reserve Board approved a reduction in the discount rate from 7 to 6½ percent. The trade-weighted value of the dollar against major foreign currencies has risen somewhat recently but on balance the dollar has declined further since the April meeting, particularly against the Japanese yen.

The Federal Open Market Committee seeks monetary and financial conditions that will foster reasonable price stability over time, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at its February meeting to establish the following ranges for monetary growth, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate was subject to substantial uncertainties in relationship to economic activity and prices, depending among other things on its responsiveness to changes in interest rates. It agreed that an appropriate target range under existing circumstances would be 3 to 8 percent, but it intends to evaluate movements in M1 in the light of its consistency with the other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures. It adopted a range of 6 to 9 percent for M2 and 6 to 9 percent for M3. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent for the year 1986.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with a deceleration in money growth over the balance of the quarter. However, in view of the rapid money growth thus far in the quarter and the apparent weakness in velocity, the Committee anticipates faster growth for the monetary aggregates, particularly

M1, than expected at the last meeting. M2 and M3 are expected to expand over the period from March to June at annual rates of about 8 to 10 percent. While the behavior of M1 continues to be subject to unusual uncertainty, growth at an annual rate of about 12 to 14 percent over the period is now anticipated. If the anticipated slowing in monetary growth does not develop, somewhat greater reserve restraint would be acceptable in the context of a pickup in growth of the economy, taking account of conditions in domestic and international financial markets and the behavior of the dollar in foreign exchange markets. Somewhat lesser reserve restraint might be acceptable in the context of a marked slowing in money growth and pronounced sluggishness in economic performance. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 5 to 9 percent.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Mrs. Horn, Messrs. Johnson, Melzer, Morris, Rice, and Ms. Seger. Vote against this action: Mr. Wallich. Absent and not voting: None.

Mr. Wallich dissented because he preferred to direct open market operations toward somewhat greater restraint. He was concerned about the implications of rapid monetary expansion for inflation and wanted to take action promptly to help assure slower monetary growth.

2. Authorization for Domestic Open Market Operations

On June 18, 1986, the Committee approved a temporary increase of \$3 billion, to \$9 billion, in the limit between Committee meetings on changes in System Account holdings of U.S. government and federal agency securities specified in paragraph 1(a) of the authorization for

domestic open market operations. The increase was effective immediately for the intermeeting period ending with the close of business on July 9, 1986.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Mrs. Horn, Messrs. Johnson, Morris, Rice, and Boykin. Votes against this action: None. Absent and not voting: Mr. Melzer, Ms. Seger and Mr. Wallich. (Mr. Boykin voted as alternate for Mr. Melzer.)

This action was taken on the recommendation of the Manager for Domestic Operations. The Manager had advised that through June 17, outright purchases of securities thus far in the intermeeting interval had reduced the leeway under the usual \$6 billion limit to about \$2¼ billion. It was anticipated that substantial additional purchases of securities in excess of that leeway would be necessary over the remainder of the intermeeting period. Currency in circulation was expanding rapidly, as expected, while required reserves were growing considerably faster than had been anticipated earlier.

Meeting Held on July 8–9, 1986

Domestic Policy Directive

The information reviewed at this meeting indicates that economic activity has expanded at a relatively slow pace recently. Consumer spending and housing activity have been strong, reflecting large gains in real income and lower interest rates. However, business investment has remained sluggish, and the trade balance has continued to deteriorate. At the same time, wage and price increases have been moderate.

Total nonfarm payroll employment grew slowly again in June,

rising about 80,000 after adjusting for strike activity. Employment continued falling in manufacturing, particularly in the metals and machinery industries, and more jobs were lost in oil and gas extraction. Hiring in construction, which had surged in April, levelled off in May and fell in June. Service industries continued to post large gains in employment in June; however, hiring at retail establishments was markedly slower than earlier in the year. The civilian unemployment rate declined to 7.1 percent from 7.3 percent in May.

The index of industrial production fell 0.6 percent in May and has declined 1¾ percent since December, erasing the gains that occurred at the end of 1985. The decrease in output in May was related in part to a further contraction in oil and gas drilling and to a decline in auto assemblies. Output elsewhere generally was lower with notable weakness in the production of business equipment and selected materials for durable goods. Available indicators of industrial activity in June are mixed; auto assemblies are expected to have increased, but the output of steel decreased and strike activity hampered production in the lumber, aluminum, and communication equipment industries. Capacity utilization in manufacturing was 78.6 percent in May, off 0.6 percentage point from April and more than 2 percentage points from January.

Total retail sales were about unchanged in May; however, sales at the retail control group of stores, which excludes outlets for autos, gasoline, and building materials, rose somewhat and were stronger in the previous two months than originally reported. Total car sales in May were at an annual rate of 11¼ million units, up from the 10¾ million unit

pace registered in the first quarter. Sales of domestic automobiles have held at around a rate of $8\frac{1}{4}$ million units since the expansion of incentive financing programs in late April, up from the $7\frac{3}{4}$ million unit pace earlier in the year.

Housing activity generally has been brisk. Starts fell a little in May but still were at a 1.9 million unit annual rate. Single-family starts held steady at a level that was fractionally above the first-quarter average, while the pace of house sales, although down in May, has remained relatively robust. At the same time, home prices have risen sharply. Multifamily starts fell sharply in May, owing in part to the depletion of tax-exempt funds raised by huge issues of mortgage revenue bonds in late 1985 and to overbuilding in a number of major markets.

Business investment probably declined again in the second quarter, reflecting weakness in the energy sector, the availability of unutilized capacity, and concerns about tax reform. Shipments of nondefense capital goods have been sluggish in recent months. In the construction area, drilling activity has fallen sharply further, and spending for office and other commercial projects also has weakened. Moreover, advance indicators of investment spending have been weak. New commitments for nonresidential building have fallen since late last year, and new orders for nondefense capital goods were flat in May after two months of declines. In addition, according to the latest surveys, businesses are planning little, if any, increase in nominal spending for 1986 as a whole.

The producer and consumer price indexes turned up in May, as the steep decline in energy prices ended.

Producer prices rose 0.6 percent,

after declining in the previous four months. Consumer prices were up 0.2 percent; retail gasoline prices rose $2\frac{1}{2}$ percent, after falling around 25 percent from January to April. Excluding food and energy, the CPI has risen at an annual rate of about $3\frac{1}{2}$ percent so far this year, somewhat less than in 1985. Prices of goods have been essentially flat, while some types of services have registered large increases.

The trade-weighted value of the dollar against major foreign currencies has declined almost $2\frac{1}{2}$ percent on balance since the FOMC meeting on May 20; the largest decline was registered against the yen. In the first two weeks of the intermeeting period, the dollar appreciated somewhat in response to data indicating a possible strengthening of U.S. economic activity. This rise was subsequently reversed when additional information on the economic performance in the United States disappointed market expectations. The differential between U.S. interest rates and a weighted average of foreign short-term interest rates changed little on balance over the period. Preliminary data for the U.S. merchandise trade deficit showed a somewhat larger deficit in April than the average for the first quarter, because a decline in the value of oil imports was more than offset by an increase in imports of other goods; exports in April-May combined seem to have been no higher than the first-quarter rate.

At its meeting on May 20, 1986, the Committee had adopted a directive that called for maintaining the existing degree of pressure on reserve positions. The members expected such an approach to policy to be consistent with a deceleration in money growth over the balance of

the quarter. However, because such growth had been rapid in April and early May, the Committee anticipated faster growth for the quarter as a whole, particularly for M1, than was expected at the time of the April meeting. M2 and M3 were expected to expand over the period from March to June at annual rates of 8 to 10 percent. Over the same period, M1 was anticipated to grow at an annual rate of 12 to 14 percent, although the members acknowledged that the behavior of M1 continues to be subject to unusual uncertainty. The Committee agreed that if money growth did not slow as anticipated, somewhat greater reserve restraint would be acceptable in the context of a pickup in the economic expansion, while also taking account of conditions in domestic and international financial markets and the behavior of the dollar on foreign exchange markets. On the other hand, they agreed that somewhat lesser restraint might be acceptable if the expansion weakened noticeably in conjunction with a marked slowing in monetary growth. The intermeeting range for the federal funds rate was reduced to 5 to 9 percent.

In the circumstances, M1 continued to expand rapidly over the past two months, with growth surging to an annual rate of around 23 percent in May before decelerating to a rate of about 15 percent in June. Consequently, growth in M1 from March to June, at an annual rate of almost 18 percent, substantially exceeded the Committee's short-run expectations and so far this year has been well above the Committee's 3 to 8 percent range for 1986. Growth in M2 slowed in both May and June but was still somewhat above earlier expectations for the quarter and brought this aggregate up to around

the midpoint of its range for the year. M3 continued to increase at rates around the middle of its long-run range in May and June.

However, in the light of the clear indications that business activity, rather than picking up momentum, was growing at a slower pace, open market operations during the intermeeting period continued to be directed at maintaining the prevailing degree of pressure on reserve positions. In the three complete maintenance periods since the May meeting, adjustment plus seasonal borrowing at the discount window averaged \$285 million. Excess reserves averaged around \$830 million in the first two maintenance periods after the meeting, but then rose to \$1.3 billion in the most recent period, which included the quarter-end statement date.

Federal funds generally traded in a narrow range around $6\frac{7}{8}$ percent over the intermeeting period, aside from some firming around the quarter end. Other interest rates rose early in the period but then retreated amid signs of weakness in the economies of the United States and some of its major trading partners, renewing expectations of a discount rate cut in the near future. Since the May meeting short-term market rates had declined 10 to 40 basis points on balance. In long-term markets, yields on Treasury securities were down about 35 to 45 basis points, while rates on corporate and municipal bonds were about unchanged and those on fixed-rate mortgages were up around $\frac{1}{2}$ of a percentage point. The widening spread between rates on long-term private securities and Treasury issues appeared to reflect strong foreign demand for recently issued long-term Treasuries, large supplies of private securities, and

increased focus on the value of the greater call protection for Treasury issues.

The staff projections presented at this meeting continued to suggest that growth in real GNP, though relatively slow in the second quarter, was likely to strengthen somewhat in the second half of the year. However, growth over the next two quarters probably would be at a slower pace than had been expected earlier in part because news on business investment and foreign trade was disappointing. Growth was projected to continue at a moderate pace in 1987. The civilian unemployment rate was forecast to decline somewhat over the projection horizon. Inflation was expected to pick up a bit over the next six quarters, as the favorable effects of declining energy prices diminished while upward pressure on prices from the effects of the dollar's depreciation tended to intensify.

In their discussion of the economic situation and outlook, Committee members generally agreed that some strengthening in the economic expansion was a reasonable expectation for the second half of the year and that, on the whole, the prospects were favorable for continuing growth at a moderate pace in 1987. At the same time, members emphasized the uncertainties that surrounded the economic outlook and a number commented that the improvement in economic activity might well be more delayed or less pronounced than they had anticipated earlier. In this connection, some members expressed concern about the lack of firm evidence to date of a prospective pickup in the rate of economic growth and, in particular, the absence thus far of any apparent improvement in the balance of trade, which many mem-

bers saw as the key to stronger economic expansion. The members continued to view the outlook for inflation as relatively favorable, although they anticipated that, in the context of a growing economy, the lagged impact of the dollar's depreciation was likely to boost prices somewhat.

In keeping with the usual practice at meetings when the Committee considers its long-run objectives for monetary growth, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members prepared specific projections of economic growth, the rate of unemployment, and changes in the overall price level. With regard to the rate of expansion in real GNP, the projections had a central tendency of $2\frac{1}{2}$ to 3 percent for 1986 as a whole and 3 to $3\frac{1}{2}$ percent for 1987. Forecasts of growth in nominal GNP centered on ranges of $4\frac{3}{4}$ to $5\frac{3}{4}$ percent for 1986 and 6 to $7\frac{1}{2}$ percent for 1987. The central tendency for the rate of unemployment was an average of 7 percent in the fourth quarter of 1986 and around $6\frac{3}{4}$ percent in the fourth quarter of 1987. With respect to the rate of inflation, as indexed by the GNP deflator, the projections centered on rates of $2\frac{1}{4}$ to $2\frac{3}{4}$ percent for 1986 and 3 to 4 percent for 1987. In making these forecasts, the members took account of the Committee's objectives for monetary growth that were established at this meeting. The projections were based on the assumption that fluctuations over the projection period in the foreign exchange value of the dollar would not be of sufficient magnitude to have a significant effect on economic activity or prices during the period. The members also assumed that the Con-

gress would seek to achieve the deficit reductions contemplated by the Gramm–Rudman–Hollings legislation. In the members' views, significant progress in reducing the federal deficit was essential in order to maintain financial conditions that were conducive to sustained economic expansion and an improved pattern of international transactions.

In their assessment of the factors pointing to somewhat faster economic growth over the balance of the year and in 1987, members referred as they had at earlier meetings to a number of favorable underlying developments including reduced interest rates, higher stock market prices, lower energy costs, and the positive impact of the dollar's depreciation on the competitive position of U.S. businesses. Members also made reference to the stimulative impact of a broadly accommodative monetary policy, as evidenced by rapid growth in money and credit and several decreases in the discount rate. One member suggested that stimulative financial conditions probably helped to account for the relative longevity of the current business expansion in the face of a variety of unfavorable factors. The latter included the negative impact that the decline in oil prices and the uncertainties associated with pending tax reform legislation were currently exerting on investment activity; some members commented that both of these factors were likely to have a less inhibiting impact on the economy over the course of the next several quarters. On the other hand, the overbuilding of various commercial facilities, notably of office structures, in several parts of the country and severe problems in agriculture were deemed likely to have retarding

influences on economic activity that could persist.

Such developments were reflected in sharp contrasts in the economic performance of different sectors and regions of the country and in strains on financial institutions that serviced the depressed industries. Moreover, members expressed concern about the continuing rapid growth in total debt and its negative implications for sustained business expansion.

The members gave particular emphasis during the discussion to the key role of foreign trade developments, which were seen as a major source of uncertainty in shaping the economic outlook. The substantial depreciation of the dollar against the currencies of several large industrial countries had strengthened the international competitiveness of U.S. businesses, notably in the industrial sector, and pointed to eventual improvement in the U.S. trade balance. Unfortunately, evidence of such improvement had proved elusive to date and several members commented that significant progress in reducing the nation's trade deficit was unlikely in the absence of faster economic growth in key industrial nations abroad. Indications of such growth were mixed, with several countries having experienced relative weakness earlier in the year. The absence of more robust growth abroad—and an improvement in the U.S. trade balance—would constitute a major risk to the realization of stronger domestic economic expansion.

At this meeting the Committee reviewed its ranges for growth of the monetary and debt aggregates in 1986 and established tentative ranges for 1987 within the framework of the Full Employment and Balanced

Growth Act of 1978 (the Humphrey–Hawkins Act).¹ At its meeting on February 11–12, 1986, the Committee had adopted monetary growth ranges of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3 for the period from the fourth quarter of 1985 to the fourth quarter of 1986. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent. With respect to M1 the Committee had recognized that, based on the experience of recent years, the behavior of that aggregate was subject to substantial uncertainties in relation to economic activity and prices. The Committee had indicated its intention to evaluate M1 behavior in the light of its consistency with the other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures.

In the Committee's discussion of its long-run ranges at this meeting, all of the members supported a proposal to retain the range of 6 to 9 percent for growth in M2 and in M3 for the year 1986. Both aggregates had expanded at rates that left them close to the midpoint of their ranges at midyear. Growth within these ranges for the year as a whole was still deemed to be consistent with the Committee's overall policy objectives. A majority of the members preferred a slightly lower range for 1987. In their view, a modest reduction would be consistent with the Committee's long-term objective of achieving a rate of monetary growth compatible with price stability. They also believed that the lower range was likely to prove fully con-

sistent with somewhat faster economic growth in 1987 and, in that context, with some decline in velocity should that develop. Some members suggested maintaining the 6 to 9 percent range for 1987 because it would provide a little extra leeway that might prove useful in support of continuing growth in nominal GNP, given the possibility of some further decline in the velocity of the broader aggregates. However, the slightly lower range favored by the majority was considered acceptable by most members.

In the discussion of appropriate ranges for M1 growth in 1986 and 1987, the members gave considerable emphasis to the exceptional uncertainties that continued to affect M1 velocity. Over the course of recent years, the relationship of M1 to income appeared to have been significantly altered by changes in the composition of the aggregate, resulting in part from the deregulation of interest rate ceilings and the relatively rapid growth of its interest-bearing components. In the process, the demand for M1 balances has become much more sensitive to movements in interest rates. Given the evolving nature of that demand, it had become very difficult to assess or predict the implications of M1 growth for the future course of economic activity and the rate of inflation. As a consequence, a number of members questioned the usefulness of M1 as a guide for the conduct of monetary policy under present circumstances. A few proposed dropping the M1 range, at least pending the reestablishment of a more predictable relationship with overall measures of economic performance. A majority, however, preferred to retain an M1 range even though they believed its operational significance

1. The midyear Monetary Policy Report prepared pursuant to this legislation was transmitted to the Congress on July 18, 1986.

could only be judged in the perspective of concurrent economic and financial developments, including the behavior of M2 and M3. It was noted in this discussion that even under current circumstances M1 continued to have some information value for policy and that retention of some range for M1, even if used only as a benchmark for measuring deviations, might well assist judgments about monetary policy. Moreover, the importance of M1 could again become greater in the future.

After reviewing the available evidence, the members concluded that much of the rapid growth of M1 in recent months probably reflected shifts in holdings of liquid assets in response to declining interest rates and subsiding inflationary expectations rather than excessive money creation with potentially inflationary consequences. Tending to reinforce that judgment was the moderate growth in overall economic activity, the behavior of broad measures of inflation, and the expansion of M2 and M3 at rates well within their ranges for the year. As events unfolded, relatively rapid growth in M1 had been needed to accommodate continuing economic expansion. Given developments for the year to date, growth in excess of the 3 to 8 percent range established in February appeared likely for 1986 as a whole, but most of the members did not want to raise or to rebase the existing range; such an adjustment might imply greater certainty about future performance than in fact existed. Since they believed that the significance of changes in M1 could only be evaluated in the context of the behavior of the broader aggregates and against the background of economic and financial developments, including trends in interest rates, they

agreed that after taking account of those factors M1 growth above the existing range would be acceptable for the year.

With regard to 1987, some members argued that the uncertainties precluded setting a meaningful range for M1 so far in advance, but a majority preferred to retain this year's range of 3 to 8 percent. The members noted that this range should be considered even more tentative than usual. Such a range assumed that the velocity of M1 would not change as much as in the recent period under conditions of greater economic, price, and interest rate stability. In any event the members agreed that developments over the balance of this year would provide a better basis for judging the prospects for M1 behavior in 1987 and that careful appraisal of the range—including the weight that M1 should receive as a guide to policy—would be required at the start of next year.

Turning to the Committee's monitoring range for total domestic non-financial debt, most of the members indicated that they were in favor of retaining the 8 to 11 percent range adopted in February for 1986 even though growth in excess of that range now appeared likely for the year. Members expressed concern about the persistence of rapid growth of total debt in the context of already large debt burdens. As in the past, they felt that raising the Committee's range for debt would create an inappropriate benchmark for evaluating long-term trends in debt expansion. One member proposed dropping the range for total debt and substituting a measure for total liquid assets, which, at least in the past year or two, had had a closer relationship to developments in nominal GNP. Other members preferred to

continue to monitor debt trends explicitly in light of their concerns about the implications of overall debt levels. For 1987, the members generally felt that a range of 8 to 11 percent for total debt growth would remain appropriate, though that range would need to be reviewed early next year.

At the conclusion of the Committee's review, all of the members indicated that they favored, or could accept, a proposal to reaffirm the ranges for monetary and debt growth that had been established in February for the year 1986. The behavior of all of the monetary aggregates would continue to be judged against the background of developments in the economy and financial markets and potential price pressures. Growth of M1 in excess of its range would be acceptable and would be evaluated in the light of the behavior of the broader aggregates. The Committee recognized that expansion in total debt also might exceed its range for the year.

The following paragraph relating to the long-run ranges for 1986 was approved for the domestic policy directive:

The Committee agreed at this meeting to reaffirm the ranges established in February for growth of 6 to 9 percent for both M2 and M3, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate is subject to substantial uncertainties in relation to economic activity and prices, depending among other things on the responsiveness of M1 growth to changes in interest rates. In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable. Acceptable growth of M1

over the remainder of the year will depend on the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and price pressures. Given its rapid growth in the early part of the year, the Committee recognized that the increase in total domestic nonfinancial debt in 1986 may exceed its monitoring range of 8 to 11 percent, but felt an increase in that range would provide an inappropriate benchmark for evaluating longer-term trends in that aggregate.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Mrs. Horn, Messrs. Johnson, Melzer, Morris, Rice, Ms. Seger, and Mr. Wallich. Votes against this action: None. Absent and not voting: None.

With respect to the tentative ranges for 1987, most of the Committee members supported a reduction of $\frac{1}{2}$ percentage point in the ranges for M2 and M3. For M1 and total debt the members agreed that with the reservations noted above, the 1986 ranges should be retained for 1987; those ranges implied considerable reductions from the rates of growth that now seemed likely for 1986. It was understood that all the ranges were provisional and that, notably in the case of M1, they would be reviewed in early 1987 in the light of intervening developments.

The following paragraph relating to the ranges for 1987 was approved for inclusion in the domestic policy directive:

For 1987 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of $5\frac{1}{2}$ to $8\frac{1}{2}$ percent for M2 and M3. While a range of 3 to 8 percent for M1 in 1987 would appear appropriate in the light of most historical experience, the Committee recognized that the exceptional uncertainties surrounding the behavior of M1 velocity over the more recent period would require careful appraisal of the target range at the beginning of 1987. The associated

range for growth in total domestic non-financial debt was provisionally set at 8 to 11 percent for 1987.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Mrs. Horn, Messrs. Johnson, Melzer, Morris, Rice, and Wallich. Vote against this action: Ms. Seger. Absent and not voting: None.

Ms. Seger dissented because she preferred to retain—at least for now—this year's range of 6 to 9 percent for growth in both M2 and M3 in 1987. In her view, the higher range might be needed to accommodate an acceptable rate of economic expansion, especially in light of the possibility that the velocity of these aggregates might remain weak next year. At the same time she did not want to rule out the possibility that interim developments might justify reductions in the M2 and M3 ranges when the latter were reconsidered early next year. She also preferred not to specify a tentative range for M1 at this time because of the substantial uncertainties currently surrounding the relationship between M1 growth and broad measures of economic activity.

In their discussion of policy implementation for the weeks immediately ahead, Committee members took account of the likelihood that the discount rate would be reduced within a few days after the meeting. Against the background of sluggish expansion in economic activity and a subdued rate of inflation, most of the members believed that some easing was desirable and they indicated a preference for implementing the easing, at least initially, through a lower discount rate rather than through open market operations. Some members commented that further easing could have a favorable impact on interest-sensitive sectors of the econ-

omy, particularly in light of what could be viewed as still relatively high real interest rates. It was also suggested that a reduction in the discount rate might encourage over time similar actions by a number of major countries abroad, although such actions were not expected over the near term, at least in the case of some of the key industrial nations.

While nearly all the members indicated their acceptance of the policy approach in question, a few referred to the risks of easing under present circumstances, particularly the risk under current conditions of sharp further depreciation of the dollar in foreign exchange markets. Concern also was expressed about the absence of clearer indications of a reduction in federal budgetary deficits. In one view, a cut in the discount rate might need to be accompanied by some increase in the degree of pressure on reserve positions, pending evaluation of further economic and financial developments.

With respect to the outlook for monetary growth, the members expected that M2 and M3 might continue to expand at rates around their 1986 ranges over coming months, even assuming some pickup in the rate of business activity and some easing in overall conditions of reserve availability. In their evaluation of the outlook for growth in M1, the members took account of an analysis that indicated that appreciably slower growth might be expected over the months ahead even if interest rates were to fall somewhat further. However, the members recognized that the timing and extent of any slowing in M1 growth continued to be subject to unusual uncertainty. In the circumstances and taking account of their willingness to accept M1 growth

in excess of the 3 to 8 percent range, especially if growth of the broader aggregates remained within their ranges, a majority of the members expressed a preference for not indicating a specific rate of expected growth for M1 in the short-run operational paragraph of the Committee's directive.

In the Committee's discussion of possible intermeeting adjustments in policy implementation, the members generally agreed that there should be no presumptions about the likely direction of any such adjustments, given the current uncertainties about prospective economic and financial developments and the behavior of the monetary aggregates. A majority of the members also indicated a preference for reducing the existing intermeeting range for the federal funds rate by 1 percentage point to 4 to 8 percent. The reduction was viewed as a technical adjustment that would provide a more symmetrical range around a lower federal funds rate that could be expected to emerge following the anticipated reduction in the discount rate. The Committee regards the federal funds range as a mechanism for initiating Committee consultation when its boundaries are persistently exceeded.

At the conclusion of the Committee's discussion, all but one member indicated their acceptance of an operational paragraph for the directive that called for some decrease in the existing degree of reserve pressure, recognizing that that relaxation could be accomplished in the first instance by a reduction in the discount rate. The members expected such an approach to policy implementation to be consistent with growth in M2 and M3 at annual rates of about 7 to 9 percent over the three-month period from June to September. Over the

same period growth in M1 was expected to moderate from the exceptionally large increase during the second quarter. The specific rate of M1 growth remained subject to unusual uncertainty and the Committee agreed that this aggregate should continue to be judged in the light of the behavior of the broader aggregates and other factors. The Committee indicated that it might find somewhat greater or somewhat lesser reserve restraint acceptable over the intermeeting period depending on the growth of the monetary aggregates, the strength of the business expansion, the performance of the dollar on foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets.

At the conclusion of the meeting, the following domestic policy directive, embodying the Committee's long-run ranges and its short-run operating instructions, was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates a mixed pattern of developments but suggests on balance that economic activity expanded slowly in the second quarter. In June total nonfarm payroll employment grew little after accounting for striking workers, with continued weakness in the industrial sector reflected in further declines in employment in manufacturing and mining. The civilian unemployment rate moved down to 7.1 percent from 7.3 percent in May. Industrial production declined in May. Total retail sales were about unchanged during the month, although consumer spending rose considerably for the second quarter as a whole. Housing starts fell somewhat in May from a relatively high level. Weakness in the energy sector has contributed to a slowing of business capital spending. Preliminary data for the U.S. merchandise trade balance in April show a somewhat larger deficit than the rate recorded in the first quarter. Both con-

sumer and producer prices turned up in May but have fallen on balance since late 1985, largely reflecting declines in energy prices.

M1 growth in June, though less than in May, was still rapid; through June, M1 grew at a rate well above the Committee's range for 1986. Growth of M2 slowed somewhat and expansion of M3 remained relatively moderate in June, keeping these two aggregates close to the middle of their respective ranges for the year. Expansion in total domestic nonfinancial debt remains appreciably above the monitoring range for 1986. Most short-term interest rates have declined on balance since the May 20 meeting of the Committee. Rates on Treasury bonds also have moved lower while rates on private long-term obligations are about unchanged to somewhat higher. The trade-weighted value of the dollar against major foreign currencies has declined somewhat on balance since the May meeting.

The Federal Open Market Committee seeks monetary and financial conditions that will foster reasonable price stability over time, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at this meeting to reaffirm the ranges established in February for growth of 6 to 9 percent for both M2 and M3, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate is subject to substantial uncertainties in relation to economic activity and prices, depending among other things on the responsiveness of M1 growth to changes in interest rates. In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable. Acceptable growth of M1 over the remainder of the year will depend on the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and price pressures. Given its rapid growth in the early part of the year, the Committee recognized that the increase in total domestic nonfinancial debt in 1986 may exceed its monitoring range of 8 to 11 percent, but felt an increase in

that range would provide an inappropriate benchmark for evaluating longer-term trends in that aggregate.

For 1987 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of 5½ to 8½ percent for M2 and M3. While a range of 3 to 8 percent for M1 in 1987 would appear appropriate in the light of most historical experience, the Committee recognized that the exceptional uncertainties surrounding the behavior of M1 velocity over the more recent period would require careful appraisal of the target range at the beginning of 1987. The associated range for growth in total domestic nonfinancial debt was provisionally set at 8 to 11 percent for 1987.

In the implementation of policy for the immediate future, the Committee seeks to decrease somewhat the existing degree of pressure on reserve positions, taking account of the possibility of a change in the discount rate. This action is expected to be consistent with growth in M2 and M3 over the period from June to September at annual rates of about 7 to 9 percent. While growth in M1 is expected to moderate from the exceptionally large increase during the second quarter, that growth will continue to be judged in the light of the behavior of M2 and M3 and other factors. Somewhat greater or lesser reserve restraint might be acceptable depending on the behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 4 to 8 percent.

Votes for the short-run operational paragraph: Messrs. Volcker, Corrigan, Angell, Guffey, Mrs. Horn, Messrs. Johnson, Morris, Rice, Ms. Seger, and Mr. Wallich. Vote against this action: Mr. Melzer. Absent and not voting: None.

Mr. Melzer preferred to direct open market operations toward maintaining the existing degree of

pressure on reserve conditions. He was concerned that easing under current circumstances could foster inflationary expectations, especially in light of the uncertain outlook for reductions in the federal deficit, and have adverse repercussions on the dollar in foreign exchange markets. In addition, he noted that the outlook for the balance of 1986 and 1987 appeared to be in line with the economy's long-run potential and, in any event, he believed that further accommodation would have little positive impact on real output in the short run and would be accompanied by greater price pressures in the long run.

Meeting Held on August 19, 1986

Domestic Policy Directive

The information reviewed at this meeting indicated an uneven pattern of developments in different sectors of the economy but suggested on balance that economic activity was expanding at a moderate pace in the current quarter. Consumer spending and housing activity have been relatively robust, while business investment has remained sluggish and the trade balance does not appear to have improved. On average, prices and wages have risen more slowly this year than in 1985, although fluctuations in energy costs have resulted in some month-to-month volatility.

Total nonfarm payroll employment grew strongly in July, rising nearly $\frac{1}{4}$ million after adjustment for strikes, well above the average monthly gains during the first half of the year. Hiring was up in construction and remained robust in the trade and service sectors. However, man-

ufacturing employment registered another drop, bringing the cumulative decline since January to 175,000. The civilian unemployment rate declined 0.2 percentage point to 6.9 percent, toward the lower end of the range that has prevailed over the past year.

The index of industrial production edged down 0.1 percent in July after declining 0.3 percent in June. Since reaching its most recent peak in January, the index has dropped about 2 percent. Despite increased production in July in industries affected by the settlement of strikes, particularly the communication equipment industry, output has remained generally sluggish. Weakness has persisted in the output of business equipment and consumer goods, although the direct effects of declines in petroleum drilling are beginning to wane; automobile assemblies were down 400,000 in July, but the decline was largely offset by gains in the production of light trucks. Capacity utilization in manufacturing, mining, and utilities decreased 0.2 percentage point further in July to 78.2 percent; during the past six months the overall rate of capacity utilization has fallen 2.6 percentage points.

Total retail sales were about unchanged in June and July; however, excluding automobiles, gasoline, and nonconsumption items, retail sales increased 0.7 percent in July after an upward-revised increase of 0.4 percent in June. Sales remained particularly strong at furniture and appliance stores. Total car sales slipped to a 10.9 million unit annual rate in July, as a drop in sales of domestic models more than offset an increase in foreign car sales.

Residential construction activity has continued to expand, reflecting the rise in housing starts earlier in the

year. However, the level of starts has tapered off recently from the exceptional pace of the early spring, reflecting in part high vacancy rates and tax law changes that have damped multifamily construction. In June, total private starts were at an annual rate of $1\frac{3}{4}$ million units. Sales of single-family homes also weakened in May and June, but from a very high April peak.

Business fixed investment apparently remained sluggish with the weakness concentrated in nonresidential structures. The sharp curtailment of petroleum drilling contributed to a further decline in the nonresidential structures component, although commercial and industrial construction also fell. Moreover, new commitments for nonresidential construction have fallen sharply since late last year, suggesting that outlays may retreat further during the third quarter. In contrast to structures, outlays for equipment rose markedly in the second quarter, led by a rebound in office and computer equipment; however, this gain only partly reversed a sharp decline in the first quarter. New orders for nondefense capital goods fell for three consecutive months before posting a small gain in June. Inventory data for the second quarter, though incomplete, suggested a marked slowdown in the rate of accumulation, as auto dealers pared stocks slightly after two quarters of rapid accumulation.

Wage increases appear to have slowed further this year, and, except for a June rebound in consumer energy prices, recent price data have reflected continued restraint through midyear. The producer price index fell 0.4 percent in July, and the consumer price index excluding energy was up 0.2 percent in June. For

the second quarter as a whole, the CPI excluding energy rose at an annual rate of about 3 percent, down almost a full percentage point from the first quarter. In the commodity markets, the price of crude oil on spot markets fell through much of July, but then rose sharply following an accord by OPEC to restrain production. At the same time, livestock and poultry prices have moved higher while gold and platinum prices have soared, apparently largely reflecting expectations of reduced supplies.

Since the July FOMC meeting, the weighted-average foreign exchange value of the dollar declined a further $3\frac{1}{2}$ percent on balance; the dollar depreciated almost $5\frac{1}{2}$ percent against the mark and somewhat less against the yen. The reduction in the discount rate by the Federal Reserve announced on July 10 and the failure of other central banks to follow apparently contributed to the dollar's weakness. Short-term interest rates abroad were little changed during the intermeeting period while comparable U.S. rates declined about $\frac{1}{3}$ of 1 percentage point. The differentials between long-term interest rates in the United States and comparable rates in Germany and Japan were about unchanged on balance. The U.S. merchandise trade deficit in the second quarter appeared unchanged from the first quarter. The value of oil imports continued to fall, while that of non-oil imports rose further. About one-half of the increase in the value of non-oil imports apparently reflected rising import prices.

At its meeting on July 8-9, the Committee adopted a directive that called for decreasing somewhat the existing degree of pressure on reserve positions, taking account of the possibility of a change in the discount rate. The members expected such an

approach to policy to be consistent with growth in M2 and M3 over the period from June to September at annual rates of 7 to 9 percent. Over the same period growth in M1 was expected to moderate from the rapid pace in the second quarter. The Committee agreed that it would continue to evaluate M1 in light of the broader aggregates and other factors. The members also acknowledged that somewhat greater or lesser reserve restraint might be acceptable depending on the behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The intermeeting range for the federal funds rate was reduced 1 percentage point to 4 to 8 percent.

An easing in reserve conditions was implemented shortly after the July meeting through a $\frac{1}{2}$ point reduction in the discount rate to 6 percent. In the two complete reserve maintenance periods since the meeting, adjustment plus seasonal borrowing at the discount window averaged just under \$400 million, somewhat higher than in the previous intermeeting period. A portion of this borrowing, however, reflected adjustment credit to depository institutions facing special situations. Incoming data during the intermeeting period indicated that growth of all of the monetary aggregates accelerated in July. M2 and M3 were estimated to have expanded at annual rates of $12\frac{3}{4}$ and 13 percent respectively. The rapid growth in the broader aggregates pushed them into the upper portions of their ranges for 1986. At the same time growth in M1 in July was close to the extraordinary pace of the second quarter.

Federal funds generally traded in the $6\frac{1}{4}$ to $6\frac{3}{8}$ percent area after the $\frac{1}{2}$ percentage point cut in the discount rate announced on July 10, down from the $6\frac{7}{8}$ percent rate prevailing at the time of the July meeting. With the reduction in the discount rate widely anticipated, however, other interest rates generally did not post comparable declines. While rates on short-term securities have fallen 25 to 50 basis points over the intermeeting period, yields in the longer-term markets have been about unchanged to only slightly lower on balance. The recent behavior of longer-term interest rates has reflected in part uncertainty about the prospects for further rate declines in light of the absence of policy actions abroad to reduce interest rates as well as a cautious interpretation of incoming economic and price news, including the possibility of some increase in inflationary pressures over time.

The staff projections presented at this meeting suggested that growth in real GNP likely would pick up somewhat in coming months. Growth was forecast to continue at a moderate pace in 1987. A projected improvement in the U.S. trade position was anticipated to be a key element supporting growth in domestic production over the next year and a half. Over the same time period, growth in domestic demand was expected to be relatively sluggish. The rate of inflation was anticipated to edge up in coming quarters, partly reflecting upward pressure on prices from the effects of the dollar's depreciation as well as the diminishing impact of oil price declines, which had served to hold down price indexes thus far in 1986. The civilian unemployment rate was forecast to

drop somewhat over the projection horizon.

In the Committee's discussion of the economic situation and outlook, members focused considerable attention on the uncertain prospects for the nation's foreign trade deficit. They saw trade developments as a key element in the outlook for domestic business activity, and several commented that the business expansion might well remain relatively weak if the trade balance did not show significant improvement over the quarters ahead. The substantial depreciation of the dollar against major foreign currencies was still expected to foster a turnaround in net exports at some point, but the absence of progress to date could be read as auguring a muted as well as a further delayed response to the dollar's depreciation.

During the discussion, a number of members emphasized that improvement in the trade balance was being inhibited by relatively sluggish economic activity in several key industrial nations abroad. Other developments working in the same direction included the lack of dollar depreciation against the currencies of a number of developing countries that had important trading relationships with the United States, the severe debt problems of several less developed nations, and the competition in agricultural export markets stemming from large grain harvests in many parts of the world. On the more positive side, members referred to the apparently more favorable prospects for economic expansion in a major European country. Some members also commented that while improvement in the trade balance had been more delayed than many had expected, some historical expe-

rience in combination with current circumstances provided reasons for remaining optimistic that a substantial turnaround in trade would occur later, perhaps toward the end of this year or in early 1987.

The members differed to some extent in their assessment of domestic developments bearing on the economic outlook. While economic performance remained uneven in different sectors of the economy and parts of the country, overall consumer spending and the demand for housing were being well maintained in association with continuing gains in employment and incomes and reduced interest rates. One member observed that, given generally lean inventories outside the automobile industry, further gains in consumer spending were likely to stimulate increasing domestic production at some point. A number of members also referred to the relatively rapid growth in money balances as a factor that would tend to support business activity over the quarters ahead. On the negative side, rising consumer debt burdens were likely to restrain the expansion in consumer spending and business investment showed no evidence of an appreciable pickup.

The members recognized that a number of developments, in addition to the uncertainties surrounding the outlook for trade, were currently clouding economic prospects. These included the tax reform legislation whose overall impact was very difficult to predict, especially for the next several quarters, because of the very comprehensive and complex changes incorporated in the legislation. In the consumption area, for example, the loss of deductibility for sales taxes starting in 1987 and the phase-out of interest deductions on consumer debt

might tend to restrain spending on consumer durables over time, but some members noted that it might also stimulate such spending over the balance of the year. The impact of the new legislation on business investment was especially hard to assess. It was suggested that on balance the impact might tend to be negative for some time, but many businessmen apparently saw the removal of uncertainties about the legislation as a positive development for the nearer term. Members also commented that the outlook for the federal budget deficit and its consequent impact on the economy remained unclear.

With regard to the prospects for inflation, the members generally were not concerned about a resurgence in the nearer term, but several expressed uneasiness about the longer-run outlook. Members referred to the inflationary implications of relatively rapid monetary growth, especially if it continued, and to the further impact of the dollar's depreciation on prices of imports and competing domestic products. In the latter connection one member observed that, despite relatively large inventories, domestic producers of automobiles were raising their prices in response to increases in the prices of competing imports. One member also expressed concern that the new tax reform legislation, to the extent that it shifted tax burdens to businesses, could put upward pressures on prices, at least initially. The favorable direct effects of large declines in oil prices now appeared to be in the past, and one member observed that commodity prices more generally might be poised for an upturn. Some members saw indications that inflationary expectations were starting to intensify, even though actual prices and wages generally

were rising less rapidly this year than in 1985.

At its meeting in July the Committee had reviewed the basic policy objectives that it had established in February for growth of the monetary and credit aggregates in 1986 and had set tentative objectives for expansion in 1987. For the period from the fourth quarter of 1985 to the fourth quarter of 1986, the Committee had reaffirmed the ranges established in February for growth of 6 to 9 percent for both M2 and M3. The associated range for expansion in total domestic nonfinancial debt also was reaffirmed at 8 to 11 percent for 1986. With respect to M1, the Committee decided that growth in excess of the 3 to 8 percent range set in February would be acceptable and would be evaluated in the light of the behavior of M1 velocity, the expansion of the broader aggregates, developments in the economy and financial markets, and price pressures. For 1987 the Committee agreed on tentative monetary growth objectives that included a reduction of $\frac{1}{2}$ percentage point to a range of $5\frac{1}{2}$ to $8\frac{1}{2}$ percent for both M2 and M3. In the case of M1 the Committee expressed the preliminary view that retention of the 1986 range of 3 to 8 percent, which implied a considerable reduction from the actual rate of growth that now seemed likely for 1986, appeared appropriate for 1987 in the light of most historical experience. The Committee also retained the range of 8 to 11 percent for growth in total domestic nonfinancial debt in 1987. It was understood that all the ranges were provisional and that, notably in the case of M1, they would be reviewed in early 1987 in the light of intervening developments.

In the Committee's discussion of

policy implementation for the weeks immediately ahead, a number of members suggested that any further easing might be accomplished through a further $\frac{1}{2}$ percentage point reduction in the discount rate, while open market operations would be directed toward maintaining an essentially unchanged degree of reserve availability. Some members expressed reservations about such a reduction, especially in the absence of indications that it would be followed fairly promptly by policy easing actions in major industrial nations abroad. In this view a unilateral decrease in the discount rate might foster substantial additional depreciation in the dollar, with adverse repercussions on investor willingness to hold dollars. Several members, however, saw a lesser risk to the dollar or one that needed to be accepted. Some wanted to reduce the risks of rapid dollar depreciation by a small increase in the degree of reserve pressure in the event of a reduction in the discount rate. Several other members indicated that they did not agree. While some firming should not be ruled out in their view, it should be made contingent on an adverse move in the exchange rate and other potential developments such as evidence of greater inflationary danger and stronger business activity. One member also commented that any increase in the degree of reserve pressure had to be weighed against the risk of triggering a rise in long-term interest rates; such a rise, if it occurred, would weaken the prospects for a pickup in the rate of economic expansion.

In further discussion, Committee members expressed some concern about the continuation of rapid growth in the monetary aggregates and the implications of such growth for po-

tential inflation later. The members recognized that much of the rapid growth, especially in M1, probably reflected increasing demands for liquid assets in response to declining interest rates and subsiding inflation rather than excessive money creation with potentially inflationary consequences. They also felt that M1 growth should continue to be evaluated in the context of a relatively sluggish economy and in light of the expansion in the broader aggregates. While a sluggish economic performance would dampen inflationary risks, continuing growth in M2 and M3 at the relatively rapid rates experienced recently might be a matter of growing concern, especially if such expansion tended to coincide with indications of stronger business activity.

In their evaluation of the outlook for monetary growth, the members took into account an analysis which indicated that much slower expansion, especially in the broader aggregates, was likely to develop over the next few months if short-term interest rates stayed around their current levels. On the other hand, monetary growth might remain relatively rapid over the period ahead if short-term rates were to drop somewhat further. The members recognized that the timing and extent of any slowing in monetary growth remained subject to a great deal of uncertainty.

In the discussion of possible intermeeting adjustments in the degree of reserve pressure, the members agreed that a degree of flexibility would be useful, taking into consideration whether or not the discount rate was reduced and subsequent developments in domestic financial markets and especially in foreign exchange markets. If the discount rate were not reduced, a slight easing in pressure on reserve positions might

be appropriate. Alternatively, if the discount rate were reduced and the reduction was followed by a substantial weakening of the dollar in foreign exchange markets, a little greater caution in the provision of reserves through open market operations would be appropriate. In keeping with the Committee's usual practice, consideration also would need to be given to ongoing economic and financial developments and the growth of the monetary aggregates. Such developments might warrant an adjustment in either direction.

At the conclusion of the Committee's discussion, all but two members indicated that they favored or could accept a directive that called for some slight easing in the degree of reserve pressure, taking account of the possibility that such easing might be accomplished through a reduction in the discount rate. The members expected this approach to policy implementation to be consistent with growth in M2 and M3 at annual rates of about 7 to 9 percent over the June-to-September period. Over the same interval, growth in M1 was expected to moderate from the exceptionally large increase during the second quarter. With the prospective behavior of M1 remaining subject to unusual uncertainty, the Committee again decided not to specify a rate of expected growth in the operational paragraph of the directive but to continue to evaluate this aggregate in the light of the performance of the broader aggregates and other factors. The Committee indicated that it might find somewhat greater or somewhat lesser reserve restraint acceptable over the intermeeting period depending on the decision with respect to the discount rate and on such other factors as the behavior of the monetary aggregates, the strength

of the business expansion, the performance of the dollar in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The members agreed that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 4 to 8 percent.

At the conclusion of the meeting, the following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates a mixed pattern of developments but suggests on balance that economic activity is expanding moderately in the current quarter. In July total nonfarm payroll employment grew strongly, boosted in part by the return of striking workers. However, continued weakness in the industrial sector was reflected in further declines in employment in manufacturing and mining. The civilian unemployment rate moved down to 6.9 percent from 7.1 percent in June. Industrial production declined slightly further in July. The nominal value of total retail sales was about unchanged during the month, as sales of new autos declined somewhat but spending on other consumer goods remained strong. Housing starts fell somewhat in May and June from a relatively high level earlier in the year. Business capital spending appears to have remained weak, partly reflecting continuing declines in the energy sector. While fluctuations in energy prices have caused some month-to-month volatility, on average prices and wages are rising more slowly this year than in 1985.

The trade-weighted value of the dollar against major foreign currencies has continued to decline since the July 8-9 meeting of the Committee. The U.S. merchandise trade deficit in the second quarter appears to have been about unchanged from the first quarter. The value of total exports and of total imports remained about the same in the two quarters, although the value of oil imports continued to fall in the second quarter while that of non-oil imports rose further.

Growth of M2 and especially of M3

picked up in July, lifting expansion of these two aggregates for the year through July well into the upper portion of their respective ranges established by the Committee for 1986. In July M1 continued to grow at a rate close to the very rapid pace of the second quarter. Expansion in total domestic nonfinancial debt remains appreciably above the Committee's monitoring range for 1986. Short-term interest rates have declined somewhat since the July meeting of the Committee, while most long-term interest rates are about unchanged to slightly lower on balance. On July 10, the Federal Reserve Board approved a reduction in the discount rate from 6½ to 6 percent.

The Federal Open Market Committee seeks monetary and financial conditions that will foster reasonable price stability over time, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at the July meeting to reaffirm the ranges established in February for growth of 6 to 9 percent for both M2 and M3, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate is subject to substantial uncertainties in relation to economic activity and prices, depending among other things on the responsiveness of M1 growth to changes in interest rates. In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable. Acceptable growth of M1 over the remainder of the year will depend on the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and price pressures. Given its rapid growth in the early part of the year, the Committee recognized that the increase in total domestic nonfinancial debt in 1986 may exceed its monitoring range of 8 to 11 percent, but felt an increase in that range would provide an inappropriate benchmark for evaluating longer-term trends in that aggregate.

For 1987 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of 5½ to 8½

percent for M2 and M3. While a range of 3 to 8 percent for M1 in 1987 would appear appropriate in the light of most historical experience, the Committee recognized that the exceptional uncertainties surrounding the behavior of M1 velocity over the more recent period would require careful appraisal of the target range at the beginning of 1987. The associated range for growth in total domestic nonfinancial debt was provisionally set at 8 to 11 percent for 1987.

In the implementation of policy for the immediate future, the Committee seeks to decrease slightly the existing degree of pressure on reserve positions, taking account of the possibility of a change in the discount rate. This action is expected to be consistent with growth in M2 and M3 over the period from June to September at annual rates of about 7 to 9 percent. While growth in M1 is expected to moderate from the exceptionally large increase during the second quarter, that growth will continue to be judged in the light of the behavior of M2 and M3 and other factors. Somewhat greater or lesser reserve restraint might be acceptable depending on the behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 4 to 8 percent.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Heller, Mrs. Horn, Messrs. Johnson, Morris, Rice, and Ms. Seger. Votes against this action: Messrs. Melzer and Wallich. Absent and not voting: None.

Messrs. Melzer and Wallich were in favor of maintaining the existing degree of reserve pressure. Mr. Melzer continued to be concerned about the impact of further easing on inflationary expectations and the value of the dollar in foreign exchange markets. In addition, he noted that during the intermeeting period the

outlook for real economic activity in the second half of 1986 and in 1987 had not deteriorated and perhaps even had improved slightly. Mr. Wallich emphasized that the implementation of unchanged reserve conditions would improve the prospects for significant slowing in monetary growth, thereby reducing the potential for inflation.

Meeting Held on September 23, 1986

Domestic Policy Directive

The information reviewed at this meeting suggested a moderate pickup in economic growth from the slow pace in the second quarter. Payroll employment expanded further in August with gains widespread by industry. Consumer spending has continued to increase at a relatively rapid pace, and construction of single-family homes has remained at a high level. Business capital spending, however, has been sluggish, particularly for new structures. Wage rates have continued to increase slowly in recent months, while producer and consumer prices have tended to firm reflecting developments in food and energy markets.

Total nonfarm payroll employment continued to expand in August, rising about $\frac{1}{4}$ million further after adjusting for strike activity, somewhat faster than the average gain so far this year. Hiring at service establishments accounted for two-thirds of the increase, but construction employment also was up substantially, and manufacturing employment rose for the first time since January. The civilian unemployment rate edged down again in August to 6.8 percent, nearly $\frac{1}{2}$ percentage

point below the second-quarter average.

After declining on balance over the first half of the year, industrial production has picked up recently. According to revised data, output was flat in June and rose 0.3 percent in July, rather than declining in both months as previously reported. In August industrial production edged up 0.1 percent. Gains in output in July and August were particularly large for defense and space equipment. Production of business equipment, consumer goods, and construction supplies also registered strong increases. Capacity utilization in manufacturing, mining, and utilities fell 0.1 percentage point in August to 79 percent, about the same as the rate in the preceding three months but 1.6 percentage points below a year ago.

Retail sales rose 0.8 percent in August, after a July increase of 0.3 percent. Sales in the automotive group strengthened noticeably in response to incentive plans offered at the end of the month by domestic auto producers. Total car sales rose to an annual rate of 12.2 million units in August, compared with 10.9 million units in July. In the early part of September, sales of domestically produced autos soared to an annual rate of 17 million units. Outlays for durable goods other than autos, which were strong earlier in the year, dropped back in August, but sales at general merchandisers posted another large gain.

Residential construction activity remained relatively high through the summer. Housing starts totaled 1.8 million units at an annual rate in July and August. Single-family starts remained close to the vigorous pace of the first half of the year, while

multifamily starts were appreciably below their average level in that period. In July sales of new homes dropped below the extraordinary levels recorded earlier in the year, but sales of existing homes remained at about the advanced pace of the second quarter.

Business capital spending has remained sluggish, reflecting continued weakness in nonresidential construction. Although the contraction in oil and gas-well drilling appears to be subsiding, the downtrend in commercial and industrial building has continued partly because of high vacancy rates and the impact of the tax reform legislation. The value of nonresidential construction put in place fell in July for the fifth time in six months. Business outlays for equipment, however, have expanded somewhat in recent months; shipments of nondefense capital goods in August were $1\frac{1}{4}$ percent above the second-quarter average. New orders fell in August, partially reversing gains in the previous two months, largely because orders for aircraft and parts dropped. Bookings for office and computing equipment, however, have rebounded from their level earlier this year.

Wage rates have continued to rise moderately over the past few months, while producer and consumer prices have firmed somewhat on balance due to developments in food and energy markets. Prices other than those for food and energy, however, have risen at about the same pace as earlier in the year. In August, the producer price index advanced 0.3 percent, after changing little on balance over the previous three months and declining sharply earlier in the year. The consumer price index increased 0.2 percent in August. The

index had risen on balance in other recent months after falling somewhat during the first four months of the year. In the commodity markets, spot prices for precious metals rose sharply during August, reflecting supply disruptions and, perhaps, renewed inflationary expectations. The latter appeared to be associated in part with oil price developments and the lower foreign exchange value of the dollar. Lumber prices also rose significantly during August.

The trade-weighted value of the dollar against major foreign currencies had changed very little on balance since the August 19 meeting of the Committee, although it fluctuated over a fairly wide range. Exchange rates appeared to be affected mainly by news about prospects for economic activity in the United States and abroad. Germany and Japan did not follow the Federal Reserve's reduction in the discount rate, and short-term interest rates abroad were little changed while money market rates in the United States were somewhat lower. At the same time, long-term rates in the United States moved up sharply relative to comparable foreign interest rates. Preliminary data for the U.S. merchandise trade deficit in July indicated a substantially larger deficit than on average in the first half of the year as non-oil imports surged. Real economic growth appeared to have picked up on balance in the foreign industrial countries during the second quarter after a weak performance in the first quarter.

At its meeting in August, the Committee adopted a directive that called for decreasing slightly the existing degree of pressure on reserve positions, taking account of the possibility of a change in the discount

rate. The members expected such an approach to policy to be consistent with growth in M2 and M3 over the period from June to September at annual rates of about 7 to 9 percent. Over the same period growth in M1 was expected to moderate from the rapid pace during the second quarter. The Committee agreed that it would continue to evaluate growth of M1 in light of the expansion of the broader aggregates and other factors. The members also decided that somewhat greater or lesser reserve restraint might be acceptable depending on the behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The intermeeting range for the federal funds rate was maintained at 4 to 8 percent.

The discount rate was reduced $\frac{1}{2}$ percentage point shortly after the August meeting. In the two complete reserve maintenance periods ending after the meeting, adjustment plus seasonal borrowing at the discount window averaged close to \$460 million, somewhat higher than in the previous intermeeting period. In the first week of the current maintenance period, borrowing dropped back to about \$280 million.

Growth in the broader monetary aggregates slowed in August; M2 and M3 grew at annual rates of about $10\frac{3}{4}$ percent and $8\frac{1}{2}$ percent, respectively. In August, both aggregates were close to the upper limits of their longer-run ranges. In contrast to the broader aggregates, growth in M1 accelerated, but it appeared to have slowed considerably in the early weeks of September.

Federal funds generally have traded

around $5\frac{7}{8}$ percent since the reduction in the discount rate shortly after the August 19 meeting of the Committee. Other short-term interest rates fell about 30 basis points following the discount rate cut. Longer-term bond yields changed little immediately after the discount rate action but have increased noticeably in recent weeks, with rates on Treasury securities rising as much as 60 basis points. The recent behavior of long-term rates apparently has reflected, at least in part, some concerns by market participants about whether inflationary pressures could develop in the context of some strengthening in economic activity, the declining dollar, firmer oil prices, and rapid monetary growth in the United States and abroad.

The staff projections presented at this meeting suggested that growth in real GNP likely would pick up a bit further in coming months. Growth was forecast to continue at a moderate pace in 1987. Through 1987, the key element supporting expansion in domestic production was a projected improvement in the U.S. trade position. Growth in domestic spending was forecast to slow over the next several quarters. The staff outlook for inflation indicated a limited increase from the current pace due to some firming in world oil prices and the effects of the dollar's depreciation. The civilian unemployment rate was expected to decline slightly over the projection horizon.

In the Committee's discussion of the economic situation and outlook, the members expressed general agreement with the staff projection that moderate growth through the forecast horizon was the most likely outcome. However, the outlook remained subject to substantial uncer-

tainties relating to both domestic and international factors. On the favorable side, consumer spending and construction of single-family housing remained elements of strength in the domestic economy, and members reported that business sentiment appeared to have improved recently in several, but not all, parts of the country. One member noted that reduced personal income taxes could help to sustain consumer expenditures next year. Another commented that the emergence of apparently more stable conditions in agriculture and energy would tend to remove the retarding influences that those key sectors had been exerting on overall economic activity. On the negative side, the demand for automobiles undoubtedly would weaken after the currently attractive incentive programs expired, and the apparent overbuilding of multifamily housing in many areas would tend to restrain overall residential construction. Business fixed investment was not expected to provide much, if any, impetus to the expansion despite indications of improvement recently in the demand for equipment. Adverse factors bearing on the investment outlook included the current oversupply of office buildings and other commercial facilities in many parts of the country and the negative effects of the tax reform legislation on investment incentives that many businessmen were reporting. The outlook for fiscal policy remained uncertain; several members noted that some of the proposed measures for reducing the deficit in 1987 did not deal with underlying imbalances and that the prospects beyond 1987 were especially unclear. However, one member observed that a reduction in government borrow-

ing, if achieved, would tend to have a favorable impact on financial markets and thus on the economy generally.

On balance, while a few members supported the view that some pickup in domestic demand was a reasonable expectation, most believed that growth in domestic demand would probably taper off over the next several quarters. In their view, therefore, the prospects for sustained economic growth depended on an improvement in the foreign trade balance. The members generally agreed that the substantial depreciation of the dollar against several major foreign currencies provided a basis for anticipating a reduction in the trade deficit in real terms, but the timing of such a reduction still was subject to a great deal of uncertainty. Moreover, several expressed concern that the improvement might well be relatively modest, especially in the absence of stronger economic growth in key industrial nations abroad; and some members also commented on the inertia on both the import and export sides associated with long-term contracts and established marketing relationships. It also was noted that the currencies of a number of developing countries had changed relatively little vis-à-vis the dollar over the past year or so, raising a question as to the speed of adjustment in the trade balance. With regard to currently available information on trade developments, a few members referred to limited indications in reports from firms in their Districts that tended to suggest some gains in the international competitive position of U.S. firms and better prospects for greater stability, if not some improvement, in the overall trade balance. However,

broadly confirming evidence of such a development had not materialized thus far.

Against the background of the dollar's depreciation, the members agreed that some upward pressure on prices could be expected over the next several quarters, a tendency that would be reinforced if world-oil prices continued to rise. Moreover, most commodity prices appeared to have stabilized recently, after declining earlier, while prices of precious metals had increased considerably and these developments along with conditions in financial markets suggested increased concern about the possibility of a pickup in inflation. On the other hand, a number of members observed that wages generally were rising somewhat less this year than in 1985 and some members also commented on the continuing efforts of many business firms to hold down their costs. And while productivity gains had been relatively limited in recent quarters, many labor contracts incorporated provisions on work rules that should help to improve efficiency and moderate pressures on costs.

At its meeting in July the Committee reviewed the basic policy objectives that it had established in February for growth of the monetary and credit aggregates in 1986 and set tentative objectives for expansion in 1987. For the period from the fourth quarter of 1985 to the fourth quarter of 1986, the Committee reaffirmed the ranges established in February for growth of 6 to 9 percent for both M2 and M3. The associated range for expansion in total domestic non-financial debt also was reaffirmed at 8 to 11 percent for 1986. With respect to M1, the Committee decided that growth in excess of the 3 to 8 percent range set in February would be

acceptable and that such growth would be evaluated in the context of the velocity of M1, the expansion of the broader aggregates, developments in the economy and financial markets, and price pressures. For 1987 the Committee agreed on tentative monetary growth objectives that included a reduction of $\frac{1}{2}$ percentage point to a range of $5\frac{1}{2}$ to $8\frac{1}{2}$ percent for both M2 and M3. In the case of M1 the Committee expressed the preliminary view that retention of the 1986 range of 3 to 8 percent, which implied a considerable reduction from the likely rate of growth in 1986, appeared appropriate for 1987 in the light of most historical experience. The Committee also retained the range of 8 to 11 percent for growth of total domestic nonfinancial debt in 1987. It was understood that all the ranges were provisional and that, notably in the case of M1, they would be reviewed in early 1987 against the background of intervening developments.

In the Committee's discussion of policy implementation for the weeks immediately ahead, nearly all the members were in favor of directing open market operations, at least initially, toward maintaining unchanged conditions of reserve availability. Several emphasized that monetary policy had moved toward an increasingly accommodative posture over the course of recent months and that it was now time to pause and observe developments, given the rapid growth in the broad as well as the narrow monetary aggregates, a few indications of more strength in the economy, and some signs of increasing inflationary expectations. One member expressed the view, however, that some tightening of reserve conditions was desirable at this time against the background of

recent economic and financial developments, notably the persistence of rapid growth in the monetary aggregates.

In their discussion of policy implementation over the near term, the members took into account an analysis that suggested that if current conditions of reserve availability were maintained and if short-term interest rates did not deviate significantly from their existing levels, the growth of the monetary aggregates could be expected to slow over the months ahead, relative to the very rapid pace over the summer months, even assuming somewhat stronger expansion in economic activity. The most recent behavior of the monetary aggregates lent some weight to such an expectation. However, the anticipated slowing still would result in growth of the broad aggregates around the upper bound of their long-term ranges. Also, the members recognized that the extent of any slowing in monetary growth was subject to perhaps more than the usual uncertainties, reflecting for example questions about the pace of further adjustments in offering rates on various types of interest-bearing deposits as depository institutions continued to respond to earlier declines in short-term market rates. The members also noted that the monetary aggregates might well continue to grow very rapidly if short-term interest rates were to decline appreciably further.

In the course of the discussion, a number of members expressed concern about the potential for the broad monetary aggregates to exceed their longer-term ranges. While recognizing the need to evaluate the aggregates in the context of economic and financial developments more generally, these members em-

phasized the potential for inflation stemming from the buildup in money balances, and in liquid assets more generally, and these members attached considerable importance to constraining the growth of the broader monetary aggregates to within the Committee's ranges for the year. A slightly different view acknowledged that the Committee's objectives for M2 and M3 appeared to remain appropriate for the year, but in this view actual growth marginally in excess of those ranges should be tolerated—and the added risks of some future inflation accepted—if such growth occurred in the context of continuing sluggish economic expansion. One member stressed that if the velocity of money continued to decline, further rapid expansion might indeed be needed to sustain an acceptable rate of economic growth.

Turning to the question of possible adjustments in the degree of reserve pressure during the intermeeting period, the members did not foresee as likely any developments that might call for more than a slight change, if any, in the availability of reserves during the weeks ahead. In this context, however, a number believed that policy implementation should be especially alert to the potential need for some slight firming of reserve conditions, particularly if monetary growth did not slow in line with expectations, though this growth would continue to be viewed in the context of other economic and financial developments. Most of these members did not want to rule out the possibility of some easing in the weeks immediately ahead, but they saw the prospects for such a move as less likely, and two favored a directive that would not contemplate any easing. Other members felt that there should be no presumptions about the

likely direction of any intermeeting adjustments, given the many uncertainties that existed about the behavior of the monetary aggregates and about prospective economic and financial developments. The members agreed that the behavior of the dollar on foreign exchange markets could be an important factor influencing any small intermeeting adjustments.

At the conclusion of the Committee's discussion, all but one member indicated that they favored a directive that called for no change in the current degree of pressure on reserve positions. The members expected this approach to policy implementation to be consistent with some reduction in the growth of M2 and M3 to annual rates of 7 to 9 percent over the four-month period from August to December. Over the same interval, growth in M1 was expected to moderate from the exceptionally large increase during the past several months. Because the prospective behavior of M1 remained subject to unusual uncertainty, the Committee again decided not to specify a rate of expected growth for this aggregate in the operational paragraph of the directive but to continue to evaluate M1 in the light of the performance of the broader aggregates and other factors. The members indicated that slightly greater reserve restraint would, or slightly lesser restraint might, be acceptable over the intermeeting period depending on the behavior of the monetary aggregates, taking into account the strength of the business expansion, the performance of the dollar in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The members agreed that the intermeeting range for the federal funds rate, which provides a mechanism for

initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 4 to 8 percent.

At the conclusion of the meeting, the following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests some pickup in the growth of economic activity from the slow pace in the second quarter. In August total non-farm payroll employment grew considerably further, with employment in manufacturing rising for the first time since January. The civilian unemployment rate edged down further to 6.8 percent. Industrial production rose slightly in July and August after declining on balance during the first half of the year. Consumer spending has remained relatively strong in recent months, with gains in retail sales in August paced by a sharp rise in auto sales. Housing starts in July and August stayed at a relatively high level. Business capital spending appears to have remained sluggish, reflecting weakness in nonresidential construction. A more moderate rate of wage increases has been sustained in recent months, while broad measures of prices have firmed somewhat due to developments in food and energy markets.

The trade-weighted value of the dollar against major foreign currencies is essentially unchanged on balance since the August 19 meeting of the Committee. Preliminary data for the U.S. merchandise trade deficit in July indicate a larger deficit than in previous months.

Growth of M2 and especially of M3 moderated in August, but expansion of these two aggregates for the year through August has been at the upper end of their respective ranges established by the Committee for 1986. In August M1 continued to grow very rapidly. Expansion in total domestic nonfinancial debt remains appreciably above the Committee's monitoring range for 1986. Short-term interest rates have declined further since the August meeting of the Committee while long-term market rates have risen on balance. On August 20, the Federal Reserve Board approved a reduction in the discount rate from 6 to 5½ percent.

The Federal Open Market Committee

seeks monetary and financial conditions that will foster reasonable price stability over time, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at the July meeting to reaffirm the ranges established in February for growth of 6 to 9 percent for both M2 and M3, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate is subject to substantial uncertainties in relation to economic activity and prices, depending among other things on the responsiveness of M1 growth to changes in interest rates. In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable. Acceptable growth of M1 over the remainder of the year will depend on the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and price pressures. Given its rapid growth in the early part of the year, the Committee recognized that the increase in total domestic nonfinancial debt in 1986 may exceed its monitoring range of 8 to 11 percent, but felt an increase in that range would provide an inappropriate benchmark for evaluating longer-term trends in that aggregate.

For 1987 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of 5½ to 8½ percent for M2 and M3. While a range of 3 to 8 percent for M1 in 1987 would appear appropriate in the light of most historical experience, the Committee recognized that the exceptional uncertainties surrounding the behavior of M1 velocity over the more recent period would require careful appraisal of the target range at the beginning of 1987. The associated range for growth in total domestic nonfinancial debt was provisionally set at 8 to 11 percent for 1987.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in M2 and M3 over the period from August

to December at annual rates of 7 to 9 percent. While growth in M1 is expected to moderate from the exceptionally large increase during the past several months, that growth will continue to be judged in the light of the behavior of M2 and M3 and other factors. Slightly greater reserve restraint would, or slightly lesser reserve restraint might, be acceptable depending on the behavior of the aggregates, taking into account the strength of the business expansion, development in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 4 to 8 percent.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Heller, Mrs. Horn, Messrs. Johnson, Melzer, Morris, Rice, and Ms. Seger. Vote against this action: Mr. Wallich.

Mr. Wallich dissented because he preferred a slight tightening of reserve conditions. He was concerned about the persistence of rapid monetary expansion and the associated potential for inflation. In his view some reduction in the availability of reserves was needed to increase the likelihood of significant slowing in monetary growth over the months ahead.

Meeting Held on November 5, 1986

1. Domestic Policy Directive

The information reviewed at this meeting suggested that economic activity grew at a moderate rate in the third quarter, after rising only slightly in the previous quarter. Payroll employment expanded somewhat fur-

ther in September, although manufacturing jobs declined following little change in August. Consumer spending, which had been quite robust in the first half of the year, strengthened further in the third quarter. Business capital spending, however, remained sluggish, reflecting declines in outlays for nonresidential construction; new orders rose in September and equipment spending picked up. Residential construction expenditures advanced further in the third quarter, but housing starts fell in September. Wage increases have continued to moderate, while prices have increased a bit because of developments in food and energy markets.

Industrial production rose another 0.1 percent in September. The gain partly reflected a surge in the production of cars and light trucks. Other production was unchanged on balance; production of defense equipment rose, but output of non-defense goods edged down and materials production remained sluggish. Domestic automakers apparently cut back assemblies during October, but still were planning relatively large production for the fourth quarter as a whole. Capacity utilization in manufacturing, mining, and utilities was unchanged in September at 79.2 percent. The utilization rate in mining continued to decline, while the rate in manufacturing edged up, reflecting the pickup in motor vehicle production.

Total nonfarm payroll employment grew somewhat further in September. The sluggish pace of industrial production was reflected in a decline in manufacturing jobs that more than offset the increase reported for August. Employment in trade, finance, and services advanced further in September, but at a less

rapid rate than in earlier months of the year. The civilian unemployment rate moved back up to 7 percent in September, close to its average level earlier in the year.

Total retail sales increased 4.6 percent in September because of a substantial jump in auto sales following the expansion of sales incentive programs by domestic automakers in late August. During September, domestic cars sold at a record $11\frac{3}{4}$ million unit annual rate, compared with an average $8\frac{1}{4}$ million unit pace in the preceding five months. Light trucks and foreign cars also sold at record monthly rates in September. Outside of the auto group, sales were virtually unchanged from August levels.

In the business sector, spending has remained sluggish. Business purchases of motor vehicles were up sharply in the third quarter, but spending for other equipment declined, and outlays for nonresidential structures dropped substantially further. However, new orders for non-defense capital goods rose sharply in September; although aircraft orders accounted for half of the increase, bookings for many other types of equipment also posted sizable gains. For structures, data on new commitments have continued to point to further declines in office building, but the drop in oil- and gas-well drilling appears to have ended.

Housing starts have declined since earlier in the year but residential construction expenditures rose through the summer. Total private housing starts dropped in September to an annual rate of 1.68 million units from a rate of about 1.8 million units during July and August. Single family starts fell somewhat in September, registering the lowest monthly reading since December, but sales of

new and existing homes increased during the month. Multifamily housing starts declined further apparently reflecting in part record high vacancy rates and prospectively diminished rates of return on rental properties as a result of tax reform.

Labor cost increases have moderated further over the past year, but price increases have been a bit higher in recent months than earlier in the year due mainly to developments in food and energy markets. Consumer food prices rose sharply during the summer, reflecting in part weather-related disruptions in some supplies. By September conditions had improved, and increases in retail food prices slowed noticeably. In the energy sector, petroleum prices moved up at the wellhead and refinery levels in the September PPI, reflecting the OPEC agreement in early August to curtail production. This increase in crude oil costs apparently has already reached the retail level as gasoline and heating oil prices turned up in the September CPI, after steep declines throughout much of the year. Excluding food and energy, consumer prices have risen recently at about the same pace as earlier in the year.

The trade-weighted value of the dollar against major foreign currencies continued to decline for several weeks after the September 23 FOMC meeting, but it subsequently recovered and has risen somewhat on balance. Short-term and long-term interest rate differentials increased a bit during the intermeeting period; foreign rates moved up, particularly at the short end, while rates in the United States eased slightly. Real net exports of goods and services dropped further in the third quarter, mainly reflecting a surge in the volume of oil imports. After the recovery

in real economic activity in most major foreign industrial countries in the second quarter, available data for the third quarter indicate further moderate expansion in Germany, France, the United Kingdom and to a lesser extent in Japan.

At its meeting in September, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions. The members expected such an approach to policy to be consistent with growth in M2 and M3 from August to December at annual rates of 7 to 9 percent. Growth in M1 over the same period was expected to moderate from the exceptionally large increase during the previous several months. The Committee agreed that the growth in M1 would continue to be evaluated in view of the behavior of the broader aggregates and other factors. The members also decided that slightly greater reserve restraint would, or slightly lesser reserve restraint might, be acceptable depending on the behavior of the monetary aggregates, taking into account the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The intermeeting range for the federal funds rate was maintained at 4 to 8 percent.

M2 and M3 increased at annual rates of $8\frac{3}{4}$ and $7\frac{1}{2}$ percent respectively, on average over September and October, well below their rates of growth since early spring. Through October, both aggregates were very close to the upper ends of their 6 to 9 percent annual growth ranges established by the Committee for 1986. Growth in M1 still was quite strong over September and October, but down substantially from its average over the previous several months.

Adjustment plus seasonal borrowing at the discount window averaged about \$325 million in the two complete maintenance periods after the September meeting. Federal funds generally continued to trade close to 5 $\frac{1}{8}$ percent over the intermeeting period. Most other interest rates eased somewhat on balance, with short-term rates about unchanged to down 15 basis points and long-term rates off as much as 35 basis points. Bond prices increased in the days just before the meeting in part reflecting perceptions of stronger foreign demand for dollar assets, prompted to some extent by the cut in the Japanese discount rate on October 31. In addition, market participants reportedly interpreted the cut in the Japanese rate as giving the Federal Reserve more leeway to ease domestic monetary policy.

The staff projections presented at this meeting suggested that real GNP would continue to grow at a moderate rate through the end of 1987. Anticipations of sustained growth in real exports, reflecting the improvement in the price competitiveness of U.S. goods, continued to be a key element supporting the expected expansion in domestic production. Growth in domestic spending was projected to be relatively sluggish over the forecast horizon. The staff's projection for inflation continued to show some step-up early next year associated with the effects of rapidly rising import prices on the prices of U.S. goods and with the turnaround in energy prices.

In the Committee's discussion of the economic situation and outlook, the members agreed that incoming data on business activity and reports on specific conditions in many indus-

tries were broadly consistent with the staff forecast of continuing expansion at a moderate pace. There were uncertainties nonetheless about the prospective performance of individual sectors of the economy and thus of the economy generally. In the view of most members the risks of a deviation from the staff projection appeared to be evenly balanced, but a few felt the risks were greater in the direction of less growth.

As they had at several previous meetings, the members focused on the performance of net exports as a key factor in the outlook for economic activity. The most recent data could be interpreted as suggesting that the trade balance was no longer worsening. However, clear evidence of an actual turnaround in the trade balance had not yet emerged and it was far from certain that there would be significant improvement during the months ahead. Some members reported that a growing number of firms were experiencing increases in orders from abroad, a development that lent support to expectations of a significant pickup in export sales over the next few quarters. To an important degree, the outlook for U.S. exports remained contingent on growing demands from major industrial nations. In that regard it was noted that the evidence was mixed. Domestic expansion—and also the demand for foreign goods—appeared to be strengthening in some major countries, but the outlook was less promising in others. On the import side, members observed that foreign competition remained intense, notably from countries whose exchange rates had not appreciated against the dollar. Nonetheless, there were reports that rising import prices

were improving the competitive position of at least some domestic producers.

In the Committee's review of the outlook for spending by domestic sectors of the economy, the members generally expected demand to continue to increase, but at a slower pace than in recent quarters. Individual members again highlighted the uneven conditions in different industries and parts of the country. One member commented that the complex tax reform legislation constituted a major source of uncertainty. The members agreed that total consumer spending would tend to be held down in the current quarter by reduced purchases of automobiles following the bulge associated with attractive incentive programs. One member observed, however, that some offsetting expenditures on high-priced items might be induced before year-end because the deductibility of sales taxes in computing personal income taxes would be terminated starting in 1987. On the negative side, one member suggested that the adjustment in automobile sales might take longer than many observers currently expected and also stressed that consumer debt burdens were an important inhibiting factor on spending. In the area of business investment, members noted that construction activity would probably be held down by relatively high vacancy rates in office buildings, multifamily housing, and other commercial facilities such as hotels, especially in the context of the reportedly adverse impact of the tax reform legislation on such investments. Members also referred to a number of plant closings in the manufacturing sector. On the other hand, some current economic

indicators pointed to a strengthening in the demand for business equipment. One member also commented that the prospects for improvement in the nation's balance of trade, if realized, would require more investment in domestic productive facilities over time. In regard to agriculture current conditions were mixed, but one member indicated that the overall situation in that industry and also in energy no longer appeared to be worsening and accordingly those key sectors of the economy had probably ceased to exert a negative influence on general economic activity. Likewise, the outlook for reduced government deficits, including surpluses for state and local governments, and the apparently favorable prospects for foreign trade implied a reduction in major structural imbalances and an improved basis for sustained economic expansion.

With regard to the outlook for inflation, the members agreed that the lagged impacts of the dollar's depreciation along with developments in energy markets were likely to contribute to somewhat faster price increases during the year ahead. Many domestic businesses reportedly continued to look for competitive opportunities to raise prices and widen profit margins. One member observed that a potential inflation risk, and one for business activity generally, would be the emergence of new protectionist measures in response to unsatisfactory progress in reducing the nation's trade deficit. On the favorable side, wages generally appeared to be continuing to rise more slowly than earlier and businesses were continuing to devote considerable attention to paring costs and improving their productivity.

Some food prices might also tend to decline following increases in recent months. More generally, the prospect that capacity utilization rates were likely to remain relatively low in most industries over the year ahead implied that inflationary pressures would be muted during that period.

At its meeting in July the Committee reviewed the basic policy objectives that it had established in February for growth of the monetary and credit aggregates in 1986 and it set tentative objectives for expansion in 1987. For the period from the fourth quarter of 1985 to the fourth quarter of 1986, the Committee reaffirmed the ranges established in February for growth of 6 to 9 percent for both M2 and M3. The associated range for expansion in total domestic nonfinancial debt also was reaffirmed at 8 to 11 percent for the current year. With respect to M1, the Committee decided that growth in excess of the 3 to 8 percent range set in February would be acceptable and that such growth would be evaluated in relation to the velocity of M1, the expansion of the broader aggregates, developments in the economy and financial markets, and price pressures. For 1987 the Committee agreed on tentative monetary growth objectives that included reductions of $\frac{1}{2}$ percentage point to ranges of $5\frac{1}{2}$ to $8\frac{1}{2}$ percent for both M2 and M3. In the case of M1 the Committee expressed the preliminary view that retaining the 1986 range of 3 to 8 percent, which implied a considerable reduction from the likely rate of growth in 1986, appeared appropriate for 1987 in the light of most historical experience. The Committee also retained the range of 8 to 11 percent for growth of total domestic

nonfinancial debt in 1987. It was understood that all the ranges were provisional and that, notably in the case of M1, they would be reviewed in early 1987 against the background of intervening developments.

The Committee's discussion of policy implementation for the weeks immediately ahead reflected the sense that the economy was continuing to expand at a moderate rate and that, while price pressures could be strengthening somewhat in response to higher import prices, those price increases should be well contained. Externally, some signs of greater stability seemed to be emerging in exchange markets. In those circumstances, all of the members indicated that they were in favor of continuing to direct open market operations toward maintaining unchanged conditions of reserve availability. That conclusion was also warranted by indications that monetary growth had moderated somewhat over September and October, and an expectation that the broad aggregates might stay close to the Committee's earlier expectations for growth near the upper ends of their long-term ranges in the closing months of the year, assuming no significant changes in reserve conditions and in short-term interest rates.

In the Committee's discussion of possible intermeeting adjustments in the degree of reserve pressure, the members suggested that developments calling for more than a slight change in reserve conditions would be unlikely during the weeks ahead. Although a few members felt that policy implementation should remain especially alert to the potential need for some easing of reserve conditions, notably the need to respond to emerging indications, if any, of

relatively weak business activity, most felt that there should be no presumptions about the likely direction of any small intermeeting adjustments, should they be desirable. With respect to the monetary aggregates, some members commented that a shortfall from current expectations would be a welcome development, given the rapid growth earlier in the year, and within limits a shortfall should be tolerated provided it occurred in the context of satisfactory economic performance and did not appear to be associated with upward pressures on market interest rates. One member commented, however, that a sharp and abrupt slowdown in M1 growth might well signal a weaker economy and, depending on the circumstances, might require more than a slight adjustment in policy implementation.

At the conclusion of the Committee's discussion, all of the members indicated that they favored a directive that called for no change in the current degree of pressure on reserve positions. The members expected this approach to policy implementation to be consistent with growth of M2 and M3 at annual rates of 7 to 9 percent over the fourth quarter from a September base. Over the same period, growth in M1 was expected to moderate from its exceptional pace during most of the period since early spring. Because the behavior of M1 remained subject to unusual uncertainty, the Committee decided to continue its recent practice of not specifying a rate of expected growth for purposes of short-run policy implementation but to evaluate this aggregate in the light of the performance of the broader monetary aggregates and other factors. The members indicated that slightly greater or

slightly lesser reserve pressures might be acceptable over the intermeeting period depending on the behavior of the monetary aggregates, taking into account the strength of the business expansion, the performance of the dollar in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The members agreed that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 4 to 8 percent.

At the conclusion of the meeting, the following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that economic activity grew at a moderate pace in the third quarter. In September total nonfarm payroll employment grew somewhat further, although employment in manufacturing fell after changing little in August. The civilian unemployment rate moved back up to 7.0 percent in September, close to its average level earlier in the year. Industrial production rose slightly further in September and posted a moderate gain over the third quarter. Consumer spending has remained strong in recent months, with gains in retail sales in August and especially in September paced by a sharp rise in auto sales. Housing starts fell in September, but residential investment increased further in the third quarter as a whole. Business capital spending appears to have remained sluggish; equipment spending picked up in the third quarter and new orders were strong in September, but outlays for nonresidential construction continued to decline. Real net exports of goods and services dropped further in the third quarter, reflecting in large part a surge in the volume of oil imports. Increases in labor compensation have slowed over the course of the year, while broad measures of prices have firmed somewhat recently due to developments in food and energy markets.

Growth of M2 moderated further in September, but appears to have picked up in October, while growth of M3 has tended to slow. Expansion of these two aggregates for the year through September has been at the upper end of their respective ranges established by the Committee for 1986. Growth of M1 slowed in the September–October period from the very rapid pace experienced since early spring. Expansion in total domestic non-financial debt remains appreciably above the Committee's monitoring range for 1986. Most interest rates have declined somewhat since the September 23 meeting of the Committee. Although the trade-weighted value of the dollar against major foreign currencies continued to decline for several weeks after the September meeting, it subsequently recovered and has risen somewhat on balance.

The Federal Open Market Committee seeks monetary and financial conditions that will foster reasonable price stability over time, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at the July meeting to reaffirm the ranges established in February for growth of 6 to 9 percent for both M2 and M3, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate is subject to substantial uncertainties in relation to economic activity and prices, depending among other things on the responsiveness of M1 growth to changes in interest rates. In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable. Acceptable growth of M1 over the remainder of the year will depend on the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and price pressures. Given its rapid growth in the early part of the year, the Committee recognized that the increase in total domestic nonfinancial debt in 1986 may exceed its monitoring range of 8 to 11 percent, but felt an increase in that range would provide an inappropriate benchmark for evaluating longer-term trends in that aggregate.

For 1987 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of 5½ to 8½ percent for M2 and M3. While a range of 3 to 8 percent for M1 in 1987 would appear appropriate in the light of most historical experience, the Committee recognized that the exceptional uncertainties surrounding the behavior of M1 velocity over the more recent period would require careful appraisal of the target range at the beginning of 1987. The associated range for growth in total domestic non-financial debt was provisionally set at 8 to 11 percent for 1987.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in M2 and M3 over the period from September to December at annual rates of 7 to 9 percent. While growth in M1 over the same period is expected to moderate from its exceptional pace during the previous several months, growth in this aggregate will continue to be judged in the light of the behavior of M2 and M3 and other factors. Slightly greater reserve restraint or slightly lesser reserve restraint might be acceptable depending on the behavior of the aggregates, taking into account the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 4 to 8 percent.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Heller, Mrs. Horn, Messrs. Johnson, Melzer, Morris, Rice, and Ms. Seger. Votes against this action: None. Absent and not voting: Mr. Wallich.

2. Authorization for Domestic Open Market Operations

Effective December 3, 1986, the Committee approved a temporary

increase of \$1 billion, to \$7 billion, in the limit between Committee meetings on changes in System Account holdings of U.S. government and federal agency securities specified in paragraph 1(a) of the authorization for domestic open market operations. The increase was effective for the intermeeting period ending with the close of business on December 16, 1986.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Heller, Mrs. Horn, Messrs. Johnson, Melzer, Morris, Rice, and Ms. Seger. Votes against this action: None. Absent and not voting: Mr. Wallich.

This action was taken on the recommendation of the Manager for Domestic Operations. The Manager had advised that outright purchases of securities in the intermeeting interval through December 1, 1986, had reduced the leeway under the usual \$6 billion limit to about \$3.5 billion. Additional purchases of securities in excess of that leeway likely would be necessary over the remainder of the intermeeting period, chiefly reflecting seasonal increases in currency in circulation and required reserves.

Meeting Held on December 15-16, 1986

Domestic Policy Directive

The information reviewed at this meeting suggested that economic activity was continuing to expand at a moderate pace in the current quarter. Payroll employment increased considerably in October and November; hiring in manufacturing rose somewhat in both months after declining on balance since the beginning of the year. Apart from sales of motor

vehicles, which dropped off with the end of financing incentive programs, consumer spending has posted sizable gains in recent months. Business investment spending, however, has remained sluggish, while housing starts have weakened. At the same time, the trade balance has shown only limited indications of improvement. Increases in labor costs still were moderate, but price increases have been somewhat higher than earlier in the year because of developments in food and energy markets.

Total nonfarm payroll employment rose about $\frac{1}{4}$ million in both October and November. Much of the gain was in the private service-producing sector, but factory employment also rose moderately, and the workweek lengthened. Aggregate hours for production and nonsupervisory workers in November were a full percentage point above the third-quarter average. The civilian unemployment rate stayed at 7 percent in November for the third consecutive month.

Gains in employment and hours worked were associated with a sizable pickup in industrial production in November. The industrial production index rose 0.6 percent last month, after essentially no change over the previous three months. Increases in output were evident in most major marketing groups, with only energy materials showing a marked decline, although auto assemblies were about unchanged from October. Capacity utilization in manufacturing, mining, and utilities rose 0.3 percentage point in November to 79.3 percent. Nonetheless, utilization has changed little on balance since March and is $2\frac{1}{2}$ points below its most recent peak in the summer of 1984.

Sales of domestic cars fell sharply after the expiration of cut-rate fi-

nancing incentive programs in early October. These sales averaged less than 7 million units at an annual rate over the October-November period, compared with the strong 9½ million unit pace for the third quarter as a whole. Excluding autos, gasoline, and nonconsumer items, retail sales in November rose 0.9 percent paced by continued strength in purchases of furniture and appliances and in other nonauto durables. In addition, data for earlier months were revised upward slightly.

Business investment appears to have remained sluggish. Shipments of nondefense capital goods increased in October, and construction spending has firmed in recent months but prospects for such spending have continued to be affected adversely by high vacancy rates and reactions to tax reform. In contrast, sales of heavy-weight trucks fell markedly in October, and business purchases of cars and light trucks also probably declined sharply after the sales incentive programs ended. At the same time, new orders for nondefense capital goods fell 5 percent. Initial surveys of capital spending plans for 1987 suggested that overall nominal spending on plant and equipment is likely to change little from the 1986 level.

Housing starts continued to decline in November. During the month total private housing starts, at 1.6 million units, were a bit below the reduced pace of September and October. Single-family starts were virtually unchanged from their rate during the preceding two months, but were below their level earlier in the year; new home sales also have remained below their previous pace in recent months. Multifamily starts declined further in November in

response to high vacancy rates and adverse changes in tax laws.

Price increases, although still moderate, have been somewhat higher than earlier in the year partly because of developments in food and energy markets. The consumer price index rose 0.2 percent in October and the producer price index was up 0.2 percent in November. In the food sector, some upward price pressure continued to be evident, although increases in food prices slowed from the rapid pace during the summer. In addition, energy prices turned down a bit at both the retail and refinery levels, despite the firming of crude oil prices in spot markets since midsummer. Excluding food and energy, the CPI rose 0.4 percent in October, somewhat faster than earlier in the year as new car prices increased sharply. Wage inflation has picked up a bit recently, but has continued at a moderate pace.

The trade-weighted value of the dollar against other G-10 currencies has declined somewhat on balance since the November 5 meeting of the Committee. Exchange rates have been affected by news about the pace of economic activity, developments in the U.S. trade balance, and prospects for monetary actions in the United States and in key industrial nations abroad. Short-term interest rates rose moderately abroad, about in line with movements in U.S. rates, while differentials in long-term interest rates moved slightly against dollar assets. Over the period, the dollar declined about 2 percent against the mark and was essentially unchanged against the yen, but the dollar's depreciation had been somewhat larger in early December. As of mid-December, the value of the dollar in relation to other major currencies

was little changed on balance from the level prevailing in August. Economic activity in major foreign industrial countries was mixed in the third quarter. The U.S. merchandise trade deficit was estimated to be about the same in the third quarter as in the previous three quarters. Exports were flat in the quarter, while the value of oil imports was close to that in the second quarter as price declines about offset volume increases. Very preliminary data indicated that the deficit in October was the smallest in recent months as exports of agricultural products rose somewhat and imports declined moderately.

At its meeting on November 5, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions. This action was expected to be consistent with growth in both M2 and M3 at annual rates of 7 to 9 percent from September to December. Growth in M1 over the same period was expected to moderate from its exceptional pace during the previous several months. The Committee agreed that the growth in M1 would continue to be evaluated in light of the behavior of the broader monetary aggregates and other factors. The members also decided that slightly greater or slightly lesser reserve restraint might be acceptable depending on the behavior of the monetary aggregates, taking into account the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The intermeeting range for federal funds was maintained at 4 to 8 percent.

M2 growth slowed substantially in November to a 6½ percent annual

rate, and M3 growth moderated further to a 5½ percent annual rate; through November both M2 and M3 were just inside the upper bounds of their 6 to 9 percent growth ranges established by the Committee for 1986. M1 accelerated again in November, reaching a rate of 21 percent, as growth in demand deposits surged. M1 growth has remained far in excess of GNP growth so far this year and its velocity is expected to fall at a historically high rate.

Growth of total reserves picked up sharply over the intermeeting period largely because of a surge in required reserves against transaction deposits. In addition, excess reserves increased from almost \$750 million in the previous three months to around \$1 billion on average in November, reflecting mainly the usual patterns around holidays and social security payment dates. Adjustment plus seasonal borrowing in the two complete maintenance periods since the November FOMC meeting averaged about \$300 million, down somewhat from the average over the previous intermeeting period. Even so, the funds rate firmed from around 5⅞ percent at the time of the last meeting to well above 6 percent in early December. More recently, the federal funds rate has averaged close to 6 percent.

With the federal funds rate firmer through much of the intermeeting period, other short-term market rates rose 15 to 50 basis points. However, bond yields generally were about unchanged to down 25 basis points. Rates on commitments for fixed-rate home mortgages dropped about ½ percentage point, moving toward a more normal alignment with Treasury bond yields. Although stock prices fell initially on the announce-

ment of insider trading violations related to takeover activity, on balance they showed little change over the period.

The staff projections presented at this meeting suggested that real GNP would continue to grow at a moderate rate through the end of 1987. Prospects for an improvement in real net exports of goods and services continued to be a key element shaping the 1987 forecast; export growth was expected to accelerate next year and import growth to moderate as world trade flows adjusted to increased U.S. competitiveness. Gross domestic purchases were projected to be relatively sluggish through the end of 1987, reflecting mainly a shift toward fiscal restraint, the likely weakness in multifamily housing and nonresidential construction, and the damping influence of higher import prices on the growth of real income and consumption. Inflation was expected to pick up a bit in early 1987 as a consequence of the dollar's depreciation and higher energy prices.

In the Committee's discussion of current and prospective economic developments, members generally agreed that continuing expansion at a moderate pace remained a reasonable expectation for the year ahead, but a number of members emphasized the risks of a shortfall from current projections, especially in the early part of 1987. In particular, members mentioned the risks that the expected improvement in the nation's foreign trade might be relatively disappointing next year and that overall business spending might remain sluggish. A few members also referred to the possibility of slower growth in consumer spending. On balance, however, while no important sector of the domestic economy seemed likely to be a source of

substantial strength in 1987, the members read current economic indicators and other business information as pointing to a fifth year of moderate expansion. Such expansion might be accompanied by some rise in the rate of inflation, primarily reflecting the effects of the dollar's depreciation and energy-sector developments.

The members again gave considerable attention to the outlook for foreign trade. An improvement in trade generally was viewed as an essential factor in sustaining a moderate rate of business expansion in the context of perhaps diminishing growth in overall domestic demands. Unfortunately, there was no convincing evidence thus far of a turnaround in the trade balance, and a number of members commented that the expected improvement could be relatively limited next year. On the favorable side, the depreciation of the dollar evidently had enhanced the competitive position of U.S. firms, and individual reports of expanding export opportunities appeared to be multiplying as well as indications of an improved ability of many U.S. firms to compete domestically with imports. As they had at earlier meetings, the members referred to a number of factors that were inhibiting an overall improvement in net exports, including limited expansion in many industrial nations abroad and strong competition from a number of countries whose currencies had not appreciated against the dollar. One member also stressed that persisting debt problems in several developing countries constituted an element of vulnerability for international financial markets and international trade and also for the U.S. economy.

With regard to the domestic econ-

omy, a number of members commented that consumer expenditures on durables, especially automobiles, and some business spending appeared to have been accelerated into 1986 in reaction to provisions of the tax reform legislation. Compensating adjustments in such spending later could have a restraining effect on economic growth, notably during the first part of 1987. Nonetheless, a few members referred to the possibility that consumer spending might be well maintained during 1987 as a whole. The latter acknowledged the inhibiting effects of the growth in consumer debt, but they stressed the favorable implications of cumulative increases in the total assets and net worth of consumers and the positive impact of reductions in personal income tax rates. The outlook for business spending continued to be uncertain and in some respects unpromising, especially with regard to multifamily housing and nonresidential construction; both areas would be adversely affected by high vacancy rates and negative reactions to the tax reform legislation. There were further reports of plant closings, notably in the Midwest. However, one member observed that business spending for plant and equipment might well hold up in response to continuing growth in overall economic activity. As usual, the prospects for inventory accumulation were uncertain and would be affected by the outlook for prices.

With regard to the outlook for prices and wages, members generally agreed that increases might be somewhat larger in 1987, reflecting the impact of rising import prices and indications of a turnaround in oil prices. However, the prospect of only moderate economic growth and continued margins of slack in labor

and product markets suggested that strong wage pressures were not likely over the year ahead. One member observed that agricultural conditions worldwide suggested an absence of pressure on food prices. Moreover, generally limited growth in key industrial nations together with an ample availability of productive resources abroad implied continuing strong competitive pressures and restrained advances in prices of U.S. imports. Even so, a somewhat higher rate of inflation appeared to be in prospect for next year.

At its meeting in July, the Committee had agreed on tentative ranges of $5\frac{1}{2}$ to $8\frac{1}{2}$ percent for growth in both M2 and M3 during the period from the fourth quarter of 1986 to the fourth quarter of 1987. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent for 1987. In the case of M1 the Committee had indicated on a more tentative basis than usual that it might retain the 1986 range of 3 to 8 percent for 1987. Such a range implied a marked reduction from the M1 growth experienced in 1986 and provisionally assumed that the relationship of M1 to income, interest rates, and other economic variables next year would be broadly consistent with earlier historical experience.

At this meeting the Committee held a preliminary discussion of the factors bearing on appropriate ranges for the various monetary aggregates in 1987. Most of the attention was devoted to the issue of whether a range should be established for M1, given the uncertainty surrounding behavior of that aggregate and its velocity in recent years. While most members currently did not favor establishing a formal target range for M1 growth in 1987, many of them

believed that this aggregate should continue to be monitored or evaluated in light of information about the economy, prices, and the broad monetary aggregates and other financial variables. The Committee will complete its review of the role of M1 and the ranges for the broad aggregates for 1987 at its February meeting.

In the Committee's discussion of policy implementation for the period immediately ahead, all of the members indicated that they were in favor of directing open market operations, at least initially, toward maintaining unchanged conditions of reserve availability. For now, monetary policy was deemed to be exerting an appropriate degree of pressure on reserve positions in light of the growth of the broader monetary aggregates within—though at the upper ends of—their longer-run ranges, and the generally favorable prospects for sustained, albeit moderate, economic growth.

The members recognized that the outlook for the monetary aggregates remained uncertain, notably in the case of M1. According to an analysis presented at this meeting, a moderate trend in the growth of M2 and M3 might be anticipated, given the outlook for fairly limited growth in economic activity and an abatement of the effects of earlier interest rate declines. For the months ahead, growth in the broader aggregates might be well within the Committee's tentative ranges for 1987 on the assumption that there would be no significant changes in market interest rates. The outlook for M1 growth remained highly uncertain, although underlying forces seemed consistent with a considerable slowing over time from the extraordinary expansion experienced during 1986. Some concern was expressed that the failure

of such a slowing to occur and the associated large provision of reserves could eventually have inflationary consequences. Even with some moderation over coming months, M1 might continue to expand at rates markedly in excess of the growth in nominal GNP. In view of the uncertainties that were involved and in keeping with the Committee's practice since mid-1986, the members did not want to indicate specific expectations with regard to M1 growth in the operational paragraph of the Committee's directive. Nonetheless, it was understood that growth of this aggregate would continue to be evaluated in light of the behavior of the broader monetary aggregates and other economic and financial developments.

In their discussion of possible intermeeting adjustments in the degree of reserve pressure, the members thought it unlikely that developments would warrant more than a minor, if any, change in reserve conditions during the weeks ahead. All of the members understood that some small adjustment in either direction might be appropriate under certain circumstances. However, in the context of what they perceived as greater downside risks in the outlook for economic activity, several believed that policy implementation should remain especially alert to developments that might call for somewhat easier reserve conditions. It was noted in this connection that the relative stability of the dollar in foreign exchange markets over the past few months provided greater flexibility for potential easing actions.

At the conclusion of the Committee's discussion, all of the members indicated that they favored a directive that called for no change in the degree of pressure on reserve posi-

tions. The members expected this approach to policy implementation to be consistent with growth of both M2 and M3 at an annual rate of about 7 percent over the four-month period from November to March. Because the behavior of M1 remained subject to unusual uncertainty, the members decided they would continue to evaluate this aggregate in the light of the performance of the broader monetary aggregates and other factors. The members indicated that slightly greater reserve restraint or somewhat lesser reserve restraint would be acceptable over the intermeeting period depending on the behavior of the monetary aggregates, taking into account the strength of the business expansion, the performance of the dollar in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The members agreed that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 4 to 8 percent.

At the conclusion of the meeting, the following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that economic activity continues to grow at a moderate pace in the current quarter. Total nonfarm payroll employment grew appreciably further in October and November, and employment in manufacturing also rose after declining on balance in previous months. The civilian unemployment rate remained at 7.0 percent in November for the third consecutive month. Industrial production picked up considerably in November. Total retail sales rose moderately last month after changing little on balance over September and October. Housing starts have weakened and business capital spending

generally appears to have remained sluggish. Preliminary data for the U.S. merchandise trade deficit in October suggest a moderate narrowing. Broad measures of prices have firmed somewhat in recent months due to developments in food and energy markets. Labor cost increases this year have remained moderate compared with other recent years.

Growth of M2 slowed substantially in November, while growth of M3 remained moderate. Expansion of these two aggregates for the year through November has been just below the upper end of their respective ranges established by the Committee for 1986. In November growth of M1 accelerated to a very rapid rate. Expansion in total domestic nonfinancial debt remains appreciably above the Committee's monitoring range for 1986. Short-term interest rates have risen somewhat since the November 5 meeting of the Committee, while long-term rates have declined on balance. In foreign exchange markets the trade-weighted value of the dollar against other G-10 currencies has declined moderately on balance since the November meeting.

The Federal Open Market Committee seeks monetary and financial conditions that will foster reasonable price stability over time, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at the July meeting to reaffirm the ranges established in February for growth of 6 to 9 percent for both M2 and M3, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate is subject to substantial uncertainties in relation to economic activity and prices, depending among other things on the responsiveness of M1 growth to changes in interest rates. In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable. Acceptable growth of M1 over the remainder of the year would depend on the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and price pressures. Given its rapid growth in the early part of the year,

the Committee recognized that the increase in total domestic nonfinancial debt in 1986 may exceed its monitoring range of 8 to 11 percent, but felt an increase in that range would provide an inappropriate benchmark for evaluating longer-term trends in that aggregate.

For 1987 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of 5½ to 8½ percent for M2 and M3. While a range of 3 to 8 percent for M1 in 1987 would appear appropriate in the light of most historical experience, the Committee recognized that the exceptional uncertainties surrounding the behavior of M1 velocity over the more recent period would require careful appraisal of the target range at the beginning of 1987. The associated range for growth in total domestic nonfinancial debt was provisionally set at 8 to 11 percent for 1987.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in

M2 and M3 over the period from November to March at an annual rate of about 7 percent. Growth in M1 will continue to be appraised in the light of the behavior of M2 and M3 and the other factors cited below. Slightly greater reserve restraint or somewhat lesser reserve restraint would be acceptable depending on the behavior of the aggregates, taking into account the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 4 to 8 percent.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Heller, Mrs. Horn, Messrs. Johnson, Melzer, Morris, and Ms. Seger. Votes against this action: None. Absent and not voting: Mr. Rice.

Consumer and Community Affairs

In 1986 the Federal Reserve Board used its rulewriting and enforcement authority to maintain statutory protections for consumers while easing regulatory burdens on institutions. This report examines in detail the activities of the Federal Reserve System in support of those goals.

Regulatory and Policy Matters

The Board issued and proposed revisions to regulations and adopted a policy statement encouraging depository institutions to provide basic services to low- and moderate-income consumers. Also, the Board published a pamphlet, *A Guide to Business Credit and the Equal Credit Opportunity Act*, to advise applicants for business credit of their rights under the act and help them prepare an effective loan presentation.

Regulation E (Electronic Fund Transfers)

In July the Board proposed revisions to Regulation E (Electronic Fund Transfers) to eliminate the requirement that service providers, such as retailers, that offer electronic fund transfer services but do not hold consumers' accounts send periodic statements to their customers. Instead, those providers would be required to furnish information for inclusion on the periodic statements of the account-holding institutions. The changes were intended to eliminate duplication of information, reduce the risk of confusion to consumers from duplicative statements,

and promote widespread use of EFTs (electronic fund transfers).

Regulation Z (Truth in Lending): Adjustable-Rate Mortgages

In November 1986 the Board issued for public comment proposed amendments to Regulation Z (Truth in Lending) on disclosure of information about adjustable-rate mortgages (ARMs). Under the proposal, creditors would be required to give consumers general information about ARMs; the *Consumer Handbook on Adjustable Rate Mortgages*, by the Federal Reserve Board and the Federal Home Loan Bank Board, could fulfill this requirement. In addition, creditors would give a more detailed description of the variable-rate feature, along with an example of the way changes in the index rate affect payments, with the application form or before the consumer pays a non-refundable fee. These revisions would permit consumers to shop for credit and would conform the Board's disclosure rules with those of several other federal agencies. The Board developed this proposal after reviewing the comments on a proposal published in May 1985 and after consulting with these other agencies.

Regulation Z: Refinancings and Rescission

In December the Board issued revisions to Regulation Z that exempted certain refinancings by original creditors from the right of rescission. The rule, which was effective immedi-

ately, provides that the right of rescission will not apply if the only items included in the refinancing, other than the unpaid principal, are closing costs such as attorney's fees, title examination fees, and insurance premiums. At the same time, the Board withdrew a proposal that would have excluded from the right of rescission certain refinancings by a creditor other than the original creditor. Consumer groups had opposed any expansion of the exemption from the right of rescission, and creditors were dissatisfied with the limited nature of the proposed exemption. The Board withdrew the proposal because a rule that might accommodate both those concerns would be complex and perhaps beyond the Board's statutory authority.

Regulation AA (Credit Practices Rule)

In November the Board granted a request from the state of Wisconsin for an exemption from the Credit Practices Rule (Regulation AA). That rule prohibits banks and their subsidiaries from using certain remedies to enforce consumer credit obligations and from "pyramiding" late charges; it also provides protections for cosigners. It covers all consumer credit transactions except those for the purchase of real property.

To qualify for an exemption, a state must have a requirement or a prohibition that protects consumers at least as well as the corresponding federal provision does. Because the Wisconsin law covers only transactions up to \$25,000, transactions above that amount remain subject to the federal rule; however, compliance with Wisconsin law for such

transactions will constitute compliance with the federal requirements. The exemption does not apply to transactions in which the creditor is a federally chartered institution.

The Board also received applications from California and New York for exemptions from the Credit Practices Rule. It will take final action on these requests in early 1987.

Interpretations

In 1986 the Board continued to provide legal interpretations through the official staff commentaries on Regulation B (Equal Credit Opportunity), Regulation E (Electronic Fund Transfers), and Regulation Z (Truth in Lending). These commentaries help financial institutions and others apply the regulations to specific situations; updates generally are published by April 1 each year. In November the Board also issued an update to its staff guidelines on the Credit Practices Rule.

Business Credit Pamphlet

In July the Board published *A Guide to Business Credit and the Equal Credit Opportunity Act* for distribution through government agencies, women's groups, and other organizations. It describes the credit application process from the lender's perspective, offers guidance on the preparation of effective loan proposals, and discusses protections the act affords as they apply to business credit. The pamphlet is designed to increase public awareness, particularly among women and minority entrepreneurs, of the rights of business credit applicants and the responsibilities of business credit lenders.

Basic Financial Services

In September the Board approved a draft policy statement on the need to make basic financial services accessible to low- and moderate-income consumers. The Board forwarded the statement to the Federal Financial Institutions Examination Council (FFIEC) with the recommendation that the council's constituent agencies—the Board, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Home Loan Bank Board (FHLBB), and the National Credit Union Administration (NCUA)—consider issuing it jointly. The policy statement encourages voluntary efforts by industry groups and individual depository institutions to offer basic services. The statement gives institutions maximum flexibility, consistent with safe and sound business practices, in designing the services. It asks that institutions consider providing a safe place to keep money, a way to get cash (including the cashing of government checks), and a way to make payments to third parties. In October the FFIEC approved the draft statement for submission to member agencies, and by year-end it had been adopted by the Board, the OCC, the FDIC, and the NCUA.

The policy statement recognizes the role of trade groups in this effort and recommends that they encourage member institutions to offer and publicize low-cost basic financial services, survey the availability of such services among member institutions, and make available to their members material on the successful experiences of institutions with basic financial services.

Cited as a goal in the joint policy statement, a free or low-cost method to cash government checks is frequently mentioned in discussions of basic financial services. The Board has been exploring this issue and in December held a conference with representatives from government, industry, and consumer groups to discuss alternatives to government checks and to address other concerns about the present system. One alternative is direct delivery of payments, such as welfare or social security, through electronic terminals or special distribution outlets, involving neither paper instruments nor accounts at financial institutions. The conferees believed that direct delivery might work for state and local benefits but were less certain that it would be economic for federal payments. Some conferees supported testing the idea by adding federal payments to a local direct-delivery system already in place.

Community Affairs

During 1986 the Federal Reserve System continued to encourage community and economic development, in keeping with its responsibilities under the Community Reinvestment Act (CRA). At the Reserve Banks, the Community Affairs Officers (CAOs) and their staffs carry out educational activities to further public-private partnerships and private sector initiatives for community development. The aim is to gather and disseminate information and to foster communication among those involved in community development, including banks and bank holding companies, borrowers, local govern-

ments, and development organizations. The CAOs increased their activities in 1986 toward these ends.

As federal funding decreased, community organizations relied less on federal programs to support community development and more on those at the local level. In pursuing its educational goal, the community affairs program helped banks and other organizations involved in community development to learn about successful programs and strategies they might duplicate. The community affairs program also brought these groups together to help them take full advantage of available resources and opportunities in devising development strategies. In other cases, the program enabled the parties to improve communication and to identify common purposes, sometimes in connection with protests of applications under the Community Reinvestment Act. These meetings often helped promote understanding between applicants and community representatives and avoid protests of applications altogether.

The staff members of the Board and of the Reserve Banks developed and participated in more than 50 presentations on economic and housing development topics such as cooperative housing, commercial revitalization, investment in black-owned businesses, employee ownership of businesses, and community development corporations. Presentations focused on the formation of bank-community and bank-public sector partnerships that would foster private sector initiatives.

To facilitate the exchange of information among community development participants, the Federal Reserve Banks of Minneapolis, Dallas, Philadelphia, Richmond, and At-

lanta publish community affairs newsletters that feature development activities in their districts. Other Reserve Banks publish lists of successful strategies and programs to help bankers extend their involvement in community development.

During the year, the Federal Reserve held approximately 100 meetings on community development issues with bankers, holding company officers, and community groups. At these meetings the System's staff learned about developments in banking and in local communities, and bankers and community developers learned about the services available through Reserve Banks. Another result was that some banks have combined their efforts to address specific credit needs.

The Board continued to support the Reserve Banks' community affairs activities with its quarterly newsletter, *Communiqué*, with lists of knowledgeable individuals and organizations, and with presentations. It also gave information to national community organizations, bankers' associations, and individuals about the community affairs program, the community development corporations that are subsidiaries of bank holding companies, community economic development programs, and community reinvestment. A member of the Board also continued to serve on the board of directors of the Neighborhood Reinvestment Corporation.

Compliance Examinations

State member banks are examined regularly by the consumer affairs examiners of the Reserve Banks for compliance with the consumer credit

protection laws and the Community Reinvestment Act. In 1986 the Board lengthened the examination cycle for some institutions. Effective January 1, 1987, a small percentage of the banks with highly satisfactory records of compliance with consumer protection and CRA laws will be examined only every 24 months, instead of the 18 months specified for banks with ratings of satisfactory or better. Banks that perform poorly will continue to receive closer supervisory attention and be examined at least every 12 months.

Survey on Delayed Availability of Funds

In March 1984 the Board joined the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board in adopting an inter-agency policy statement on delayed availability of funds. The statement asked financial institutions that delay availability on paper-check deposits to review their policies and consider reducing the delays, consistent with prudent business practices; to disclose their policies to depositors at the time an account is opened and, when practical, at the time a deposit is made; and to refrain from imposing unnecessary delays on all checks, particularly social security and other government checks.

Between 1984 and mid-1986 the System surveyed the policies and practices on delayed availability of all state member banks. The findings suggest that state member banks are addressing appropriately the provisions of the policy statement:

- Most state member banks that placed holds on check deposits did so only in special cases.

- Few state member banks placed automatic holds on all deposits or on particular types of deposits.

- Most state member banks with hold policies disclosed those policies to depositors when an account was opened, the majority of them in writing.

- Most state member banks did not hold funds beyond the provisional crediting period.

Compliance with Consumer Regulations

Data received from the five federal agencies that supervise financial institutions and from other federal supervisory agencies indicate that compliance with the Truth in Lending Act (implemented through Regulation Z), the Equal Credit Opportunity Act (Regulation B), and the Electronic Fund Transfer Act (Regulation E) remained substantially the same as in 1985. This section summarizes data covering the reporting period July 1, 1985, to June 30, 1986.¹

Truth in Lending Act (Regulation Z)

The Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Federal Home Loan Bank Board, and the National Credit Union Administration reported that 62 percent of the institutions examined were in full compliance with the requirements of Regulation Z, compared with 63 percent in 1985. The agencies that provide data on the

1. Not all the federal agencies that regulate financial institutions use the same method to compile compliance data. However, the data support the general conclusions presented here.

frequency of violations (the Board, the OCC, and the NCUA) reported that 48 percent of the institutions that were not in full compliance had no more than five violations. These data suggest that many institutions not in full compliance are making a satisfactory effort toward compliance.

From the findings of the five financial regulatory agencies, the most frequent violations of Regulation Z appear to be the following:

- Failure to disclose the annual percentage rate accurately.
- Failure to disclose the number, amounts, and timing of payments scheduled to repay the obligation.
- Failure to disclose the amount financed accurately.
- Failure to disclose the finance charge accurately.
- Failure to make the disclosures clearly and conspicuously in writing in a form that the consumer may keep.

The OCC and the FHLBB issued five cease-and-desist orders for violations involving Regulation Z; the Board issued three formal enforcement actions that included provisions relating to Regulation Z. The Board, the OCC, the FDIC, and the FHLBB reported reimbursements of \$1.3 million (involving 243 institutions and 12,252 customer accounts) under the Regulation Z Interagency Enforcement Policy Guide. These numbers compare with a total of \$2 million in 1985 that involved 235 institutions and 29,823 customer accounts.

The Federal Trade Commission (FTC) continued its special efforts to enforce the credit-advertising provisions of the Truth in Lending Act, with particular attention to the sale of homes and automobiles. The FTC reported that 90 percent of the ad-

vertisers in its real estate credit program were in compliance, the same as in 1985. This program has enabled the FTC to monitor companies nationwide and, in most cases, has resulted in voluntary compliance with the law. The FTC follows up on its monitoring program through enforcement action against companies that continue to violate the law. During this reporting period, four real estate companies agreed to pay \$375,000 in civil money penalties for advertising violations, such as advertising only a reduced, first-year rate of interest for a mortgage without disclosing the much higher annual percentage rate, and advertising specific credit terms without providing all the required disclosures.

Since it began in 1983, the FTC's compliance program aimed at automobile credit advertising has brought numerous automobile dealers into voluntary compliance. In the past year, enforcement efforts were concentrated on the relatively small number of dealers that continued to violate the law. The FTC filed four complaints. Three of these cases currently are in litigation; in the fourth, the dealer agreed to pay \$70,000 in civil money penalties.

The other agencies that enforce the Truth in Lending Act—the Packers and Stockyards Administration of the Department of Agriculture, the Farm Credit Administration, and the Department of Transportation—reported satisfactory levels of compliance. The Department of Transportation concluded an enforcement action against an air carrier for violations of the rules governing credit refunds.

To heighten consumer and creditor awareness of the rights and responsibilities established by the act, the

Board, the FTC, and the FHLBB issued or distributed several publications. The FTC issued new brochures entitled "Second Mortgage Financing," "Refinancing Your Home," "Escrow Accounts," and "A Consumer Guide to Vehicle Leasing," and revised editions of its "Money Mortgage Guide" and "Holiday Shopping Tips." The Board issued four compliance brochures entitled "Construction Loan Disclosures and Regulation Z," "Combined Construction/Permanent Loan Disclosures and Regulation Z," "Regulation Z: The Right of Rescission," and "Regulation Z: Understanding Prepaid Finance Charges." As of August 1, 1985, the FHLBB required all institutions insured by the Federal Savings and Loan Insurance Corporation to distribute the *Consumer Handbook on Adjustable Rate Mortgages*, as a way of giving early and uniform information about these mortgages.

Equal Credit Opportunity Act (Regulation B)

The five federal agencies that supervise financial institutions reported that 79 percent of the institutions examined were in full compliance with the Equal Credit Opportunity Act (ECOA), compared with 81 percent in 1985. These are the most frequent violations of Regulation B:

- Failure to provide a written notice of adverse action that includes a statement of the action taken, the name and address of the creditor, the ECOA notice, and the name and address of the federal agency that enforces compliance.
- Failure to notify the applicant of the action taken within 30 days after receiving a completed application.

- Failure to provide the specific reasons for adverse action.

- Failure to request information for monitoring purposes as part of an application for credit primarily for the purchase or refinancing of a dwelling.

- Illegally inquiring about the sex of an applicant.

The OCC and the FHLBB, in conjunction with the Department of Justice, issued two cease-and-desist orders involving violations of Regulation B. The Board issued five formal enforcement actions that included provisions relating to Regulation B.

Most creditors that were subject to the FTC testing program, in which auditors pose as credit applicants, appeared to be complying with the nondiscrimination provisions of the act. However, some creditors continue to discourage or disfavor credit applicants because of their age or because they rely on alimony or other protected income. During this reporting period, the FTC took enforcement action against three creditors, two of which were found through the FTC's testing program. The FTC is conducting several other investigations to identify illegal discrimination.

Other agencies responsible for enforcing the ECOA—the Department of Transportation, the Interstate Commerce Commission, and the Packers and Stockyards Administration—reported satisfactory levels of compliance. The Farm Credit Administration, the Securities and Exchange Commission, and the Small Business Administration reported violations, but none required formal enforcement action.

The FTC prepared a film for distribution to credit unions on the

requirements of the act and issued a brochure entitled "Scoring for Credit." As noted earlier, the Board distributed "A Guide to Business Credit and the Equal Credit Opportunity Act."

Electronic Fund Transfer Act (Regulation E)

The federal regulatory agencies responsible for enforcing the Electronic Fund Transfer Act reported that 91 percent of the institutions examined were in full compliance, compared with 93 percent in 1985. The most frequent violations of Regulation E were the following:

- Failure to provide, in a timely manner, a written statement outlining the terms and conditions of the EFT service.
- Failure to provide a periodic notice on procedures for resolving disputes.
- Failure to provide a written receipt at the time of an electronic fund transfer.
- Failure to provide a statement of the consumer's liability for unauthorized transfers.

According to the FTC, the fact that complaints regarding Regulation E were so few suggests that there is no special compliance problem. The other agencies responsible for enforcing the EFT act, the Department of Transportation and the Securities and Exchange Commission, reported a satisfactory level of compliance.

Economic Impact of Regulation E

In accordance with statutory requirements, the Board monitors the effects of the Electronic Fund Transfer Act on the costs and benefits of EFT service to financial institutions and

consumers. The economic effects of the act spread during 1986 as more financial institutions offered EFTs and more consumers used them. Approximately two-thirds of the nation's depository financial institutions, representing every class size, now provide EFT services that are covered by the requirements of the act and Regulation E. These services include direct deposits, preauthorized electronic transfers, and access to automated teller machines (ATMs). Although the number of ATMs remained about the same in 1986 as in 1985, the use of the machines continued to increase. Moreover, consumers gained wider access to EFT services through the expansion of shared ATM networks. The volume of fund transfers made at electronic point-of-sale terminals grew, and point-of-sale transactions appeared poised for rapid expansion in coming years.

Consumer demand for EFT services has continued to grow. The evidence indicates that at least 70 percent of households have a savings or transaction account with an EFT feature that they use at least occasionally. The number of transactions conducted through ATMs has increased, and the number of consumers electing to receive payroll or government transfer payments by electronic direct deposit has also risen.

The benefits to consumers from the EFT act are difficult to measure because they cannot be isolated from consumer protections that would have been provided in any case. Statistics from examination reports do not suggest widespread problems or violations of the consumer rights established by the act. The federal agencies that regulate financial institutions

reported little change from 1985 in the percentage of institutions not in full compliance. The most frequent violation was failure to provide one or more disclosures to consumers. The majority of institutions cited for noncompliance had one to five violations, a small number in light of the volume of consumer EFT transactions.

Data from the Board's Consumer Complaint Control System confirm that consumers have no serious problems with EFT. Of the 2,400 complaints processed in 1986, 94 involved EFTs. The Federal Reserve System forwarded 32, which did not pertain to state member banks, to other agencies for resolution. Of the remaining 62 complaints, only 2 involved a possible violation of the regulation.

The costs of industry practices that would have evolved in the absence of statutory requirements are unknown. Consequently, the incremental costs associated with the act, as in the case of consumer benefits, are difficult to quantify. But the compliance cost of an EFT transaction is probably not high enough to compromise the cost advantage such transactions have over check-based transactions.

As EFT systems mature, as transaction volume builds, and as start-up costs for compliance are amortized, compliance costs per EFT transaction and per dollar of transferred funds are likely to decline. As noted earlier, the Board has proposed to amend Regulation E to eliminate the statement requirement for providers of point-of-sale services. The Board expects this proposal, if adopted, to lower costs substantially for these EFT transactions and promote wider use of the system.

Complaints against State Member Banks

In 1986 the Federal Reserve System received a total of 2,400 complaints (see the accompanying table). Within this total, 930 were complaints against state member banks, which the Federal Reserve investigates and resolves. The System referred the remaining 1,470 complaints, involving other creditors or businesses, to the appropriate enforcement agencies. Most of the complaints (1,909) were made in letters; 478 came by telephone, and 13 were made in person. The Board also received 181 written inquiries concerning consumer credit laws and regulations, and banking policies and practices. In responding, the Board's staff gave consumers brochures on the general issues plus explanations of laws, regulations,

Consumer Complaints Received by the Federal Reserve System, by Subject, 1986¹

Subject	Number
Regulation B (Equal Credit Opportunity)	144
Regulation C (Home Mortgage Disclosure)	9
Regulation E (Electronic Fund Transfers)	94
Regulation M (Consumer Leasing)	8
Regulation Q (Interest on Deposits)	100
Regulation Z (Truth in Lending)	494
Regulation BB (Community Reinvestment)	2
Fair Credit Reporting Act	118
Fair Debt Collection Practices Act	34
Holder in due course	1
Real Estate Settlement Procedures Act	1
Transfer agents	3
Unregulated bank practices	1,329
Other ²	63
Total	2,400

1. Includes 930 complaints about state member banks, over which the Federal Reserve has jurisdiction, and 1,470 complaints about other lenders, which the Federal Reserve referred to the appropriate agencies.

2. Primarily miscellaneous complaints against business entities.

and banking practices specific to their complaints or inquiries.

The Board's staff continues regularly to review and assess the System's handling of complaints. The staff reviews a sample of complaints about state member banks for adherence to System policies; and, through follow-up questionnaires, it attempts to gauge complainants' perceptions of the System's handling of complaints. Approximately 66 percent of the respondents found the System's explanations clear and understandable; 79 percent were satisfied with the speed in handling their com-

plaints; 97 percent felt that the Federal Reserve staff treated them courteously; 92 percent said they would contact the Federal Reserve again if they had another problem with a bank; and 55 percent found the resolutions of their complaints acceptable. The proportion of those satisfied with the System's handling of their complaints is higher than the proportion of those satisfied with the outcome because some complaints involved banking practices that are permissible and that cannot be changed unless the bank does so voluntarily or the law is changed.

Consumer Complaints about State Member Banks Received by the Federal Reserve System, by Function and Resolution, 1986

Type of resolution	Total complaints	Type of complaint					
		Loan function		Deposit function	Electronic fund transfers	Trust services	Other
		Discrimination	Other				
<i>Total complaints about state member banks</i>							
Number	930	72	432	216	57	9	144
Percent	100	8	46	23	6	1	15
<i>By type</i>							
Insufficient information ¹	34	4	10	7	0	0	13
Information furnished to complainant ²	117	15	50	26	2	0	24
Bank legally correct							
No accommodation	355	21	173	77	34	7	43
Accommodation made ³	90	9	43	18	1	1	18
Clerical error, corrected	164	5	76	52	10	0	21
Factual dispute ⁴	40	1	21	10	2	0	6
Bank violation, resolved ⁵	15	3	4	4	2	1	1
Possible bank violation, unresolved ⁶	3	1	2	0	0	0	0
Customer error	9	0	4	5	0	0	0
Pending, December 31	103	13	49	17	6	0	18
Complaints referred to other agencies	1,470	72	741	360	37	3	257
Total, all complaints	2,400	144	1,173	576	94	12	401

1. The staff has been unable, after follow-up correspondence with the consumer, to obtain sufficient information to process the complaint.

2. When it appears that the complainant does not understand the law and that there has been no violation on the part of the bank, the Federal Reserve System explains the law in question and provides the complainant with other pertinent information.

3. In these cases the bank appears to be legally correct but has chosen to make an accommodation.

4. These cases involve factual disputes not resolvable by the Federal Reserve System and contractual disputes that can be resolved only by the courts. Con-

sumers wishing to pursue the matter may be advised to seek legal counsel or legal aid or to use small claims court.

5. In these cases a bank appears to have violated a law or regulation and has taken corrective measures voluntarily or as indicated by the Federal Reserve System.

6. When a bank appears to have violated a law or regulation, customers are advised to seek civil remedy through the courts. Cases that appear to involve criminal irregularity are referred to the appropriate law enforcement agency.

The accompanying table summarizes the nature and resolution of complaints filed against state member banks in 1986, classified according to bank functions: loans, deposits, electronic fund transfers, trust services, and others. Of the 930 complaints received about state member banks, just over half concern loan functions, including alleged discrimination on a prohibited basis, disclosure of credit costs, and credit denial on a nonprohibited basis; another quarter involved practices concerning deposit accounts, including disputes about interest.

Unregulated Practices

Under section 18(f) of the Federal Trade Commission Act, the Federal Reserve Board is authorized to identify unfair or deceptive banking practices and adopt regulations that prohibit them. The Board has a system to monitor complaints about banking practices that are not subject to existing regulation but that may be unfair or deceptive. The Board identifies unregulated practices that are the subject of 15 or more complaints per quarter, or 50 or more for the year. Of the 1,329 complaints about unregulated practices received in 1986, the 398 identified by this system fell into the following categories: credit denial based on credit history (109); other unregulated lending practices (96); credit denial based on other nonprohibited factors, such as the lack of sufficient assets (77); excessive time taken to clear checks, including delayed availability of funds (60); and crediting of deposits to accounts (56). Each of these categories accounts for less than 5 percent of all consumer complaints received. Many of the complaints about

denials based on credit history indicated that the applicant did not realize the implications of a poor credit history or of a lack of borrowing experience on the decision about creditworthiness.

Community Reinvestment Act

The Board is required by the Community Reinvestment Act to encourage institutions under its jurisdiction to help meet the credit needs of their communities—including low- and moderate-income neighborhoods—in a manner consistent with the safety and soundness of the institutions. The Board assesses the record of state member banks in meeting these needs as part of its examinations and takes an institution's CRA performance into account when acting on certain applications filed by banks and bank holding companies.

During the 1986 reporting period (July 1, 1985, through June 30, 1986), Federal Reserve personnel examined 761 state member banks for compliance with the CRA. The records of almost all of these banks were deemed satisfactory or better.

During calendar year 1986, 20 applications filed by banks or bank holding companies with the Federal Reserve System were protested under the CRA; 13 were decided by year-end. Seven of these protests were withdrawn after the applicants and protestants reached agreement, often as a result of meetings facilitated by the Federal Reserve Banks.

Consumer Advisory Council

November 1986 marked the tenth anniversary of the Federal Reserve's

Consumer Advisory Council (CAC). Created by the Congress and representing a wide spectrum of interests, the 30-member CAC advises the Board on the implementation of federal laws governing consumers' rights and responsibilities in their dealings with the financial services industry. In 1986 the council met in March, June, and October.

Throughout 1986 a study group of the CAC focused on reduced-rate financing offered by automakers. The CAC was concerned that these programs, which offer rates far below the market, might undermine the usefulness of the annual percentage rate (APR) for comparing the cost of credit offered by different credit providers. In some reduced-rate programs, a purchaser has the choice of financing the vehicle through the automaker's subsidiary at a reduced rate of interest or receiving a cash rebate from the manufacturer. Some critics believe that the rebate should be treated as part of the financing cost and taken into account in computing the APR, a required disclosure under truth in lending. The act, however, does not require such adjustments. The CAC was unable to reach consensus on appropriate disclosures for reduced-rate financing; it will continue to study the issue.

In June 1986 the CAC unambiguously reiterated its support, first voiced in October 1985, for the Board's issuing a policy statement that would encourage state member banks to offer basic financial services for low- and moderate-income consumers. It also asked the Board to encourage other financial regulatory agencies to join in a statement. After considering the council's strong views,

the Board approved a policy statement on basic financial services, which it sent to the FFIEC in October (described above).

The council expressed views on disclosures about funds availability and on the general improvement of the check-clearing process. It adopted resolutions recommending the mandatory disclosure of hold periods by all financial institutions, the adoption of a uniform system for counting the days that checks are held, and the continuation of industry efforts to streamline check-clearing.

Uniformity in the required disclosures for adjustable-rate mortgages was another issue the CAC addressed in 1986. In March and October the council urged the federal agencies to adopt uniform disclosure requirements, supported the use of an ARMs brochure, and encouraged early disclosures. It also adopted a resolution calling for the Board's approval of consumer financial counseling as an activity of bank holding companies.

In 1986 the council also considered the following issues:

- A Board proposal for amending Regulation E that would eliminate the periodic statement requirements for institutions that issue debit cards but do not hold accounts.
- Protests by community groups in connection with holding company applications under the Community Reinvestment Act.
- Projected increases in second-mortgage debt.
- The effect that proposed ceilings on credit card interest rates might have on creditors and consumers.
- The effect of interstate banking on consumers, small businesses, and the financial industry.

Legislative Recommendations

In 1986 the Board testified before various subcommittees of the Senate and the House on legislation dealing with credit card interest rates and disclosures, truth in savings, and business credit.

Credit Card Interest Rates

In January the Board testified before the Subcommittee on Financial Institutions and Consumer Affairs of the Senate Committee on Banking, Housing, and Urban Affairs on legislation that would establish a federal ceiling on the interest rates that could be charged on credit card debt. The Board opposed the legislation in the belief that credit is most efficiently and productively distributed when interest rates are determined in markets free from artificial restraints. The Board noted that on average, for the period 1972 through 1984, the rate of return earned on credit card operations was below that earned on other types of lending. While the Board noted that returns on credit cards had increased in recent years, it also pointed out that credit card finance rates had tended to decline in the months before the hearing. The Board stated that efforts to constrain rates through federal regulation are likely to reduce credit availability, particularly for less affluent borrowers, or encourage less efficient means of recapturing credit costs.

Credit Card Disclosures

In May the Board testified before the Subcommittee on Financial Insti-

tutions and Consumer Affairs of the Senate Committee on Banking, Housing, and Urban Affairs on several bills dealing with credit card disclosures. The proposed legislation covered issues such as early disclosures of the cost of a credit card plan, additional disclosures of the conditions under which a finance charge may be imposed, a mandated method for computing balances, and quarterly reports to the Board by credit card issuers about costs. The Board endorsed full disclosure both as the fair way to deal with customers and as an aid in the competitive process. At the same time, the Board pointed out that the costs of requiring additional disclosures in all applications (rather than only in mail solicitations, as one of the bills provided) may not be justified.

The Board believed that a mandated method for computing balances would depart from the approach of the Truth in Lending Act, which is to leave the regulation of substantive terms to the states. The Board acknowledged that a uniform method might eliminate the consumer's need to understand how one creditor's method differs from another's, but it noted that this approach had several drawbacks. Often the timing of a consumer's purchases and payments determines which method yields the lowest finance charge. In addition, if regulating the method causes an increase in operating costs or a reduction in revenues, creditors might seek to make up the difference by restricting credit availability, eliminating grace periods, or imposing annual fees or higher interest rates. The Board also believed that states, with their experience in regulating yield-producing terms of accounts,

were in a better position to regulate this area. In addition, the Board pointed to ongoing efforts by the Federal Reserve System and others to increase consumer awareness of this and other aspects of credit card transactions.

The Board suggested postponing action on requiring creditors to report information on credit card costs until it had evaluated an APR demonstration project then under way. This study was conducted at the request of the Congress in three test cities to measure the benefits of providing consumers with comparative information, through newspaper charts, about the closed-end credit charges of lenders.

Truth in Savings

In June the Board testified before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance and Urban Affairs on proposed truth-in-savings legislation. This legislation would establish uniform requirements for all depository institutions regarding advertisements of interest rates and disclosures. Among other things, it would require the disclosure of an annual percentage yield, an annual rate of simple interest, and a schedule of fees and charges. The Board supported providing bank customers with clear and complete information when they open accounts, but questioned whether legislation is necessary. Should the Congress decide it is necessary, the Board believed, the legislation should provide for a flexible structuring of rules to enhance consumer benefits as new types of

deposit accounts evolve while minimizing the burden on depository institutions. The Board noted its proposal to amend Regulation Q to update and clarify its rules on advertising of accounts and its work toward a policy statement on disclosures of terms on deposit accounts. As these measures would be limited to member banks, the Board is consulting with the other regulatory agencies so that these requirements would be applied uniformly to all depository institutions.

Regulation B and Business Credit

In August the Board testified before the Subcommittee on Consumer Affairs and Coinage of the House Committee on Banking, Finance and Urban Affairs on proposed changes to the Equal Credit Opportunity Act with respect to business credit transactions. The proposal would extend to business transactions certain technical requirements of Regulation B that currently relate only to consumer transactions, would require public hearings on any exemptions, and would put a five-year limit on exemptions. The Board believed that the ECOA and Regulation B in their present form provide adequate legal protection against discrimination. The exceptions established for business credit are narrowly drawn and respond directly to the distinctions between consumer and business credit. The Board stated that the legislation would not significantly improve the Board's rulewriting processes. Although a public hearing before granting or continuing any exception for business credit would

afford an extra opportunity to gather information, the Board has found written public comment to be adequate. And the Board already periodically evaluates regulatory provisions under its Regulatory Improvement Project, a program calling for the review of regulations every five years or so. Finally, the Board expects that the business credit pamphlet developed with industry and minority group organizations will inform business credit applicants of their rights under the ECOA, besides

giving them practical assistance in obtaining credit.

Recommendations of Other Agencies

Each year the Board asks the agencies with enforcement responsibilities under Regulations B, E, and Z for recommendations concerning changes to the regulations or the underlying acts. In 1986 the agencies submitted no suggestions or recommendations for changes.

Legislative Recommendations

The Board of Governors has made the following recommendations for legislation to the Congress of the United States.

Bank Holding Company Legislation

The Federal Reserve believes that reform of the existing statutory framework is urgently needed to maintain a strong, stable, and competitive banking system. The forces of change—technological, economic, and competitive—at work on an international scale need to be channeled constructively if the broader public interests are to be served. Clearly, areas exist in which market competition should be freed and efficiency promoted. At the same time, there are areas in which institutional stability and public policy objectives need to be protected by maintaining an appropriate legislative and regulatory framework.

To these ends, the Federal Reserve has recommended that the Congress include in any legislative reform these features:

- Expansion of the powers of bank holding companies.
- Clarification of the definition of “bank” to resolve the “nonbank bank” issue and clarification of the proper scope of powers for state-chartered institutions.
- Streamlining of the procedures of the Bank Holding Company Act.

Powers

The legitimate boundaries of activities permitted to banking organizations need to be reviewed and enlarged.

The Federal Reserve recommends that the Congress recognize the competitive, technological, and international forces operating in the banking and financial marketplace and expand the authorized role for bank holding companies.

Plainly, the time has arrived to clarify and expand certain securities powers of bank holding companies, a matter that cannot be dealt with reasonably and rationally without congressional action.

The Board believes that it would be appropriate, as a matter of good public policy, to permit bank holding companies to underwrite municipal revenue bonds, mortgage-backed securities, commercial paper, and mutual funds. The Board would also encourage the Congress to consider other financial areas appropriate for bank holding companies, including insurance and real estate brokerage, and insurance underwriting.

The Federal Reserve would also urge the Congress to undertake hearings of other studies in the area of corporate underwriting—a process that the Board would be pleased to support. The issues in this area are more complicated because of the greater potential for conflict of interest. However, a substantial amount of such activity is already conducted by bank holding companies abroad, and the increased securitization of financial assets by banks and others requires fresh consideration of how banks may participate in that process.

Definitions

New definitions of the terms “bank” and “thrift institution” are necessary

to assure an orderly framework for the development of the financial system, to promote competitive equity, and to maintain the basic separation of banking and commerce. The Board believes that banks continue to perform a unique and critical role in the financial system and the economy—as operators of the payments system, as custodians of liquid savings, as key and impartial suppliers of short-term credit, and as the link between monetary policy and the economy.

The Board believes that all institutions having the unique character of banks should be subject to the rules applicable to banking institutions—that is, the limitations on the range of activities and ownership, as well as the protections against conflict of interest, concentration of resources, and excessive risk. To achieve that end and to close the so-called “nonbank bank” loophole, the Board has recommended clarifying the definition of “bank” in the Bank Holding Company Act by, among other changes, extending the definition to cover all institutions that are insured by the Federal Deposit Insurance Corporation.

The Board has also recommended that thrift institutions meet a minimum residential mortgage test to remain eligible for the special benefits provided by law for such institutions. The holding companies of thrift institutions not meeting the test would be limited so that the scope of their permissible nonbanking activities would be similar to those of bank holding companies.

The Board has recommended that the Congress establish limits with respect to the ability of states to authorize state-chartered institutions to engage in certain activities that

may affect the safety and soundness of the financial system with adverse consequences for the federal insurance funds.

Procedures

The Board favors streamlining the procedures for dealing with bank holding company applications. By recent changes in the regulation governing holding company activities, the Board has gone as far as it believes it can, consistent with present law, to speed up procedures and lessen regulatory burdens. The Board has recommended legislation eliminating the “benefits and burdens” test of present law, providing for expedited notice procedures for approval of new activities, and setting out new and simplified criteria for determining the permissibility of new activities generally.

Emergency Acquisition Authority

The Board favors an extension and modification of the provisions contained in title I of the Garn–St Germain Depository Institutions Act that permit the FDIC and the FSLIC to arrange for emergency interstate mergers and acquisitions of financially troubled thrift institutions and failed insured commercial banks with assets of \$500 million or more.

In light of the continuing strains evident in some sectors of the thrift and banking industries, including difficulties experienced by some banks engaged in lending to the agricultural and energy sectors, the Board has recommended that the emergency arrangements for failing institutions in the Garn–St Germain Act be extended and liberalized in the following ways: (1) reduce the threshold

amount for interstate emergency acquisitions from \$500 million to \$250 million; (2) permit interstate acquisition of banks in danger of closing as well as of closed banks; and (3) allow for acquisition of a holding company and its affiliated banks if the holding company has a bank or banks in danger of closing with total assets of \$250 million or more and which represent at least 33 percent of its banking assets.

Increasing the Number of Class C Directors

The Board has recommended that the Federal Reserve Act be amended to increase the number of Class C directors at each Federal Reserve Bank from three to five. The proposal aims to diversify further the backgrounds and interests represented on the boards of directors of the Reserve Banks as a way of accomplishing one of the objectives of the Federal Reserve Reform Act of 1977. That act provides for the representation of the interests of consumers, labor, and services, in addition to agriculture, commerce, and industry, on the boards of the Reserve Banks.

The Board also has recommended that thrift institutions be added to the groups that should be considered in selecting Class C directors in view of the changes made by the Monetary Control Act of 1980. That act applied reserve requirements to such institutions and made Federal Reserve credit and services available to them.

Funds for Reserve Bank Branches

The Board has recommended that the Federal Reserve Act be amended

with respect to the limit on the cumulative dollar amount that may be spent on construction of Federal Reserve Bank branch buildings. The System incurs expenses for branch construction principally for additions to, or replacements for, existing branch facilities. The current limitation, set in 1974, will be exhausted by projects that are under way or that are currently at an advanced planning stage. Branches of Federal Reserve Banks provide important services to the financial system and the public, including the distribution of coin and currency, the clearing of checks, and the processing of electronic payments. The current statutory limitation will prevent needed renovation and new construction at branch buildings.

Interstate Banking

The Board believes that the Congress should review and clarify national policy toward interstate banking. It recognizes that regional arrangements provide a possible transitional approach to full interstate banking. Viewed as a permanent solution, however, regional compacts would tend to balkanize banking, with a tendency toward regional concentrations. The potential weaknesses of regional compacts could be substantially ameliorated if states entering into such regional arrangements were also required after a few years to permit reciprocal entry by banks in any state that has enacted a regional arrangement or otherwise provides for entry of banks of any other states.

To forestall large concentrations of domestic banking resources, the Board has recommended that certain safeguards be included in liberalizing

interstate banking. The Board has suggested the following approaches: the very largest holding companies might be prohibited from merging with one another; institutions could be prohibited from obtaining by acquisition more than some fixed share of banking assets, although de novo or small acquisitions could still be permitted; and states could set limits on the percentage of banking assets within their own borders that could be acquired through acquisitions or mergers.

The Board has also recommended that Congress authorize interstate branching within metropolitan areas and within neighboring areas of contiguous states.

Improving Check Collection

The Board believes that depository institutions should clearly disclose to customers their policies with respect to the availability of deposited funds at the time an account is opened and when such policies are changed. Moreover, authority to override individual state statutes is necessary if the process of collection and return of checks is to be speeded, thus reducing or eliminating the risk to

depository institutions of making funds available more promptly.

The Board has felt primary emphasis should be placed on efforts to alleviate the problem of funds availability through disclosure and improvements to the check collection and return process. However, the Board is aware that some states have enacted mandatory schedules that appear to be operating reasonably well. The Board believes that mandatory schedules could be workable provided the Federal Reserve is given authority to determine those schedules in the light of anticipated improvements to the check system.

Such schedules should be based on the times in which most checks can reasonably be expected to be collected and returned to the depository institution in which they were first deposited in the event of dishonor. The Board believes that, after a relatively short transition period, schedules of from two to six business days or even less are feasible depending on where the check is drawn. The Board also believes that mandatory schedules should contain exceptions to permit depository institutions to place holds on deposits of accounts presenting unusually high risks.

Litigation

During 1986 the Board of Governors was named in 47 pending lawsuits, compared with 55 in 1985. Of the 12 new lawsuits filed in 1986, 9 raised questions under the Bank Holding Company Act, compared with 4 in 1985. As of December 31, 1986, 29 cases were pending, 14 of which involve questions under the Bank Holding Company Act. The sections below briefly describe each of these cases.

Bank Holding Companies— Antitrust Action

In 1986 no bank holding company acquisitions or mergers that had been approved by the Board were challenged by the U.S. Department of Justice under antitrust laws, and no such cases were pending from previous years.

Bank Holding Company Act— Review of Board Actions

In *Dimension Financial Corporation et al. v. Board of Governors*, No. 83-2696 (10th Circuit, filed December 30, 1983); *First Bancorporation v. Board of Governors*, No. 84-1011 (10th Circuit, filed January 5, 1984); and *Colorado Industrial Bankers Association et al. v. Board of Governors*, No. 84-1122 (10th Circuit, filed January 27, 1984), petitioners challenged the definition of “commercial loan” and “demand deposit” in a revision of the Board’s Regulation Y that was approved by the Board on December 14, 1983 (*Federal Reserve Bulletin*, vol. 70, February 1984, p. 121). The court of appeals set aside

the definitions challenged in Regulation Y on September 24, 1984 (744 F.2d 1402). A petition for writ of certiorari (No. 84-1274, filed February 6, 1985) was granted by the Supreme Court on April 29, 1985 (105 S. Ct. 2137). By decision dated January 22, 1986, the Court affirmed the court of appeals decision (106 S. Ct. 681).

In *Florida Bankers Association et al. v. Board of Governors*, Nos. 84-3269 and 84-3270 (11th Circuit, filed on April 20, 1984), petitioners seek review of a Board order dated March 23, 1984, approving an application by U.S. Trust Corporation, New York, New York, to expand the activities of its subsidiary, U.S. Trust Company of Florida, N.A., Palm Beach, Florida, to include the acceptance of time and demand deposits and the making of consumer loans (*Federal Reserve Bulletin*, vol. 70, April 1984, p. 371). On May 20, 1985, the court reversed the Board’s order of approval (760 F.2d 1135). By order dated January 27, 1986, the Supreme Court granted intervenor U.S. Trust Company’s petition for certiorari (No. 85-193), vacated the court of appeals judgment, and remanded the case back to the court of appeals (106 S. Ct. 875). In an opinion dated October 6, 1986, that court upheld the Board’s order (800 F.2d 1534). A petition for certiorari filed December 23, 1986, by petitioners is pending (No. 86-1023).

In *Florida Department of Banking v. Board of Governors*, Nos. 84-3831 and 84-3832 (11th Circuit, filed November 30, 1984), and *Florida Bankers Association v. Board of Gover-*

nors, Nos. 84-3883 and 84-3884 (11th Circuit, filed December 21, 1984), petitioners seek review of Board orders dated November 1, 1984, approving the applications by Bank of Boston Corporation, Boston, Massachusetts, and Bankers Trust New York Corporation, New York, New York, to expand the activities of their subsidiaries—Bank of Boston Trust Company of Southeast Florida, N.A., Dearfield Beach, Florida; Bank of Boston Trust Company of Southwest Florida, N.A., Sarasota, Florida; and Bankers Trust Company of Florida, N.A., Palm Beach, Florida—to include the acceptance of time and demand deposits and the making of consumer loans (*Federal Reserve Bulletin*, vol. 71, January 1985, pp. 55 and 51, respectively). Proceedings in the cases have been stayed pending a final disposition by the Supreme Court in *Florida Bankers Association v. Board of Governors*.

In *Independent Community Bankers Association of South Dakota v. Board of Governors*, No. 85-1496 (D.C. Circuit, filed August 7, 1985), petitioner seeks review of the Board's order dated July 12, 1985, approving the application of First City Bancorporation of Texas, Inc., Houston, Texas, to acquire First City Bank-Sioux Falls, N.A., Sioux Falls, South Dakota (*Federal Reserve Bulletin*, vol. 71, September 1985, p. 716). The case is pending.

In *First National Bancshares Corp. II v. Board of Governors*, No. 85-3702 (6th Circuit, filed September 4, 1985), petitioner sought review of the Board's order dated August 5, 1985, denying the application of First National Bancshares Corporation II, Lexington, Tennessee, to become a bank holding company by acquiring First National Bancshares Corpora-

tion, Lexington, Tennessee, and, indirectly, its subsidiary, First National Bank of Lexington, Lexington, Tennessee (*Federal Reserve Bulletin*, vol. 71, October 1985, p. 793). By order dated October 28, 1986, the court affirmed the Board's order (804 F.2d 54).

In *First National Bank of Blue Island Employee Stock Ownership Plan v. Board of Governors*, No. 85-2615 (7th Circuit, filed September 23, 1985), petitioner sought review of the Board's order dated August 22, 1985, denying the application of First National Bank of Blue Island Employee Stock Ownership Plan, Blue Island, Illinois, to become a bank holding company by acquiring Great Lakes Financial Resources, Inc., Blue Island, Illinois (*Federal Reserve Bulletin*, vol. 71, October 1985, p. 804). By order dated October 1, 1986, the court affirmed the Board's order (802 F.2d 291).

In *CBC, Inc. v. Board of Governors*, No. 86-1001 (10th Circuit, filed January 2, 1986), petitioner seeks review of the Board's order dated December 15, 1985, requiring that bank holding companies with assets of \$150 million or more must file certified financial statements with their annual reports. The case is pending.

In *St. James Bancorp v. Board of Governors*, No. 86-1224 (8th Circuit, filed February 19, 1986), petitioner sought review of the Board's order dated January 21, 1986, denying the application of St. James Bancorp, Inc., St. James, Minnesota, to become a bank holding company by acquiring Roseville Bancorp, Inc., Minneapolis, Minnesota, and thereby to indirectly acquire Mid America National Bank of Roseville, Roseville, Minnesota (*Federal Reserve Bulletin*, vol. 72, March 1986, p.

199). On April 15, 1986, petitioner's motion for dismissal of the case was granted by the court.

In *Securities Industry Association v. Board of Governors*, No. 86-1412 (D.C. Circuit, filed July 14, 1986), petitioner seeks review of the Board's order dated June 13, 1986, approving the application of National Westminster Bank PLC, London, England, and its U.S. subsidiary, NatWest Holdings, Inc., New York, New York, to offer investment advice and securities brokerage services to institutional customers through a single subsidiary (*Federal Reserve Bulletin*, vol. 72, August 1986, p. 584). The case is pending.

In *Jenkins v. Board of Governors et al.*, No. 86-1419 (D.C. Circuit, filed July 18, 1986), petitioner seeks review of the Board's action of May 21, 1986, approving the application of First Security Financial, Salt Lake City, Utah, for membership in the Federal Reserve System. The Board filed a motion to dismiss on August 14, 1986. The case is pending.

In *Independent Community Bankers Association of South Dakota v. Board of Governors*, No. 86-5373 (8th Circuit, filed October 3, 1986), petitioner seeks review of the Board's order dated September 15, 1986, approving the application of Michigan National Corporation, Bloomfield Hills, Michigan, to acquire Independence One Bank, N.A., Rapid City, South Dakota (*Federal Reserve Bulletin*, vol. 72, November 1986, p. 792). The case is pending.

In *Securities Industry Association v. Board of Governors*, No. 86-2768 (D.C. Circuit, filed October 7, 1986), petitioner seeks a declaration from the court that Charles Schwab & Co., Inc., a discount broker that is a subsidiary of a bank holding company, participated in the public offer-

ing of securities in violation of the Bank Holding Company Act. On October 27, 1986, the court dismissed the case for lack of jurisdiction, and on October 30, 1986, petitioner appealed. The case is pending (No. 86-5667).

In *Independent Insurance Agents of America, Inc., et al. v. Board of Governors*, Nos. 86-1572, 86-1573 and 86-1576 (D.C. Circuit, filed October 24, 1986), petitioners seek review of the Board's order dated October 3, 1986, amending the provisions of Regulation Y that deal with permissible insurance activities for bank holding companies. The case is pending.

Other Litigation Involving Challenges to Board Procedures and Regulations

In 1986 actions were taken or were pending, including those under the Financial Institutions Supervisory Act, the Glass-Steagall Act, and the Farm Credit Act.

Financial Institutions Supervisory Act

In *Carter v. Board of Governors et al.*, No. 85-4021 (6th Circuit, filed December 9, 1985), plaintiff sought review of the Board's order dated November 18, 1985, removing him as an officer of First National Bank of Clinton, Clinton, Kentucky. On February 13, 1986, the case was voluntarily dismissed by the petitioner.

In *Adkins v. Board of Governors*, No. 86-3853 (4th Circuit, filed May 8, 1986), petitioner seeks review of the Board's order dated April 24, 1986, assessing civil money penalties against him. The case is pending.

In a case filed in the U.S. District

Court for the District of Minnesota, No. 4-83-995 (filed November 16, 1983), which was placed under seal by court order, plaintiff alleges that the Board reviewed and copied his records at a national bank in violation of the Right to Financial Privacy Act. The case is pending.

In a case filed in the U.S. District Court for the District of Columbia, No. 86-2868 (filed October 20, 1986), which was placed under seal by court order, plaintiff seeks injunctive relief from a Temporary Order of Cease and Desist issued against him by the Board. The case is pending.

The Glass-Steagall Act

In *Securities Industry Association v. Board of Governors*, Nos. 80-2614 and 80-2730 (D.D.C., filed October 24, 1980), plaintiffs sought review of a Board statement dated September 26, 1980, denying in part plaintiff's petition that the Board prohibit Bankers Trust Company, a state member bank, from selling third-party commercial paper as an agent of the issuer, pursuant to the Glass-Steagall Act. On June 28, 1984, the Supreme Court overruled the Board's decision and remanded the case to the court of appeals (104 S. Ct. 2979), which remanded it to the district court. On October 19, 1984, the district court remanded the case to the Board to determine whether the methods that Bankers Trust uses to place commercial paper constitute underwriting or similar activities within the meaning of the Act. On June 4, 1985, the Board determined that the current placement methods of Bankers Trust are consistent with the Act. By memorandum orders dated February 4 and 18, 1986, the district court invalidated the Board's

decision and permanently enjoined Bankers Trust from their current placement methods (627 F.Supp. 695, 628 F.Supp. 1438). The injunction was subsequently stayed by the court of appeals. By order dated December 23, 1986, the court of appeals reversed the district court and reinstated the Board's decision (Nos. 86-5089, 86-5090, 86-5091, 86-5139).

Farm Credit Act

Several cases have been filed in various district courts seeking injunctive relief and damages relating to loans made to plaintiff farmers by commercial banks and the Farm Credit System. *Populist Party of Iowa v. Federal Reserve Board*, No. 85-626-B (S.D. Iowa, filed August 2, 1985), was dismissed on December 11, 1985, for lack of jurisdiction. *Alfson v. Wilkinson et al.*, No. A1-85-267 (D.N.D., filed October 8, 1985), was dismissed by court order on November 17, 1986. *Jensen v. Wilkinson et al.*, No. 85-4436-S (D. Kan., filed October 10, 1985), and related cases, were dismissed by court order on October 7, 1986. *Souser et al. v. Volcker et al.*, No. 85-C-2370 (D. Colo., filed November 1, 1985), and related cases, were dismissed by court order on December 4, 1985.

Kurkowski v. Wilkinson et al., No. CV-85-0-916 (D. Neb., filed October 16, 1985) was dismissed on April 22, 1986, and plaintiff appealed to the eighth circuit. The case is pending. *Podolak v. Volcker et al.*, No. C85-0456 (D. Wyo., filed October 28, 1985), and related cases were dismissed on February 24, 1986, and plaintiffs appealed to the tenth circuit. The cases are pending.

A motion by the federal defend-

ants to dismiss has been filed in each of the following cases: *Farmer v. Wilkinson et al.*, No. 4-85-CIVIL-1448 (D. Minn., filed October 21, 1985); *Kolb v. Wilkinson et al.*, No. C85-4184 (N.D. Iowa, filed October 22, 1985); *Myers et al. v. Federal Reserve Board*, No. 85-1427 (D. Ida., filed November 18, 1985).

Other Actions

In *Melcher v. Federal Open Market Committee*, No. 84-1335 (D.D.C., filed April 30, 1984), plaintiff challenges the constitutionality of the Federal Open Market Committee. On June 5, 1986, the court denied the defendant's motion to dismiss (644 F.2d 510). By order dated September 26, 1986, the court upheld the constitutionality of the Federal Open Market Committee and dismissed the case (*Id.*). The court denied plaintiff's motion to alter or amend judgment on November 18, 1986, and plaintiff filed a notice of appeal. The case is pending.

In *Brown v. United States Congress et al.*, No. 84-2887-6 (IG) (S.D. Cal., filed December 7, 1984), plaintiff seeks damages resulting from alleged discrimination in home financing and mandatory injunctions regarding the Board's monetary policy. The court dismissed the case on September 17, 1985. Plaintiff filed a notice of appeal on September 20, 1985, No. 85-6313 (9th Circuit), then voluntarily dismissed the appeal on November 12, 1985. On September 27, 1985, plaintiff filed a motion for reconsideration with the district court. The case is pending.

In *Lewis v. Volcker et al.*, No. C-1-85-0099 (S.D. Ohio, filed January 14, 1985), plaintiff seeks damages resulting from alleged violations of

federal monetary credit and bankruptcy statutes by the Board and BancOhio National Bank. On November 20, 1985, the U.S. magistrate recommended dismissal of the action. Plaintiff filed a notice of appeal on March 5, 1986, No. 86-3210 (6th Circuit). The case is pending.

In *Cook v. Spillman et al.*, No. CIV-S-85-0953 EJG (E.D. Cal., filed July 10, 1985); *Wight et al. v. Internal Revenue Service et al.*, No. CIV-S-85-0012 MLS (E.D. Cal., filed July 12, 1985); and *Urwyler et al. v. Internal Revenue Service et al.*, No. CV-F-85-402 REC (E.D. Cal., filed July 18, 1985), plaintiffs allege that the sixteenth amendment to the Constitution was not properly ratified and that the use of Federal Reserve notes constitutes illegal gambling. The Board's motions to dismiss the cases were granted by the district court. The plaintiff in *Cook* filed a notice of appeal on January 10, 1986, No. 86-1642 (9th Circuit), and by order dated December 22, 1986, the court dismissed the appeal. The plaintiffs in *Wight* and *Urwyler* filed notices of appeal on December 22, 1985, No. 85-2826, and December 3, 1985, No. 85-2877, respectively (9th Circuit). These cases are pending.

In *Johnson v. Federal Reserve System et al.*, Nos. S85-0958(R) and S85-1269(N) (S.D. Miss., filed July 16 and October 21, 1985), plaintiff sought injunctive relief and damages against defendants relating to foreclosures on plaintiff's property. By order dated June 23, 1986, the court dismissed the complaint. Plaintiff filed a notice of appeal on July 23, 1986, No. 86-4536 (5th Circuit). On September 29, 1986, the court dismissed the appeal for failure to prosecute.

In *McHuin v. Volcker et al.*, No. 85-2170 WARB (W.D. Okla., filed

August 29, 1985), plaintiff sought reinstatement as an employee at the Federal Reserve Bank of Kansas City. By order dated December 9, 1986, the complaint was dismissed by the court.

In *Howe v. United States et al.*, No. 85-4504-C (D. Mass., filed December 6, 1985), plaintiff challenges the constitutionality of the current monetary system. By order dated April 18, 1986, the court dismissed the complaint. Plaintiff filed a notice of appeal on April 28, 1986, No. 86-1430 (1st Circuit). By order dated

July 30, 1986, the court affirmed the district court's dismissal of the action, and plaintiff filed a petition for rehearing. By order dated August 29, 1986, the court denied the petition. Appellant filed a petition for writ of certiorari on November 26, 1986 (No. 86-889). The case is pending.

In *Optical Coating Laboratory, Inc. v. United States*, No. 288-86C (Ct. Cl., filed May 6, 1986), plaintiff seeks damages based upon the expiration of its contract with the Federal Reserve Board. The case is pending.

Banking Supervision and Regulation

In 1986 the Board of Governors continued its program to strengthen the supervision and regulation of the banking organizations under its jurisdiction. The Board initiated the program in the fall of 1985 in light of developments within the banking system over the past several years, and it is aimed at three broad areas of supervision: (1) preventing the emergence of problems in banking organizations through strengthened policies designed to encourage sound banking practices, (2) the early identification of problems that do emerge through more frequent and thorough on-site examinations and inspections, and (3) improved communication of findings to bank management and boards of directors so that they will move quickly to correct problems. The new program resulted in a 21 percent increase over 1985 in on-site examinations and inspections and a substantial expansion in the number of meetings with boards of directors.

The Board took several steps in 1986 to further strengthen its supervisory program. The principal step was its proposal in early 1986 for a risk-adjusted measure of capital adequacy. The plan has been revised and issued jointly for public comment with the other federal banking regulators and the Bank of England. The Board also revised its guidelines on capital adequacy, specifying that perpetual debt, properly structured, could qualify as a noncommon equity form of primary capital and respecifying the percentages of these forms of capital that can qualify as primary capital.

In recognition of the unique problems currently facing banks with substantial exposure to the agricultural and energy sectors of the economy, the Board in 1986 adopted policies to assist these banks. The policy allows such banks to operate with reduced levels of capital if they have the ability to improve their capital position over a reasonable period of time and if they have instituted reasonable plans to correct their financial or operating deficiencies. In addition, the policy makes clear that problem loans need not necessarily be written down if they are restructured in line with Financial Accounting Standard 15 so that the sum of future interest and principal payments equals at least the face amount of the loan.

Supervision for Safety and Soundness

The Federal Reserve conducts the following activities to ensure the safety and soundness of financial institutions: on-site examinations and inspections, surveillance and monitoring, and enforcement and other supervisory actions.

Examinations and Inspections

The on-site review of operations is an integral part of ensuring the safety and soundness of financial institutions. Examinations of state member banks and Edge corporations and inspections of bank holding companies and their subsidiaries entail (1)

an appraisal of the quality of the institution's assets; (2) an evaluation of management, including internal policies, operations, and procedures; (3) an assessment of the key financial factors of capital, earnings, asset and liability management, and liquidity; and (4) a review for compliance with applicable laws and regulations.¹

State Member Banks

The Federal Reserve is the primary federal supervisor and regulator of state-chartered commercial banks that are members of the Federal Reserve System. At the end of 1986 there were 1,110 state member banks, accounting for about 8 percent of all insured commercial banks. These banks held about 18 percent of total assets of insured commercial banks.

As stated above, the Federal Reserve in 1986 increased the frequency of scheduled examinations and inspections of state member banks and bank holding companies. In general, the new guidelines, established by the Board in the fall of 1985, call for state member banks to be examined at least annually. Except for large or troubled banks, examination by either a Reserve Bank or a state banking agency will meet that requirement. In 1986, 1,016 state member banks were examined, 298 of which were examined by state banking depart-

ments. System examiners conducted 811 examinations, many jointly or concurrently with examiners from state regulatory agencies.

Bank Holding Companies

In 1986 the number of bank holding companies increased by 12 to a total of 6,465. These organizations control 9,409 commercial banks, which hold about 92 percent of the total assets of insured commercial banks in the United States.

Most large bank holding companies, as well as small companies with significant nonbank assets, are inspected annually under the new policy. Others are inspected at least every three years or, in the case of the smallest companies that do not have nonbank assets, on a sample basis. The inspection focuses on the operations of the parent holding company and its nonbank subsidiaries; the subsidiary banks are examined by the appropriate federal banking regulatory agencies. In 1986, System examiners made 2,242 on-site inspections of bank holding companies. An additional 96 off-site inspections were conducted, and state examiners made 87 inspections.

Enforcement Actions and Civil Money Penalties

Under the Financial Institutions Supervisory Act of 1966, the Board of Governors has the authority to enter into written agreements with, or issue cease and desist orders against, state member banks and bank holding companies, and persons associated with such organizations that engage in unsafe or unsound practices or that violate applicable laws or regulations. The Board may also assess civil money penalties for violations of a cease-and-desist order,

1. The Board's Division of Consumer and Community Affairs is responsible for reviewing compliance with consumer and civil rights laws. The responsibility is accomplished mainly through examinations by specially trained Reserve Bank examiners. These regulatory responsibilities are described in the section of this REPORT covering consumer and community affairs. Compliance with other statutes and regulations, which is treated in this section, is the responsibility of the Board's Division of Banking Supervision and Regulation and of the Reserve Banks, whose examiners check for safety and soundness.

of the Bank Holding Company Act, or of certain provisions of the Federal Reserve Act.

In 1986 the Reserve Banks recommended and the Board's staff initiated and worked on 260 enforcement cases that involved 481 separate actions, such as cease and desist orders, removals, and civil money penalties, most dealing with unsafe or unsound banking practices; 125 cases involving 178 actions were completed by year-end. Also, the Board assessed or collected 12 civil money penalties, totaling \$625,000, paid by 1 state member bank, 1 bank holding company, and 10 individuals. A description of all formal supervisory actions during the year and the reasons for them were made available to the public in the Board's twice-yearly "Report on Formal Enforcement Actions."

International Activities

The Federal Reserve is responsible for supervising several international banking activities.

Edge and Agreement Corporations

Edge corporations are international banking organizations chartered by the Board to provide all segments of the U.S. economy with a means of financing international trade, especially exports. An agreement corporation is a company that enters into an agreement with the Board not to exercise any power that is impermissible for an Edge corporation. In 1986 the Federal Reserve conducted examinations of 124 Edge and agreement corporations.

Foreign-Office Operations of U.S. Banking Organizations

Examinations of the international operations of state member banks,

Edge corporations, and bank holding companies are conducted principally at the banking organizations' head offices in the United States, where the ultimate responsibility for foreign offices lies. To verify and supplement the results of the head-office examinations, on-site reviews of important foreign offices are performed at least every three years. In 1986 the Federal Reserve examined 16 foreign branches of state member banks and 15 foreign subsidiaries of Edge corporations and bank holding companies. All the examinations abroad were coordinated with the supervisory authorities of the countries in which the examinations took place.

U.S. Activities of Foreign Banks

Foreign banks continue to expand their operations in the United States and are significant participants in the U.S. banking system. As of December 31, 1986, 259 foreign banks operated 398 state-licensed branches and agencies, of which 32 are insured by the Federal Deposit Insurance Corporation; at year-end these foreign banks also operated 89 branches and agencies licensed by the Office of the Comptroller of the Currency, of which 3 have FDIC insurance. Foreign banks also directly owned 19 Edge corporations and 11 commercial lending companies. In addition, foreign banks held a majority interest in 72 U.S. commercial banks. Together, these foreign banks at year-end controlled approximately 12 percent of U.S. banking assets.

The Federal Reserve has broad authority to supervise and regulate foreign banks that engage in banking in the United States through branches, agencies, commercial lending companies, Edge corporations, or banks. In exercising this authority, the Fed-

eral Reserve relies on examinations conducted by the appropriate federal or state regulatory agency. Although states have primary authority for examining state-licensed, uninsured branches and agencies, the Federal Reserve participated in the examination of 98 such offices during the past year.

Specialized Examinations

The Federal Reserve conducts specialized examinations in the following areas of bank activity: electronic data processing, trust activities, municipal securities dealing and clearing, and securities transferring. In 1986, guidelines for the frequency of specialized examinations were adopted, and in conformance with the System's program for strengthening Reserve Bank supervision, the frequency of specialized examinations for problem institutions was increased.

Electronic Data Processing

Under the Interagency EDP Examination Program, the Federal Reserve examines the electronic data processing (EDP) activities of state member banks, Edge and agreement corporations, and independent centers that provide EDP services to these institutions. In 1986, System examiners conducted 334 on-site EDP reviews. In addition, the Federal Reserve reviews reports of EDP examinations issued by other bank regulatory agencies on organizations that provide data processing services to state member banks.

Trust Activities

The Federal Reserve examines trust departments of state member banks, trust companies that are members of the Federal Reserve System, and

certain foreign and domestic trust company subsidiaries of bank holding companies. These examinations review the trust functions to ensure that they are conducted in accordance with laws, regulations, and applicable fiduciary principles. During the year, the Federal Reserve conducted 250 such examinations.

Municipal Securities Dealers and Clearing Agents

The Securities Act Amendments of 1975 made the Board responsible for supervising state member banks and bank holding companies that act as municipal securities dealers or as clearing agencies. In 1986 the Board examined 32 of the 50 state member banks registered with the Board that deal in municipal securities.

A clearing agency acts as a custodian of securities involved in transactions settled by bookkeeping entries. The four agencies registered with the Board were examined in 1986.

Transfer Agents

System examiners conduct separate reviews of state member banks and bank holding companies that act as transfer agents. Transfer agents countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. During 1986 the Board examined 91 such banks and bank holding companies.

Surveillance and Monitoring

In line with the overall supervisory objective of maintaining a safe and sound banking system, the Federal Reserve monitors quarterly the financial condition of member banks and bank holding companies. The surveillance program supplements the

examination process through computerized screening systems that identify institutions with poor or deteriorating financial profiles. It further aids in the allocation of the System's examination resources by focusing on banking institutions that have serious financial problems and that may be subject to accelerated examinations or may warrant closer supervision. In 1986 the System strengthened its surveillance program by revising its screening program while continuing the electronic transmission of surveillance results between the Reserve Banks and the Board of Governors.

The Board revised the reporting requirements for large and small bank holding companies and introduced new requirements for reporting of data on nonbank subsidiaries. These changes enhanced the Federal Reserve System's ability to evaluate the financial condition of these institutions. Also, the performance report for bank holding companies has been revised and now includes information on nonbank activities.

Supervisory Reporting Requirements

In 1986 the Federal Reserve completely revised the Bank Holding Company Supervision Manual to incorporate amendments to Regulation Y and the programs to strengthen the overall supervision of bank holding companies. The Commercial Bank Examination Manual, which covers state member banks, was similarly updated to incorporate the strengthened program of supervision and regulation.

In 1986 the Federal Reserve made major revisions to the following reports required of bank holding companies: the financial statements for

bank holding companies with consolidated assets of \$150 million or more or with more than one subsidiary bank (FR Y-9C) and the parent-company-only financial statements for these bank holding companies (FR Y-9LP), both filed quarterly; the parent-company financial statements for one-bank holding companies with less than \$150 million (FR Y-9SP), filed semiannually; and the combined financial statements for nonbank subsidiaries (FR Y-11Q), filed quarterly, with a supplement (FR Y-11AS) filed annually by type of nonbank subsidiary. Under these revisions, the Federal Reserve significantly improved the overall quality of the financial data needed for the timely supervision and monitoring of bank holding companies.

Supervisory Policy

In 1986 the Board of Governors made or initiated major changes in its supervisory guidelines. The following sections summarize these changes and review other activities during the year to strengthen the supervisory program.

Capital Adequacy

In November 1986 the Board of Governors issued revisions to its capital adequacy guidelines for bank holding companies. These revisions (1) allowed certain perpetual debt securities to be treated as primary capital and (2) placed a combined limit on the amount of perpetual debt, perpetual preferred stock, and mandatory convertible debt securities that may qualify as primary capital. The combined amount of such securities that may qualify as primary capital was limited to one-third of total primary capital. In addition, the revisions limited the

amount of mandatory convertible securities and perpetual debt that may qualify as primary capital to 20 percent of total primary capital.

Supplemental Measure of Adjusted Capital

In January 1986 the Federal Reserve issued for public comment a proposal to supplement its capital adequacy guidelines for state member banks and bank holding companies. The supplemental adjusted capital measure was designed to relate capital requirements more closely to the risk profiles of banking organizations. The goals of the proposal are to (1) address off-balance-sheet exposures, which have expanded rapidly at many large banking organizations for the past several years; (2) temper the disincentives, inherent in the existing guidelines, to hold low-risk, relatively liquid assets; and (3) move capital requirements of state member banks and bank holding companies into closer alignment with capital adequacy policies in use or under development in other major industrial countries.

Similar proposals were issued by the Office of the Comptroller of the Currency (for national banks) and by the Federal Deposit Insurance Corporation (for federally insured nonmember banks). After most of the public comments that were to be received were in hand, the three U.S. bank regulatory authorities discussed with representatives of the Bank of England ways to bring into closer alignment the capital requirements of regulators in their respective countries. Those discussions produced a risk-based measure of capital that would create for the two countries a single definition of primary capital and a single set of standards

of capital adequacy. In January 1987 the Board of Governors issued the risk-based measure for public comment.

Problem Loans in Agriculture and Energy

In 1986 the three federal bank regulatory agencies agreed to employ a common general supervisory policy to assist banks that are essentially sound and well-managed yet are experiencing difficulty with their capital ratios because of problems with their loans in the agriculture and energy sectors. The policy calls for the Reserve Banks to exercise appropriate forbearance in applying capital adequacy guidelines for such banks if they demonstrate a clear potential for restoring their capital position over a reasonable period of time. Banks seeking such "capital forbearance" are required to notify their Reserve Bank immediately when loan losses have caused their capital ratios to fall to levels materially below the minimum regulatory standards. Notification is to be followed by a comprehensive operating plan for restoring capital to normal levels.

This policy does not discourage banks from forbearance on agricultural and energy loans in instances where it will work to the benefit of the bank as well as the borrower. Restructured loans do not require an automatic charge-off when future payments of principal and interest will at least equal the face amount of the loan under the criteria of Financial Accounting Standard 15 (Accounting by Debtors and Creditors for Troubled Debt Restructurings). In a related action effective June 30, 1986, the Federal Financial Institutions Examination Council amended the regulatory reports for

banks. These revised reports permit such restructured, performing loans to be reported separately from restructured but troubled loans.

Fees for Processing Applications and for Examining Edge Corporations

In 1986 the Board's staff studied the various methods the Federal Reserve System might use to recover some or all of the expenses involved in examining Edge corporations and in processing various types of applications. The Board has received, and at year-end was analyzing, public comments on its proposal to charge fees for these activities.

Relations with the States

The Board approved a policy, adopted by the Federal Financial Institutions Examination Council, to share confidential information with state agencies regulating banks and thrift institutions. This policy was adopted to better supervise the growing interstate activities of financial institutions.

The Board in 1986 provided \$100,000 to the Education Foundation of State Bank Supervisors. Established by the Conference of State Bank Supervisors, the foundation offers technical courses to state bank examiners. The Board also authorized the Federal Reserve Banks to provide scholarships to examiners employed by state banking agencies to help them cover expenses in attending training courses offered by the Federal Reserve and by the Federal Financial Institutions Examination Council.

Work on Accounting Standards

The Board and its staff are working to eliminate, to the greatest extent

possible, differences between regulatory reporting requirements and generally accepted accounting principles. Board staff members have served on various advisory committees of the Financial Accounting Standards Board (FASB) and are participating in that group's project on financial instruments. Staff members also provide commentary on proposals affecting banking organizations that are issued by FASB and by the American Institute of Certified Public Accountants.

Reducing Risks in Large-Dollar Electronic Payment Systems

In March 1986 the Board implemented a policy to reduce the risks associated with large-dollar payment systems. The Board strongly encouraged depository institutions using Fedwire or one of the private, large-dollar wire networks to adopt voluntary limits on their own overdrafts. The Board announced that institutions not complying with the policy would not be permitted to incur daylight overdrafts on Fedwire.

The program has reduced the risk associated with daylight overdrafts in several ways. First, the number of depository institutions incurring overdrafts during a typical monitoring period decreased from about 4,000 to about 3,200 between 1985 and 1986. Second, average cross-system funds overdrafts (to be distinguished from book-entry security overdrafts) remained approximately constant during this period, at about \$80 billion, while the dollar volume of wire funds transfers increased more than 30 percent. Thus, overdrafts as a portion of gross payments volume declined markedly. Finally, virtually no institutions exceeded their over-

draft caps. Together, these facts indicate that the program has contained the growth of overdrafts without disrupting the payments systems and thereby has lowered the risks to the Federal Reserve, to the depository institutions, and to the wider economy.

In December 1986 the Board issued for comment a series of proposals to further reduce payments system risk. The most significant of these would include in the total overdraft subject to voluntary ceilings those overdrafts due to book-entry security transactions. Depository institutions would have two options for including book-entry overdrafts in their total net debits subject to a cap: (1) depository institutions could include all of these overdrafts in their current net debit cap, or (2) institutions could collateralize the overdrafts caused by the book-entry transfers with book-entry securities that are eligible for pledging. Under the second option, only the uncollateralized portion of book-entry overdrafts would be added to the net debit subject to the cap.

The Board is also seeking comment on whether there should be a book-entry transfer limit and whether that limit should be \$25 million or \$50 million per transaction. Such a limit would induce market participants to deliver securities earlier in the day rather than "building" positions of securities until late in the day. Position-building by securities dealers is a major source of book-entry overdrafts.

The Board proposed the following additional changes:

- Reduce the levels for the sender net debit cap in the present policy by 25 percent.

- Establish a new de minimis cap category for institutions that do not

incur large or frequent daylight overdrafts. This cap would be the lesser of 10 percent of capital or \$500,000 and would be available to institutions that do not wish to undergo the self-assessment currently required for establishing a regular cap.

- Amend its policy statement regarding consolidation of payments activities by affiliated institutions. Under one option, holding companies might consolidate payment activities at one subsidiary through affiliate transfers over Fedwire, provided that the board of directors of the sending institution approved such transfers periodically. Under the second approach, transfers that create a pattern of overdrafts at the sending institution would be prohibited.

In addition, the Board proposed several changes affecting automated clearinghouse (ACH) procedures: (1) for purposes of calculating daylight overdraft levels only, post all entries for ACH debit payments and checks as of 1:00 p.m. Eastern time; (2) grant finality for ACH credit payments of \$5,000 or less at 1:00 p.m. local time; (3) treat as provisional credit all ACH debit items and those ACH credit items greater than \$5,000 until the Reserve Banks have received the funds; (4) accelerate the deadline for the return of debit transactions larger than \$2,500 to the nighttime deposit deadline on the banking day following settlement or receipt; and (5) require notification of returns of \$100,000 or more by 3:00 p.m. Eastern time on the banking day following settlement of receipt.

The Board will review the public comments on these proposals in the spring and summer of 1987. Final actions that may be taken are likely to have effective dates in both 1987 and 1988.

Staff Training

System staff training emphasizes analytical and supervisory themes common to the four areas of supervision and regulation—examinations, inspections, applications, and surveillance—and stresses the interdependence among these areas. In 1986 the Federal Reserve conducted forty-two school sessions covering a wide variety of topics.

Programs included twelve banking sessions split into three levels—core, intermediate, and advanced—plus a seminar for senior examiners on energy lending, six sessions of a credit analysis course, two sessions of a bank holding company applications school, and three consumer compliance schools.

New courses were held on bank holding company inspections, parent cash flow and liquidity analysis, and effective writing for banking supervision staff. In addition, some staff members attended two schools conducted jointly with the Federal Bureau of Investigation on white-collar crime and bank failures.

The Federal Financial Institutions Examination Council (FFIEC), of which the System is a member, conducted approximately 78 courses covering off-balance sheet risks, international banking, income property lending, securities dealers, white-collar crime, management, conducting meetings with management, and instructor training.

Overall, the Federal Reserve and the FFIEC in 1986 trained 1,433 persons: 830, including 33 from foreign central banks, in System schools; and 603 in FFIEC schools. In addition, 122 state examiners received training under the scholarship program for states provided by the Federal Reserve Banks—84 in Fed-

eral Reserve courses and 38 in FFIEC courses.

Federal Financial Institutions Examination Council

In 1986 the Federal Financial Institutions Examination Council made several policy recommendations to its constituent agencies; all the recommendations were adopted by the Federal Reserve's Board of Governors.² The Federal Reserve endorsed guidelines on uniform disclosure for adjustable-rate mortgages; and it endorsed a policy statement dealing with the provision of basic financial services, both of which are discussed in detail in the chapter on consumer and community affairs.

The Federal Reserve also endorsed the sharing of confidential supervisory information with state banking agencies, thereby formally adopting a policy in place at the Federal Reserve since the advent of regional interstate compacts. The new policy calls for the signing of formal agreements between federal and state regulatory agencies to assure uniform treatment of the information among the sharing agencies and to provide increased security.

The council also approved new and revised reporting requirements:

- The Reports of Condition and Income (Call Reports) were modified to reflect adoption of new regulatory policies toward agricultural lenders, which were announced by

2. The Federal Financial Institutions Examination Council consists of representatives of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the National Credit Union Administration, and the Office of the Comptroller of the Currency.

the banking constituency of the council.

- New reporting requirements for the sale of assets permit banks to treat loans transferred “without recourse” as sales in certain situations where banks retain residual interests in related escrow accounts. The new rule provides guidance for banks desiring to transfer assets and have the transactions qualify as sales rather than as borrowings.

- The Uniform Bank Performance Report was revised in several respects to make the presentation in it identical to that in the Call Report.

Regulation of the U.S. Banking Structure

The Board of Governors administers the Bank Holding Company Act, the Bank Merger Act, and the Change in Bank Control Act for state member banks and bank holding companies. In doing so, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the

structure of U.S. banking at the local, regional, and national levels. The Board also has primary responsibility for regulating the international operations of domestic banking organizations and the U.S. banking operations of foreign banks, whether conducted directly through a branch or agency or indirectly through a subsidiary commercial lending company. In addition, the Board has established regulations for the interstate banking activities of these foreign banks and for foreign banks that control a U.S. subsidiary commercial bank.

Bank Holding Company Act

By law, a company must obtain the Board’s approval if it is to form a bank holding company by acquiring control of one or more banks. Moreover, once formed, a bank holding company must receive the Board’s approval before acquiring additional banks or nonbanking companies.

In reviewing an application filed

Bank Holding Company Decisions by the Federal Reserve, Domestic Applications, 1986

Proposal	Direct action by the Board of Governors		Action under authority delegated by Board of Governors					Total
			Director of Division of Banking Supervision and Regulation ¹		Office of the Secretary ¹	Federal Reserve Banks		
	Approved	Denied	Approved	Denied	Approved	Approved	Permitted	
Formation of holding company ...	57	3	0	0	3	457	0	520
Merger of holding company	23	0	0	0	6	71	0	100
Acquisition								
Bank	76	2	0	0	28	405	0	511
Nonbank	117	0	0	0	14	171	240	542
Acquisition of bank service corporation ² ...	0	0	0	0	2	3	0	5
Other	1	1	1	0	0	0	0	3
Total	274	6	1	0	53	1,107	240	1,681

1. Official staff of the Board of Governors.
 2. Approved under the Bank Service Corporation

Act, which contains standards patterned after those of the Bank Holding Company Act.

by a bank holding company, the Board considers factors relating to the convenience and needs of the community to be served, the applicant's financial and managerial resources, the prospects of both the applicant and the firm to be acquired, and the competitive effects of the proposal.

In 1986 the Federal Reserve System acted on 1,681 bank holding company and related applications. The System approved 517 proposals to organize bank holding companies and denied 3; approved 509 bank acquisitions by existing bank holding companies and denied 2; and approved 542 requests to acquire non-bank companies that are engaged in activities closely related to banking and denied none. Data on these and related bank holding company decisions are shown in the accompanying table.

Bank Merger Act

The Bank Merger Act requires that all proposed bank mergers be acted upon by the appropriate federal bank regulatory agency. If the bank surviving the merger is a state member bank, the Federal Reserve has primary jurisdiction. Before acting on a proposed bank merger, the Federal Reserve considers factors relating to the community's convenience and needs, the financial and managerial resources and prospects of the existing and proposed institutions, and the competitive effects of the proposal. The Board must also consider the views of certain other agencies on the competitive factors involved in the transaction.

During 1986, the Federal Reserve approved 61 merger applications: 1 was approved by the Board; under authority delegated by the Board, its

Office of the Secretary approved 4 and the Reserve Banks approved 56. As required by law, each merger is described in this REPORT, in table 19 of the Statistical Tables section.

When the Office of the Comptroller of the Currency or the Federal Deposit Insurance Corporation has jurisdiction over a merger, the Board is asked to comment on the competitive factors to assure comparable enforcement of the antitrust provisions of the act. The Board and those agencies have adopted standard terminology for assessing competitive factors in bank merger cases to assure consistency in administering the act. On behalf of the Board, the Reserve Banks submitted 722 reports on competitive factors to the OCC and the FDIC in 1986.

Change in Bank Control Act

The Change in Bank Control Act of 1978 requires persons seeking control of a bank or bank holding company to obtain approval from the appropriate federal banking agency before the transaction occurs. The Board is responsible for reviewing changes in the control of state member banks and of bank holding companies. In evaluating a transfer of control under the Change in Bank Control Act, the Board must review the financial condition, competence, experience, and integrity of the acquiring person; it must consider the effect on the financial condition of the bank or bank holding company to be acquired; and it must determine the effect on competition in any relevant market. In October 1986 the Congress amended the act, requiring the federal banking agencies to publish notice of each proposed change in control and to invite public com-

ment, particularly from persons located in the markets served by the institution to be acquired. The amendments also require the federal banking agencies to investigate the qualifications of each person seeking control; the Board routinely conducts such an investigation under the Change in Bank Control Act. In 1986, the Federal Reserve System acted on 217 proposed changes in control of state member banks and bank holding companies. The Reserve Banks processed 208 cases, and the Board processed 9; the Board disapproved 1 proposal.

Delegation of Applications

The Board has delegated certain regulatory functions—including the authority to approve, but not the authority to deny, certain types of applications—to the Reserve Banks, to the Director of the Board's Division of Banking Supervision and Regulation, and to the Secretary of the Board.

The delegation of responsibility for applications permits staff members to work more efficiently at both the Board and the Reserve Banks by removing routine cases from the Board's agenda. During 1986, 85 percent of the applications were acted upon under delegated authority.

Timely Processing of Applications

The System maintains target dates and procedures for the processing of applications. These target dates promote efficiency at the Board and the Reserve Banks and reduce the burden on applicants. The time allowed for a decision is 60 days; during 1986, 93 percent of the applications met this standard.

In 1986, all of the 61 applications for bank mergers were processed within 60 days. The System also prepared 722 reports on the competitive factors of proposed mergers for the other two banking agencies; nearly all of these reports were processed within 30 days. Of the 217 change-of-control notices involving state member banks or bank holding companies, 201 were handled within 60 days.

The System measures its performance in processing international applications against a 60-day standard. In 1986 the Federal Reserve acted on 119 international applications, 87 percent of which the System handled within the time allowed.

Board Policy Decisions and Developments in Bank-Related Activities

In 1986 the Board approved a number of new nonbanking activities, including several for individual bank holding companies. It also had under consideration other proposed nonbanking activities, including those involving securities underwriting and real estate investment. In addition, the Board approved several acquisitions involving interstate banking.

Approval of Permissible Nonbanking Activities

In 1986 the Board for the first time approved the following activities for individual bank holding companies: (1) printing and selling checks and related documents that carry coded information for depository institutions; (2) providing investment advice in connection with securities brokerage, subject to certain conditions; and (3) placement of commercial paper to a limited extent.

In addition, the Board permitted

the formation of limited-purpose insurance companies, owned cooperatively by bank holding companies; the insurance firms would underwrite directors' and officers' blanket bond insurance for the shareholder bank holding companies.

The Board approved the addition to Regulation Y of six nonbanking activities for bank holding companies; the action means that applications for these activities, some of which had been approved previously in individual cases, are simplified and action on them is quickened. The new activities are: consumer financial counseling; tax planning and tax preparation; futures and options advisory services; check guaranty services; collection and credit bureau services; and appraisals of personal property. The Board also revised the portion of Regulation Y dealing with permissible insurance activities for bank holding companies.

The Board approved the application of a bank holding company to acquire a firm that electronically processes and transmits banking and economic data, a service permitted in Regulation Y. The Board determined, however, that the portion of the firm that designs and assembles the hardware for the data services was not incidental to the provision of those services. Therefore the Board disapproved the acquisition of the hardware portion of the firm.

Applications to Engage in New Nonbanking Activities

At year-end the Board also had under consideration applications to engage in two new nonbank activities: providing advisory services with respect to futures contracts on stock indexes; and acting as drawee for

instruments without a limit on face value when such instruments are sold or issued by nonaffiliated third parties.

At year-end, applications were also pending that would allow affiliates that already underwrite U.S. government securities to underwrite and deal in commercial paper, mortgage-backed securities, municipal revenue bonds and consumer-related receivables. The Board held a hearing in February 1987 on the complex factual and legal issues involved in these applications.

In 1986 the Board solicited public comment on whether to permit bank holding companies to engage in real estate investment activities under specific conditions. The conditions are designed to ensure that the conduct of the activity does not result in unsafe or unsound banking practices, unfair competition, conflicts of interest, or other adverse effects.

Interstate Banking

The Federal Reserve during 1986 approved applications by out-of-state banking organizations to acquire financially troubled thrift institutions. In one case the institution was uninsured; in two others the institutions were federally insured. These acquisitions helped restore financial stability to the affected communities and provided depositors with better access to their funds. Because of the significant public benefits resulting from the proposed transactions, the Board approved the acquisitions despite its general prohibition on affiliations between bank holding companies and thrift institutions.

In other matters, the Board continued to approve interstate bank holding company applications based on state laws that permit regional interstate banking. The U.S. Supreme

Court has upheld the constitutionality of such laws, and the Board has found in individual instances that these laws satisfy the requirement of the Bank Holding Company Act that each state's laws must allow the acquisition.

Applications by State Member Banks

State member banks must obtain the permission of the Board to open new domestic branches, to make investments in bank premises that exceed 100 percent of capital stock, and to add to the capital base from sales of subordinated debt. State member banks must also give six months' notice of their intention to withdraw from membership in the System, although the Board may shorten or eliminate the notice period in specific cases. These matters are normally handled under delegated authority by the Federal Reserve Banks or, in the case of bank premises or proposed sales of subordinated debt, by the Director of the Board's Division of Banking Supervision and Regulation.

Stock Repurchases by Bank Holding Companies

A bank holding company sometimes purchases its own shares from its shareholders. When the company borrows the money to buy the shares, the transaction increases the debt of the bank holding company and simultaneously decreases its equity. Relatively large repurchases may undermine the financial condition of a bank holding company and its bank subsidiaries. The Board's regulations require holding companies to give advance notice of repurchases that retire 10 percent or more of their

consolidated equity capital. The Board may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital guidelines. During 1986 the Federal Reserve reviewed 142 proposed stock repurchases by bank holding companies, 139 of which were acted on by the Reserve Banks on behalf of the Board.

Public Notice of Board Decisions

Each action by the Board that involves a bank holding company, bank merger, change in control, or international banking proposal is effected by an order or announcement. Orders state the decision along with the essential facts of the application and the basis for the decision; announcements state only the decision. All orders and announcements are released immediately to the public; they are also reported in the Board's weekly H.2 statistical release and in the monthly *Federal Reserve Bulletin*. Actions taken by the Reserve Banks are also reported in the H.2 statistical release and in the *Bulletin*. Announcements of applications and notices received by the System but not yet acted on are made in the H.2 release.

International Activities of U.S. Banking Organizations

The Board has four principal statutory responsibilities in supervising the international operations of U.S. banking organizations: it must provide authorization and regulation of foreign branches of member banks; of overseas investments by member banks, Edge corporations, and bank holding companies; and of investments by bank holding companies in

export trading companies; and it must charter and regulate Edge corporations and their investments.

Foreign Branches of Member Banks

Under provisions of the Federal Reserve Act and of Regulation K, member banks in most cases must seek Board approval to establish branches in foreign countries. In reviewing proposed foreign branches, the Board considers the requirements of the law, the condition of the bank, and the bank's experience in international business. In 1986 the Board approved the opening of three foreign branches.

By the end of 1986, 158 member banks were operating 952 branches in foreign countries and overseas areas of the United States; 131 national banks were operating 822 of these branches, and 27 state member banks were operating the remaining 130 branches.

International Banking Facilities

The Board amended its Regulations D and Q to permit the establishment of international banking facilities (IBFs) in the United States as of December 3, 1981. An IBF is essentially a set of asset and liability accounts that is segregated from the other accounts of the office establishing the IBF. Deposits from, and credit extended to, foreign residents or other IBFs generally can be booked at these facilities free from domestic reserve requirements and interest rate limitations. Subject to conditions specified by the Board, IBFs may be established by U.S. depository institutions, by Edge and agreement corporations, and by U.S.

branches and agencies of foreign banks. By the end of 1986, 540 IBFs had been established.

Edge and Agreement Corporations

Under sections 25 and 25(a) of the Federal Reserve Act, Edge and agreement corporations may engage in international banking and foreign financial transactions. These corporations, which are usually subsidiaries of member banks, provide their owner organizations with the following powers: (1) they may conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions; and (2) their powers to make foreign investments are broader than those of member banks because they can invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks. By the end of 1986 there were 137 Edge corporations, which had 104 branches. The Board requires each Edge corporation that is engaged in banking to maintain a ratio of equity to risk-assets of at least 7 percent.

Foreign Investments

Under authority of the Federal Reserve Act and the Bank Holding Company Act, U. S. banking organizations may engage in activities overseas with the authorization of the Board. To a significant extent, the Board's Regulation K permits such investments without prior Board review. In 1986 the Board reviewed and permitted 64 foreign investments by member banks, Edge and agreement corporations, and bank holding

companies. In most cases, the applicant requested permission to increase an existing investment.

Export Trading Companies

In 1982 the Bank Export Services Act amended section 4 of the Bank Holding Company Act to permit bank holding companies, their subsidiary Edge or agreement corporations, and bankers' banks to invest in export trading companies, subject to certain limitations and after Board review. The purpose was to allow effective participation by bank holding companies in the financing and development of export trading companies. On June 2, 1983, the Board adopted regulations to achieve the objectives set forth in the law: to facilitate the export of goods and services produced in the United States and to minimize potential adverse effects on the subsidiary banks of the bank holding companies involved. In 1986 the Board acted affirmatively on the 2 notifications received for the establishment of export trading companies. At year-end, 33 bank holding companies had investments in export trading companies.

Enforcement of Other Laws and Regulations

The preceding sections have discussed the Board's activities in carrying out its statutory responsibilities for the supervision of bank safety and soundness and the regulation of the banking structure. This section describes the enforcement of other laws, rules, and regulations.

Bank Secrecy Act

Through the examination process, the Federal Reserve monitors whether

the institutions it supervises are complying with the recordkeeping and reporting requirements of the Currency and Foreign Transactions Reporting Act (the Bank Secrecy Act). Among the stipulations in the act to combat unlawful currency transactions is the requirement that financial institutions and selected other businesses report to the Internal Revenue Service certain cash transactions and shipments of more than \$10,000.

As mandated by the passage of the Anti-Drug Abuse Act of 1986, Board staff members worked with the other federal financial institutions to develop regulations to ensure compliance with the Bank Secrecy Act. The regulations took effect January 27, 1987.

In 1986 the Board also strengthened its examination procedures to emphasize the provisions of the Bank Secrecy Act that federal law enforcement authorities consider to be critical. Board staff members continue to serve as active participants on the Bank Secrecy Act interagency working group headed by the Department of the Treasury.

Securities Regulation

Under the Securities Exchange Act of 1934, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. In fulfilling its responsibility under the act, the Board limits the amount of credit that may be provided by securities brokers and dealers (Regulation T), by banks (Regulation U), and by other lenders (Regulation G). Regulation X extends these credit limitations, or margin requirements, to certain borrowers and to certain credit extensions, such as credit obtained from foreign lenders by U.S. citizens.

Brokers and dealers are examined for compliance with Regulation T by the Securities and Exchange Commission, the National Association of Securities Dealers, and the national securities exchanges. The three federal bank supervisory agencies examine banks under their respective jurisdictions for compliance with Regulation U. Other lenders are examined for compliance with Regulation G by the Board, the National Credit Union Administration, the Farm Credit Administration, or the Federal Home Loan Bank Board according to the jurisdiction involved. At the end of 1986 there were 533 "G-lenders," of which 297 were subject to the Board's supervision. Of these 297, 180 are subject to regular inspection by the Federal Reserve System. During the year, Federal Reserve examiners inspected 52 G-lenders for compliance with the Federal Reserve's margin requirements (these lenders are inspected on either a biennial or triennial basis, according to the type of credit extended).

Regulations U and G in general impose credit limits on loans whose purpose is the purchasing or carrying of publicly held equity securities and that are secured by such securities.

Regulation T limits the amount of credit that brokers and dealers may extend when securities serve as collateral for credit that is used to purchase or carry securities. This collateral must consist of stocks and bonds traded on national securities exchanges, of certain over-the-counter (OTC) stocks that the Board designates as having characteristics similar to those of stocks listed on national exchanges, or of bonds meeting certain requirements.

The Board's Division of Banking Supervision and Regulation monitors

the market activity of all over-the-counter stocks to determine what stocks are subject to the Board's margin regulations. In 1986 the Board published the resulting "List of Marginable OTC Stocks" in February, May, August, and November. The November list consisted of 2,887 stocks.

In January 1986 the Board adopted an interpretive rule regarding the margin requirements under Regulation G. The interpretation declares that debt securities issued by a shell corporation set up to acquire and hold the stock of a target company in a takeover attempt are presumed to be secured indirectly by the target stock and thus subject to the margin restrictions of Regulation G. The interpretation indicates that the presumption would not apply to certain transactions if the lenders could rely on assets other than the target stock as collateral or look to a guaranty of the parent of the shell corporation for repayment.

Under section 8 of the Securities Exchange Act, a nonmember domestic or foreign bank may lend to brokers or dealers posting registered securities as collateral only if the bank has filed an agreement with the Board that it will comply with all the statutes, rules, and regulations applicable to member banks regarding credit on securities. During the year, the Board processed 17 such agreements.

In 1986 the Securities Regulation Section of the Board's Division of Banking Supervision and Regulation issued 43 interpretations of the margin regulations. Those that presented sufficiently important or novel issues were published in the "Securities Credit Transactions Handbook," which is part of the Federal Reserve Regulatory Service. These interpre-

Loans by State Member Banks to their Executive Officers, 1985-86

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
October 1-December 31, 1985	1,111	23,869,607	6.25-21
January 1-March 31, 1986	1,199	21,566,130	1.0-21
April 1-June 30, 1986	1,356	23,509,393	6.0-21
July 1-September 30, 1986	1,410	26,715,716	6.5-30.53

tations serve as a guide to the margin regulations.

Financial Disclosure by State Member Banks

Under the Board's Regulation F, state member banks must disclose certain information of interest to investors, including financial reports and proxy statements, if they issue securities registered under the Securities Exchange Act of 1934. Board staff members review the information for compliance with the regulation. At the end of 1986, 31 state member banks, most of which are of small or medium size, were registered with the Board under Regulation F.

The disclosure rules of Regulation F are required by statute to be substantially similar to those issued by the Securities and Exchange Commission. In 1986 a comprehensive revision of Regulation F was under consideration by the Board's staff. That revision would require banks subject to Regulation F to use the forms prescribed by the Securities and Exchange Commission. Small banks would have the option of filing

simplified quarterly reports. The proposal would ease compliance with the regulation.

Loans to Executive Officers

Under section 22(g) of the Federal Reserve Act, each state member bank must include with each quarterly report of condition a report of all extensions of credit made by the bank to its executive officers since the date of the bank's previous report of condition. The accompanying table summarizes these data for the last quarter of 1985 and the first three quarters of 1986.

Federal Reserve Membership

At the end of 1986, 5,995 banks were members of the Federal Reserve System, a decrease of 55 from the previous year.

Member banks operated 28,456 branches on December 31, 1986, a net increase of 861 for the year. Member banks accounted for 40 percent of all commercial banks in the United States and for 64 percent of all commercial banking offices.

Regulatory Simplification

The Board of Governors established the Regulatory Improvement Project in 1978 and reaffirmed its commitment to regulatory improvement by creating a Regulatory Policy and Planning Committee in 1986. The program was established to minimize the burdens imposed by regulation; to ensure that consideration is given to minimizing the economic impact of regulation on small business; to see that interested parties have the opportunity to participate in the design of proposed regulations and to comment on them; and to ensure that regulations are written in simple and clear language. In addition to monitoring the creation of new regulations, the program periodically reviews all existing regulations for adherence to these objectives.

Regulation Q

The statutory authority to set interest rate ceilings on time and savings deposits and to prescribe rules regarding early withdrawals from time deposits expired on March 31, 1986. In anticipation of that date, the Board of Governors in early 1986 revised and simplified its Regulation Q, which governed the payment of interest on deposits. Following that action, the major substantive provision of Regulation Q that remains, as authorized by section 19(i) of the Federal Reserve Act, prohibits a member bank from paying interest on a demand deposit. As part of the revision, the definition of "savings deposit" was deleted from Regulation Q, and an amended definition

of the term was incorporated in Regulation D. Together, these changes removed the \$150,000 limitation on business savings accounts.

The provisions of Regulation Q dealing with the advertising of interest on deposits were not amended in final form in March; however, the Board has issued for comment in a separate rulemaking a consolidation of the various provisions regarding advertising that will be included in the final version of Regulation Q. To promote equity of treatment among financial institutions and to promote consumer understanding, the Board is attempting to develop advertising provisions that will be adopted by all the financial regulatory agencies.

Published interpretations of Regulation Q that are obsolete will be rescinded; viable interpretations of it will be revised in line with the simplification of that regulation.

Policy Regarding Risk on Large-Dollar Wire Transfer Systems

In December 1986 the Board issued for comment several refinements to its policy regarding large-dollar transfers. One of the proposals would establish a de minimus cap for institutions that do not incur large or frequent daylight overdrafts. This cap would be the lesser of 10 percent of capital or \$500,000 and would be available to institutions that do not undergo the self-assessment required for establishing a positive limit or

cap on the amount of daylight overdrafts that can be accumulated on Fedwire.

Under the Board's current policy, a bank must submit a formal cap to the Federal Reserve for incurring daylight overdrafts or else the Federal Reserve imposes a limit of zero. This part of the policy has proved difficult to administer. In any two-week period, almost half of the 3,400 institutions incurring an overdraft have either not filed a cap or have filed a cap of zero. These 1,600 institutions are mainly small and account for about 0.4 percent of all overdrafts. The managements of these institutions find either the self-evaluation or the absolute avoidance of overdrafts excessively burdensome, and many Reserve Banks have found the resources required to monitor and counsel these institutions to be unusually high relative to the risks involved. The proposed de minimus cap is intended to alleviate these burdens and costs.

In order to further reduce the burden on participating institutions, the Board amended its policy statement in December to provide that depository institutions that perform a self-assessment need do so only once each year rather than every six months as provided in the original policy statement.

Regulation Y

In May 1986 the Board requested comment on whether it should ease the conditions it imposes through Regulation Y on the acquisition of thrift institutions by bank holding companies. Currently, under regulations implementing the Bank Holding Company Act and the Garn-St Germain Depository Institutions Act

of 1982, bank holding companies are prohibited from allowing their thrift subsidiaries and other affiliates to conduct joint marketing and sales operations; from cross-advertising through thrift subsidiaries the services and products offered by other affiliates; and from engaging in certain transactions, such as the transfer, purchase, sale, or loan of any assets or liabilities between the thrift institution and other affiliates of the bank holding company.

These limitations were developed in the context of specific applications pending before the Board and after informal public hearings and public comment.

The conditions were designed to assure that the thrift institution continued to be operated as a separate and independent institution engaged primarily in mortgage lending activities and did not operate in fact as a bank in violation of the interstate banking prohibitions of the Bank Holding Company Act. The conditions were also designed to prevent the acquiring bank holding company from obtaining an unfair competitive advantage over other banks and thrift institutions.

In light of the deregulation of interest rate differentials, the increasing similarity in the powers of banks and thrift institutions, and the spread of interstate deposit-taking in both the thrift and banking industries, the Board believes that the recent requests for relief from the restrictions in Regulation Y present an appropriate framework for re-evaluating them.

In October 1986 the Federal Reserve Board expanded the list of permissible nonbanking activities for bank holding companies; it also eliminated a 1972 limit on the premiums

that could be charged by bank holding companies engaging in credit life insurance underwriting. The requirement had stipulated that premiums must be set on a sliding scale 2 to 5 percent lower than the maximum allowed by the state where the company is located. In its decision, the Board determined that this requirement put bank holding companies at an unfair disadvantage with respect to competing insurance providers.

During the past 14 years the underwriting of credit life insurance has remained the only permissible non-banking activity for which the Board has imposed a requirement or condition that effectively determines the fee structure for the activity. This is a matter of concern to the Board because, under authorization of a federal statute, credit insurance rate ceilings are set by the individual states. Moreover, the rate reduction requirement can give the appearance that only lower rates than those permitted by the states are in the public interest or create a public

benefit. This may be inappropriate at a time when the states have become increasingly active in reviewing and setting credit life insurance rate ceilings.

Regulation K

In July the Board amended the portion of Regulation K (International Banking Activities) requiring that a banking organization apply to the Board when it proposes to invest more than 10 percent of its capital and surplus in a foreign organization. After several years' experience with these procedures, the Board has found that the investments do not always raise issues that require Board consideration. The July amendment permits the bank to make an additional investment after giving 45 days' notice to the Board, a change that will shorten the time that banking organizations must wait before making additional foreign investments.

Federal Reserve Banks

Developments in the Pricing of Federal Reserve Services and in the Payments Mechanism

In 1986 the Federal Reserve Banks fully recovered their costs of providing priced services, as required by the Monetary Control Act of 1980. The System as a whole recovered 104.3 percent of its operating expenses and imputed costs, compared with 105.6 percent in 1985. Table 10, in the Statistical Tables section of this REPORT, presents revenue and expenses by major category of service for 1986 and 1985.

Revenue at the Reserve Banks from all priced services totaled \$742.0 million and costs were \$711.7 million. These figures include the income and expenses related to clearing balances, the value of priced float, and the PSAF (the private sector adjustment factor—the taxes and costs of capital that the System would have incurred if it were a private firm). The Federal Reserve System had a net revenue of \$30.3 million from priced services.

In March 1986 the Board implemented a policy to reduce risk on networks used to transfer large-dollar payments. Proposals to further reduce risk on funds transfer systems, on the book-entry securities system, and on automated clearing-house systems, were published in December. See the chapter in this REPORT on banking supervision and regulation for a discussion of the Board's policy and proposals on reducing and controlling risks in the payments system.

Check Collection

Check operations of the Federal Reserve Banks cost the System \$547.9 million in 1986, including the cost of float and the PSAF. Check operations generated \$572.5 million in revenue, for a surplus of \$24.6 million. The number of checks processed by Federal Reserve Banks rose 5 percent in 1986, to 16.2 billion.

In May the Board adopted amendments to Regulation J, which governs check collection and wire transfers. One change permits the Reserve Banks to collect checks drawn on banks located in foreign countries. This service will be limited, and the checks will be collected through correspondent banks. The other amendments relate primarily to a Reserve Bank's liabilities regarding check collection and funds transfers.

In July the Board requested public comment on proposals to make permanent the two-tiered pricing structure being tested at the head offices of the Federal Reserve Banks of Minneapolis and Kansas City and to establish criteria for determining the conditions under which a tiered fee structure would be extended to other Federal Reserve offices. A tiered pricing structure can reflect the costs of check processing more accurately because it permits setting fees for sending institutions according to the costs associated with the presentment point. The Board approved the proposals in November.

The Federal Reserve System in 1986 continued its efforts to improve the handling of return items (checks

not honored by the institution on which they were drawn). In one initiative, the Federal Reserve and the financial industry conducted a test in which they learned that the forward collection process had the potential to speed the return of many items to the institution of first deposit. The Federal Reserve and the financial industry will continue to pursue this initiative.

In November the Board issued for public comment a proposal to provide a redeposit service for low-dollar checks that are returned because of insufficient or uncollected funds. Under this service, which is being tested in the St. Louis, Atlanta, and Cleveland Districts, Reserve Banks would intercept dishonored checks and redeposit them on behalf of the collecting institution. This practice would speed processing times and reduce costs. No final action was taken in 1986 on this proposal.

Automated Clearinghouse

In 1986, for the first time, the prices of automated clearinghouse (ACH) services were established to recover 100 percent of costs. Previously, an incentive pricing program had been in effect. The cost of providing commercial ACH services in 1986 was \$35.3 million; revenue was \$36.5 million. The System processed 363 million commercial transactions, 28 percent more than in 1985.

In September the Board issued for public comment a proposal for recovering the cost of float generated by ACH transactions processed during the night cycle and for a corresponding reduction of the per-item surcharge on such transactions. Specifically, the Board proposed to es-

tablish a float factor that would be applied to the value of ACH debit transactions processed at night. No final action was taken in 1986 on this proposal.

Wire Transfer of Funds and Net Settlement Service

The number of funds transfers over Fedwire grew 10.6 percent in 1986, for a total of 49.9 million transactions. This service and the net settlement service incurred costs of \$79.6 million and earned \$82.7 million, for a net surplus of \$3.1 million.

In June the Board published for public comment a proposal to require that information in third-party Fedwire messages be in a standard format to facilitate the automated handling of transfers. In November, the Board approved a 25-cent surcharge to be imposed beginning April 1, 1988, for Fedwire funds transfers not conforming to the format; it set April 3, 1989, as the date on which use of the standard format will be mandatory.

In March the Board approved a modification to the interim terms for treating ACH net settlement entries for credit transactions. Pending adoption of policies to address the risk involved in these transactions, net settlement entries for ACH credit transactions will be treated as final at 6:00 p.m. Eastern time on the settlement date. Net settlement entries for ACH debit transactions are treated as provisional until the business day following the settlement date.

Net settlement services based on next-day finality were approved for one network of automated teller machines in 1986.

Coin and Currency Services

In its coin and currency operations the Federal Reserve continued to focus on controls, on efficiency in processing currency, and on the maintenance of high quality in circulating currency.

Four Federal Reserve Districts provided transportation of cash in 1986, and five Districts provided wrapped coins for depository institutions. Two other priced services—special packaging and more frequent access—were approved by the Board in December. These services are now covered by the uniform standards for cash services. In addition, the System tested and evaluated prototype second-generation equipment intended to improve the processing of currency.

The Federal Reserve continued to work with the Treasury to develop measures to deter the counterfeiting of U.S. currency.

Definitive Securities and Noncash Collection Services

The System received \$24 million in revenue for definitive safekeeping and noncash collection services in 1986; the total cost of these services, including the PSAF, was \$24.4 million. The number of definitive securities issues and deposits increased 4 percent in 1986 to 165,000. The number of items for noncash collection decreased 7 percent to 4.3 million.

In November the Board approved the consolidation at the Federal Reserve Bank of Minneapolis of the collections involving municipal bonds and coupons that were being carried out by the Federal Reserve Bank of San Francisco. It also published for

public comment a list of factors to be considered when the Reserve Banks propose to consolidate in one District the priced services offered by one or more other Districts. No action was taken on this proposal in 1986.

Book-Entry Securities

The Federal Reserve provides book-entry securities services for the Treasury and for certain federally sponsored agencies, such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. Since October 1985 the Treasury has established the fees, and the Reserve Banks have charged institutions for these transfers. The Treasury component of the book-entry service incurred costs, excluding the PSAF, of \$11.9 million in 1986. For the year, the Federal Reserve processed 6.0 million transfers of Treasury securities, 98 percent of which were on line. Book-entry services for federal agency securities incurred costs, including the PSAF, of \$7.9 million and earned revenue of \$9.4 million in 1986. The Federal Reserve processed 1.8 million such transfers during the year, 98 percent of which were on line.

In July 1986 the Federal Reserve implemented the Treasury Direct book-entry securities system. This system, which was developed on behalf of the Treasury, is used primarily by individual investors. Treasury bonds and notes were converted to Treasury Direct in 1986; Treasury bills will be phased into the system in 1987.

Book-entry safekeeping and transfer of mortgage-backed securities issued by federal agencies were ex-

panded from the Federal Reserve Bank of New York to all Districts during 1986.

Float

Federal Reserve float increased to a daily average of \$446 million in 1986, compared with \$440 million in 1985. The costs of all Federal Reserve float associated with priced services are recovered each year.

In May the Board approved a standard holiday schedule to be followed by the Federal Reserve Banks, effective January 1, 1987. At that time, it also adopted proposals to modify the procedures that the Federal Reserve Banks use to recover the cost of float generated by ACH debit and check transactions associated with nonstandard holiday and midweek closings. The allocation of check float, which was adopted as an amendment to Regulation J, is effective January 1, 1987. The modifications to the procedures for recovering the cost of ACH float take effect on April 1, 1987.

In conjunction with proposals issued in December to reduce risk in the ACH system, the Board proposed procedures to recover the cost of float generated by ACH credit transactions. No final action was taken in 1986 on this proposal.

Examinations

The Board's Division of Federal Reserve Bank Operations examines the 12 Reserve Banks and their 25 branches each year, as required by section 21 of the Federal Reserve Act. The results of the audits are given to the management and directors of the respective Banks and to the Board of Governors. Also, to

assess conformance with the policies issued by the Federal Open Market Committee, the Division annually audits the accounts and holdings of the Federal Reserve System Open Market Account at the Federal Reserve Bank of New York and the foreign currency operations conducted by that Bank. The Division furnishes copies of these reports to the Committee. The examination procedures used by the Division are reviewed each year by a private firm of certified public accountants.

Income and Expenses

The accompanying table summarizes the income, expenses, and distribution of net earnings of the Federal Reserve Banks for 1986 and 1985.

Income was \$17,465 million in 1986, \$667 million less than in 1985, reflecting the decrease in interest rates on securities. Total expenses were \$1,254 million (\$1,049 million in operating expenses, \$108 million in earnings credits granted to depository institutions, and \$97 million in assessment for expenditures by the Board of Governors). The cost of currency was \$181 million. Income from financial services was \$628 million.

The profit-and-loss account showed a net addition of \$1,976 million, due primarily to a \$1,971 million increase in the value of assets denominated in foreign currencies and revalued at market exchange rates. Statutory dividends to member banks totaled \$110 million, \$7 million more than in 1985. The rise reflected an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to the U.S. Treasury in

Income, Expenses, and Distribution of Net Earnings of Federal Reserve Banks,
1986 and 1985

Thousands of dollars

Item	1986	1985
Current income	17,464,528	18,131,983
Current expenses	1,156,868	1,127,744
Operating expenses	1,049,159	1,022,527
Earnings credits granted	107,709	105,217
Current net income	16,307,661	17,004,238
Net addition to (deduction from) current net income	1,975,893	1,301,624
Assessments by the Board of Governors	278,118	251,116
For expenditures of Board	97,338	77,378
For cost of currency	180,780	173,739
Net income before payments to U.S. Treasury	18,005,437	18,054,746
Dividends paid	109,588	103,029
Payments to U.S. Treasury (interest on Federal Reserve notes)	17,803,895	17,796,464
Transferred to surplus	91,954	155,253

Details may not add to totals because of rounding.

the form of interest on Federal Reserve notes totaled \$17,804 million, compared with \$17,796 million in 1985. This sum consists of all net income after dividends and the amount necessary to bring the surplus of the Banks to the level of their paid-in capital.

In the Statistical Tables section of this REPORT, table 7 provides a summary statement of the income and expenses of the Federal Reserve System for 1982-86; table 8 details income and expenses of each Federal Reserve Bank for 1986, and table 9 shows a condensed statement for each Bank for 1914-86. A detailed account of the assessments and expenditures of the Board of Governors appears in the next section, Financial Statements.

In early 1986 the Board produced a new document, *Annual Report: Budget Review*, which consolidated public information available from other sources in order to provide a single, comprehensive view of the System's 1986 calendar year budgets and its budgetary processes. That publication has been produced again to cover the budgets of the Board and the Banks for 1987.

Federal Reserve Bank Premises

During 1986 the Board of Governors authorized the construction of an addition to the Federal Reserve Bank of Atlanta and a new building for the Charlotte Branch in North Carolina. With Board approval the Helena Branch acquired two properties adjacent to the existing building for future expansion. Table 6, in the Statistical Tables section of this REPORT, shows the cost and book values of premises owned or occupied by the Federal Reserve Banks and Branches and of real estate acquired for future banking-house purposes.

Holdings of Securities and Loans

The accompanying table presents holdings, earnings, and average interest rates on securities and loans of the Federal Reserve Banks for the years 1984-86.

Average daily holdings of securities and loans during 1986 were \$193,354 million, an increase of \$16,666 million over 1985. Holdings of U.S. government securities in-

Securities and Loans of Federal Reserve Banks, 1984–86

Millions of dollars, except as noted

Item and year	Total ¹	U.S. government securities ²	Loans
<i>Average daily holdings³</i>			
1984.....	165,002	161,247	3,726
1985.....	176,688	175,359	1,329
1986.....	193,354	192,514	840
<i>Earnings</i>			
1984.....	17,080	16,688	389
1985.....	16,954	16,843	111
1986.....	16,199	16,142	57
<i>Average interest rate (percent)</i>			
1984.....	10.35	10.35	10.44
1985.....	9.60	9.60	8.38
1986.....	8.38	8.38	6.84

1. Includes acceptances.

2. U.S. Treasury securities and obligations of federal agencies.

3. Based on holdings at opening of business.

creased \$17,155 million, and holdings of loans decreased \$489 million.

From 1985 to 1986 the average rate of interest on all types of holdings decreased—from 9.60 percent to 8.38 percent on U.S. government securities and from 8.38 percent to 6.84 percent on loans.

Volume of Operations

Table 11, in the Statistical Tables section of this REPORT, shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 1983–86.

Board of Governors

Financial Statements

The financial statements of the Board examined by Price Waterhouse, independent public accountants, for the years 1986 and 1985 were

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Governors of the
Federal Reserve System

In our opinion, the accompanying balance sheets and the related statements of revenues and expenses and fund balance and of changes in financial position present fairly the financial position of the Board of Governors of the Federal Reserve System at December 31, 1986 and 1985, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied. Our examinations of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.



Washington, D.C.
February 18, 1987

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
BALANCE SHEETS

ASSETS	As of December 31	
	1986	1985
CURRENT ASSETS		
Cash	\$ 8,646,210	\$ 8,144,767
Accounts receivable	2,045,873	1,542,680
Stockroom and cafeteria inventories, at cost	285,843	290,475
Prepaid expenses and other assets	627,054	151,851
Total current assets	<u>11,604,980</u>	<u>10,129,773</u>
PROPERTY, BUILDINGS AND EQUIPMENT, Net (Note 3)	64,827,375	56,176,157
OTHER ASSETS	1,708,506	—
Total assets	<u>\$78,140,861</u>	<u>\$66,305,930</u>
LIABILITIES AND FUND BALANCE		
CURRENT LIABILITIES		
Accounts payable	\$ 4,655,794	\$ 6,508,435
Accrued payroll and related taxes	2,861,053	2,611,001
Accrued annual leave	3,896,398	3,807,048
Other liabilities	478,716	440,831
Total current liabilities	<u>11,891,961</u>	<u>13,367,315</u>
COMMITMENTS AND CONTINGENCIES (Note 6)	—	—
FUND BALANCE	66,248,900	52,938,615
Total liabilities and fund balance	<u>\$78,140,861</u>	<u>\$66,305,930</u>

The accompanying notes are an integral part of these statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
STATEMENTS OF REVENUES AND EXPENSES
AND FUND BALANCE

	For the years ended December 31	
	1986	1985
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	\$ 97,337,500	\$ 77,377,700
Other revenues (Note 4)	<u>3,169,567</u>	<u>2,531,681</u>
Total operating revenues	<u>100,507,067</u>	<u>79,909,381</u>
BOARD OPERATING EXPENSES		
Salaries	53,259,376	53,179,014
Retirement and insurance contributions	5,401,797	6,052,103
Depreciation and losses (gains) on disposals	6,156,450	4,954,614
Contractual services and professional fees	4,085,161	2,722,449
Postage and supplies	3,490,423	3,341,459
Utilities	2,970,714	2,874,688
Equipment and facility rentals	2,598,055	2,943,864
Travel	2,537,670	2,230,242
Repairs and maintenance	2,083,894	1,928,506
Printing and binding	2,022,535	2,000,230
Other (Note 4)	2,150,807	2,044,414
Total operating expenses	<u>86,756,882</u>	<u>84,271,583</u>
BOARD OPERATING REVENUES OVER (UNDER) EXPENSES	<u>13,750,185</u>	<u>(4,362,202)</u>
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	180,779,673	173,738,745
Expenses for currency printing, issuance, retirement, shipping and research costs (Note 5)	<u>181,219,573</u>	<u>173,298,845</u>
CURRENCY ASSESSMENTS (UNDER) OVER EXPENSES	<u>(439,900)</u>	<u>439,900</u>
TOTAL REVENUES OVER (UNDER) EXPENSES	13,310,285	(3,922,302)
FUND BALANCE, Beginning of year	<u>52,938,615</u>	<u>56,860,917</u>
FUND BALANCE, End of year	<u>\$ 66,248,900</u>	<u>\$ 52,938,615</u>

The accompanying notes are an integral part of these statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
STATEMENTS OF CHANGES IN FINANCIAL POSITION

	For the years ended December 31	
	1986	1985
SOURCES OF CASH		
Board operations		
Net revenues over (under) expenses	\$13,310,285	\$(3,922,302)
Add (deduct) items not affecting cash		
Depreciation and losses (gains) on disposals	6,156,450	4,954,614
Accrued annual leave	89,350	142,740
(Increase) decrease in accounts receivable, inventories, and prepaid expenses and other assets	(973,764)	77,752
(Decrease) increase in accounts payable, accrued payroll and related taxes, and other liabilities	(1,564,704)	1,058,996
Funds provided by operations	17,017,617	2,311,800
Proceeds from disposals of furniture and equipment	2,277,264	3,628
Total sources	<u>19,294,881</u>	<u>2,315,428</u>
USES OF CASH		
Capital expenditures for		
Buildings	303,557	399,094
Furniture and equipment	16,781,375	4,069,299
Increase in other non-current assets	1,708,506	—
Total uses	<u>18,793,438</u>	<u>4,468,393</u>
INCREASE (DECREASE) IN CASH	501,443	(2,152,965)
CASH BALANCE, Beginning of year	<u>8,144,767</u>	<u>10,297,732</u>
CASH BALANCE, End of year	<u>\$ 8,646,210</u>	<u>\$ 8,144,767</u>

The accompanying notes are an integral part of these statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 1986 AND 1985

(1) SIGNIFICANT ACCOUNTING POLICIES

Board Operating Revenues and Expenses—Assessments made on the Federal Reserve Banks for Board operating expenses are calculated based on expected cash needs. These assessments, other operating revenues, and operating expenses are recorded on the accrual basis of accounting.

Issuance and Redemption of Federal Reserve Notes—The Board incurs expenses and assesses the Federal Reserve Banks for the cost of printing, issuing, shipping and retiring Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are not Board operating transactions.

Property, Buildings and Equipment—The Board's property, buildings and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 3 to 10 years for furniture and equipment and from 10 to 50 years for building equipment and structures.

Other Assets—The Board has made prepayments for computer equipment to be received over the next two years. In addition, maintenance on this and other computer equipment received during 1986 has been prepaid through January 1989. Other Assets includes the equipment prepayments and the portion of the prepaid maintenance services which will be received during 1988 and 1989. As the equipment is received and maintenance service provided the furniture and equipment account and the appropriate expense account will be charged accordingly.

Contingency Processing Center—The Board operates on behalf of the Federal Reserve System a contingency processing center to handle data processing requirements during emergency situations. The Board recovers from the Federal Reserve Banks a proportionate amount of the operating expenses of the center in the form of fees.

(2) RETIREMENT BENEFITS

Substantially all employees of the Board participate in either the Retirement Plan for Employees of the Federal Reserve Board (Board Plan), the Retirement Plan for Employees of the Federal Reserve System (Bank Plan) or the Civil Service Plan. The Board Plan, the Bank Plan and the Civil Service Plan are a contributory defined benefit plan, a non-contributory defined benefit plan, and a defined contribution plan, respectively.

Board contributions to the Board Plan and the Bank Plan are actuarially determined and funded in the current period. Board contributions to the Civil Service Plan directly match employee contributions. The Board contributions to the retirement plans totaled \$719,000 in 1986 and \$1,960,000 in 1985.

As of January 1, 1986 and 1985 (the dates of the most recent actuarial valuations), the accumulated

plan benefits for the Federal Reserve Board Plan, including those arising from COLA supplements, were as follows:

	As of January 1	
	1986	1985
Actuarial present value of accumulated plan benefits		
Vested	\$65,003,000	\$57,167,000
Nonvested.....	4,625,000	3,691,000
	<u>\$69,628,000</u>	<u>\$60,858,000</u>

The assumed rate of return used in determining the present value of accumulated plan benefits was 8.5% in 1986 and 9.5% in 1985.

As of January 1, 1986 and 1985, net assets available for plan benefits were approximately \$165 million and \$135 million, respectively.

As of January 1, 1987, the Board will implement Statement of Financial Accounting Standards No. 87, Employers Pension Accounting. This implementation will require changes in the accounting principles for the Board Plan and the Bank Plan. Because of the overfunded status of the plans, it is presently estimated that implementation of FAS 87 will result in a reduction of operating expense (pension income) and the recording of prepaid pension cost.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Under the Thrift Plan, members may contribute up to a fixed percentage of their salary. Board contributions are based upon a fixed percentage of each member's basic contribution and were \$1,337,000 in 1986 and \$877,000 in 1985.

The Board also provides certain health care benefits for retired employees. The cost of providing the benefits is recognized by expensing the insurance premiums which were \$98,300 in 1986 and \$54,200 in 1985.

(3) PROPERTY, BUILDINGS AND EQUIPMENT

The following is a summary of the components of the Board's fixed assets, at cost, net of accumulated depreciation.

	As of December 31	
	1986	1985
Land and		
improvements	\$ 1,301,314	\$ 1,301,314
Buildings	62,062,311	61,851,962
Furniture and		
equipment	<u>31,955,505</u>	<u>24,799,885</u>
	95,319,130	87,953,161
Less accumulated		
depreciation	<u>30,491,755</u>	<u>31,777,004</u>
Total property,		
buildings and		
equipment ...	<u>\$64,827,375</u>	<u>\$56,176,157</u>

(4) OTHER REVENUES AND OTHER EXPENSES

The following are summaries of the components of Other Revenues and Other Expenses.

	As of December 31	
	1986	1985
Other Revenues		
Contingency		
Processing		
Center fees	\$1,543,761	\$ 981,573
Sale of		
publications	1,124,482	1,104,154
Miscellaneous	<u>501,324</u>	<u>445,954</u>
Total other		
revenues	<u>\$3,169,567</u>	<u>\$2,531,681</u>
Other Expenses		
Subsidies and		
contributions ..	\$ 703,213	\$ 794,611
Tuition, registrations		
and membership		
fees	587,670	495,694
Cafeteria operations,		
net	520,450	531,411
Miscellaneous	<u>339,474</u>	<u>222,698</u>
Total other		
expenses	<u>\$2,150,807</u>	<u>\$2,044,414</u>

(5) ADVANCED COUNTERFEIT DETERRENCE RESEARCH

During the period 1983 through 1986, the Board sponsored programs to develop technology to deter counterfeiting of U.S. currency and to detect counterfeit currency in circulation. In connection with this program, the Board: 1) sponsored basic research into applying a deterrent device to currency; 2) sponsored the prototyping of production equipment and processes; 3) purchased certain equipment required for a contractor to make test production runs; 4) purchased application machines for use in the production of currency; and 5) sponsored research into methods for detecting counterfeit currency during sorting processes by the Federal Reserve Banks. The Board's participation in this program was substantially complete by the end of 1985.

The Board's programs were research and development efforts and, accordingly, all costs were expensed as incurred. Board costs associated with this program were \$728,964 and \$6,734,590 for 1986 and 1985, respectively, and are included in currency expenses. Certain equipment was sold for \$750,000 in 1986 and \$451,400 in 1985. The sale proceeds were credited to currency costs.

(6) CONTINGENCIES

The major research contract associated with the counterfeit deterrence program discussed in Note 5 expired on January 31, 1985. The contractor has filed a lawsuit for contract termination costs of approximately \$4 million. Board counsel believes that the contract properly expired, the claim for termination costs is without merit, and additional costs, if any, to the Board will not be material.

The Board has been named as a defendant in various litigation involving challenges to, or appeals from, actions or proposed actions of the Board pursuant to statutory requirement or authorization. Such lawsuits generally seek injunctive or declaratory relief against the Board rather than monetary awards. It is the opinion of Board counsel that such lawsuits involving monetary awards do not represent a material liability to the Board.

(7) FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

The Board is one of the five member agencies of the Federal Financial Institutions Examination Council (the "Council"). During 1986 and 1985, the Board paid \$137,000 and \$131,000, respectively, in assessments for operating expenses of the Council. These amounts are included in subsidies and contributions for 1986 and 1985.

The Board serves as custodian for the Council's cash account. This cash is not reflected in the accompanying financial statements. It also processes accounting transactions, including payroll for most of the Council employees, and performs other administrative services for which the Board is reimbursed by the Council.

The Board is not reimbursed for the costs of personnel who serve on the Council and on the various task forces and committees of the Council.

Statistical Tables

222 Tables

1: Detailed Statement of Condition of All Federal Reserve Banks Combined,
December 31, 1986¹

Thousands of dollars

ASSETS		
Gold certificate account		11,083,947
Special drawing rights certificate account		5,018,000
Coin		485,827
<i>Loans and securities</i>		
Loans to depository institutions	1,564,797	
Federal agency obligations		
Bought outright	7,829,312	
Held under repurchase agreement	2,313,535	
U.S. Treasury securities		
Bought outright		
Bills	103,774,920	
Notes	68,125,600	
Bonds	<u>25,723,814</u>	
Total bought outright	197,624,334	
Held under repurchase agreement	<u>13,691,465</u>	
Total securities		<u>211,315,799</u>
Total loans and securities		223,023,443
<i>Items in process of collection</i>		
Transit items	8,063,084	
Other items in process of collection	<u>2,211,741</u>	
Total items in process of collection		10,274,825
<i>Bank premises</i>		
Land	105,638	
Buildings (including vaults)	452,363	
Building machinery and equipment	157,448	
Construction account	<u>127,236</u>	
Total bank premises	737,047	
Less depreciation allowance	<u>182,516</u>	554,531
Bank premises, net		660,169
<i>Other assets</i>		
Furniture and equipment	515,885	
Less depreciation	<u>249,460</u>	
Total furniture and equipment, net	266,425	
Denominated in foreign currencies ²	9,474,797	
Interest accrued	2,601,442	
Premium on securities	1,206,675	
Due from Federal Deposit Insurance Corporation	2,904,299	
Overdrafts	190,096	
Prepaid expenses	26,159	
Suspense account	17,483	
Real estate acquired for banking-house purposes	6,368	
Other	<u>126,488</u>	
Total other assets		<u>16,820,232</u>
Total assets		<u><u>267,366,443</u></u>

I.—Continued

LIABILITIES	
<i>Federal Reserve notes</i>	
Outstanding (issued to Federal Reserve Banks)	231,612,805
Less held by Federal Reserve Banks	<u>36,252,042</u>
Total Federal Reserve notes, net	195,360,763
<i>Deposits</i>	
Depository institutions	48,107,361
U.S. Treasury, general account	7,587,759
Foreign, official accounts	286,709
<i>Other deposits</i>	
Officers' and certified checks	54,673
International organizations	198,757
Other ³	<u>669,890</u>
Total other deposits	923,320
Deferred credit items	9,012,278
<i>Other liabilities</i>	
Discount on securities	2,247,837
Sundry items payable	49,437
Suspense account	30,228
All other	<u>14,121</u>
Total other liabilities	2,341,623
Total liabilities	263,619,813
CAPITAL ACCOUNTS	
Capital paid in	1,873,315
Surplus	1,873,315
Other capital accounts ⁴	<u>0</u>
Total liabilities and capital accounts	267,366,443

1. Amounts in boldface type indicate items in the Board's weekly statement of condition of the Federal Reserve Banks.

2. Of this amount \$3,028.1 million was invested in securities issued by foreign governments, and the balance was invested with foreign central banks and the Bank for International Settlements.

3. In closing out the other capital accounts at year-end, the Reserve Bank earnings that are payable to the Treasury are included in this account pending payment.

4. During the year, includes undistributed net income, which is closed out on Dec. 31; see table 8.

224 Tables

2. Statement of Condition of Each Federal Reserve Bank,
December 31, 1986 and 1985

Millions of dollars

Item	Total		Boston	
	1986	1985	1986	1985
ASSETS				
Gold certificate account	11,084	11,090	703	658
Special drawing rights certificate account	5,018	4,718	314	281
Coin	485	487	26	26
<i>Loans</i>				
To depository institutions	1,565	3,060	43	24
Other	0	0	0	0
Acceptances held under repurchase agreements	0	0	0	0
<i>Federal agency obligations</i>				
Bought outright	7,829	8,227	464	481
Held under repurchase agreements	2,314	1,694	0	0
<i>U.S. Treasury securities</i>				
Bought outright ¹	197,625	177,798	11,702	10,386
Held under repurchase agreements	13,691	3,529	0	0
Total loans and securities	223,024	194,308	12,209	10,891
Items in process of collection	10,273	11,667	621	529
Bank premises	661	607	92	93
<i>Other assets</i>				
Denominated in foreign currencies ²	9,475	7,016	284	196
All other	7,345	7,679	209	201
Interdistrict Settlement Account	0	0	+ 1,444	+ 449
Total assets	267,365	237,572	15,902	13,324
LIABILITIES				
Federal Reserve notes	195,360	181,450	12,260	11,349
<i>Deposits</i>				
Depository institutions	48,107	28,631	2,870	1,178
U.S. Treasury, general account	7,588	9,351	0	0
Foreign, official accounts	287	480	5	4
Other	923	1,041	21	36
Total deposits	56,905	39,503	2,896	1,218
Deferred credit items	9,012	10,679	497	521
Other liabilities and accrued dividends ³	2,342	2,378	127	130
Total liabilities	263,619	234,010	15,780	13,218
CAPITAL ACCOUNTS				
Capital paid in	1,873	1,781	61	53
Surplus	1,873	1,781	61	53
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	267,365	237,572	15,902	13,324
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding (issued to Bank)	231,603	208,427	14,393	13,504
LESS: Held by Bank	36,243	26,977	2,133	2,155
Federal Reserve notes, net	195,360	181,450	12,260	11,349
<i>Collateral for Federal Reserve notes</i>				
Gold certificate account	11,084	11,090	...	...
Special drawing rights certificate account	5,018	4,718	...	...
Other eligible assets	0	0	...	...
U.S. Treasury and federal agency securities	179,258	165,642	...	...
Total collateral	195,360	181,450	...	...

2. --- Continued

New York		Philadelphia		Cleveland		Richmond	
1986	1985	1986	1985	1986	1985	1986	1985
3,146	3,277	431	483	650	635	959	969
1,489	1,354	162	195	314	270	461	426
14	16	20	23	33	33	81	88
	2,060	178	155	206	153	231	312
134	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0
2,539	2,744	251	288	460	481	673	726
2,314	1,694	0	0	0	0	0	0
64,079	59,305	6,328	6,226	11,605	10,394	16,985	15,682
13,691	3,529	0	0	0	0	0	0
82,757	69,332	6,757	6,669	12,271	11,028	17,889	16,720
1,311	1,338	595	533	375	432	701	682
32	31	47	48	32	28	100	101
2,341	1,712	436	344	569	449	483	344
2,038	1,521	115	128	203	212	280	365
-5,576	-3,210	-466	-651	+247	+215	-158	-417
87,552	75,371	8,097	7,772	14,694	13,302	20,796	19,278
61,693	53,848	5,513	5,870	12,482	11,341	17,150	16,656
14,639	8,153	1,945	1,136	1,528	1,126	2,645	1,584
7,588	9,351	0	0	0	0	0	0
174	367	7	7	9	10	8	7
516	495	8	28	27	43	45	69
22,917	18,366	1,960	1,171	1,564	1,179	2,698	1,660
1,158	1,486	381	485	298	434	564	584
852	793	71	80	128	134	182	196
86,620	74,493	7,925	7,606	14,472	13,088	20,594	19,096
466	439	86	83	112	107	101	91
466	439	86	83	112	107	101	91
0	0	0	0	0	0	0	0
87,552	75,371	8,097	7,772	14,694	13,302	20,796	19,278
65,671	57,138	7,908	7,999	13,896	12,543	19,955	18,176
4,068	3,290	2,395	2,129	1,414	1,202	2,805	1,520
61,693	53,848	5,513	5,870	12,482	11,341	17,150	16,656
...
...
...
...

2. Statement of Condition of Each Federal Reserve Bank,
December 31, 1986 and 1985—Continued

Millions of dollars

Item	Atlanta		Chicago	
	1986	1985	1986	1985
ASSETS				
Gold certificate account	507	413	1,394	1,451
Special drawing rights certificate account	203	192	656	620
Coin	47	53	29	29
<i>Loans</i>				
To depository institutions	73	38	89	32
Other	0	0	0	0
Acceptances held under repurchase agreements	0	0	0	0
<i>Federal agency obligations</i>				
Bought outright	312	252	873	906
Held under repurchase agreements	0	0	0	0
<i>U.S. Treasury securities</i>				
Bought outright ¹	7,885	5,446	22,040	19,588
Held under repurchase agreements	0	0	0	0
Total loans and securities	8,270	5,736	23,002	20,526
Items in process of collection	815	909	1,013	958
Bank premises	51	48	43	22
<i>Other assets</i>				
Denominated in foreign currencies ²	777	582	1,279	982
All other	158	220	3,319	3,659
Interdistrict Settlement Account	+1,489	+3,476	+2,975	-263
Total assets	12,317	11,629	33,710	27,984
LIABILITIES				
Federal Reserve notes	7,557	7,341	27,064	23,724
<i>Deposits</i>				
Depository institutions	3,430	2,893	5,008	2,545
U.S. Treasury, general account	0	0	0	0
Foreign, official accounts	12	12	20	21
Other	28	31	103	109
Total deposits	3,470	2,936	5,131	2,675
Deferred credit items	867	914	752	849
Other liabilities and accrued dividends ³	87	144	261	254
Total liabilities	11,981	11,335	33,208	27,502
CAPITAL ACCOUNTS				
Capital paid in	168	147	251	241
Surplus	168	147	251	241
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	12,317	11,629	33,710	27,984
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding (issued to Bank)	12,545	10,558	29,158	25,553
LESS: Held by Bank	4,988	3,217	2,094	1,829
Federal Reserve notes, net	7,557	7,341	27,064	23,724

1. Includes securities loaned—fully guaranteed by U.S. Treasury securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale-purchase transactions.

2. Valued monthly at market exchange rates.

3. Includes exchange-translation account reflecting the monthly revaluation at market exchange rates of foreign-exchange commitments.

4. Includes special investment account at the Federal Reserve Bank of Chicago in Treasury bills maturing within 90 days.

2.—Continued

St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
1986	1985	1986	1985	1986	1985	1986	1985	1986	1985
366	357	168	156	598	617	692	713	1,470	1,361
160	157	66	63	216	263	307	307	670	590
26	26	20	22	43	48	40	39	106	84
37	15	206	3	152	207	195	19	21	42
0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0
230	239	113	108	321	367	501	532	1,092	1,103
0	0	0	0	0	0	0	0	0	0
5,816	5,162	2,856	2,343	8,118	7,930	12,655	11,492	27,556	23,844
0	0	0	0	0	0	0	0	0	0
6,083	5,416	3,175	2,454	8,591	8,504	13,351	12,043	28,669	24,989
568	828	492	654	1,527	1,840	710	1,358	1,545	1,606
20	18	24	25	46	46	20	19	154	128
284	197	313	232	426	316	786	561	1,497	1,101
104	114	60	92	162	156	214	540	483	471
-1	+487	+78	-39	-106	-769	-80	-612	+154	+1,334
7,610	7,600	4,396	3,659	11,503	11,021	16,040	14,968	34,748	31,664
5,889	5,796	2,838	2,391	8,293	7,823	11,250	11,100	23,371	24,211
1,021	896	884	471	1,425	1,055	3,675	2,615	9,037	4,979
0	0	0	0	0	0	0	0	0	0
4	4	5	5	7	7	12	12	24	24
12	21	12	13	28	37	41	51	82	108
1,037	921	901	489	1,460	1,099	3,728	2,678	9,143	5,111
504	709	495	630	1,495	1,837	610	751	1,391	1,479
64	66	40	33	93	102	136	143	301	303
7,494	7,492	4,274	3,543	11,341	10,861	15,724	14,672	34,206	31,104
58	54	61	58	81	80	158	148	271	280
58	54	61	58	81	80	158	148	271	280
0	0	0	0	0	0	0	0	0	0
7,610	7,600	4,396	3,659	11,503	11,021	16,040	14,968	34,748	31,664
7,467	7,091	3,383	2,999	11,665	11,100	14,236	13,043	31,236	28,723
1,578	1,295	545	608	3,372	3,277	2,986	1,943	7,865	4,512
5,889	5,796	2,838	2,391	8,293	7,823	11,250	11,100	23,371	24,211

3. Federal Reserve Open Market Transactions, 1986¹

Millions of dollars

Type of transaction	Jan.	Feb.	Mar.	Apr.
U.S. TREASURY SECURITIES				
<i>Outright transactions (excluding matched transactions)</i>				
Treasury bills				
Gross purchases	286	0	396	2,988
Gross sales	225	2,277	0	0
Exchange	0	0	0	0
Redemptions	0	1,000	0	0
Others within 1 year				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Maturity shift	725	4,776	1,152	447
Exchange	-596	-2,148	-1,458	-1,129
Redemptions	0	0	0	0
1 to 5 years				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Maturity shift	-703	-4,776	-1,152	-447
Exchange	596	1,548	1,458	1,134
5 to 10 years				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Maturity shift	-22	0	0	-5
Exchange	0	350	0	0
More than 10 years				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Maturity shift	0	0	0	0
Exchange	0	250	0	0
All maturities				
Gross purchases	286	0	396	2,988
Gross sales	225	2,277	0	0
Redemptions	0	1,000	0	0
Matched transactions				
Gross sales	63,109	90,459	88,917	109,253
Gross purchases	61,156	94,368	88,604	103,957
Repurchase agreements²				
Gross purchases	24,257	0	6,748	21,156
Gross sales	24,699	3,087	6,748	13,634
Net change in U.S. Treasury securities	-2,335	-2,456	83	5,214
FEDERAL AGENCY OBLIGATIONS				
<i>Outright transactions</i>				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Redemptions	0	40	0	0
Repurchase agreements²				
Gross purchases	5,384	0	1,821	3,387
Gross sales	6,454	623	1,821	1,955
Net change in agency obligations	-1,070	-663	0	1,432
Total net change in System Open Market Account	-3,405	-3,119	83	6,647

*Less than \$500,000 in absolute value.

1. Sales, redemptions, and negative figures reduce holdings of the System Open Market Account; all other figures increase such holdings. Details may not add to totals because of rounding.

2. In July 1984 the Open Market Trading Desk discontinued accepting bankers acceptances in repurchase agreements.

3. -- Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
3,196	1,402	867	2,940	861	928	3,318	5,422	22,602
0	0	0	0	0	0	0	0	2,502
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	1,000
0	0	0	0	0	0	190	0	190
0	0	0	0	0	0	0	0	0
1,847	1,152	579	1,715	1,053	974	2,974	1,280	18,673
-1,819	-1,957	-1,253	-4,087	-1,892	-529	-1,810	-1,502	-20,179
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	893	0	893
-1,532	-1,152	-386	-1,194	-1,053	-969	-2,414	-1,280	-17,058
1,019	1,957	1,253	2,587	1,892	529	1,510	1,502	16,984
0	0	0	0	0	0	236	0	236
0	0	0	0	0	0	0	0	0
-315	0	-193	-520	0	-5	-560	0	-1,620
500	0	0	1,000	0	0	200	0	2,050
0	0	0	0	0	0	158	0	158
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
300	0	0	500	0	0	100	0	1,150
3,196	1,402	867	2,940	861	928	4,795	5,422	24,078
0	0	0	0	0	0	0	0	2,502
0	0	0	0	0	0	0	0	1,000
62,663	80,219	70,928	60,460	73,179	77,262	60,146	91,404	927,997
67,147	80,674	69,659	60,011	70,817	81,892	60,232	88,730	927,247
12,395	5,640	18,657	0	14,717	5,670	16,888	44,303	170,431
19,917	5,640	18,657	0	8,403	11,984	15,471	32,028	160,268
158	1,857	-403	2,491	4,814	-756	6,298	15,023	29,989
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
50	0	*	90	*	93	125	0	398
3,135	1,691	4,984	0	2,678	952	1,622	5,488	31,142
4,567	1,691	4,984	0	869	2,761	1,274	3,522	30,522
-1,482	0	*	-90	1,809	-1,902	223	1,965	222
-1,324	1,857	-403	2,401	6,623	-2,658	6,522	16,988	30,211

4. Federal Reserve Bank Holdings of U.S. Treasury
and Federal Agency Securities, December 31, 1984-86¹

Millions of dollars

Description	December 31			Increase or decrease (-)	
	1986	1985	1984	1986	1985
U.S. Treasury securities, total	206,520	177,281	157,010	29,239	20,271
<i>By term</i>					
1-15 days ²	15,684	5,261	415	10,423	4,846
16-90 days	53,611	43,462	37,396	10,148	6,067
91 days to 1 year	62,239	56,364	47,795	5,875	8,568
1-5 years	36,469	35,650	37,072	818	-1,421
5-10 years	15,451	14,783	14,100	666	685
More than 10 years	23,066	21,759	20,233	1,308	1,526
<i>By type of holding</i>					
Held outright ³					
Treasury bills	103,775	85,425	71,035	18,350	14,390
Treasury notes	68,126	67,647	65,237	479	2,410
Treasury bonds	25,724	24,726	22,951	997	1,775
Held under RPs	13,691	3,529	1,627	10,163	1,902
Federal agency obligations, total	10,143	9,921	8,777	222	1,144
<i>By term</i>					
1-15 days ²	2,704	1,836	575	868	1,261
16-90 days	808	961	521	-153	440
91 days to 1 year	1,224	1,471	1,665	-247	-193
1-5 years	3,854	4,056	4,350	-202	-294
5-10 years	1,178	1,187	1,267	-9	-80
More than 10 years	374	409	399	-35	10
<i>By type of holding</i>					
Held outright					
Banks for Cooperatives	0	21	21	-21	0
Federal Farm Credit Banks	2,486	2,477	2,363	8	114
Federal Home Loan Banks	2,252	2,260	2,260	-8	0
Federal Home Loan Mortgage Corporation	0	0	0	0	0
Federal Intermediate Credit Banks	30	50	50	-21	0
Federal Land Banks	236	236	350	0	-115
Farmers Home Administration	101	101	147	0	-46
Federal National Mortgage Association	2,490	2,847	2,962	-357	-115
Government National Mortgage Association participation certificates	67	67	67	0	0
U.S. Postal Service	37	37	37	0	0
Washington Metropolitan Area Transit Authority	117	117	117	0	0
General Services Administration	14	14	14	0	0
Held under RPs	2,314	1,693	388	620	1,306

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

2. Includes the effects of temporary transactions (repurchase agreements and matched sale-purchase agreements).

3. Excludes the effects of temporary transactions (repurchase agreements and matched sale-purchase agreements).

5. Number and Salaries of Officers and Employees of Federal Reserve Banks, December 31, 1986

Federal Reserve Bank (including Branches)	President	Other officers		Employees			Total	
	Annual salary (dollars)	Number	Annual salaries (dollars)	Number		Annual salaries (dollars)	Number	Annual salaries (dollars)
				Full-time	Part-time			
Boston	150,300	53	3,410,600	1,267	242	33,767,315	1,563	37,328,215
New York	170,800	161	11,949,050	3,695	57	98,737,087	3,914	110,856,937
Philadelphia	131,200	52	3,473,550	1,096	81	26,130,930	1,230	29,735,680
Cleveland	135,300	57	3,529,300	1,263	62	28,421,330	1,383	32,085,930
Richmond	131,300	79	4,798,000	1,744	153	37,015,168	1,977	41,944,468
Atlanta	141,600	66	4,098,650	2,037	81	44,564,265	2,185	48,804,515
Chicago	155,900	80	4,974,300	2,589	32	63,141,844	2,702	68,272,044
St. Louis	128,500	57	3,246,600	1,204	86	26,000,824	1,348	29,375,924
Minneapolis	110,000	43	2,550,600	942	152	22,400,458	1,138	25,061,058
Kansas City	130,000	60	4,333,600	1,512	61	33,762,405	1,634	38,226,005
Dallas	127,700	60	3,627,403	1,457	47	32,746,058	1,565	36,501,161
San Francisco	146,500	98	6,146,314	2,239	82	55,969,264	2,420	62,262,078
Total	1,659,100	866	56,137,967	21,045	1,136	502,656,948	23,059	560,454,015

6. Acquisition Costs and Net Book Value of Premises of Federal Reserve Banks and Branches, December 31, 1986¹

Dollars

Federal Reserve Bank or Branch	Acquisition costs				Net book value	Other real estate ⁴
	Land	Buildings (including vaults) ²	Building machinery and equipment	Total ³		
BOSTON	22,036,681	80,543,612	5,360,169	107,940,462	92,447,624	...
Annex	27,840	89,202	44,538	161,580	125,652	...
NEW YORK	3,436,277	21,160,038	21,735,584	46,331,899	28,217,354	...
Annex	477,863	1,136,219	745,855	2,359,936	788,472	...
Buffalo	887,844	2,693,864	2,258,313	5,840,022	3,241,643	...
PHILADELPHIA	1,876,601	52,413,293	5,903,704	60,193,598	46,842,992	...
CLEVELAND	1,074,281	7,409,713	4,697,832	13,181,825	7,564,641	1,224,363
Cincinnati	2,246,599	13,537,723	7,528,477	23,312,798	14,177,766	...
Pittsburgh	1,658,376	7,717,686	3,287,248	12,663,310	9,798,480	...
RICHMOND	3,912,575	55,727,664	14,314,313	73,954,552	58,785,695	...
Annex	522,733	3,725,466	3,924,584	8,172,784	4,041,391	...
Baltimore	6,472,984	26,826,903	3,842,189	37,142,077	34,045,323	...
Charlotte	347,071	2,758,209	946,943	4,052,223	2,767,990	1,675,934
ATLANTA	1,202,255	6,375,901	3,558,580	11,136,737	5,874,793	...
Birmingham	2,363,463	1,905,770	1,046,244	5,315,476	3,588,824	608,243
Jacksonville	1,066,862	19,192,963	778,381	21,038,206	19,106,106	48,365
Annex	107,925	76,236	15,843	200,003	149,727	...
Miami	3,607,531	11,965,974	2,107,796	17,681,302	15,587,112	...
Nashville	592,342	1,474,678	1,252,346	3,319,367	1,488,340	...
New Orleans	3,087,693	2,782,464	1,477,946	7,348,103	4,843,229	283,753
CHICAGO	4,511,942	38,084,306	12,203,707	54,799,956	38,036,406	...
Annex	53,066	548,119	215,796	816,981	762,364	...
Detroit	797,734	3,154,226	2,798,874	6,750,834	4,366,443	...
ST. LOUIS	700,378	10,601,614	4,634,979	15,936,971	9,320,327	...
Little Rock	1,148,492	2,082,669	1,010,869	4,242,031	2,689,032	...
Louisville	700,075	3,182,471	1,131,238	5,013,784	2,574,551	...
Memphis	1,135,623	4,216,382	2,126,755	7,478,760	5,015,257	...
MINNEAPOLIS	1,394,384	26,681,737	7,692,189	35,768,310	23,533,226	157,115
Helena	289,619	106,380	66,777	462,775	342,040	...
KANSAS CITY	1,798,804	11,609,885	8,450,928	21,859,617	16,646,625	149,948
Denver	2,997,746	4,321,485	2,610,017	9,929,248	7,203,281	...
Oklahoma City	646,386	3,245,825	1,672,442	5,564,653	3,892,965	...
Omaha	6,534,083	12,382,609	0	18,916,692	18,675,728	2,220,765
DALLAS	3,738,290	5,137,194	3,738,335	12,613,819	9,816,367	...
El Paso	262,477	1,348,665	393,301	2,004,443	1,692,162	...
Houston	2,049,064	2,722,066	898,037	5,669,167	5,153,564	...
San Antonio	459,635	2,293,818	574,346	3,327,799	2,699,718	...
SAN FRANCISCO	15,541,937	117,592,789	16,434,132	149,568,859	140,287,078	...
Los Angeles	2,910,659	4,353,961	2,494,074	9,758,695	6,030,890	...
Portland	207,381	1,683,361	649,432	2,540,173	2,116,864	...
Salt Lake City	480,222	1,972,068	1,137,923	3,590,213	2,779,171	...
Seattle	274,772	2,184,342	1,686,734	4,145,847	2,567,210	...
Total	105,638,563	579,019,548	157,447,772	842,105,883	659,684,425	6,368,485

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

2. Includes expenditures for construction at some offices, pending allocation to appropriate accounts.

3. Excludes charge-offs of \$17,698,968 before 1952.

4. Covers acquisitions for banking-house purposes and Bank premises formerly occupied and being held pending sale.

7. Income and Expenses of the Federal Reserve System, 1982-86

Millions of dollars

Item	1982	1983	1984	1985	1986
CURRENT INCOME					
Loans	174.6	132.9	569.5	427.9	279.2
Acceptances	18.3	6.0	3.2	0	0
U.S. Treasury and federal agency securities	15,492.9	15,150.2	16,687.5	16,843.1	16,141.5
Foreign currencies	432.5	273.8	217.1	228.7	393.9
Other	12.3	9.3	16.9	17.3	22.1
Total current income	16,130.7	15,572.1	17,494.2	17,517.1	16,836.8
CURRENT EXPENSES					
Monetary and economic policy	138.4	148.3	152.0	148.3	145.8
Supervision and regulation	140.3	155.0	163.3	175.7	189.1
Services to financial institutions and the public	648.8	678.4	704.6	746.2	773.2
Services to the U.S. Treasury and other government agencies ...	115.1	120.3	126.3	131.5	136.8
Total current expenses	1,042.6	1,102.1	1,146.1	1,201.6	1,244.9
LESS					
Reimbursements	77.3	78.1	85.8	97.4	112.1
Revenue from priced services	386.7	496.2	574.7	614.9	627.7
EQUALS					
Net expenses	578.6	527.7	485.6	489.4	505.0
PLUS					
Currency costs	98.4	152.1	162.6	173.3	181.2
EQUALS					
Net expenses including currency costs	677.0	679.8	648.2	662.7	686.2
PLUS					
Earnings-credit costs ¹	28.3	71.8	118.7	105.2	107.7
Current net income	15,425.4	14,820.5	16,727.2	16,749.2	16,042.9
ADDITIONS TO AND DEDUCTIONS FROM CURRENT NET INCOME					
Unrealized gains or losses (-) on the reevaluation of foreign currency assets	-149.6	-456.3	-454.8	1,210.0	1,970.6
Gains or losses (-) on sales of U.S. Treasury and federal agency securities	85.2	21.0	48.6	99.4	66.8
Other	-4.5	34.9	-6.7	-7.9	-61.6
Total	-68.8	-400.4	-412.9	1,301.6	1,975.9
Net income before distributions	15,356.6	14,420.2	16,314.3	18,050.8	18,018.7
DISTRIBUTIONS					
Dividends paid	79.4	85.2	92.6	103.0	109.6
Transfers to surplus	78.3	106.7	162.0	155.3	92.0
Net transfers to or deductions from (-) Board account	-5.7	-5	5.5	-3.9	13.3
Interest on Federal Reserve notes	15,204.6	14,228.8	16,054.1	17,796.5	17,803.9
Total distributions	15,356.6	14,420.2	16,314.3	18,050.8	18,018.7

1. The amount of the credits granted to depository institutions on clearing balances maintained with the Reserve Banks. These earnings credits may be used to offset charges for Federal Reserve priced services.

The clearing balances are invested in U.S. Treasury securities, the earnings on which are reflected in the current-income section of this table.

8. Income and Expenses of Federal Reserve Banks, 1986

Dollars

Item ¹	Total	Boston	New York	Philadelphia	Cleveland
CURRENT INCOME					
Loans	279,190,611	1,120,763	4,896,983	2,018,391	674,180
U.S. Treasury and federal agency securities	16,141,544,144	945,814,646	5,349,330,871	532,591,184	941,194,643
Foreign currencies	393,563,826	11,816,759	97,225,032	18,089,170	23,594,141
Priced services	627,736,431	40,112,790	91,705,355	27,488,236	38,173,956
Other	22,116,636	718,137	12,202,190	416,697	415,209
Total	17,464,151,647	999,583,095	5,555,360,431	580,603,678	1,004,052,128
CURRENT EXPENSES					
Salaries and other personnel expenses	596,170,328	37,836,420	121,402,742	31,833,173	33,961,449
Retirement and other benefits	133,360,309	8,309,368	24,926,134	7,455,196	8,233,284
Fees	11,206,609	3,115,473	1,410,355	544,866	1,586,532
Travel	19,775,226	895,990	2,608,710	781,103	1,642,322
Postage and other shipping costs	81,879,848	3,689,087	9,081,204	4,700,356	5,996,838
Communications	15,254,693	1,032,847	3,485,763	659,592	734,643
Materials and supplies	46,004,715	2,647,573	8,607,238	2,702,203	2,958,404
<i>Building expenses</i>					
Taxes on real estate	22,213,256	4,049,382	3,942,496	1,484,083	1,032,263
Property depreciation	23,549,010	2,451,201	2,266,744	1,699,042	1,336,295
Utilities	22,809,177	2,024,412	3,473,847	2,339,572	1,572,713
Rent	14,975,977	491,003	9,019,992	44,964	238,568
Other	14,217,178	831,804	3,097,100	1,121,352	683,830
<i>Equipment</i>					
Purchases	3,095,811	144,496	0	181,191	124,568
Rentals	40,665,348	1,575,224	6,911,418	905,877	4,298,098
Depreciation	68,000,516	4,122,377	11,178,992	4,085,222	3,887,739
Repairs and maintenance	38,997,781	2,310,667	6,299,082	2,199,042	1,348,496
Earnings-credit costs	107,709,013	6,285,764	13,328,823	8,790,331	9,581,389
Other	42,977,117	2,709,019	7,104,336	1,962,449	3,274,418
Shared costs, net ²	(0)	(3,026,998)	1,492,712	2,519,609	(1,148,176)
Recoveries	(31,379,530)	(6,460,239)	(3,283,543)	(2,165,453)	(3,014,681)
Expenses capitalized ³	(2,484,527)	(107,054)	(5,734)	(55,564)	(234,019)
Total	1,268,997,855	74,927,816	236,348,411	73,788,206	78,094,973
Reimbursements	(112,130,141)	(5,318,162)	(23,720,410)	(13,028,800)	(7,215,209)
Net expenses	1,156,867,714	69,609,654	212,628,001	60,759,406	70,879,764

For notes see end of table.

8. ---Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
8,683,419	1,758,728	206,123,740	1,553,429	1,155,916	19,203,921	29,553,875	2,447,266
1,393,795,932	583,449,314	1,782,213,012	470,078,035	224,144,963	681,240,909	1,031,823,291	2,205,867,344
20,081,599	32,267,312	53,106,506	11,816,759	12,987,606	17,710,372	32,680,564	62,188,006
52,082,123	69,092,954	84,722,988	28,079,122	35,415,830	41,805,226	46,291,219	72,766,632
795,769	1,650,635	1,712,351	370,493	390,753	351,111	1,096,215	1,997,076
1,475,438,842	688,218,943	2,127,878,597	511,897,838	274,095,068	760,311,539	1,141,445,164	2,345,266,324
44,080,072	51,549,126	72,064,506	30,525,105	26,434,759	39,562,626	38,673,184	68,247,166
10,038,418	11,539,975	16,365,777	7,139,832	5,724,870	9,171,739	8,274,539	16,181,177
349,272	513,462	1,137,153	482,665	472,366	526,234	341,835	726,396
1,665,257	1,619,936	3,242,904	1,009,051	787,209	1,469,358	1,352,176	2,701,210
6,576,593	8,825,877	8,763,448	4,514,170	5,681,792	6,398,070	4,643,382	13,009,031
999,950	2,004,836	1,560,278	553,216	524,644	1,110,055	911,626	1,677,243
4,117,490	4,500,592	5,348,490	3,017,772	1,864,426	3,075,365	2,912,327	4,252,835
1,798,916	1,192,616	2,467,453	439,828	2,499,795	822,327	576,649	1,907,448
3,584,287	1,221,876	1,253,534	807,715	1,049,995	1,807,786	1,239,587	4,830,948
1,990,046	1,901,214	2,582,728	1,275,662	842,796	1,378,799	1,097,629	2,329,759
471,346	331,446	2,344,884	374,633	120,392	57,265	1,090,216	391,268
1,505,402	840,507	2,503,667	658,529	579,423	635,011	679,652	1,080,901
398,444	267,476	508,815	488,684	340,332	62,221	185,795	393,789
2,236,631	4,460,076	6,340,781	914,504	1,014,199	1,551,465	4,706,426	5,750,649
6,502,505	6,457,395	7,860,609	3,150,813	3,955,537	3,756,425	5,857,989	7,184,913
3,660,276	3,871,991	6,331,553	1,891,150	1,914,523	2,410,548	2,247,760	4,512,693
7,809,201	11,555,130	21,705,770	4,423,451	5,576,544	6,387,245	4,412,349	7,853,016
4,538,660	3,642,064	5,992,257	1,718,082	2,098,738	2,087,056	2,462,461	5,387,577
(167,450)	2,295,570	(5,718,346)	1,016,171	1,889,536	739,942	605,203	(497,773)
(4,092,201)	(1,408,749)	(2,438,685)	(1,224,932)	(635,004)	(1,061,559)	(2,281,496)	(3,312,988)
(201,859)	(228,960)	(546,832)	(29,033)	(58,479)	(482,825)	(423,006)	(111,162)
97,861,256	116,953,456	159,670,744	63,147,068	62,678,393	81,465,153	79,566,283	144,496,096
(7,619,873)	(8,052,423)	(12,795,133)	(7,293,892)	(3,587,127)	(5,751,432)	(5,433,355)	(12,314,325)
90,241,383	108,901,033	146,875,611	55,853,176	59,091,266	75,713,721	74,132,928	132,181,771

8. Income and Expenses of Federal Reserve Banks, 1986—Continued

Dollars

Item ¹	Total	Boston	New York	Philadelphia	Cleveland
PROFIT AND LOSS					
Current net income	16,307,283,932	929,973,442	5,342,732,429	519,844,271	933,172,362
<i>Additions to and deductions from current net income</i>					
Profits on sales of U.S. Treasury and federal agency securities					
	66,836,210	3,938,872	21,891,327	2,210,987	3,918,560
Other additions	2,015,616,683	59,127,102	486,783,891	90,652,224	118,246,959
Total additions	2,082,452,893	63,065,974	508,675,217	92,863,212	122,165,518
Deductions from current net income	106,559,537	3,070,996	12,535,159	5,913,742	5,032,520
Net additions to or deductions (-) from current net income	1,975,893,356	59,994,978	496,140,058	86,949,469	117,132,998
<i>Assessments by Board</i>					
Board expenditures ⁴	97,337,500	2,912,600	24,112,100	4,522,900	5,865,800
Cost of currency	180,779,673	11,306,558	53,649,878	5,848,170	11,299,418
Net income before payment to U.S. Treasury	18,005,060,114	975,749,262	5,761,110,509	596,422,670	1,033,140,142
Dividends paid	109,587,968	3,346,081	27,204,022	4,964,655	6,590,413
Payments to U.S. Treasury (interest on Federal Reserve notes)	17,803,517,996	964,288,881	5,707,345,837	587,538,416	1,022,235,729
Transferred to surplus	91,954,150	8,114,300	26,560,650	3,919,600	4,314,000
Surplus, January 1	1,781,361,150	52,798,900	439,440,700	82,545,900	107,000,300
Surplus, December 31	1,873,315,300	60,913,200	466,001,350	86,465,500	111,314,300

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

2. Includes distribution of costs for projects performed by one Bank for the benefit of one or more other Banks.

3. Includes expenses for labor and materials tem-

porarily capitalized and charged to activities when the products are consumed.

4. For additional details, see the last four pages of the preceding section: Board of Governors, Financial Statements.

8.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
1,385,197,458	579,317,913	1,981,002,986	456,044,663	215,003,799	684,597,818	1,067,312,237	2,213,084,554
5,797,536	2,447,617	7,421,767	1,957,658	935,655	2,828,720	4,294,070	9,193,441
100,693,533	161,618,945	266,049,513	59,122,161	65,044,501	88,680,559	206,670,303	312,926,994
106,491,069	164,066,562	273,471,280	61,079,819	65,980,156	91,509,279	210,964,372	322,120,434
4,346,605	5,232,023	7,555,952	3,699,975	1,975,070	3,419,573	46,518,066	7,259,856
102,144,465	158,834,539	265,915,328	57,379,844	64,005,086	88,089,706	164,446,306	314,860,578
5,019,100	8,066,900	13,217,900	2,959,100	3,191,300	4,395,000	8,137,900	14,936,900
16,595,018	7,312,579	23,637,227	5,774,394	2,381,509	7,794,959	11,059,110	24,120,852
1,465,727,805	722,772,973	2,210,063,188	504,691,013	273,436,076	760,497,564	1,212,561,533	2,488,887,379
5,798,975	9,472,564	14,838,725	3,373,526	3,554,079	4,878,187	9,223,358	16,343,385
1,449,589,630	691,586,059	2,185,033,713	497,265,437	267,240,546	755,101,827	1,194,015,275	2,482,276,645
10,339,200	21,714,350	10,190,750	4,052,050	2,641,450	517,550	9,322,900	(9,732,650)
90,812,250	146,545,500	241,181,250	53,722,900	58,493,400	80,135,800	148,211,250	280,473,000
101,151,450	168,259,850	251,372,000	57,774,950	61,134,850	80,653,350	157,534,150	270,740,350

9. Income and Expenses of Federal Reserve Banks, 1914-86¹

Dollars					
Period, or Federal Reserve Bank	Current income	Net expenses	Net additions or deductions (-)	Assessments by Board of Governors	
				Board expenditures	Costs of currency
<i>All Banks</i>					
1914-15	2,173,252	2,018,282	5,875	302,304	...
1916	5,217,998	2,081,722	-193,001	192,277	...
1917	16,128,339	4,921,932	-1,386,545	237,795	...
1918	67,584,417	10,576,892	-3,908,574	382,641	...
1919	102,380,583	18,744,815	-4,673,446	594,818	...
1920	181,296,711	27,548,505	-3,743,907	709,525	...
1921	122,865,866	33,722,409	-6,314,796	741,436	...
1922	50,498,699	28,836,504	-4,441,914	722,545	...
1923	50,708,566	29,061,539	-8,233,107	702,634	...
1924	38,340,449	27,767,886	-6,191,143	663,240	...
1925	41,800,706	26,818,664	-4,823,477	709,499	...
1926	47,599,595	24,914,037	-3,637,668	721,724	1,714,421
1927	67,024,484	24,894,487	-2,457,792	779,116	1,844,840
1928	64,052,860	25,401,233	-5,026,029	697,677	805,900
1929	70,955,496	25,810,067	-4,861,642	781,644	3,099,402
1930	36,424,044	25,357,611	-93,136	809,585	2,175,530
1931	29,701,279	24,842,964	311,451	718,554	1,479,146
1932	50,018,817	24,456,755	-1,413,192	728,810	1,105,816
1933	49,487,318	25,917,847	-12,307,074	800,160	2,504,830
1934	48,902,813	26,843,653	-4,430,008	1,372,022	1,025,721
1935	42,751,959	28,694,965	-1,736,758	1,405,898	1,476,580
1936	37,900,639	26,016,338	485,817	1,679,566	2,178,119
1937	41,233,135	25,294,835	-1,631,274	1,748,380	1,757,399
1938	36,261,428	25,556,949	2,232,134	1,724,924	1,629,735
1939	38,500,665	25,668,907	2,389,555	1,621,464	1,356,484
1940	43,537,805	25,950,946	11,487,697	1,704,011	1,510,520
1941	41,380,095	28,535,547	720,636	1,839,541	2,588,062
1942	52,662,704	32,051,226	-1,568,208	1,746,326	4,826,492
1943	69,305,715	35,793,816	23,768,282	2,415,630	5,336,118
1944	104,391,829	39,659,496	3,221,880	2,296,357	7,220,068
1945	142,209,546	41,666,453	-830,007	2,340,509	4,710,309
1946	150,385,033	50,493,246	-625,991	2,259,784	4,482,077
1947	158,655,566	58,191,428	1,973,001	2,639,667	4,561,880
1948	304,160,818	64,280,271	-34,317,947	3,243,670	5,186,247
1949	316,536,930	67,930,860	-12,122,274	3,242,500	6,304,316
1950	275,838,994	69,822,227	36,294,117	3,433,700	7,315,844
1951	394,656,072	83,792,676	-2,127,889	4,095,497	7,580,913
1952	456,060,260	92,051,063	1,583,988	4,121,602	8,521,426
1953	513,037,237	98,493,153	-1,058,993	4,099,800	10,922,067
1954	438,486,040	99,068,436	-133,641	4,174,600	6,489,895
1955	412,487,931	101,158,921	-265,456	4,194,100	4,707,002
1956	595,649,092	110,239,520	-23,436	5,339,800	5,603,176
1957	763,347,530	117,931,908	-7,140,914	7,507,900	6,374,195
1958	742,068,150	125,831,215	124,175	5,917,200	5,973,240
1959	886,226,116	131,848,023	98,247,253	6,470,600	6,384,083
1960	1,103,385,257	139,893,564	13,874,702	6,533,700	7,455,011
1961	941,648,170	148,253,719	3,481,628	6,265,100	6,755,756
1962	1,048,508,335	161,451,206	-55,779	6,654,900	8,030,028
1963	1,151,120,060	169,637,656	614,835	7,572,800	10,062,901
1964	1,343,747,303	171,511,018	725,948	8,655,200	17,229,671
1965	1,559,484,027	172,110,934	1,021,614	8,576,396	23,602,856
1966	1,908,499,896	178,212,045	996,230	9,021,600	20,167,481
1967	2,190,403,752	190,561,166	2,093,876	10,769,596	18,790,084
1968	2,764,445,943	207,677,768	8,519,996	14,198,198	20,474,404
1969	3,373,360,559	237,827,579	-557,553	15,020,084	22,125,657

For notes see end of table.

9.—Continued

Dividends paid	Payments to U.S. Treasury			Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Franchise tax	Under section 13b	Interest on Federal Reserve notes		
217,463	...	...	...	...	...
1,742,775	...	...	...	...	...
6,804,186	1,134,234	...	...	...	1,134,234
5,540,684	...	...	...	...	48,334,341
5,011,832	2,703,894	...	...	...	70,651,778
5,654,018	60,724,742	...	...	...	82,916,014
6,119,673	59,974,466	...	...	...	15,993,086
6,307,035	10,850,605	...	...	...	-659,904
6,552,717	3,613,056	...	...	...	2,545,513
6,682,496	113,646	...	...	...	-3,077,962
6,915,958	59,300	...	...	...	2,473,808
7,329,169	818,150	...	...	...	8,464,426
7,754,539	249,591	...	...	...	5,044,119
8,458,463	2,584,659	...	...	...	21,078,899
9,583,911	4,283,231	...	...	...	22,535,597
10,268,598	17,308	...	...	...	-2,297,724
10,029,760	...	...	...	...	-7,057,694
9,282,244	2,011,418	...	...	...	11,020,582
8,874,262	...	...	...	...	-916,855
8,781,661	...	...	...	-60,323	6,510,071
8,504,974	...	297,667	...	27,695	607,422
7,829,581	...	227,448	...	102,880	352,524
7,940,966	...	176,625	...	67,304	2,616,352
8,019,137	...	119,524	...	-419,140	1,862,433
8,110,462	...	24,579	...	-425,653	4,533,977
8,214,971	...	82,152	...	-54,456	17,617,358
8,429,936	...	141,465	...	-4,333	570,513
8,669,076	...	197,672	...	49,602	3,554,101
8,911,342	...	244,726	...	135,003	40,327,362
9,500,126	...	326,717	...	201,150	48,409,795
10,182,851	...	247,659	...	262,133	81,969,625
10,962,160	...	67,054	...	27,708	81,467,013
11,523,047	...	35,605	75,233,818	86,772	8,366,350
11,919,809	...	...	166,690,356	...	18,522,518
12,329,373	...	...	193,145,837	...	21,461,770
13,082,992	...	...	196,628,858	...	21,849,490
13,864,750	...	...	254,873,588	...	28,320,759
14,681,788	...	...	291,934,634	...	46,333,735
15,558,377	...	...	342,567,985	...	40,336,862
16,442,236	...	...	276,289,457	...	35,887,775
17,711,937	...	...	251,740,721	...	32,709,794
18,904,897	...	...	401,555,581	...	53,982,682
20,080,527	...	...	542,708,405	...	61,603,682
21,197,452	...	...	524,058,650	...	59,214,569
22,721,687	...	...	910,649,768	...	-93,600,791
23,948,225	...	...	896,816,359	...	42,613,100
25,569,541	...	...	687,393,382	...	70,892,300
27,412,241	...	...	799,365,981	...	45,538,200
28,912,019	...	...	879,685,219	...	55,864,300
30,781,548	...	...	1,582,118,614	...	-465,822,800
32,351,602	...	...	1,296,810,053	...	27,053,800
33,696,336	...	...	1,649,455,164	...	18,943,500
35,027,312	...	...	1,907,498,270	...	29,851,200
36,959,336	...	...	2,463,628,983	...	30,027,250
39,236,599	...	...	3,019,160,638	...	39,432,450

9. Income and Expenses of Federal Reserve Banks, 1914-86¹—Continued

Dollars					
Period, or Federal Reserve Bank	Current income	Net expenses	Net additions or deductions (-)	Assessments by Board of Governors	
				Board expenditures	Costs of currency
1970	3,877,218,444	276,571,876	11,441,829	21,227,800	23,573,710
1971	3,723,369,921	319,608,270	94,266,075	32,634,002	24,942,528
1972	3,792,334,523	347,917,112	(49,615,790)	35,234,499	31,454,740
1973	5,016,769,328	416,879,377	(80,653,488)	44,411,700	33,826,299
1974	6,280,090,965	476,234,586	(78,487,237)	41,116,600	30,190,288
1975	6,257,936,784	514,358,633	(202,369,615)	33,577,201	37,130,081
1976	6,623,220,383	558,128,811	7,310,500	41,827,700	48,819,453
1977	6,891,317,498	568,851,419	(177,033,463)	47,366,100	55,008,163
1978	8,455,390,401	592,557,841	(633,123,486)	53,321,700	60,059,365
1979	10,310,148,406	625,168,261	(151,148,220)	50,529,700	68,391,270
1980	12,802,319,335	718,032,836	(115,385,855)	62,230,800	73,124,423
1981	15,508,349,653	814,190,392	(372,879,185)	63,162,700	82,924,013
1982	16,517,385,129	926,033,957	(68,833,150)	61,813,400	98,441,027
1983	16,068,362,117	1,023,678,474	(400,365,922)	71,551,000	152,135,488
1984	18,068,820,742	1,102,444,454	(412,943,156)	82,115,700	162,606,410
1985	18,131,982,786	1,127,744,490	1,301,624,294	77,377,700	173,738,784
1986	17,464,528,361	1,156,867,714	1,975,893,356	97,337,500	180,779,673
Total, 1914-86 ...	201,351,041,661	15,388,965,389	719,539,608	1,104,734,408	1,632,591,378
<i>Aggregate for each Bank, 1914-86</i>					
Boston	9,803,200,724	1,017,553,501	12,451,897	40,245,686	94,541,879
New York	57,385,270,437	3,137,962,811	226,300,627	285,823,686	384,580,071
Philadelphia	8,717,528,786	813,507,271	34,022,670	54,357,018	81,336,705
Cleveland	14,139,606,581	1,048,066,501	(11,731,536)	88,679,690	103,387,314
Richmond	15,827,364,278	1,199,898,709	23,752,524	57,039,076	157,346,619
Atlanta	8,156,237,834	1,290,631,358	65,940,608	80,003,260	107,259,873
Chicago	30,096,109,587	2,023,093,302	47,687,622	158,691,072	228,273,239
St. Louis	7,099,272,065	832,610,270	6,419,380	34,805,272	64,705,904
Minneapolis	3,701,637,078	688,831,380	24,764,072	32,581,415	29,477,129
Kansas City	8,886,354,267	960,456,350	32,041,055	47,391,509	81,238,328
Dallas	11,432,350,490	853,164,594	100,690,486	68,658,773	97,291,884
San Francisco	26,106,109,536	1,523,189,340	157,200,201	156,457,951	203,152,433
Total	201,351,041,661	15,388,965,389	719,539,608	1,104,734,408	1,632,591,378

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

2. The \$2,001,987,499 transferred to surplus was reduced by direct charges of \$500,000 for charge-off on Bank premises (1927), \$139,299,557 for contributions to capital of the Federal Deposit Insurance

Corporation (1934), and \$3,657 net upon elimination of sec. 13b surplus (1958); and was increased by transfer of \$11,131,013 from reserves for contingencies (1945), leaving a balance of \$1,873,315,298 on Dec. 31, 1986.

9.—Continued

Dividends paid	Payments to U.S. Treasury			Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Franchise tax	Under section 13b	Interest on Federal Reserve notes		
41,136,551	...	...	3,493,570,636	...	32,579,700
43,488,074	...	...	3,356,559,873	...	40,403,250
46,183,719	...	...	3,231,267,663	...	50,661,000
49,139,682	...	...	4,340,680,482	...	51,178,300
52,579,643	...	...	5,549,999,411	...	51,483,200
54,609,555	...	...	5,382,064,098	...	33,827,600
57,351,487	...	...	5,870,463,382	...	53,940,050
60,182,278	...	...	5,937,148,425	...	45,727,650
63,280,312	...	...	7,005,779,497	...	47,268,200
67,193,615	...	...	9,278,576,140	...	69,141,200
70,354,516	...	...	11,706,369,955	...	56,820,950
74,573,806	...	...	14,023,722,907	...	76,896,650
79,352,304	...	...	15,204,590,947	...	78,320,350
85,151,835	...	...	14,228,816,297	...	106,663,100
92,620,451	...	...	16,054,094,674	...	161,995,900
103,028,905	...	...	17,796,464,292	...	155,252,950
109,587,968	...	...	17,803,894,710	...	91,954,150
1,916,915,357	149,138,300	2,188,893	179,874,063,709	(3,657)	2,001,987,499²
80,693,766	7,111,395	280,843	8,504,082,114	135,411	71,008,025
522,528,517	68,006,262	369,116	52,709,476,089	(433,412)	503,257,921
105,358,897	5,558,901	722,406	7,589,623,877	290,661	100,795,722
162,246,232	4,842,447	82,930	12,596,031,746	(9,906)	124,548,093
95,361,774	6,200,189	172,493	14,228,138,199	(71,517)	107,031,258
125,692,661	8,950,561	79,264	6,436,029,586	5,491	173,526,390
266,882,194	25,313,526	151,045	27,174,680,395	11,682	266,700,754
61,775,316	2,755,629	7,464	6,046,163,532	(26,515)	62,894,578
53,126,165	5,202,900	55,615	2,852,049,609	64,874	65,012,063
79,977,326	6,939,100	64,213	7,657,543,870	(8,674)	84,793,300
111,616,868	560,049	102,083	10,239,779,757	55,337	161,811,628
251,655,641	7,697,341	101,421	23,840,464,936	(17,089)	280,607,767
1,916,915,357	149,138,300	2,188,893	179,874,063,709	(3,657)	2,001,987,499

10. Priced Services Revenue and Expenses
at Federal Reserve Banks, 1986 and 1985¹

Millions of dollars

Item	Total		Service			
			Commercial check collection		Wire transfer and net settlement	
	1986	1985	1986	1985	1986	1985
Revenue ²	742.0	733.0	572.5	555.8	82.7	77.4
Expenses ²	625.8	617.2	481.3	464.6	68.8	62.4
Net revenue	116.2	115.7	91.2	91.2	13.9	14.9
Private sector adjustment ³	85.9	82.2	66.6	61.6	10.8	10.6
Net revenue after private sector adjustment	30.3	33.6	24.6	29.6	3.1	4.3
MEMO						
Net revenue after private sector ad- justment, with allowance for ACH program ⁴ .....	...	38.6	...	...	...	...

1. Derived from the income and expense data shown in table 8. Expenses for priced services are based primarily on the Federal Reserve Planning and Control System, which provides for the allocation of expenses to the principal areas of activity of the Banks.

2. Total System revenue for 1986 and 1985 respectively comprises \$627.7 million and \$613.8 million

of income from fees for services, and \$114.2 million and \$119.1 million of income related to clearing balances established by depository institutions. Total System expenses for 1986 and 1985 respectively include \$106.3 million and \$105.6 million of earnings credits granted to depository institutions on clearing balances.

10.--Continued

Service							
Commercial ACH ⁴		Definitive safekeeping and noncash collection		Book-entry securities		Cash services	
1986	1985	1986	1985	1986	1985	1986	1985
36.5	27.5	24.0	25.0	9.4	28.8	16.8	18.5
31.2	29.1	21.9	23.0	6.3	20.1	16.3	18.0
5.4	(1.6)	2.1	2.0	3.1	8.7	.5	.5
4.1	2.5	2.5	2.3	1.6	4.8	.4	.3
1.3	(4.1)	(.4)	(.3)	1.5	3.9	.2	.2
...	.9	...	...	...	...	...	...

Expenses for commercial check collection, wire transfer and net settlement, commercial ACH, book-entry securities, and definitive safekeeping and non-cash collection include costs of float.

3. An imputed cost intended to reflect the taxes that would have been paid and the return on capital that would have been provided had a private firm furnished the services.

4. The Board established an incentive pricing program for the commercial ACH service that provided for fee structures designed to recover an increasing share of expenses over a period of several years. Revenue for the commercial ACH service was expected to represent approximately 80 percent of expenses plus the private sector adjustment in 1985 and 100 percent of expenses plus the private sector adjustment in 1986.

11. Operations in Principal Departments of Federal Reserve Banks, 1983-86

Operation	1986	1985	1984	1983
<i>Millions of pieces (except as noted)</i>				
Loans (thousands)	19	24	33	22
Currency received and counted	15,408	14,655	13,422	11,464
Currency verified and destroyed	5,584	5,744	5,329	4,403
Coin received and counted	20,461	19,691	19,201	17,712
Checks handled				
U.S. government checks	584	592	598	612
Postal money orders	140	130	135	115
All other ¹	16,226	15,965	15,178	14,650
Issues, redemptions, and exchanges of U.S.				
Treasury and federal agency securities	204	171	168	168
Transfer of funds ²	50	45	42	38
Food stamps redeemed	2,216	2,322	2,536	2,684
<i>Millions of dollars</i>				
Loans	193,424	307,856	852,777	214,190
Currency received and counted	195,515	182,095	183,419	141,684
Currency verified and destroyed	47,842	51,081	50,164	36,224
Coin received and counted	3,088	3,226	3,624	2,795
Checks handled				
U.S. government checks	606,029	538,261	529,895	552,493
Postal money orders	11,103	9,486	9,085	7,854
All other ¹	11,137,202	9,557,753	9,553,515	9,854,112
Issues, redemptions, and exchanges of U.S.				
Treasury and federal agency securities	75,447,899	65,866,333	50,327,014	51,352,275
Transfer of funds ²	125,028,070	109,126,369	98,003,445	87,754,086
Food stamps redeemed	10,475	10,195	9,941	10,861

1. In the REPORT for 1983 and for 1984, data included checks handled by more than one Federal Reserve office.

2. In the REPORT for 1983 and for 1984, data included transfers processed by both sending and receiving Federal Reserve offices.

12. Federal Reserve Bank Interest Rates, December 31, 1986

Percent per year

Bank	Loans to depository institutions			
	Short-term adjustment credit and seasonal credit ¹	Extended credit ²		
		First 60 days of borrowing	Next 90 days of borrowing	After 150 days
All Federal Reserve Banks	5½	5½	6½	7½

1. Rates applied to short-term advances for the purpose of meeting temporary funding requirements and to longer-term advances made to smaller institutions for the purpose of meeting seasonally recurring needs for funds. A temporary simplified seasonal program was established on Mar. 8, 1985, and the interest rate was a fixed rate ½ percent above the rate on adjustment credit. The program was reestablished on Feb. 18, 1986; the rate may be either the same as that for adjustment credit or a fixed rate ½ percent higher. See sections 201.3(a) and 201.3(b)(1) of Regulation A.

2. Applicable to advances when exceptional circumstances or practices involve only a particular de-

pository institution and to advances when an institution is under sustained liquidity pressures. As an alternative, for loans outstanding for more than 150 days, a Federal Reserve Bank may charge a flexible rate that takes into account rates on market sources of funds, but in no case will the rate charged be less than the basic rate plus one percentage point. Where credit provided to a particular depository institution is anticipated to be outstanding for an unusually prolonged period and in relatively large amounts, the time period in which each rate under this structure is applied may be shortened. See section 201.3(b)(2) of Regulation A.

13. Reserve Requirements of Depository Institutions¹

Type of deposit, and deposit interval ²	Depository institution requirements after implementation of the Monetary Control Act	
	Percent of deposits	Effective date
<i>Net transaction accounts</i> ^{3,4}		
\$0 million–\$36.7 million	3	12/30/86
More than \$36.7 million	12	12/30/86
<i>Nonpersonal time deposits</i> ⁵		
By original maturity		
Less than 1½ years	3	10/6/83
1½ years or more	0	10/6/83
<i>Eurocurrency liabilities</i>		
All types	3	11/13/80

1. Reserve requirements in effect on Dec. 31, 1986. Required reserves must be held in the form of deposits with Federal Reserve Banks or vault cash. Nonmembers may maintain reserve balances with a Federal Reserve Bank indirectly on a pass-through basis with certain approved institutions.

For previous reserve requirements, see earlier editions of the ANNUAL REPORT and of the *Federal Reserve Bulletin*. Under provisions of the Monetary Control Act, depository institutions include commercial banks, mutual savings banks, savings and loan associations, credit unions, agencies and branches of foreign banks, and Edge corporations.

2. The Garn–St Germain Depository Institutions Act of 1982 (Public Law 97–320) requires that \$2 million of reservable liabilities (transaction accounts, nonpersonal time deposits, and Eurocurrency liabilities) of each depository institution be subject to a zero percent reserve requirement. The Board is to adjust the amount of reservable liabilities subject to this zero percent reserve requirement each year for the succeeding calendar year by 80 percent of the percentage increase in the total reservable liabilities of all depository institutions, measured on an annual basis as of June 30. No corresponding adjustment is to be made in the event of a decrease. On Dec. 30, 1986, the exemption was raised from \$2.6 million to \$2.9 million. In determining the reserve requirements of depository institutions, the exemption shall apply in the following order: (1) net NOW accounts (NOW accounts less allowable deductions); (2) net other transaction accounts; and (3) nonpersonal time deposits or Eurocurrency liabilities starting with those

with the highest reserve ratio. With respect to NOW accounts and other transaction accounts, the exemption applies only to such accounts that would be subject to a 3 percent reserve requirement.

3. Transaction accounts include all deposits on which the account holder is permitted to make withdrawals by negotiable or transferable instruments, payment orders of withdrawal, and telephone and preauthorized transfers in excess of three per month for the purpose of making payments to third persons or others. However, MMDAs and similar accounts subject to the rules that permit no more than six preauthorized, automatic, or other transfers per month, of which no more than three can be checks, are not transaction accounts (such accounts are savings deposits subject to time deposit reserve requirements).

4. The Monetary Control Act of 1980 requires that the amount of transaction accounts against which the 3 percent reserve requirement applies be modified annually by 80 percent of the percentage increase in transaction accounts held by all depository institutions, determined as of June 30 each year. Effective Dec. 30, 1986, the amount was increased from \$31.7 million to \$36.7 million.

5. In general, nonpersonal time deposits are time deposits, including savings deposits, that are not transaction accounts and in which a beneficial interest is held by a depositor that is not a natural person. Also included are certain transferable time deposits held by natural persons and certain obligations issued to depository institution offices located outside the United States. For details, see section 204.2 of Regulation D.

14. Dates of Removal of Interest Rate Ceilings on Deposits at Federally Insured Institutions¹

Type of deposit	Effective date
Savings	4/1/86
Negotiable order of withdrawal	1/1/86
Money market deposit account	1/1/86
<i>Time accounts</i>	
7-31 days	1/1/86
More than 31 days	10/1/83

1. All restrictions on the maximum rates of interest payable on various categories of deposits were removed over a period beginning on Dec. 14, 1982, and ending on Apr. 1, 1986. For information on the maximum rates payable on specific types of accounts at

various times, see the *Federal Reserve Bulletin*, the *Federal Home Loan Bank Board Journal*, and the *Annual Report of the Federal Deposit Insurance Corporation*.

15. Initial Margin Requirements under Regulations T, U, G, and X¹

Percent of market value

Effective date	Margin stocks	Convertible bonds	Short sales, T only ²
1934, Oct. 1	25-45	...	...
1936, Feb. 1	25-55	...	...
Apr. 1	55	...	...
1937, Nov. 1	40	...	50
1945, Feb. 5	50	...	50
July 5	75	...	75
1946, Jan. 21	100	...	100
1947, Feb. 21	75	...	75
1949, Mar. 3	50	...	50
1951, Jan. 17	75	...	75
1953, Feb. 20	50	...	50
1955, Jan. 4	60	...	60
Apr. 23	70	...	70
1958, Jan. 16	50	...	50
Aug. 5	70	...	70
Oct. 16	90	...	90
1960, July 28	70	...	70
1962, July 10	50	...	50
1963, Nov. 6	70	...	70
1968, Mar. 11	70	50	70
June 8	80	60	80
1970, May 6	65	50	65
1971, Dec. 6	55	50	55
1972, Nov. 24	65	50	65
1974, Jan. 3	50	50	50

1. These regulations, adopted by the Board of Governors pursuant to the Securities Exchange Act of 1934, limit the amount of credit to purchase and carry "margin securities" (as defined in the regulations) when such credit is collateralized by securities. Margin requirements on securities other than options are the difference between the market value (100 percent) and the maximum loan value of collateral as prescribed by the Board. Regulation T was adopted effective Oct. 15, 1934; Regulation U, effective May 1, 1936; Regulation G, effective Mar. 11, 1968; and Regulation X, effective Nov. 1, 1971.

On Jan. 1, 1977, the Board of Governors for the first time established in Regulation T the initial margin required for writing options on securities, setting

it at 30 percent of the current market value of the stock underlying the option. On Sept. 30, 1985, the Board changed the required initial margin, allowing it to be the same as the option maintenance margin required by the appropriate exchange or self-regulatory organization; such maintenance margin rules must be approved by the Securities and Exchange Commission. Effective Jan. 31, 1986, the SEC approved new maintenance margin rules, permitting margins to be the price of the option plus 15 percent of the market value of the stock underlying the option.

2. From Oct. 1, 1934, to Oct. 31, 1937, the requirement was the margin "customarily required" by the brokers and dealers.

16. Principal Assets and Liabilities and Number of Insured Commercial Banks, by Class of Bank, June 30, 1986 and 1985¹

Asset and liability items shown in millions of dollars

Item	Total	Member banks			Nonmember banks
		Total	National	State	
June 30, 1986					
Loans and investments	1,847,784	1,362,285	1,088,052	274,233	485,499
Gross loans	1,429,545	1,086,417	869,696	216,721	343,128
Net loans	1,415,173	1,076,351	861,926	214,426	338,822
Investments	418,239	275,868	218,356	57,512	142,371
U.S. Treasury and federal agency securities	253,205	161,648	131,632	30,016	91,557
Other	165,034	114,220	86,724	27,496	50,814
Cash assets	220,219	170,583	134,379	36,205	49,636
Deposits, total	1,805,885	1,298,430	1,048,265	250,166	507,454
Interbank	63,279	56,234	39,356	16,878	7,045
Other transaction	539,334	402,206	318,165	84,041	137,127
Other nontransaction	1,343,692	934,080	770,128	163,952	409,611
Equity capital	173,666	127,109	98,472	28,637	46,557
Number of banks	14,186	5,954	4,866	1,088	8,232
June 30, 1985					
Loans and investments	1,698,882	1,237,788	987,793	249,995	461,094
Gross loans	1,313,609	990,950	791,578	199,373	322,659
Net loans	1,296,823	979,587	782,744	196,843	317,236
Investments	385,273	246,837	196,215	50,622	138,436
U.S. Treasury and federal agency securities	252,375	158,099	127,427	30,672	94,276
Other	132,899	88,738	68,788	19,950	44,160
Cash assets, total	203,479	158,215	121,805	36,409	45,264
Deposits	1,656,573	1,179,123	954,143	224,980	477,450
Interbank	56,252	50,598	35,210	15,388	5,654
Other demand	463,744	340,487	268,786	71,701	123,257
Other time and savings	1,252,395	864,651	715,332	149,319	387,744
Equity capital	160,101	117,454	91,721	25,733	42,648
Number of banks	14,367	5,979	4,910	1,069	8,388

1. All insured commercial banks in the United States. Details may not add to totals because of rounding.

17. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items—Year-End 1918–86, and Month-End 1986¹

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding							Gold stock ⁵	Special drawing rights certificate account	Treasury currency outstanding ⁶	
	U.S. Treasury and federal agency securities			Loans	Float ²	All other ³	Other Federal Reserve assets ⁴				Total
Total	Bought out-right	Held under repurchase agreement									
1918	239	239	0	1,766	199	294	0	2,498	2,873	...	1,795
1919	300	300	0	2,215	201	575	0	3,292	2,707	...	1,707
1920	287	287	0	2,687	119	262	0	3,355	2,639	...	1,709
1921	234	234	0	1,144	40	146	0	1,563	3,373	...	1,842
1922	436	436	0	618	78	273	0	1,405	3,642	...	1,958
1923	134	80	54	723	27	355	0	1,238	3,957	...	2,009
1924	540	536	4	320	52	390	0	1,302	4,212	...	2,025
1925	375	367	8	643	63	378	0	1,459	4,112	...	1,977
1926	315	312	3	637	45	384	0	1,381	4,205	...	1,991
1927	617	560	57	582	63	393	0	1,655	4,092	...	2,006
1928	228	197	31	1,056	24	500	0	1,809	3,854	...	2,012
1929	511	488	23	632	34	405	0	1,583	3,997	...	2,022
1930	739	686	43	251	21	372	0	1,373	4,306	...	2,027
1931	817	775	42	638	20	378	0	1,853	4,173	...	2,035
1932	1,855	1,851	4	235	14	41	0	2,145	4,226	...	2,204
1933	2,437	2,435	2	98	15	137	0	2,688	4,036	...	2,303
1934	2,430	2,430	0	7	5	21	0	2,463	8,238	...	2,511
1935	2,431	2,430	1	5	12	38	0	2,486	10,125	...	2,476
1936	2,430	2,430	0	3	39	28	0	2,500	11,258	...	2,532
1937	2,564	2,564	0	10	19	19	0	2,612	12,760	...	2,637
1938	2,564	2,564	0	4	17	16	0	2,601	14,512	...	2,798
1939	2,484	2,484	0	7	91	11	0	2,593	17,644	...	2,963
1940	2,184	2,184	0	3	80	8	0	2,274	21,995	...	3,087
1941	2,254	2,254	0	3	94	10	0	2,361	22,737	...	3,247
1942	6,189	6,189	0	6	471	14	0	6,679	22,726	...	3,648
1943	11,543	11,543	0	5	681	10	0	12,239	21,938	...	4,094
1944	18,846	18,846	0	80	815	4	0	19,745	20,619	...	4,131
1945	24,252	24,262	0	249	578	2	0	15,091	20,065	...	4,339
1946	23,350	23,350	0	163	580	1	0	24,093	20,529	...	4,562
1947	22,559	22,559	0	85	535	1	0	23,181	22,754	...	4,562
1948	23,333	23,333	0	223	541	1	0	24,097	24,244	...	4,589
1949	18,885	18,885	0	78	534	2	0	19,499	24,427	...	4,598
1950	20,778	20,725	53	67	1,368	3	0	22,216	22,706	...	4,636
1951	23,801	23,605	196	19	1,184	5	0	25,009	22,695	...	4,709
1952	24,697	24,034	663	156	967	4	0	25,825	23,187	...	4,812
1953	25,916	25,318	598	28	935	2	0	26,880	22,030	...	4,894
1954	24,932	24,888	44	143	808	1	0	25,885	21,713	...	4,985
1955	24,785	24,391	394	108	1,585	29	0	26,507	21,690	...	5,008
1956	24,915	24,610	305	50	1,665	70	0	26,699	21,949	...	5,066
1957	24,238	23,719	519	55	1,424	66	0	25,784	22,781	...	5,146
1958	26,347	26,252	95	64	1,296	49	0	27,755	20,534	...	5,234
1959	26,648	26,607	41	458	1,590	75	0	28,771	19,456	...	5,311
1960	27,384	26,984	400	33	1,847	74	0	29,338	17,767	...	5,398
1961	28,881	30,478	159	130	2,300	51	0	31,362	16,889	...	5,585
1962	30,820	28,722	342	38	2,903	110	0	33,871	11,978	...	5,567
1963	33,593	33,582	11	63	2,600	162	0	36,418	15,513	...	5,578
1964	37,044	36,506	538	186	2,606	94	0	39,930	15,388	...	5,405

For notes see last two pages of table.

17.—Continued

Factors absorbing reserve funds											
Cur- rency in cir- cu- la- tion	Treasury cash hold- ings ⁷	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve ac- counts ⁴	Re- quired clear- ing bal- ances	Other Federal Reserve li- abilities and capital ⁴	Member bank reserves ⁸			
		Treasury	For- eign	Other				With Federal Reserve Banks	Cur- rency and coin ⁹	Re- quired ¹⁰	Ex- cess ¹⁰
4,951	288	51	96	25	118	0	0	1,636	0	1,585	51
5,091	385	31	73	28	208	0	0	1,890	0	1,822	68
5,325	218	57	5	18	298	0	0	1,781	0	0	0
4,403	214	96	12	15	285	0	0	1,753	0	1,654	99
4,530	225	11	3	26	276	0	0	1,934	0	0	0
4,757	213	38	4	19	275	0	0	1,898	0	1,884	14
4,760	211	51	19	20	258	0	0	2,220	0	2,161	59
4,817	203	16	8	21	272	0	0	2,212	0	2,256	-44
4,808	201	17	46	19	293	0	0	2,194	0	2,250	-56
4,716	208	18	5	21	301	0	0	2,487	0	2,424	63
4,686	202	23	6	21	348	0	0	2,389	0	2,430	-41
4,578	216	29	6	24	393	0	0	2,355	0	2,428	-73
4,603	211	19	6	22	375	0	0	2,471	0	2,375	96
5,360	222	54	79	31	354	0	0	1,961	0	1,994	-33
5,388	272	8	19	24	355	0	0	2,509	0	1,933	576
5,519	284	3	4	128	360	0	0	2,729	0	1,870	859
5,536	3,029	121	20	169	241	0	0	4,096	0	2,282	1,814
5,882	2,566	544	29	226	253	0	0	5,587	0	2,743	2,844
6,543	2,376	244	99	160	261	0	0	6,606	0	4,622	1,984
6,550	3,619	142	172	235	263	0	0	7,027	0	5,815	1,212
6,856	2,706	923	199	242	260	0	0	8,724	0	5,519	3,205
7,598	2,409	634	397	256	251	0	0	11,653	0	6,444	5,209
8,732	2,213	368	1,133	599	284	0	0	4,026	0	7,411	6,615
11,160	2,215	867	774	586	291	0	0	12,450	0	9,365	3,085
15,410	2,193	799	793	485	256	0	0	13,117	0	11,129	1,988
20,499	2,303	579	1,360	356	339	0	0	12,886	0	11,650	1,236
25,307	2,375	440	1,204	394	402	0	0	14,373	0	12,748	1,625
28,515	2,287	977	862	446	495	0	0	15,915	0	14,457	1,458
28,952	2,272	393	508	314	607	0	0	16,139	0	15,577	562
28,868	1,336	870	392	569	563	0	0	17,899	0	16,400	1,499
28,224	1,325	1,123	642	547	590	0	0	20,479	0	19,277	1,202
27,600	1,312	821	767	750	106	0	0	16,568	0	15,550	1,018
27,741	1,293	668	895	565	714	0	0	17,681	0	16,509	1,172
29,206	1,270	247	526	363	746	0	0	20,056	0	19,667	389
30,433	1,270	389	550	455	777	0	0	19,950	0	20,520	-570
30,781	761	346	423	493	839	0	0	20,160	0	19,397	763
30,509	796	563	490	441	907	0	0	18,876	0	18,618	258
31,158	767	394	402	554	925	0	0	19,005	0	18,903	102
31,790	775	441	322	426	901	0	0	19,059	0	19,089	-30
31,834	761	481	356	246	998	0	0	19,034	0	19,091	-57
32,193	683	358	272	391	1,122	0	0	18,504	0	18,574	-70
32,591	391	504	345	694	841	0	0	18,174	310	18,619	-135
32,869	377	485	217	533	941	0	0	17,081	2,544	18,988	637
33,918	422	465	279	320	1,044	0	0	17,387	2,544	18,988	96
35,338	380	597	247	393	1,007	0	0	17,454	3,262	20,071	645
37,692	361	880	171	291	1,065	0	0	17,049	4,099	20,677	471
39,619	612	820	229	321	1,036	0	0	18,086	4,151	21,663	574

17. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items—Year-End 1918–86, and Month-End 1986¹—Continued

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding							Gold stock ⁵	Special drawing rights certificate account	Treasury currency outstanding ⁶	
	U.S. Treasury and federal agency securities ¹¹			Loans	Float ²	All other ³	Other Federal Reserve assets ⁴				Total
Total	Bought out-right ¹²	Held under repurchase agreement									
1965	40,768	40,478	290	137	2,248	187	0	43,340	13,733	...	5,575
1966	44,316	43,655	661	173	2,495	193	0	47,177	13,159	...	6,317
1967	49,150	48,980	170	141	2,576	164	0	52,031	11,982	...	6,784
1968	52,937	52,937	0	186	3,443	58	0	56,624	10,367	...	6,795
1969	57,154	57,154 ³	0	183	3,440	64	2,743	64,584	10,367	...	6,852
1970	62,142	62,142	0	335	4,261	57	1,123	67,918	10,732	400	7,147
1971	70,804	69,481	1,323	39	4,343	261	1,068	76,515	10,132	400	7,710
1972	71,230	71,119	111	1,981	3,974	106	1,260	78,551	10,410	400	8,313
1973	80,495	80,395	100	1,258	3,099	68	1,152	86,072	11,567	400	8,716
1974	85,714	84,760	954	299	2,001	999	3,195	92,208	11,652	400	9,253
1975	94,124	92,789	1,335	211	3,688	1,126	3,312	102,461	11,599	500	10,218
1976	104,093	100,062	4,031	25	2,601	991	3,182	110,892	11,598	1,200	10,810
1977	111,274	108,922	2,352	265	3,810	954	2,442	118,745	11,718	1,250	11,331
1978	118,591	117,374	1,217	1,174	6,432	587	4,543	131,327	11,671	1,300	11,831
1979	126,167	124,507	1,660	1,454	6,767	704	5,613	140,705	11,172	1,800	13,083
1980	130,592	128,038	2,554	1,809	4,467	776	8,739	146,383	11,160	2,518	13,427
1981	140,348	136,863	3,485	1,601	1,762	195	9,230	153,136	11,151	3,318	13,687
1982	148,837	144,544	4,293	717	2,735	1,480	9,890	63,659	11,148	4,618	13,786
1983	160,795	159,203	1,592	918	1,605	418	8,728	172,464	11,121	4,618	15,732
1984	169,627	167,612	2,015	3,577	833	0	12,347	186,384	11,096	4,618	16,418
1985	191,248	186,025	5,223	3,060	988	0	15,302	210,598	11,090	4,718	17,075
1986	221,459	205,454	16,005	1,565	1,261	0	17,475	241,760	11,084	5,018	17,567
1986											
Jan.	187,842	184,132	3,710	827	663	0	15,814	205,146	11,090	4,718	17,103
Feb.	184,723	184,723	0	661	-212	0	15,301	200,473	11,090	4,718	17,154
Mar.	184,807	184,807	0	818	560	0	15,635	201,820	11,090	4,718	17,207
Apr.	191,454	182,499	8,955	954	851	0	17,235	210,494	11,090	4,718	17,252
May	190,129	190,129	0	850	132	0	15,326	206,437	11,085	4,818	17,296
June	191,986	191,986	0	952	283	0	15,800	209,021	11,084	4,818	17,330
July	191,583	191,583	0	737	831	0	16,515	209,666	11,084	4,818	17,353
Aug.	193,984	193,984	0	913	261	0	16,547	211,705	11,084	5,018	17,394
Sept.	200,607	192,484	8,123	879	849	0	17,023	219,358	11,084	5,018	17,438
Oct.	197,949	197,949	0	806	441	0	16,797	215,993	11,084	5,018	17,477
Nov.	204,470	202,705	1,765	557	748	0	15,898	221,673	11,084	5,018	17,517
Dec.	221,459	205,454	16,005	1,565	1,261	0	17,475	241,760	11,084	5,018	17,567

1. For a description of figures and discussion of their significance, see *Banking and Monetary Statistics, 1941–1970* (Board of Governors of the Federal Reserve System, 1976), pp. 507–23.

2. Beginning with 1960, figures reflect a minor change in concept; see *Federal Reserve Bulletin*, vol. 47 (February 1961), p. 164.

3. Principally acceptances and, until Aug. 21, 1959, industrial loans, authority for which expired on that date.

4. For the period before Apr. 16, 1969, includes the total of Federal Reserve capital paid in, surplus, other capital accounts, and other liabilities and accrued dividends, less the sum of bank premises and other assets, and was reported as "Other Federal Reserve accounts"; thereafter, "Other Federal Reserve assets" and "Other Federal Reserve liabilities and capital" are shown separately.

5. For the period before Jan. 30, 1934, includes gold held in Federal Reserve Banks and in circulation.

6. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see "Currency and Coin in Circulation," *Treasury Bulletin*.

7. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

8. Beginning in November 1979, includes reserves of member banks, Edge corporations, and U.S. agencies and branches of foreign banks. Beginning on Nov. 13, 1980, includes reserves of all depository institutions.

9. Between Dec. 1, 1959, and Nov. 23, 1960, part was allowed as reserves; thereafter all was allowed.

10. Estimated through 1958. Before 1929 data were available only on call dates (in 1920 and 1922 the call dates were Dec. 29). Beginning on Sept. 12, 1968, the amount is based on close-of-business figures for

17.—(Continued)

Factors absorbing reserve funds											
Curren- cy in cir- culation	Treasury cash hold- ings ⁷	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve ac- counts ⁴	Re- quired clear- ing bal- ances	Other Federal Reserve lia- bilities and capital ⁵	Member bank reserves ⁶			
		Treasury	For- eign	Other				With Federal Reserve Banks	Curren- cy and coin ⁹	Re- quired ¹⁰	Ex- cess ^{10,13}
42,056	760	668	150	355	211	0	0	18,447	4,163	22,848	-238
44,663	1,176	416	174	588	-147	0	0	19,779	4,310	24,321	-232
47,226	1,344	1,123	135	563	-773	0	0	21,092	4,631	25,905	-182
50,961	695	703	216	747	-1,353	0	0	21,818	4,921	27,439	-700
53,950	596	1,312	134	807	0	0	0	22,085	5,187	28,173	-901
57,903	431	1,156	148	1,233	0	0	1,986	24,150	5,423	30,033	-460
61,068	460	2,020	294	999	0	0	2,131	27,788	5,743	32,496	1,035
66,516	345	1,855	325	840	0	0	2,143	25,647	6,216	32,044	98 ¹³
72,497	317	2,542	251	1,419 ¹⁴	0	0	2,669	27,060	6,781	35,268	-1,360
79,743	185	2,113	418	1,275 ¹⁴	0	0	2,935	25,843	7,370	37,011	-3,798
86,547	483	7,285	353	1,090	0	0	2,968	26,052	8,036	35,197	-1,103 ¹⁵
93,717	460	10,393	352	1,357	0	0	3,063	25,158	8,628	35,461	-1,535
103,811	392	7,114	379	1,187	0	0	3,292	26,870	9,421	37,615	-1,265
114,645	240	4,196	368	1,256	0	0	4,275	31,152	10,538	42,694	-893
125,600	494	4,075	429	1,412	0	0	4,957	29,792	11,429	44,217	-2,835
136,829	441	3,062	411	617	0	0	4,671	27,456	13,654	40,558	675
144,774	443	4,301	505	781	0	117	5,261	25,111	15,576	42,145	-1,442
154,908	429	5,033	328	1,033	0	436	4,990	26,053	16,666	41,391	1,328
171,935	479	3,661	191	851	0	1,013	5,392	20,413	17,821	39,179	-945
183,796	513	5,316	253	867	0	1,126	5,952	20,693	n.a.	n.a.	n.a.
197,488	550	9,351	480	1,041	0	1,490	5,940	27,141	n.a.	n.a.	n.a.
211,995	447	7,588	287	917	0	1,812	6,088	46,295	n.a.	n.a.	n.a.
190,430	565	16,228	256	477	0	1,164	6,622	22,316	n.a.	n.a.	n.a.
191,033	604	5,026	277	436	0	1,226	6,735	28,098	n.a.	n.a.	n.a.
193,209	617	3,280	274	511	0	1,542	6,162	29,240	n.a.	n.a.	n.a.
194,503	638	11,550	326	441	0	1,590	6,680	27,826	n.a.	n.a.	n.a.
197,812	631	3,083	254	417	0	1,582	6,110	29,747	n.a.	n.a.	n.a.
199,281	601	3,143	354	450	0	1,593	6,484	30,347	n.a.	n.a.	n.a.
200,552	532	3,983	233	688	0	1,631	6,658	28,644	n.a.	n.a.	n.a.
201,778	497	1,106	227	461	0	1,169	6,652	32,901	n.a.	n.a.	n.a.
200,630	492	7,514	342	663	0	1,681	6,463	35,113	n.a.	n.a.	n.a.
202,506	485	2,491	303	479	0	1,744	6,342	35,222	n.a.	n.a.	n.a.
206,878	459	2,529	225	425	0	1,802	6,480	36,494	n.a.	n.a.	n.a.
211,995	447	7,588	287	917	0	1,812	6,088	46,295	n.a.	n.a.	n.a.

the reserve period two weeks before the report date.
11. Beginning on Dec. 1, 1966, includes federal agency obligations held under repurchase agreements and beginning on Sept. 29, 1971, federal agency issues bought outright.

12. Includes, beginning in 1969, securities loaned—fully guaranteed by U.S. government securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale-purchase transactions.

13. Beginning with week ending Nov. 15, 1972, includes \$450 million of reserve deficiencies on which Federal Reserve Banks are allowed to waive penalties for a transition period in connection with bank adaptation to Regulation J as amended, effective Nov. 9, 1972. Allowable deficiencies are as follows (beginning with first statement week of quarter, in millions): 1973—Q1, \$279; Q2, \$172; Q3, \$112; Q4, \$84; 1974—Q1, \$67; Q2, \$58. The transition period ended with

the second quarter of 1974.

14. For the period before July 1973, includes certain deposits of domestic nonmember banks and foreign-owned banking institutions held with member banks and redeposited in full with Federal Reserve Banks in connection with voluntary participation by nonmember institutions in the Federal Reserve System program of credit restraint.

As of Dec. 12, 1974, the amount of voluntary nonmember bank and foreign-agency and branch deposits at Federal Reserve Banks that are associated with marginal reserves are no longer reported. However, two amounts are reported: (1) deposits voluntarily held as reserves by agencies and branches of foreign banks operating in the United States and (2) Euro-dollar liabilities.

15. Adjusted to include waivers of penalties for reserve deficiencies, in accordance with change in Board policy effective Nov. 19, 1975.

18. Changes in Number of Banking Offices in the United States, 1986¹

Type of office and change	All banks	Commercial banks (including stock savings banks and nondeposit trust companies)						Mutual savings banks	
		Total	Member			Nonmember		Insured	Non-insured
			Total	National	State	Insured	Non-insured		
Banks, Dec. 31, 1985.....	15,442	15,068	6,050	4,967	1,083	8,392	626 ²	358	16
<i>Changes during 1986</i>									
New banks.....	307	304	154	105	49	90	60	3	0
Ceased banking operation....	-148	-148	-56	-46	-10	-78	-14	0	0
Banks converted into branches.....	-305	-300	-133	-111	-22	-167	0	-3	-2
Other ³	-88	-76	-23	-33	10	-4	-49	1	-13
Net change.....	-234	-220	-58	-85	27	-159	-3	1	-15
Banks, Dec. 31, 1986.....	15,208	14,848	5,992	4,882	1,110	8,233	623	359	1
Branches and additional offices, Dec. 31, 1985 ⁴ ...	45,352	43,092	27,595	22,661	4,934	15,409	88	2,219	41
<i>Changes during 1986</i>									
De novo.....	1,226	1,098	646	490	156	448	4	128	0
Banks converted.....	305	300	133	111	22	167	0	3	2
Discontinued.....	-615	-601	-411	-342	-69	-190	0	-14	0
Sale of branch.....	0	19	16	-8	24	3	0	-19	0
Other ³	4	9	419	307	112	-405	-5	33	-38
Net change.....	920	825	803	558	245	23	-1	131	-36
Branches and additional offices, Dec. 31, 1986⁴....	46,272	43,917	28,398	23,219	5,179	15,432	87	2,350	5

1. Preliminary. Final data will be available in the *Annual Statistical Digest, 1986*, forthcoming.

2. As of Dec. 31, 1986, includes 14 noninsured state member banks and 2 noninsured national trust companies.

3. Includes interclass changes.

4. Excludes banking facilities.

19. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1986

Colonial Bank, Montgomery, Alabama, to merge with Luverne Bank and Trust Company, Luverne, Alabama

SUMMARY REPORT BY THE ATTORNEY GENERAL (12/6/85)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (1/8/86)

Colonial Bank (Applicant) has assets of \$102 million, and Luverne Bank and Trust Company (Bank) has assets of \$31 million. Applicant and Bank are not located in the same market, and the proposal would have no significant effect on competition.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

The Suburban Bank, Richmond, Virginia, to merge with Virginia Capital Bank, Richmond, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (2/6/86)

The proposed transaction would not have a significantly adverse effect on competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (2/5/86)

The Suburban Bank (Applicant) has assets of \$13.2 million, and Virginia Capital Bank has assets of \$23.4 million. Although Applicant and Bank compete in the Richmond banking market, the proposal would have no significant effect on competition. The resulting bank's pro forma market share would be only 0.5 percent.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Shelby County State Bank, Shelbyville, Illinois, to merge with Windsor State Bank, Windsor, Illinois

SUMMARY REPORT BY THE ATTORNEY GENERAL (10/10/86)

The proposed transaction would not have a significantly adverse effect on competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (3/4/86)

Shelby County State Bank (Applicant) has assets of \$52.6 million, and Windsor State Bank (Bank) has assets of \$11.5 million. Applicant and Bank are not in the same banking market. Thus, no adverse competitive factors exist.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Norstar Bank of Upstate New York, Albany, New York, to acquire six branches of The Bank of New York, New York, New York

SUMMARY REPORT BY THE ATTORNEY GENERAL (1/24/86)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (3/18/86)

Norstar Bank of Upstate New York (Applicant) has assets of \$2.7 billion, and six branches of The Bank of New York (Branches) have assets of \$220 million. Applicant and Branches are both located in the Syracuse market; however, the Herfindahl-Hirschman index will increase only 18 points to 1850, and thus no adverse competitive factors exist.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

City Bank and Trust Company, Moberly, Missouri, to acquire certain assets and insured deposits of Farmers and Merchants Bank of Huntsville, Huntsville, Missouri

SUMMARY REPORT BY THE ATTORNEY GENERAL
No report received. Request for report on the competitive factors was dispensed with, as authorized by the Bank Merger Act, to permit the Federal Reserve System to act immediately to safeguard depositors of Farmers and Merchants Bank.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (3/31/86)

City Bank and Trust Company (Applicant) has assets of \$108.2 million, and Farmers and Merchants Bank of Huntsville (Bank) has assets of \$18.8 million.

The FDIC has recommended immediate action by the Federal Reserve System to prevent the probable failure of Bank.

American Trust and Savings Bank, Dubuque, Iowa, to acquire certain assets and liabilities of The National Bank, Dyersville, Iowa

SUMMARY REPORT BY THE ATTORNEY GENERAL
No report received. Request for report on the competitive factors was dispensed with, as authorized by the Bank Merger Act, to per-

19. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1986—Continued

mit the Federal Reserve System to act immediately to safeguard depositors of The National Bank.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (4/10/86)

American Trust and Savings Bank (Applicant) has assets of \$246 million, and The National Bank (Bank) has assets of \$41.6 million.

The Comptroller of the Currency has recommended immediate action by the Federal Reserve System to ensure continuation of Bank's services.

Georgia Railroad Bank & Trust Company, Augusta, Georgia, to merge with Bank of Waynesboro, Waynesboro, Georgia

SUMMARY REPORT BY THE ATTORNEY GENERAL (4/16/86)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (4/22/86)

Georgia Railroad Bank & Trust Company (Applicant) has assets of \$753.6 million, and Bank of Waynesboro (Bank) has assets of \$43.4 million. Applicant and Bank operate in separate banking markets.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Norstar Bank of Upstate New York, Albany, New York, to assume the assets and liabilities of the Greenwich branch of Chemical Bank, New York, New York

SUMMARY REPORT BY THE ATTORNEY GENERAL (4/25/86)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (4/25/86)

Norstar Bank of Upstate New York (Applicant), with assets of \$2.7 billion, proposes to assume \$11.7 million in assets and \$11.6 million in liabilities of the Greenwich branch of Chemical Bank (Bank). Applicant and Bank operate in the Glen Falls banking market. On a pro forma basis, Applicant will control 12.3 percent of the commercial banking deposits in the market. The Herfindahl-Hirschman index will increase only 47 points. Consummation of the

proposal would have no significant effect on competition.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Manufacturers Hanover Trust Company, New York, New York to acquire certain assets and assume certain liabilities of six branches of Dollar Dry Dock Savings Bank, White Plains, New York

SUMMARY REPORT BY THE ATTORNEY GENERAL (3/28/86)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (5/8/86)

Manufacturers Hanover Trust Company (Applicant), with assets of \$62.3 billion, proposes to acquire \$333 million in assets and assume \$354 million in liabilities of six branches of Dollar Dry Dock Savings Bank (Branches). Both Applicant and Branches are located in the metropolitan New York banking market. Applicant is ranked third in the market, with 8.1 percent of market deposits. On a pro forma basis, Applicant's market share will increase to 8.3 percent, and Applicant will remain the third largest banking organization in the market.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First Community Bank, Inc., Princeton, West Virginia, to merge with First Community Bank-Castle Rock, Pineville, West Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (5/2/86)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (5/23/86)

First Community Bank, Inc. (Applicant) has assets of \$136 million, and First Community Bank-Castle Rock (Bank) has assets of \$56 million. Applicant and Bank are not located in the same market, and the proposal would have no significant effect on competition.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

(Continued)

Indiana Southern Bank, Sellersburg, Indiana, to acquire United Bank of Indiana, N.A., Clarksville, Indiana

SUMMARY REPORT BY THE ATTORNEY GENERAL (5/2/86)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (6/26/86)

Indiana Southern Bank (Applicant) has assets of \$82.4 million, and United Bank of Indiana, N.A. (Bank), has assets of \$38 million. Applicant and Bank operate in the Louisville banking market, and each controls less than 2 percent of the commercial banking deposits in the market. Although Applicant, combined with other commercial banking deposits controlled by its parent holding company, would control slightly more than 30 percent of the market deposits, thrift institutions offer substantial competition to commercial banks. No significant adverse competitive effects arise from the transaction.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

The Bank of New York, New York, New York, to acquire certain assets and assume certain liabilities of three branches of The Home Savings Bank, Brooklyn, New York

SUMMARY REPORT BY THE ATTORNEY GENERAL (5/2/86)

The proposed transaction will not have a significantly adverse effect on competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (7/2/86)

The Bank of New York (Applicant), with assets of \$17.2 billion, proposes to acquire assets of \$1.4 million and liabilities of \$79 million of three branches of The Home Savings Bank (Branches). Applicant and Branches operate in the metropolitan New York-New Jersey banking market. The pro forma market share is 2.4 percent. The proposal would have no significant effect on competition.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Ireland Bank, Malad City, Idaho, to acquire all the assets and liabilities of Downey State Bank, Downey, Idaho

SUMMARY REPORT BY THE ATTORNEY GENERAL (7/7/86)

No existing competition of significance will be eliminated by the proposed transaction.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (8/15/86)

Ireland Bank (Applicant) has assets of \$25.2 million, and Downey State Bank (Bank) has assets of \$18.1 million. The Director of the Idaho Department of Finance has recommended immediate action by the Federal Reserve System to prevent the probable failure of Bank.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Norstar Bank of Upstate New York, Albany, New York, to purchase assets and assume liabilities of three branches of Citibank (New York State), N.A., Buffalo, New York

SUMMARY REPORT BY THE ATTORNEY GENERAL (9/12/86)

The proposed transaction would not have a significantly adverse effect on competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (10/1/86)

Norstar Bank of Upstate New York (Applicant), with assets of \$2.7 billion, proposes to purchase assets of \$1 million and assume liabilities of \$42 million of three branches of Citibank (New York State), N.A., in the Albany banking market. Applicant's resulting increase in market share in the Albany area is well within Justice Department and Board guidelines.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Security Savings Bank, Marshalltown, Iowa, to acquire certain assets and liabilities of The First National Bank of Prairie City, Prairie City, Iowa

SUMMARY REPORT BY THE ATTORNEY GENERAL

No report received. Request for report on the competitive factors was dispensed with, as authorized by the Bank Merger Act, to permit

19. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1986—Continued

the Federal Reserve System to act immediately to safeguard depositors of The First National Bank of Prairie City.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (7/24/86)

Security Savings Bank (Applicant) has assets of \$163.3 million, and The First National Bank of Prairie City (Bank) has assets of \$8.7 million.

The Comptroller of the Currency has requested immediate action by the Federal Reserve System to ensure continuation of Bank's services.

Banco de Ponce, Ponce, Puerto Rico, to acquire certain assets and assume certain liabilities of two branches of The East New York Savings Bank, New York, New York

SUMMARY REPORT BY THE ATTORNEY GENERAL (9/26/86)

The proposed transaction would not have a significantly adverse effect on competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (10/10/86)

Banco de Ponce (Applicant), with assets of \$2.3 billion, proposes to acquire certain assets and assume certain liabilities of two branches of The East New York Savings Bank (Bank), with assets of \$1.4 billion. Both Applicant and Bank are in the metropolitan New York-New Jersey banking market. As a result of this acquisition, Applicant's market share of 0.1 percent will remain unchanged. Consummation would result in no significant adverse competitive effects.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Imperial Bank of Florida, Coral Gables, Florida, to acquire certain assets and assume certain liabilities of the Hialeah branch of Popular Bank of Florida, Miami, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (7/25/86)

The proposed transaction would not have a significantly adverse effect on competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (10/14/86)

Imperial Bank of Florida (Applicant), with assets of \$18.0 million, proposes to acquire \$12.5

million in assets from the Hialeah branch of Popular Bank of Florida (Bank), with total banking assets of \$71.2 million. Both Applicant and Bank are in the Miami-Fort Lauderdale banking market. As a result of this acquisition, the Herfindahl-Hirschman index will remain unchanged at 909. Thus, no significant adverse competitive effects exist.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Norstar Bank of Upstate New York, Albany, New York, to merge with Seaway National Bank, Watertown, New York

SUMMARY REPORT BY THE ATTORNEY GENERAL (9/12/86)

The proposed transaction would not have a significantly adverse effect on competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (11/14/86)

Norstar Bank of Upstate New York (Applicant) has assets of \$3.2 billion, and Seaway National Bank (Bank) has assets of \$25.8 million. Applicant does not currently operate in Bank's market, and no issues are raised with respect to competition. Thus, the proposed transaction would have no adverse competitive effects.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

United Virginia Bank, Richmond, Virginia, to merge with People's Bank of Chesapeake, Chesapeake, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (10/17/86)

The proposed transaction would not have a significantly adverse effect on competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (11/3/86)

United Virginia Bank (Applicant) has assets of \$6.9 billion, and People's Bank of Chesapeake (Bank) has assets of \$80 million. Applicant and Bank compete in the areas of Norfolk-Portsmouth, Virginia, and Currituck County, North Carolina, with Applicant ranked second and Bank ranked eighth among 16 banks in the market. Applicant would remain the second largest bank in the market with 16.7 percent of commercial banking deposits.

19. — Continued

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First Interstate Bank of California, Los Angeles, California, to acquire the assets and assume the liabilities of First National Bank, Willows, California

SUMMARY REPORT BY THE ATTORNEY GENERAL
No report received. Request for report on the competitive factors was dispensed with, as authorized by the Bank Merger Act, to permit the Federal Reserve System to act immediately to safeguard depositors of First National Bank.

BASIS FOR APPROVAL BY THE BOARD (11/21/86)
First Interstate Bank of California (Applicant) has assets of \$20.6 billion, and First National Bank (Bank) has assets of \$65 million.

The Comptroller of the Currency has recommended immediate action by the Federal Reserve System to ensure continuation of Bank's services.

First Virginia Bank—Citizens, Clintwood, Virginia, to merge with Peoples Bank of Pound, Pound, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (11/21/86)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (11/28/86)

First Virginia Bank—Citizens (Applicant) has assets of \$28.7 million, and Peoples Bank of Pound (Bank) has assets of \$45.9 million. Applicant and Bank are not located in the same market, and the proposal would have no significant effect on competition.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Security Bank, Marshalltown, Iowa, to purchase the assets and liabilities of Hawkeye Bank & Trust, Eldora, Iowa

SUMMARY REPORT BY THE ATTORNEY GENERAL (11/21/86)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE BANK (12/30/86)

Security Bank (Applicant) has assets of \$188 million, and Hawkeye Bank & Trust (Bank) has assets of \$16.5 million. Applicant and Bank are not located in the same market, and the proposal would have no significant effect on competition.

The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Mergers Approved Involving Wholly Owned Subsidiaries of the Same Bank Holding Company

In each of the following cases, the summary report by the attorney general indicates that the transaction would not have a significantly adverse effect on competition because the proposed merger is essentially a corporate reorganization. The Board of Governors, the Federal Reserve Bank, or the Secretary of the Board of Governors, whichever approved the application, determined that the competitive effects of the proposed transaction, the financial and managerial resources and the prospects of the banks concerned, and the convenience and needs of the community to be served were consistent with approval.

Institution ¹	Assets (millions of dollars)	Date of approval
Commerce Union Bank, Nashville, Tennessee..... <i>Merger</i>	1,956	3/7/86
Commerce Union Bank of Humphreys County, Waverly, Tennessee	48	
Commerce Union Bank of Rutherford County, Murfreesboro, Tennessee	118	
Commerce Union Bank of Sumner County, Gallatin, Tennessee	79	

19. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1986—Continued

Institution ¹	Assets (millions of dollars)	Date of approval
The Toledo Trust Company Three Sea Gate, Toledo, Ohio.....	2,184	3/25/86
<i>Merger</i>		
First Buckeye Bank, N.A., Mansfield, Ohio	833	
The Merrill Trust Company, Bangor, Maine	665	3/31/86
<i>Merger</i>		
Merrill Bank, N.A., Farmington, Maine	108	
The Central Trust Company, Newark, Ohio	367	5/27/86
<i>Merger</i>		
The Clear Creek Valley Banking Company, Amanda, Ohio	15	
Security Bank & Trust Company, Southgate, Michigan	1,100	6/19/86
<i>Merger</i>		
Security Bank & Trust Company of Oakland County, Novi, Michigan.....	50	
State Bank of Carthage, Carthage, Indiana	11	6/23/86
<i>Merger</i>		
The First National Bank of Mays, Mays, Indiana	9	
Ohio Citizens Bank, Toledo, Ohio	773	7/8/86
<i>Merger</i>		
The Citizens National Bank, Bryan, Ohio	134	
First Source Bank, South Bend, Indiana.....	827	8/15/86
<i>Merger</i>		
Community State Bank, North Liberty, Indiana.....	19.7	
Rocky Mountain State Bank, Salt Lake City, Utah	15	8/29/86
<i>Merger</i>		
Rocky Mountain State Bank of Bountiful, Bountiful, Utah	13	
Mercantile Bank & Trust Company, Kansas City, Missouri	237	9/25/86
<i>Merger</i>		
Noland Road Mercantile Bank, Independence, Missouri.....	138	
Mercantile Regional Bank, Kansas City, Missouri	164	
Mercantile National Bank of Clay County, Kansas City, Missouri	31	
Old Kent Bank of Kalamazoo, Kalamazoo, Michigan	28	10/1/86
<i>Merger</i>		
The American National Bank in Portage, Portage, Michigan ...	33	
The American National Bank & Trust Company of Michigan, Kalamazoo, Michigan	420	
Old Kent Bank—Southwest, Niles, Michigan	258	10/2/86
<i>Merger</i>		
The American Bank of Niles, N.A., Niles, Michigan.....	25	

1988 (Continued)

Institution ¹	Assets (millions of dollars)	Date of approval
Norstar Bank, Rochester, New York.....	1,682	10/10/86
<i>Merger</i>		
Norstar Bank of Upstate New York, Albany, New York	1,043	
Hawkeye-Capital Bank & Trust Company, Des Moines, Iowa.....	107	10/16/86
<i>Merger</i>		
Hawkeye Bank and Trust of Des Moines, Des Moines, Iowa ...	61	
Silicon Valley Bank, San Jose, California	101	10/31/86
<i>Merger</i>		
National Intercity Bank, Santa Clara, California	54	
Commerce Union Bank, Nashville, Tennessee.....	1,956	11/18/86
<i>Merger</i>		
Commerce Union Bank of Lawrence County, Lawrenceburg, Tennessee	64	
Security Bank of Richmond, Richmond, Michigan.....	83	11/25/86
<i>Merger</i>		
Security Bank Imlay City, Imlay City, Michigan	40	
First Virginia-Commonwealth, Grafton, Virginia.....	37	12/1/86
<i>Merger</i>		
First Virginia Bank-Surry, Surry, Virginia.....	17	
The Merchants Bank, Kansas City, Missouri.....	963	12/15/86
<i>Merger</i>		
The Bank of Kansas City, Kansas City.....	114	
Westport Bank, Kansas City, Missouri.....	84	

1. Each proposed transaction was to be effected under the charter of the first-named bank. The entries are in chronological order of approval.

Mergers Approved Involving a Nonoperating Institution with an Existing Bank

The following transactions have no significant effect on competition; they merely facilitate the acquisition of the voting shares of a bank or banks by a holding company. In such cases the summary report by the attorney general indicates that the transaction will merely combine an existing bank with a nonoperating institution; in consequence, and without regard

to the acquisition of the surviving bank by the holding company, the merger would have no effect on competition. The Board of Governors, the Federal Reserve Bank, or the Secretary of the Board of Governors, whichever approved the application, determined that the proposal would, in itself, have no adverse competitive effects, and that the financial factors and considerations relating to the convenience and needs of the community were consistent with approval.

Institution ¹	Assets (millions of dollars) ²	Date of approval
Shelbyville Interim Bank .....	...	3/4/86
<i>Merger</i>		
Shelby County State Bank, Shelbyville, Illinois.....	50	

19. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1986—Continued

Institution ¹	Assets (millions of dollars) ²	Date of approval
B.N.S. Bank, Northbrook, Illinois..... <i>Merger</i>	...	3/11/86
Bank of the North Shore, Northbrook, Illinois	32	
The New Waterford Interim Bank, New Waterford, Ohio..... <i>Merger</i>	...	3/27/86
The New Waterford Bank, New Waterford, Ohio	46	
The Bel Air Bank, Bel Air, Maryland .....	...	4/21/86
<i>Merger</i>		
Commercial Bank, Bel Air, Maryland	122	
PCB Company, Hurricane, West Virginia .....	...	6/5/86
<i>Merger</i>		
Putnam County Bank, Hurricane, West Virginia	128	
New First Union Bank and Trust Company, Medaryville, Indiana .....	...	6/19/86
<i>Merger</i>		
First Union Bank and Trust Company, Winamac, Indiana	476	
FIBC Service Bank III, Howe, Indiana .....	...	8/5/86
<i>Merger</i>		
State Bank of Lima, Howe, Indiana.....	31	
Central Virginia Bank, Powhatan, Virginia .....	...	8/28/86
<i>Merger</i>		
Community Bank of Powhatan, Powhatan, Virginia	31	
Barbour Interim Bank, Philippi, West Virginia..... <i>Merger</i>	...	9/15/86
Barbour County Bank, Philippi, West Virginia	36	
Beach Bank, Seabrook, New Hampshire		9/26/86
<i>Merger</i>		
Seabrook Bank & Trust Company, Seabrook, New Hampshire	44	
Lakeview Interim Bank, Lakeview, Michigan..... <i>Merger</i>	...	10/29/86
Bank of Lakeview, Lakeview, Michigan	50	
New Lowell State Bank, Lowell, Michigan..... <i>Merger</i>	...	11/25/86
State Savings Bank, Lowell, Michigan	67	
Traders Interim Bank, Spencer, West Virginia .....	...	11/26/86
<i>Merger</i>		
Trader Bank, Spencer, West Virginia	63	

19.—Continued

Institution	Assets (millions of dollars) ²	Date of approval
The Lunenburg County Bank, Kenbridge, Virginia .....	. . .	12/1/86
<i>Merger</i> Community Bank of Lunenburg, Kenbridge, Virginia	24	

1. Each proposed transaction was to be effected under the charter of the first-named bank. The entries are in chronological order of approval.

2. In each case, the first-named bank is newly organized and not in operation.

The Federal Reserve System

Boundaries of Federal Reserve Districts and their Branch Territories



Legend

- Boundaries of Federal Reserve Districts
- Boundaries of Federal Reserve Branch Territories
- Board of Governors of the Federal Reserve System
- Federal Reserve Bank Cities
- Federal Reserve Branch Cities
- Federal Reserve Bank Facilities

*Federal Reserve
Directories and Meetings*

Board of Governors of the Federal Reserve System

December 31, 1986

Term expires

PAUL A. VOLCKER of New Jersey, <i>Chairman</i> ¹	January 31, 1992
MANUEL H. JOHNSON of Virginia, <i>Vice Chairman</i> ¹	January 31, 2000
Vacant	January 31, 1988
WAYNE D. ANGELL of Kansas	January 31, 1994
EMMETT J. RICE of New York	January 31, 1990
MARTHA R. SEGER of Michigan	January 31, 1998
H. ROBERT HELLER of California	January 31, 1996

OFFICE OF BOARD MEMBERS

JOSEPH R. COYNE, *Assistant to the Board*
 DONALD J. WINN, *Assistant to the Board*
 STEVEN M. ROBERTS, *Assistant to the Chairman*
 BOB S. MOORE, *Special Assistant to the Board*

OFFICE OF STAFF DIRECTOR FOR MONETARY AND FINANCIAL POLICY

DONALD L. KOHN, *Deputy Staff Director*
 NORMAND R. V. BERNARD, *Special Assistant to the Board*

OFFICE OF STAFF DIRECTOR FOR MANAGEMENT

S. DAVID FROST, *Staff Director*
 EDWARD T. MULRENIN, *Assistant Staff Director*
 CHARLES L. HAMPTON, *Senior Technical Adviser*
 PORTIA W. THOMPSON, *Equal Employment Opportunity Programs Officer*

OFFICE OF STAFF DIRECTOR FOR FEDERAL RESERVE BANK ACTIVITIES

THEODORE E. ALLISON, *Staff Director*

OFFICE OF EXECUTIVE DIRECTOR FOR INFORMATION RESOURCES MANAGEMENT

ALLEN E. BEUTEL, *Executive Director*
 STEPHEN R. MALPHRUS, *Assistant Director*

OFFICE OF THE SECRETARY

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 BARBARA R. LOWREY, *Associate Secretary*
 JAMES MCAFEE, *Associate Secretary*

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 J. VIRGIL MATTINGLY, JR., *Deputy General Counsel*
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 OLIVER IRELAND, *Associate General Counsel*
 RICKI R. TIGERT, *Assistant General Counsel*
 MARYELLEN A. BROWN, *Assistant to the General Counsel*

DIVISION OF RESEARCH AND STATISTICS

JAMES L. KICHLINE, *Director*
 EDWARD C. ETTIN, *Deputy Director*
 MICHAEL J. PRELL, *Deputy Director*

1. The designations as Chairman and Vice Chairman expire on August 6, 1987, and August 4, 1990, respectively, unless the services of these members of the Board shall have terminated sooner.

DIVISION OF RESEARCH
AND STATISTICS—Continued
JARED J. ENZLER, *Associate Director*
DAVID E. LINDSEY, *Associate Director*
ELEANOR J. STOCKWELL, *Associate
Director*
MARTHA BETHEA, *Deputy Associate
Director*
THOMAS D. SIMPSON, *Deputy Associate
Director*
LAWRENCE SLIFMAN, *Deputy Associate
Director*
PETER A. TINSLEY, *Deputy Associate
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RICHARD D. PORTER, *Assistant
Director*
MARTHA S. SCANLON, *Assistant
Director*
JOYCE ZICKLER, *Assistant Director*
LEVON H. GARABEDIAN, *Assistant
Director (Administration)*

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Director*
CHARLES J. SIEGMAN, *Senior Associate
Director*
DAVID H. HOWARD, *Deputy Associate
Director*
ROBERT F. GEMMILL, *Staff Adviser*
DONALD B. ADAMS, *Assistant Director*
PETER HOOPER, III, *Assistant Director*
KAREN H. JOHNSON, *Assistant Director*
RALPH W. SMITH, JR., *Assistant
Director*

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BANK OPERATIONS
CLYDE H. FARNSWORTH, JR., *Director*
ELLIOTT C. McENTEE, *Associate
Director*
DAVID L. ROBINSON, *Associate Director*
C. WILLIAM SCHLEICHER, JR., *Associate
Director*

DIVISION OF FEDERAL RESERVE
BANK OPERATIONS—Continued
CHARLES W. BENNETT, *Assistant
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ANNE M. DEBEER, *Assistant Director*
JACK DENNIS, JR., *Assistant Director*
EARL G. HAMILTON, *Assistant Director*
JOHN H. PARRISH, *Assistant Director*
FLORENCE M. YOUNG, *Adviser*

DIVISION OF BANKING
SUPERVISION AND REGULATION
WILLIAM TAYLOR, *Director*
WELFORD S. FARMER, *Deputy Director*²
FREDERICK R. DAHL, *Associate
Director*
DON E. KLINE, *Associate Director*
FREDERICK M. STRUBLE, *Associate
Director*
WILLIAM A. RYBACK, *Deputy Associate
Director*
STEPHEN C. SCHEMERING, *Deputy
Associate Director*
RICHARD SPILLENKOTHEN, *Deputy
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HERBERT A. BIERN, *Assistant Director*
JOE M. CLEAVER, *Assistant Director*
ANTHONY CORNYN, *Assistant Director*
JAMES I. GARNER, *Assistant Director*
JAMES D. GOETZINGER, *Assistant
Director*
MICHAEL MARTINSON, *Assistant
Director*
ROBERT S. PLOTKIN, *Assistant Director*
SIDNEY M. SUSSAN, *Assistant Director*
LAURA M. HOMER, *Securities Credit
Officer*

DIVISION OF CONSUMER
AND COMMUNITY AFFAIRS
GRIFFITH L. GARWOOD, *Director*
JERAULD C. KLUCKMAN, *Associate
Director*
GLENN E. LONEY, *Assistant Director*
ELLEN MALAND, *Assistant Director*
DOLORES S. SMITH, *Assistant Director*

². On loan from the Federal Reserve Bank of Richmond.

Board of Governors of the Federal Reserve System— Continued

DIVISION OF PERSONNEL

DAVID L. SHANNON, *Director*
JOHN R. WEIS, *Assistant Director*
CHARLES W. WOOD, *Assistant Director*

DIVISION OF SUPPORT SERVICES

ROBERT E. FRAZIER, *Director*
WALTER W. KREIMANN, *Associate
Director*
GEORGE M. LOPEZ, *Assistant Director*

OFFICE OF THE CONTROLLER

GEORGE E. LIVINGSTON, *Controller*
BRENT L. BOWEN, *Assistant Controller*

DIVISION OF HARDWARE AND SOFTWARE SYSTEMS

BRUCE M. BEARDSLEY, *Director*
THOMAS C. JUDD, *Assistant Director*
ELIZABETH B. RIGGS, *Assistant
Director*
ROBERT J. ZEMEL, *Assistant Director*

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DAY RADEBAUGH, *Assistant Director*
RICHARD C. STEVENS, *Assistant
Director*
PATRICIA A. WELCH, *Assistant Director*

Federal Open Market Committee

December 31, 1986

Members

PAUL A. VOLCKER, *Chairman*, Board of Governors
E. GERALD CORRIGAN, *Vice Chairman*, elected member by Federal Reserve Bank
of New York
WAYNE D. ANGELL, Board of Governors
ROGER GUFFEY, elected by Federal Reserve Banks of Minneapolis, Kansas City,
and San Francisco
H. ROBERT HELLER, Board of Governors
KAREN N. HORN, elected by Federal Reserve Banks of Cleveland and Chicago
MANUEL H. JOHNSON, Board of Governors
THOMAS C. MELZER, elected by Federal Reserve Banks of Atlanta, St. Louis,
and Dallas
FRANK E. MORRIS, elected by Federal Reserve Banks of Boston, Philadelphia,
and Richmond
EMMETT J. RICE, Board of Governors
MARTHA R. SEGER, Board of Governors

Alternate Members

EDWARD G. BOEHNE, elected by Federal Reserve Banks of Boston, Philadelphia,
and Richmond
ROBERT H. BOYKIN, elected by Federal Reserve Banks of Atlanta, St. Louis,
and Dallas
SILAS KEEHN, elected by Federal Reserve Banks of Cleveland and Chicago
GARY H. STERN, elected by Federal Reserve Banks of Minneapolis, Kansas City,
and San Francisco
THOMAS M. TIMLEN, elected by Federal Reserve Bank of New York

Federal Open Market Committee—Continued

Officers

NORMAND R. V. BERNARD,
Assistant Secretary

MICHAEL BRADFIELD,
General Counsel

JAMES H. OLTMAN,
Deputy General Counsel

JAMES L. KICHLINE,
Economist

EDWIN M. TRUMAN,
Economist (International)

ANATOL B. BALBACH,
Associate Economist

JOHN M. DAVIS,
Associate Economist

RICHARD G. DAVIS,
Associate Economist

THOMAS E. DAVIS,
Associate Economist

DONALD L. KOHN,
Associate Economist

DAVID E. LINDSEY,
Associate Economist

ALICIA H. MUNNELL,
Associate Economist

MICHAEL J. PRELL,
Associate Economist

CHARLES J. SIEGMAN,
Associate Economist

PETER D. STERNLIGHT, *Manager for Domestic Operations,
System Open Market Account*

SAM Y. CROSS, *Manager for Foreign Operations,
System Open Market Account*

During 1986, the Federal Open Market Committee held eight regularly scheduled meetings (See Record of Policy Actions

of the Federal Open Market Committee in this REPORT.)

Federal Advisory Council

December 31, 1986

Members

District 1—ROBERT L. NEWELL, *Chairman and Chief Executive Officer,* Connecticut National Bank, Hartford, Connecticut

District 2—JOHN F. MCGILLICUDDY, *Chairman of the Board and Chief Executive Officer,* Manufacturers Hanover Trust Company, New York, New York

District 3—GEORGE A. BUTLER, *Chairman,* First Pennsylvania Bank, N.A., Philadelphia, Pennsylvania

District 4—JULIEN L. MCCALL, *Chairman and Chief Executive Officer,* National City Corporation, Cleveland, Ohio

District 5—JOHN G. MEDLIN, JR., *Chairman of the Board and Chief Executive Officer,* Wachovia Bank and Trust Company, N.A., *President and Chief Executive Officer,* The First Wachovia Corporation, Winston-Salem, North Carolina

District 6—BENNETT A. BROWN, *Chairman and Chief Executive Officer,* Citizens and Southern Georgia Corporation and The Citizens and Southern National Bank, Atlanta, Georgia

District 7—HAL C. KUEHL, *Chairman of the Board and Chief Executive Officer,* First Wisconsin National Bank of Milwaukee, Milwaukee, Wisconsin

District 8—WILLIAM H. BOWEN, *Chairman of the Board and Chief Executive Officer,* First Commercial Bank, N.A., Little Rock, Arkansas

*Federal Advisory Council—Continued***Members—Continued**

District 9—D. H. ANKENY, JR., *Chairman and Chief Executive Officer*, First Bank System, Minneapolis, Minnesota

District 10—F. PHILLIPS GILTNER, *President*, First National Bank, Omaha, Nebraska

District 11—NAT S. ROGERS, *Consultant and Director*, First City National Bancorporation of Texas, Inc., Houston, Texas

District 12—G. ROBERT TRUEX, JR., *Chairman*, Rainier Bancorporation and Rainier National Bank, Seattle, Washington

Officers

ROBERT L. NEWELL, *President*

WILLIAM H. BOWEN, *Vice President*

HERBERT V. PROCHNOW, *Secretary*

WILLIAM J. KORSVIK, *Associate Secretary*

Directors

GEORGE A. BUTLER

JOHN G. MEDLIN, JR.

HAL C. KUEHL

Meetings of the Federal Advisory Council were held on February 6–7, May 1–2, September 11–12, and November 13–14, 1986. The Board of Governors met with the council on February 7, May 2, September 12, and November 14, 1986. The council, which is composed of 12 repre-

sentatives of the banking industry, one from each Federal Reserve District, is required by law to meet in Washington at least four times per year and is authorized by the Federal Reserve Act to consult with and advise the Board on all matters within the jurisdiction of the Board.

Consumer Advisory Council

December 31, 1986

Members

RACHEL G. BRATT, *Associate Professor*, Department of Urban and Environmental Policy, Tufts University, Medford, Massachusetts

EDWIN B. BROOKS, *President*, Security Federal Savings and Loan Association, Richmond, Virginia

JONATHAN A. BROWN, *Director*, BankWatch, Washington, D.C.

MICHAEL S. CASSIDY, *Senior Vice President*, Chase Manhattan Bank, New York, New York

THERESA FAITH CUMMINGS, *Social Services Consultant*, Springfield, Illinois

NEIL J. FOGARTY, *Attorney*, Hudson County Legal Services, Jersey City, New Jersey

STEVEN M. GEARY, *Associate General Counsel*, Missouri Division of Finance, Jefferson City, Missouri

KENNETH A. HALL, *President*, Great Southern National Bank of Jackson, Jackson, Mississippi

STEVEN W. HAMM, *Administrator*, South Carolina Department of Consumer Affairs, Columbia, South Carolina

ROBERT J. HOBBS, *Senior Attorney*, National Consumer Law Center, Boston, Massachusetts

Consumer Advisory Council—Continued

Members—Continued

- ROBERT W. JOHNSON, *Professor of Management and Director*, Credit Research Center, Purdue University, West Lafayette, Indiana
- JOHN M. KOLESAR, *President*, Ameritrust Development Bank, Cleveland, Ohio
- EDWARD N. LANGE, *Partner*, Davis, Wright, Todd, Riese & Jones, Seattle, Washington
- ALAN B. LERNER, *Senior Executive Vice President*, Associates Corporation of North America, Dallas, Texas
- FRED S. MCCHESENEY, *Visiting Fellow of Law and Economics*, University of Chicago, Chicago, Illinois
- FRED H. MILLER, *Professor of Law*, University of Oklahoma, Norman, Oklahoma
- MARGARET M. MURPHY, *Associate Professor and Director*, Columbia Center, Johns Hopkins University, Columbia, Maryland
- ROBERT F. MURPHY, *Chairman*, General Motors Acceptance Corporation, Detroit, Michigan
- HELEN E. NELSON, *President*, Consumer Research Foundation, Mill Valley, California
- LAWRENCE S. OKINAGA, *Partner*, Carlsmith, Carlsmith, Wichman & Case, Honolulu, Hawaii
- SANDRA R. PARKER, *Chairman*, Banking Committee, Richmond United Neighborhoods, Richmond, Virginia
- JOSEPH L. PERKOWSKI, *Chief Executive Officer*, Minneapolis Federal Employees Credit Union, Minneapolis, Minnesota
- BRENDA L. SCHNEIDER, *Director of Community Relations*, Manufacturers National Bank, Detroit, Michigan
- JANE SHULL, *Director*, Institute for the Study of Civic Values, Philadelphia, Pennsylvania
- TED L. SPURLOCK, *Vice President and Director of Credit and Consumer Banking Services*, J.C. Penney Company, Inc., Dallas, Texas
- MEL STILLER, *Executive Director*, Consumer Credit Counseling Service of Eastern Massachusetts, Boston, Massachusetts
- CHRISTOPHER J. SUMNER, *President and Chief Executive Officer*, Western Savings & Loan Company, Salt Lake City, Utah
- EDWARD J. WILLIAMS, *Senior Vice President*, Consumer Banking Group, Harris Trust and Savings Bank, Chicago, Illinois
- MERVIN WINSTON, *Vice President*, First Bank System, Inc., Minneapolis, Minnesota
- MICHAEL ZOROYA, *Retail Services Consultant*, The May Department Stores, St. Louis, Missouri

Officers

MARGARET M. MURPHY, *Chairman*

LAWRENCE S. OKINAGA, *Vice Chairman*

The Consumer Advisory Council met with members of the Board of Governors on March 20–21, June 19–20, and October 8–9, 1986. The council is composed of academics, state government officials, representatives of the financial industry,

and representatives of consumer and community interests. It was established pursuant to the 1976 amendments to the Equal Credit Opportunity Act to advise the Board on consumer financial services.

Thrift Institutions Advisory Council

December 31, 1986

Members

- ELLIOTT G. CARR, *President and Chief Executive Officer*, The Cape Cod Five Cents Savings Bank, Orleans, Massachusetts
- M. TODD COOKE, *Vice Chairman*, Meritor Financial Group, Philadelphia, Pennsylvania
- RICHARD H. DEIHL, *Chairman of the Board and Chief Executive Officer*, Home Savings of America, Los Angeles, California
- JOHN C. DICUS, *President*, Capitol Federal Savings and Loan Association, Topeka, Kansas
- HAROLD W. GREENWOOD, JR., *Chairman, President, and Chief Executive Officer*, Midwest Federal Savings and Loan Association, Minneapolis, Minnesota
- JOHN A. HARDIN, *Chairman and President*, First Federal Savings Bank, Rock Hill, South Carolina
- JAMIE J. JACKSON, *President*, Commonwealth Financial Group, Houston, Texas
- FRANCES LESNIESKI, *President*, Michigan State University Federal Credit Union, East Lansing, Michigan
- DONALD F. MCCORMICK, *Chairman of the Board*, Howard Savings Bank, Livingston, New Jersey
- HERSCHEL ROSENTHAL, *President*, Flagler Federal Savings and Loan Association, Miami, Florida
- GARY L. SIRMON, *President*, First Federal Savings and Loan Association, Walla Walla, Washington
- MICHAEL R. WISE, *Chairman and Chief Executive Officer*, Silverado Banking, Denver, Colorado

Officers

RICHARD H. DEIHL, *President*

MICHAEL R. WISE, *Vice President*

The members of the Thrift Institutions Advisory Council met with the Board of Governors on January 31, May 1, September 9, and November 6, 1986. The council, which is composed of representatives from credit unions, savings and loan

associations, and savings banks, consults with and advises the Board on issues pertaining to the thrift industry and on various other matters within the Board's jurisdiction.

*Officers of Federal Reserve Banks, Branches,
and Offices*

December 31, 1986¹

BANK, Branch, or facility	Chairman ² Deputy Chairman	President First Vice President	Vice President in charge of Branch
BOSTON ³	Joseph A. Baute George N. Hatsopoulos	Frank E. Morris Robert W. Eisenmenger	
NEW YORK ³	John Brademas Clifton R. Wharton, Jr.	E. Gerald Corrigan Thomas M. Timlen	
Buffalo	Mary Ann Lambertsen		John T. Keane
PHILADELPHIA ..	Robert M. Landis Nevius M. Curtis	Edward G. Boehne Richard L. Smoot	
CLEVELAND ³	W.H. Knoell E. Mandell de Windt	Karen N. Horn William H. Hendricks	
Cincinnati	Owen B. Butler		Charles A. Cerino ⁴
Pittsburgh	James E. Haas		Harold J. Swart ⁴
RICHMOND ³	Leroy T. Canoles, Jr. Robert A. Georgine	Robert P. Black Jimmie R. Monhollon	
Baltimore	Robert L. Tate		Robert D. McTeer ⁴
Charlotte	Wallace J. Jorgenson		Albert D. Tinkelenberg ⁴
Culpeper			John G. Stoides ⁴
ATLANTA	John H. Weitnauer, Jr. Bradley Currey, Jr.	Robert P. Forrestal Jack Guynn	Delmar Harrison
Birmingham	A.G. Trammell		Fred R. Herr
Jacksonville	E. William Nash, Jr.		James D. Hawkins
Miami	Sue McCourt Cobb		Patrick K. Barron
Nashville	Patsy R. Williams		Jeffrey J. Wells
New Orleans	Sharon A. Perlis		Henry H. Bourgau, Jr.
CHICAGO ³	Robert J. Day Marcus Alexis	Silas Keehn Daniel M. Doyle	
Detroit	Robert E. Brewer		Roby L. Sloan ⁴
ST. LOUIS	W.L. Hadley Griffin Mary P. Holt	Thomas C. Melzer Joseph P. Garbarini	
Little Rock	Sheffield Nelson		John F. Breen
Louisville	William C. Ballard, Jr.		James E. Conrad
Memphis	G. Rives Neblett		Paul I. Black, Jr.

BANK, Branch, or facility	Chairman ² Deputy Chairman	President First Vice President	Vice President in charge of Branch
MINNEAPOLIS	John B. Davis, Jr. Michael W. Wright	Gary H. Stern Thomas E. Gainor	
Helena	Marcia S. Anderson		Robert F. McNellis
KANSAS CITY	Irvine O. Hockaday, Jr. Robert G. Lueder	Roger Guffey Henry R. Czerwinski	
Denver	James E. Nielson		Enis Alldredge, Jr.
Oklahoma City	Patience S. Latting		William G. Evans
Omaha	Kenneth L. Morrison		Robert D. Hamilton
DALLAS	Robert D. Rogers Bobby R. Inman	Robert H. Boykin William H. Wallace	
El Paso	Peyton Yates		James L. Stull
Houston	Walter M. Mischer, Jr.		Joel L. Koonce, Jr. J.Z. Rowe ⁴
San Antonio	Ruben M. Garcia		Thomas H. Robertson
SAN FRANCISCO	Alan C. Furth Fred W. Andrew	Robert T. Parry Carl E. Powell	
Los Angeles	Richard C. Seaver		Thomas C. Warren ⁵
Portland	Paul E. Bragdon		Angelo S. Carella ⁴
Salt Lake City	Don M. Wheeler		E. Ronald Liggett ⁴
Seattle	John W. Ellis		Gerald R. Kelly ⁴

1. A current list of these officers appears each month in the *Federal Reserve Bulletin*.

2. The Chairman of a Federal Reserve Bank, by statute, serves as Federal Reserve Agent.

3. Additional offices of these Banks are located at Lewistown, Maine; Windsor Locks, Connecticut; Cranford, New Jersey; Jericho, New York; Utica at

Oriskany, New York; Columbus, Ohio; Columbia, South Carolina; Charleston, West Virginia; Des Moines, Iowa; Indianapolis, Indiana; and Milwaukee, Wisconsin.

4. Senior Vice President.

5. Executive Vice President.

Conference of Chairmen

The chairmen of the Federal Reserve Banks are organized into the Conference of Chairmen that meets to consider matters of common interest and to consult with and advise the Board of Governors. Such meetings, attended also by the deputy chairmen, were held in Washington on June 4-5 and December 3-4, 1986.

The Executive Committee of the Conference of Chairmen during 1986 comprised Robert D. Rogers, Chairman; John H. Weitnauer, Jr., Vice Chairman; and Joseph A. Baute, member.

On December 4, 1986, the Conference elected its Executive Committee for 1987, naming Joseph A. Baute as Chairman,

Robert J. Day as Vice Chairman, and Leroy T. Canoles, Jr., as the other member.

Conference of Presidents

The presidents of the Federal Reserve Banks are organized into the Conference of Presidents, which meets periodically to consider matters of common interest and to consult with and advise the Board of Governors. On October 15, 1985, Edward G. Boehne, President of the Federal Reserve Bank of Philadelphia, was elected Chairman of the conference for 1986, and Silas Keehn, President of the Federal Reserve Bank of Chicago, was elected Vice Chairman. Joanna H. Frodin, of the Federal Reserve Bank of Philadelphia, was ap-

pointed Secretary, and Joan M. DeRycke, of the Federal Reserve Bank of Chicago, was appointed Assistant Secretary.

Conference of First Vice Presidents

The Conference of First Vice Presidents of the Federal Reserve Banks was organized in 1969 to meet periodically to consider operational issues and other matters. On October 21, 1985, Richard L. Smoot, First Vice President of the Federal Reserve Bank of Philadelphia, was elected Chairman of the conference for 1986, and Daniel M. Doyle, First Vice President of the Federal Reserve Bank of Chicago, was elected Vice Chairman. Joanna H. Frodin, of the Federal Reserve Bank of Philadelphia, was appointed Secretary, and Joan M. DeRycke, of the Federal Reserve Bank of Chicago, was appointed Assistant Secretary.

Directors

The following list of directors of Federal Reserve Banks and Branches shows for each director the class of directorship, the principal business affiliation, and the date the term expires. Each Federal Reserve Bank has nine members on its board of directors: three Class A and three Class B directors, who are elected by the stockholding member banks, and three Class C directors, who are appointed by the Board of Governors of the Federal Reserve System. Directors are chosen without discrimination as to race, creed, color, sex, or national origin.

Class A directors represent the stockholding member banks in each Federal Reserve District. Class B and Class C directors represent the public and are chosen with due, but not exclusive, consideration to the interests of agriculture, commerce, industry, services, labor, and consumers; they may not be officers, directors, or employees of any bank. In addition, Class C directors may not be stockholders of any bank.

For the election of Class A and Class B directors, the Board of Governors classifies the member banks of each Federal Reserve District into three groups. Each group, which comprises banks with similar capitalization, elects one Class A director and one Class B director. The Board of Governors designates one Class C director as chairman of the board of directors and Federal Reserve Agent of each District Bank and appoints another Class C director as deputy chairman.

Federal Reserve Branches have either five or seven directors, a majority of whom are appointed by the parent Federal Reserve Bank; the others are appointed by the Board of Governors. One of the directors appointed by the Board is designated annually as chairman of the board of that Branch in a manner prescribed by the parent Federal Reserve Bank.

For the name of the chairman and deputy chairman of the board of directors of each Reserve Bank and of the chairman of each Branch, see the preceding table, "Officers of Federal Reserve Banks, Branches, and Offices."

*Term
expires
Dec. 31***District 1—BOSTON***Class A*

William S. Ederly	Chairman of the Board and President, State Street Bank and Trust Company, Boston, Massachusetts	1986
Homer B. Ellis, Jr.	Chairman, Factory Point National Bank, Manchester Center, Vermont	1987
Harry R. Mitiguy	President, Howard Bancorp, Burlington, Vermont	1988

Class B

Richard M. Oster	President and Chief Executive Officer, Cookson America, Inc., Providence, Rhode Island	1986
Ralph Z. Sorenson	Chairman, President and Chief Executive Officer, Barry Wright Corporation, Newton Lower Falls, Massachusetts	1987
Matina S. Horner	President, Radcliffe College, Cambridge, Massachusetts	1988

Class C

Michael J. Harrington	Harrington Company, Peabody, Massachusetts	1986
Joseph A. Baute	Chairman and Chief Executive Officer, Markem Corporation, Keene, New Hampshire	1987
George N. Hatsopoulos	Chairman of the Board and President, Thermo Electron Corporation, Waltham, Massachusetts	1988

District 2—NEW YORK*Class A*

T. Joseph Semrod	Chairman of the Board, United Jersey Bank, Hackensack, New Jersey	1986
Robert W. Moyer	President and Chief Executive Officer, Wilber National Bank, Oneonta, New York	1987
Lewis T. Preston	Chairman of the Board, Morgan Guaranty Trust Company of New York, New York, New York	1988

Class B

John R. Opel	Chairman of the Board, International Business Machines Corp., Armonk, New York	1986
John F. Welch, Jr.	Chairman and Chief Executive Officer, General Electric Company, Fairfield, Connecticut	1987
Richard L. Gelb	Chairman and Chief Executive Officer, Bristol-Myers Company, New York, New York	1988

	<i>Term expires Dec. 31</i>
<i>Class C</i>	
Clifton R. Wharton, Jr. Chancellor, State University of New York System, Albany, New York	1986
Virginia A. Dwyer Senior Vice President—Finance (Retired), American Telephone and Telegraph Co., New York, New York	1987
John Brademas President, New York University, New York, New York	1988

BUFFALO BRANCH

Appointed by the Federal Reserve Bank

Herbert Fort President, The Bath National Bank, Bath, New York	1986
Ross B. Kenzie Chairman and Chief Executive Officer, Goldome FSB, Buffalo, New York	1987
R. Carlos Carballada President and Chief Executive Officer, Central Trust Company, Rochester, New York	1988
Donald I. Wickham President, Tri-Way Farms, Inc., Stanley, New York	1988

Appointed by the Board of Governors

Matthew Augustine President and Chief Executive Officer, Eltrex Industries, Inc., Rochester, New York	1986
Joseph Yantomasi Consultant, United Auto Workers, Buffalo, New York	1987
Mary Ann Lambertsen Vice President, Human Resources, Fisher-Price, East Aurora, New York	1988

District 3—PHILADELPHIA

Class A

John H. Walther Chairman of the Board, New Jersey National Bank, Pennington, New Jersey	1986
Ronald H. Smith President and Chief Executive Officer, CCNB Bank, N.A., New Cumberland, Pennsylvania	1987
Clarence D. McCormick ... President, The Farmers and Merchants National Bank, Bridgeton, New Jersey	1988

Class B

Carl E. Singley Dean and Professor of Law, Temple University Law School, Philadelphia, Pennsylvania	1986
Charles F. Seymour Chairman and Chief Executive Officer, Jackson-Cross Company, Philadelphia, Pennsylvania	1987

	<i>Term expires Dec. 31</i>
Nicholas Riso .....President and Chief Executive Officer, Giant Food Stores, Inc., Carlisle, Pennsylvania	1988
<i>Class C</i>	
Robert M. Landis.....Partner, Dechert, Price, and Rhoads, Philadelphia, Pennsylvania	1986
George E. Bartol III.....Chairman of the Board, Hunt Manufacturing Company, Philadelphia, Pennsylvania	1987
Nevius M. Curtis.....Chairman and Chief Executive Officer, Delmarva Power & Light Company, Wilmington, Delaware	1988

District 4—CLEVELAND

Class A

J. David Barnes .....Chairman and Chief Executive Officer, Mellon Bank, Pittsburgh, Pennsylvania.....	1986
Raymond D. Campbell.....Chairman, President, and Chief Executive Officer, Independent State Bank of Ohio, Columbus, Ohio.....	1987
William A. Stroud .....Chairman and President, First-Knox National Bank, Mount Vernon, Ohio.....	1988

Class B

John R. Hall .....Chairman of the Board and Chief Executive Officer, Ashland Oil, Inc., Ashland, Kentucky	1986
Richard D. Hannan .....Chairman of the Board and President, Mercury Instruments, Inc., Cincinnati, Ohio.....	1987
Daniel M. Galbreath.....President, John W. Galbreath & Co., Columbus, Ohio.....	1988

Class C

W.H. Knoell .....President and Chief Executive Officer, Cyclops Corporation, Pittsburgh, Pennsylvania	1986
E. Mandell de Windt .....Chairman of the Board (Retired), Eaton Corporation, Cleveland, Ohio.....	1987
John R. Miller.....Former President and CEO, The Standard Oil Company, Cleveland, Ohio.....	1988

CINCINNATI BRANCH

Appointed by the Federal Reserve Bank

Vernon J. Cole .....Executive Vice President and Chief Executive Officer, Harlan National Bank, Harlan, Kentucky.....	1986
Sherrill Cleland.....President, Marietta College, Marietta, Ohio.....	1987

	<i>Term expires Dec. 31</i>
Jerry L. Kirby .....Chairman of the Board, President, and Chief Executive Officer, Citizens Federal Savings & Loan Association, Dayton, Ohio	1987
Robert A. Hodson .....President and Chief Executive Officer, 1st Security Bank, Hillsboro, Ohio	1988
<i>Appointed by the Board of Governors</i>	
Owen B. Butler .....Chairman of the Board (Retired), The Procter & Gamble Company, Cincinnati, Ohio	1986
Don Ross .....Owner, Dunreath Farm, Lexington, Kentucky	1987
Kate Ireland.....National Chairman, Frontier Nursing Service, Wendover, Kentucky.....	1988

PITTSBURGH BRANCH

Appointed by the Federal Reserve Bank

G.R. Rendle .....President and Chief Executive Officer, Gallatin National Bank, Uniontown, Pennsylvania	1986
Charles L. Fuellgraf, Jr. ...Chief Executive Officer, Fuellgraf Electric Company, Butler, Pennsylvania	1987
James S. Pasman, Jr. ....Former Vice Chairman, Aluminum Company of America, Pittsburgh, Pennsylvania	1987
Lawrence F. Klima.....President, The First National Bank of Pennsylvania, Erie, Pennsylvania.....	1988

Appointed by the Board of Governors

Karl M. von der Heyden ..Senior Vice President—Finance and Chief Financial Officer, H. J. Heinz Company, Pittsburgh, Pennsylvania	1986
Milton A. Washington.....President and Chief Executive Officer, Allegheny Housing Rehabilitation Corporation, Pittsburgh, Pennsylvania.....	1987
James E. Haas.....President and Chief Operating Officer, National Intergroup, Inc., Pittsburgh, Pennsylvania	1988

District 5—RICHMOND

Class A

Robert S. Chiles, Sr. ....President and Chief Executive Officer, Greensboro National Bank, Greensboro, North Carolina	1986
Robert F. Baronner.....Chairman of the Board and Chief Executive Officer, One Valley Bancorp of West Virginia, Inc. and Kanawha Valley Bank, N.A., Charleston, West Virginia	1987

	<i>Term expires Dec. 31</i>
K. Donald Menefee.....Chairman of the Board and Chief Executive Officer, Madison National Bank, Washington, D.C.	1988
<i>Class B</i>	
Thomas B. Cookerly.....President, Broadcast Division, Allbritton Communications, Washington, D.C.	1986
Floyd D. Gottwald, Jr. ....Chairman of the Board and Chief Executive Officer, Ethyl Corporation, Richmond, Virginia	1987
Edward H. Covell.....President, The Covell Company, Easton, Maryland.....	1988
<i>Class C</i>	
Leroy T. Canoles, Jr. ....President, Kaufman & Canoles, Norfolk, Virginia	1986
Hanne Merriman.....President, Garfinckel's, Washington, D.C. ..	1987
Robert A. Georgine.....President, Building & Construction Trades Department, AFL-CIO, Washington, D.C.	1988

BALTIMORE BRANCH

Appointed by the Federal Reserve Bank

Charles W. Hoff III.....President and Chief Executive Officer, Farmers and Mechanics National Bank, Frederick Maryland	1986
Raymond V. Haysbert, Sr. ....President and Chief Executive Officer, Parks Sausage Company, Baltimore, Maryland...	1987
H. Grant Hathaway.....Chairman of the Board, Equitable Bank, N.A., Baltimore, Maryland.....	1988
Joseph W. Mosmiller.....Chairman of the Board, Loyola Federal Savings and Loan Association, Baltimore, Maryland.....	1988

Appointed by the Board of Governors

Robert L. Tate.....Chairman, Tate Industries, Baltimore, Maryland.....	1986
Gloria L. Johnson.....President, Hutzler Brothers Company, Baltimore, Maryland.....	1987
Thomas R. Shelton.....President, Resource Management Group, Inc., Salisbury, Maryland.....	1988

CHARLOTTE BRANCH

Appointed by the Federal Reserve Bank

John A. Hardin.....Chairman of the Board and President, First Federal Savings Bank, Rock Hill, South Carolina	1986
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	<i>Term expires Dec. 31</i>
James M. Culberson, Jr. ..Chairman and President, The First National Bank of Randolph County, Asheboro, North Carolina	1987
J. Donald Collier .....Orangeburg, South Carolina.....	1988
James G. Lindley .....Chairman, South Carolina National Corporation, and Chairman and President, South Carolina National Bank, Columbia, South Carolina.....	1988

Appointed by the Board of Governors

Wallace J. Jorgenson .....President, Jefferson–Pilot Communications Company, Charlotte, North Carolina	1986
James E. Bostic, Jr. ....Division General Manager, Convenience Products Division, Georgia–Pacific Corporation, Aiken, South Carolina	1987
G. Alex Bernhardt .....President, Bernhardt Industries, Inc., Lenoir, North Carolina.....	1988

District 6—ATLANTA

Class A

Mary W. Walker .....Vice Chairman, The National Bank of Walton County, Monroe, Georgia	1986
E. B. Robinson, Jr. ....Chairman and Chief Executive Officer, Deposit Guaranty National Bank and Deposit Guaranty Corporation, Jacksonville, Mississippi.....	1987
Virgil H. Moore, Jr. ....Chairman and Chief Executive Officer, First Farmers and Merchants National Bank, Columbia, Tennessee	1988

Class B

Harold B. Blach, Jr. ....President, Blach's Inc., Birmingham, Alabama.....	1986
Horatio C. Thompson .....President, Horatio Thompson Investments, Inc., Baton Rouge, Louisiana.....	1987
Bernard F. Sliger .....President, Florida State University, Tallahassee, Florida.....	1988

Class C

Bradley Currey, Jr. ....President, Rock–Tenn Company, Norcross, Georgia.....	1986
Jane C. Cousins .....President and Chief Executive Officer, Merrill Lynch Realty/Cousins, Miami, Florida	1987
John H. Weitnauer, Jr. ....Chairman (Retired), Richway, Atlanta, Georgia.....	1988

*Term
expires
Dec. 31*

BIRMINGHAM BRANCH

Appointed by the Federal Reserve Bank

Charles L. Peery	Chairman, The First National Bank of Florence, Florence, Alabama.....	1986
Willard L. Hurley.....	Chairman and Chief Executive Officer, First Alabama Bancshares, Inc., Birmingham, Alabama.....	1987
Judith Thompson	Vice Chairman, Thompson Tractor Company, Inc., Birmingham, Alabama	1988
Milton A. Wendland.....	Owner-Operator, Autauga Farming Company, Autaugaville, Alabama.....	1988

Appointed by the Board of Governors

Margaret E.M. Tolbert.....	Associate Provost for Research and Development and Director, Carver Research Foundation, Tuskegee University, Tuskegee, Alabama	1986
A.G. Trammell.....	President, Alabama Labor Council, AFL-CIO, Birmingham, Alabama	1987
Roy D. Terry	President and Chief Executive Officer, Terry Manufacturing Company, Inc., Roanoke, Alabama.....	1988

JACKSONVILLE BRANCH

Appointed by the Federal Reserve Bank

John D. Uible	Chairman and Chief Executive Officer, Florida National Banks of Florida, Inc., Jacksonville, Florida	1986
Buell G. Duncan, Jr.	Chairman, President, and Chief Executive Officer, Sun Bank, N.A., Orlando, Florida	1987
Robert R. Deison.....	President and Chairman of the Board, Andrew Jackson State Savings and Loan Association, Tallahassee, Florida.....	1988
George W. Gibbs III	President, Atlantic Dry Dock Corporation, Jacksonville, Florida	1988

Appointed by the Board of Governors

Sandra H. Gray.....	Owner, Gemini Springs Farm, DeBary, Florida	1986
Andrew A. Robinson.....	Dean, College of Education and Human Services, University of North Florida, Jacksonville, Florida	1987
E. William Nash, Jr.	President, South-Central Operations, The Prudential Insurance Company of America, Jacksonville, Florida.....	1988

MIAMI BRANCH

*Term
expires
Dec. 31*

Appointed by the Federal Reserve Bank

Robert L. Kester.....	Vice Chairman, Barnett Bank of South Florida, N.A., Pompano Beach, Florida ...	1986
Robert D. Rapaport	Chairman, Royal Palm Savings Association, Palm Beach, Florida	1987
Robert M. Taylor.....	Chairman and Chief Executive Officer, The Mariner Group, Inc., Fort Myers, Florida	1987
William H. Losner.....	President and Chief Executive Officer, The First National Bank of Homestead, Homestead, Florida	1988

Appointed by the Board of Governors

Eugene E. Cohen.....	Chief Financial Officer and Treasurer, Howard Hughes Medical Institute, Coconut Grove, Florida.....	1986
Robert D. Apelgren	President, Apelgren Corporation, Pahokee, Florida	1987
Sue McCourt Cobb.....	Attorney, Greenberg, Traurig, Askew, Hoffman, Lipoff, Rosen, and Quentel, P.A., Miami, Florida	1988

NASHVILLE BRANCH

Appointed by the Federal Reserve Bank

Robert W. Jones.....	Chairman and President, First National Bank, McMinnville, Tennessee	1986
Will A. Hildreth	President and Chief Executive Officer, First National Bank of Loudon County, Lenoir City, Tennessee.....	1987
Eugene C. Cheatham	President, Advanced Integrated Technology, Inc., Nashville, Tennessee.....	1988
Shirley A. Zeitlin	President, Shirley Zeitlin & Co. Realtors, Nashville, Tennessee.....	1988

Appointed by the Board of Governors

Patsy R. Williams.....	Partner, Rhyne Lumber Company, Newport, Tennessee	1986
C. Warren Neel	Dean, College of Business Administration, The University of Tennessee, Knoxville, Tennessee	1987
Condon S. Bush.....	President, Bush Brothers & Company, Dandridge, Tennessee	1988

*Term
expires
Dec. 31*

NEW ORLEANS BRANCH

Appointed by the Federal Reserve Bank

Carl E. Jones, Jr.	Chairman, President, and Chief Executive Officer, First Alabama Bank of Mobile, N.A., Mobile, Alabama	1986
James G. Boyer	Chairman, President, and Chief Executive Officer, Gulf National Bank at Lake Charles, Lake Charles, Louisiana	1987
Alan R. Barton.....	President and Chief Executive Officer, Mississippi Power Company, Gulfport, Mississippi	1988
Robert M. Shofstahl	President and Chief Executive Officer, Pelican Homestead and Savings Association, Metairie, Louisiana	1988

Appointed by the Board of Governors

Leslie B. Lampton.....	President, Ergon, Inc., Jackson, Mississippi	1986
Caroline K. Theus.....	President, Inglewood Land and Development Company, Alexandria, Louisiana.....	1987
Sharon A. Perlis	President, Sharon A. Perlis (APLC), Metairie, Louisiana.....	1988

District 7—CHICAGO

Class A

O. Jay Tomson	Chairman of the Board and Chief Executive Officer, Citizens National Bank of Charles City, Charles City, Iowa	1986
Barry F. Sullivan.....	Chairman of the Board and Chief Executive Officer, First National Bank of Chicago, Chicago, Illinois.....	1987
John W. Gabbert	President and Chief Executive Officer, First National Bank and Trust Company, LaPorte, Indiana.....	1988

Class B

Leon T. Kendall	Chairman of the Board, Mortgage Guaranty Insurance Corporation, Milwaukee, Wisconsin	1986
Edward D. Powers	President and Chief Executive Officer, Mueller Company, Decatur, Illinois.....	1987
Max J. Naylor	Farmer, Jefferson, Iowa	1988

Class C

Robert J. Day	Chairman and Chief Executive Officer, USG Corporation, Chicago, Illinois.....	1986
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	<i>Term expires Dec. 31</i>
Marcus Alexis.....Dean, College of Business Administration, University of Illinois at Chicago, Chicago, Illinois.....	1987
Charles S. McNeer .....Chairman of the Board and Chief Executive Officer, Wisconsin Electric Power Company, Milwaukee, Wisconsin.....	1988

DETROIT BRANCH

Appointed by the Federal Reserve Bank

Ronald D. Story .....Chairman and President, The Ionia County National Bank of Ionia, Ionia, Michigan....	1986
Richard M. Gillett.....Chairman of the Board, Old Kent Financial Corporation, Grand Rapids, Michigan.....	1987
Thomas R. Ricketts .....Chairman of the Board and President, Standard Federal Bank, Troy, Michigan ...	1987
Donald R. Mandich .....Chairman and Chief Executive Officer, Comerica Bank—Detroit, Detroit, Michigan	1988

Appointed by the Board of Governors

Karl D. Gregory .....Professor of Economics and Management, School of Economics and Management, Oakland University, Rochester, Michigan....	1986
Robert E. Brewer .....Senior Vice President, Accounting, Administration & Financial Services, K mart Corporation, Troy, Michigan	1987
Phyllis E. Peters.....Director, Professional Standards Review, Touche Ross & Company, Detroit, Michigan	1988

District 8—ST. LOUIS

Class A

Clarence C. Barksdale.....Chairman of the Board, Centerre Bancorporation, St. Louis, Missouri.....	1986
H.L. Hembree III .....Chairman of the Board and Chief Executive Officer, Arkansas Best Corporation, Fort Smith, Arkansas	1987
Paul K. Reynolds .....President and Chief Executive Officer, The First National Bank of Pittsfield, Pittsfield, Illinois.....	1988

Class B

Frank A. Jones, Jr. ....President, Dietz Forge Company, Memphis, Tennessee	1986
Jesse M. Shaver .....President, JMS Corporation, Louisville, Kentucky.....	1987

	<i>Term expires Dec. 31</i>
Robert J. Sweeney .....President and Chief Executive Officer, Murphy Oil Corporation, El Dorado, Arkansas	1988
<i>Class C</i>	
Mary P. Holt.....President, Clothes Horse, Little Rock, Arkansas	1986
W.L. Hadley Griffin .....Chairman of the Executive Committee, Brown Group, Inc., St. Louis, Missouri....	1987
Robert L. Virgil, Jr. ....Dean, School of Business, Washington University, St. Louis, Missouri.....	1988

LITTLE ROCK BRANCH

Appointed by the Federal Reserve Bank

William H. Kennedy, Jr. ..Chairman of the Board (Retired), Worthen Banking Corporation, Little Rock, Arkansas	1986
Wilbur P. Gulley, Jr. ....Chairman of the Board, Savers Federal Savings & Loan Association, Little Rock, Arkansas	1987
W. Wayne Hartsfield .....President and Chief Executive Officer, First National Bank, Searcy, Arkansas	1987
Robert C. Connor, Jr. ....President, Union National Bank of Little Rock, Little Rock, Arkansas	1988

Appointed by the Board of Governors

Richard V. Warner.....Group Vice President, Wood Products Group, Potlatch Corporation, Warren, Arkansas	1986
Sheffield Nelson.....Attorney, Little Rock, Arkansas	1987
James R. Rodgers .....Airport Manager, Little Rock Regional Airport, Little Rock, Arkansas	1988

LOUISVILLE BRANCH

Appointed by the Federal Reserve Bank

Frank B. Hower, Jr. ....Chairman of the Board and Chief Executive Officer, Liberty National Bank and Trust Company of Louisville, Louisville, Kentucky.....	1986
John E. Darnell, Jr. ....Chairman of the Board, The Owensboro National Bank, Owensboro, Kentucky	1987
R. I. Kerr, Jr. ....Chairman of the Board, President, and Chief Executive Officer, Great Financial Federal, Louisville, Kentucky	1987
Allan S. Hanks .....President, The Anderson National Bank of Lawrenceburg, Lawrenceburg, Kentucky.....	1988

*Term
expires
Dec. 31*

Appointed by the Board of Governors

William C. Ballard, Jr.	Executive Vice President, Finance and Administration, Humana, Inc., Louisville, Kentucky	1986
Raymond M. Burse	President, Kentucky State University, Frankfort, Kentucky	1987
Lois H. Gray	Chairman of the Board, James N. Gray Construction Company, Inc., Glasgow, Kentucky	1988

MEMPHIS BRANCH

Appointed by the Federal Reserve Bank

Wayne W. Pyeatt	President, Memphis Fire Insurance Company, Memphis, Tennessee	1986
Edgar H. Bailey	Chairman and Chief Executive Officer, Leader Federal Savings and Loan Association, Memphis, Tennessee	1987
John P. Dulin	President, First Tennessee Bank, N.A., Memphis, Tennessee	1987
William H. Brandon, Jr. ...	President, First National Bank of Phillips County, Helena, Arkansas	1988

Appointed by the Board of Governors

Donald B. Weis	President, Tamak Transportation Corporation, West Memphis, Arkansas ...	1986
G. Rives Neblett	Neblett and Havens, Attorneys at Law, Shelby, Mississippi	1987
Katherine Hinds Smythe ...	President, Memorial Park, Inc., Memphis, Tennessee	1988

District 9—MINNEAPOLIS

Class A

Burton P. Allen, Jr.	President, First National Bank, Milaca, Minnesota	1986
Thomas M. Strong	President and Chief Executive Officer, Citizens State Bank, Ontonagon, Michigan	1987
Duane W. Ring	President and Chief Executive Officer, Norwest Bank La Crosse, N.A., La Crosse, Wisconsin	1988

Class B

Harold F. Zigmund	Chairman (Retired), Blandin Paper Company, Grand Rapids, Minnesota	1986
William L. Mathers	President, Mathers Land Company, Miles City, Montana	1987
Richard L. Falconer	District Staff Manager, Northwestern Bell, Minneapolis, Minnesota	1988

*Term
expires
Dec. 31*

Class C

John B. Davis, Jr.	President Emeritus, Macalester College, St. Paul, Minnesota	1986
Michael W. Wright	Chairman, President, and Chief Executive Officer, Super Valu Stores, Inc., Minneapolis, Minnesota.....	1987
John A. Rollwagen.....	Chairman and Chief Executive Officer, Cray Research Inc., Minneapolis, Minnesota	1988

HELENA BRANCH

Appointed by the Federal Reserve Bank

Dale W. Anderson	President and Chief Executive Officer, Norwest Bank Great Falls, N.A., Great Falls, Montana.....	1986
Seabrook Pates	President and General Manager, Midland Implement Company, Inc., Billings, Montana.....	1986
F. Charles Mercord	President and Chief Executive Officer, First Federal Savings Bank of Montana, Kalispell, Montana	1987

Appointed by the Board of Governors

Marcia S. Anderson.....	President, Bridger Canyon Stallion Station, Inc., Bozeman, Montana	1986
Warren H. Ross.....	President, Ross 87 Ranch, Inc., Chinook, Montana.....	1987

District 10—KANSAS CITY

Class A

Harold L. Gerhart, Jr.	President and Chief Executive Officer, First National Bank of Newman Grove, Newman Grove, Nebraska	1986
Donald D. Hoffman	Chairman of the Board, Central Bank of Denver, Denver, Colorado.....	1987
Robert L. Hollis	Chairman of the Board and Chief Executive Officer, First National Bank & Trust Co., Okmulgee, Oklahoma	1988

Class B

Richard D. Harrison.....	Chairman and Chief Executive Officer, Fleming Companies, Inc., Oklahoma City, Oklahoma.....	1986
Vacancy		1987
Jerry D. Geist	Chairman and President, Public Service Company of New Mexico, Albuquerque, New Mexico.....	1988

	<i>Term expires Dec. 31</i>
<i>Class C</i>	
Fred W. Lyons, Jr. ....President and Chief Executive Officer, Marion Laboratories, Inc., Kansas City, Missouri	1986
Robert G. Lueder .....Chairman of the Board, Lueder Construction Company, Omaha, Nebraska	1987
Irvine O. Hockaday, Jr. ...President and Chief Executive Officer, Hallmark Cards, Inc., Kansas City, Missouri	1988

DENVER BRANCH

Appointed by the Federal Reserve Bank

Roger L. Reisher .....Co-Chairman, FirstBank Holding Company of Colorado, Lakewood, Colorado	1986
Junius F. Baxter.....Chairman of the Board and Chief Executive Officer, Bank Western Federal Savings Bank, Denver, Colorado	1987
George S. Jenks.....President and Chief Executive Officer, Sunwest Financial Services, Inc., Albuquerque, New Mexico	1988
W. Richard Scarlett III....Chairman and President, The Jackson State Bank, Jackson Hole, Wyoming	1988

Appointed by the Board of Governors

James C. Wilson .....President and Chief Executive Officer, Rocky Mountain Energy, Broomfield, Colorado	1986
James E. Nielson .....President and Chief Executive Officer, JN Incorporated, Cody, Wyoming.....	1987
Anthony W. Williams .....Attorney, Williams, Turner, & Holmes, P.C., Grand Junction, Colorado.....	1988

OKLAHOMA CITY BRANCH

Appointed by the Federal Reserve Bank

William O. Alexander.....President and Chief Executive Officer, Continental Federal Savings & Loan Association, Oklahoma City, Oklahoma ...	1986
Marcus R. Tower .....Tulsa, Oklahoma.....	1986
William H. Crawford .....Chairman and Chief Executive Officer, First National Bank and Trust Company, Frederick, Oklahoma	1987

Appointed by the Board of Governors

John F. Snodgrass .....President and Trustee, The Samuel Roberts Noble Foundation, Inc., Ardmore, Oklahoma.....	1986
Patience S. Latting .....Oklahoma City, Oklahoma	1987

*Term
expires
Dec. 31*

OMAHA BRANCH

Appointed by the Federal Reserve Bank

Donald J. Murphy	Director, Norwest Bank Nebraska, N.A., Omaha, Nebraska	1986
John T. Selzer	President, Scottsbluff National Bank and Trust Company, Scottsbluff, Nebraska	1987
Charles H. Thorne	Chairman of the Board and Chief Executive Officer, First Federal Savings and Loan Association of Lincoln, Lincoln, Nebraska	1987

Appointed by the Board of Governors

Janice D. Stoney	Executive Vice President and Chief Operating Officer, Northwestern Bell Telephone Company, Omaha, Nebraska...	1986
Kenneth L. Morrison	President, Morrison-Quirk Grain Corporation, Hastings, Nebraska.....	1987

District 11—DALLAS

Class A

Miles D. Wilson.....	Chairman of the Board and Chief Executive Officer, The First National Bank of Bellville, Bellville, Texas	1986
Gene Edwards.....	Chairman of the Board, First Amarillo Bancorporation, Inc., Amarillo, Texas	1987
Charles T. Doyle.....	Chairman and Chief Executive Officer, Gulf National Bank, Texas City, Texas	1988

Class B

Kent Gilbreath	Associate Dean, Hankamer School of Business, Baylor University, Waco, Texas	1986
Robert L. Pfluger.....	Rancher, San Angelo, Texas	1987
Robert Ted Enloe III.....	President, Lomas & Nettleton Financial Corporation, Dallas, Texas	1988

Class C

Hugh G. Robinson	President, Cityplace Development Corporation, Dallas, Texas	1986
Bobby R. Inman	Chairman of the Board, President, and Chief Executive Officer, Microelectronics and Computer Technology Corporation, Austin, Texas	1987
Robert D. Rogers	President and Chief Executive Officer, Texas Industries, Inc., Dallas, Texas.....	1988

EL PASO BRANCH

Appointed by the Federal Reserve Bank

David L. Stone	President, The Portales National Bank, Portales, New Mexico	1986
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	<i>Term expires Dec. 31</i>
Tony A. MartinChairman of the Board, First City National Bank of Midland, Midland, Texas	1987
Gerald W. Thomas.....President Emeritus and Professor of Animal Range Science, Center for International Programs, New Mexico State University, Las Cruces, New Mexico	1987
Vacancy	1988
<i>Appointed by the Board of Governors</i>	
John R. Sibley.....President, Delaware Mountain Enterprises, Carlsbad, New Mexico	1986
Mary Carmen Saucedo .....Associate Superintendent, Central Area Office, El Paso Independent School District, El Paso, Texas.....	1987
Peyton Yates.....President, Yates Drilling Company, Artesia, New Mexico	1988

HOUSTON BRANCH

Appointed by the Federal Reserve Bank

Marcella D. Perry .....Port Commissioner, Port of Houston Authority of Harris County, Houston, Texas.....	1986
Thomas B. McDade.....Vice Chairman (Retired), Texas Commerce Bancshares, Inc., Houston, Texas.....	1987
David E. Sheffield.....Victoria, Texas	1987
Jeff Austin, Jr. ....President, First National Bank of Jacksonville, Jacksonville, Texas	1988

Appointed by the Board of Governors

Walter M. Mischer, Jr.....President, The Mischer Corporation, Houston, Texas.....	1986
Andrew L. Jefferson, Jr. ..Attorney, Jefferson, Mims, and Plummer, Houston, Texas.....	1987
Leo E. Linbeck, Jr. ....Chairman and Chief Executive Officer, Linbeck Construction Corporation, Houston, Texas.....	1988

SAN ANTONIO BRANCH

Appointed by the Federal Reserve Bank

C. Ivan Wilson .....Chairman of the Board and Chief Executive Officer, First City Bank of Corpus Christi, Corpus Christi, Texas.....	1986
Joe D. Barbee .....President and Chief Executive Officer, Barbee-Neuhaus Implement Company, Weslaco, Texas.....	1987
Robert T. Rork .....Chairman of the Board and Chief Executive Officer, RepublicBank San Antonio, N.A., San Antonio, Texas	1987
Jane Flato Smith .....Rancher, San Antonio, Texas.....	1988

*Term
expires
Dec. 31*

Appointed by the Board of Governors

Lawrence L. Crum	Professor of Banking and Finance, The University of Texas at Austin, Austin, Texas	1986
Ruben M. Garcia	Chief Executive Officer, Modern Machine Shop, Inc., Laredo, Texas.....	1987
Robert F. McDermott	Chairman of the Board and President, United Services Automobile Association, San Antonio, Texas	1988

District 12—SAN FRANCISCO

Class A

Rayburn S. Dezember.....	Chairman, Central Pacific Corporation, and American National Bank, Bakersfield, California	1986
Donald J. Gehb	President and Chief Executive Officer, Alameda Bancorporation and Alameda First National Bank, Alameda, California	1987
Spencer F. Eccles.....	Chairman, President and Chief Executive Officer, First Security Corporation, Salt Lake City, Utah.....	1988

Class B

John C. Hampton.....	President, Willamina Lumber Company, Portland, Oregon	1986
George H. Weyerhaeuser.....	President and Chief Executive Officer, Weyerhaeuser Company, Tacoma, Washington	1987
Togo W. Tanaka	Chairman, Gramercy Enterprises, Inc., Los Angeles, California	1988

Class C

Fred W. Andrew.....	President, Apex Orchards, Inc., Bakersfield, California	1986
Alan C. Furth.....	Vice Chairman, Santa Fe Southern Pacific Corporation, and President, Southern Pacific Company, San Francisco, California	1987
Carolyn S. Chambers	President and Chief Executive Officer, Chambers Communications Corp., Eugene, Oregon.....	1988

LOS ANGELES BRANCH

Appointed by the Federal Reserve Bank

Harvey J. Mitchell.....	President and Chief Executive Officer, Escondido National Bank, Escondido, California	1986
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	<i>Term expires</i>
Robert R. DocksonChairman of the Board, CalFed, Inc., and California Federal Savings and Loan Association, Los Angeles, California.....	1987
Howard C. McCrady.....Chairman of the Board, Valley National Bank, Phoenix, Arizona	1988
William L. Tooley .....Chairman, Tooley & Company, Investment Builders, Los Angeles, California	1988
<i>Appointed by the Board of Governors</i>	
Lola M. McAlpin-Grant ....Attorney, Inglewood, California.....	1986
Richard C. Seaver .....President, Hydril Company, Los Angeles, California	1987
Thomas R. Brown, Jr. ....Chairman of the Board, Burr-Brown Corporation, Tucson, Arizona	1988

PORTLAND BRANCH

Appointed by the Federal Reserve Bank

William S. Naito .....Vice President, Norcrest China Company, Portland, Oregon	1986
John A. Elorriaga .....Chairman of the Board and Chief Executive Officer, United States National Bank of Oregon, Portland, Oregon	1987
G. Dale Weight .....Chairman of the Board and Chief Executive Officer, Benjamin Franklin Savings and Loan Association, Portland, Oregon	1987
Herman C. Bradley, Jr. ....President and Chief Executive Officer, Tri-County Banking Company, Junction City, Oregon.....	1988

Appointed by the Board of Governors

Paul E. Bragdon .....President, Reed College, Portland, Oregon..	1986
Sandra A. Suran .....Partner in Charge, Peat, Marwick, Mitchell and Co., Beaverton, Oregon	1987
G. Johnny Parks .....Former Northwest Regional Director, International Longshoremen's & Warehousemen's Union, Portland, Oregon.....	1988

SALT LAKE CITY BRANCH

Appointed by the Federal Reserve Bank

Albert C. Gianoli.....President and Chairman of the Board, First National Bank of Ely, Ely, Nevada.....	1986
Lela M. Ence .....Executive Director, University of Utah Alumni Association, Salt Lake City, Utah	1987
Fred C. Humphreys.....Chairman and Chief Executive Officer, The Idaho First National Bank and Moore Financial Group, Boise, Idaho	1987
Gerald R. Christensen.....President, First Federal Savings and Loan Association, Salt Lake City, Utah	1988

*Term
expires
Dec. 31*

Appointed by the Board of Governors

Robert N. Pratt	President, Moriah Enterprises, Inc., Bountiful, Utah	1986
Don M. Wheeler.....	President, Wheeler Machinery Company, Salt Lake City, Utah.....	1987
D. N. Rose	President and Chief Executive Officer, Mountain Fuel Supply Company, Salt Lake City, Utah.....	1988

SEATTLE BRANCH

Appointed by the Federal Reserve Bank

H. H. Larison.....	President, Columbia Paint Company, Spokane, Washington.....	1986
John N. Nordstrom.....	Co-Chairman of the Board, Nordstrom, Inc., Seattle, Washington.....	1987
William S. Randall	President and Chief Executive Officer, First Interstate Bank of Washington, N.A., Seattle, Washington	1987
William W. Philip.....	Chairman of the Board and President, Puget Sound National Bank, Tacoma, Washington	1988

Appointed by the Board of Governors

Carol A. Nygren	Managing Partner, Laventhol & Horwath, Seattle, Washington	1986
John W. Ellis	President and Chief Executive Officer, Puget Sound Power & Light Company, Bellevue, Washington	1987
Byron I. Mallott.....	Chief Executive Officer, Sealaska Corporation, Juneau, Alaska.....	1988

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