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July 3, 1985

## **SUMMARY AND OUTLOOK**

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Prepared for the Federal Open Market Committee

By the staff of the Board of Governors of the Federal Reserve System

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## DOMESTIC NONFINANCIAL DEVELOPMENTS

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Recent developments. Economic growth appears to have picked up somewhat in the second quarter, but sectoral imbalances persisted. Incoming wage and price data so far this year suggest that inflation is holding in the same range as during 1984.

In the industrial sector, production edged down again in May, as a further decline in business equipment output and a small drop in consumer durables offset further gains in defense and space equipment and construction materials. Most major categories of output have shown little net change over the past ten months, and, overall, the capacity utilization rate has declined more than 2 percentage points since mid-1984, to a level of 80.3 percent in May.

Employment in manufacturing also continued to fall in May, bringing the total reduction in factory jobs since the start of the year to more than 160,000. Nevertheless, with hiring remaining quite strong in the service sectors and in construction, total payroll employment increased nearly 350,000 in May, a larger gain than in most recent months. The civilian unemployment rate was 7.3 percent, about the same as during most of the past year.

Growth in consumer spending remained strong into the spring quarter. Personal consumption expenditures, in nominal terms, rose 0.7 percent in May, after an even larger gain the month before. Consumer outlays for nondurables rose rapidly in both months, and sales of foreign-made autos surged in May to the highest level in several months. Domestic car sales

also held up well in May, but with the phasing out of special financing programs, sales were lower in the first 20 days of June. Overall, the gains in consumer spending so far this year have been running well ahead of income growth, and the personal saving rate has averaged around 5-1/4 percent, toward the lower end of its range over the past decade.

Activity in the housing sector still appears to be trending upward. Although the average pace of housing starts in April and May was about the same as the improved first-quarter rate, newly-issued building permits have continued to move up, and sales of new homes rebounded in May to a level above the first-quarter average. Qualitative reports generally indicate that the decline in mortgage interest rates over the past three months should provide the underpinnings for future increases in homebuilding.

After declining in the first quarter, business fixed investment appears to be rising again, but at a much slower rate than in 1983 or 1984. Spending for nonresidential construction remained strong into the second quarter, as the value of construction put in place rose almost 5 percent in April and another 1 percent in May. In contrast, shipments of nondefense capital goods by domestic producers have shown little net change since last fall, and new orders also have remained weak. The Commerce Department's latest survey of capital spending plans suggests that nominal outlays for fixed investment this year will be roughly 9 percent above the 1984 average.

Firms have maintained a tight rein on inventories so far this year. Real factory inventories showed little net change from December to April, and the book value of manufacturers' stocks fell sharply in May. In the trade sector, auto dealers' stocks rose rapidly in the first quarter, but more recently sales have outpaced production. Excluding autos, trade

inventories have generally continued to rise at a somewhat slower rate than during 1984. On balance, stocks do not appear to be excessive in the trade sector, with the possible exception of nondurable retail outlets where inventory-sales ratios have been on the high side of historical experience.

After picking up a little early in the year, the rate of increase in prices and wages has slowed in recent months. The consumer price index rose 0.2 percent in May, its smallest advance since January. A rebound in gasoline prices, which had boosted the CPI in March and April, began to dissipate, and food prices declined for the second month in a row. Prices of commodities other than food and energy were little changed in May at both the consumer and producer levels. Service prices, however, rose faster than in previous months, mainly because of a spurt in the CPI rent index. On the wage side, increases in the hourly earnings index have been small in recent months, after a temporary period of acceleration around the turn of the year. In addition, incoming reports suggest that union wage settlements have remained moderate.

Outlook. The broad contours of the staff's economic forecast have changed little since the last Greenbook. Real GNP is estimated to have risen at about a 2 percent annual rate in the quarter just completed, after increasing at only a 0.3 percent rate in the first quarter. As in many recent quarters, the growth in domestic final demand appears to have been well-maintained in the second quarter. However, with a further drop in exports and a reduced rate of inventory accumulation, domestic output growth has lagged. For the first and second quarters combined, domestic final demand is estimated to have risen at more than a 4 percent rate-- 2-1/2 percentage points faster than real GNP. Prices, as measured by the

fixed-weighted price index for gross business product, are estimated to have risen at a 3-3/4 percent annual rate in the second quarter, not much different from the rates of the two previous quarters.

The staff's assumptions regarding monetary growth rates have changed somewhat since the last Greenbook. In particular, the increase in M1 for the year as a whole is expected to be above the upper end of the Committee's present range. For 1986, M1 expansion has been assumed at around 5-1/2 percent. Interest rates are expected to remain near current levels over the forecast period, and thus a bit lower than projected in the last Greenbook. Regarding fiscal policy, the staff continues to assume that a \$50 billion deficit-reduction package will be adopted and that the federal budget deficit, on a unified basis, will be nearly \$210 billion in fiscal 1985 and around \$185 billion in fiscal 1986. After four years of rapid growth, the structural deficit is likely to show little change over the next year and a half.

As in the last Greenbook, growth in real GNP is expected to average about 3-1/4 percent in the second half of this year and then slow to about 2-1/2 percent during 1986. Gains in domestic final demand are projected to moderate over the forecast period, reflecting a waning of fiscal stimulus, a diminishing backlog of pent-up demands, and the damping influence of slow output growth on business investment spending. Recent declines in interest rates are expected to stimulate more housing activity than was projected in the last Greenbook. At the same time, the forecast for business fixed investment has been revised down slightly this month, owing to less favorable prospects for equipment outlays.



With respect to the external sector, the staff is projecting that the exchange rate of the U.S. dollar will remain on a moderate downward trajectory, similar to the path assumed in the last Greenbook. With the dollar falling and the U.S. economy growing less rapidly than in 1983 or 1984, import growth is expected to slow over the next year and a half. Moreover, the dollar depreciation is projected to have a beneficial effect on U.S. exports, so that the net influence of the trade sector on domestic production growth is expected to become slightly positive for 1986 as a whole.

Given the growth path projected for real GNP, the staff expects that the unemployment rate will decline only slightly through the end of 1986 and that the remaining slack in the labor market will help restrain wage inflation. However, rising costs associated with the assumed depreciation of the dollar are expected to lead to some upward pressures on prices, mainly in 1986. Reflecting these influences, the fixed-weighted price index for gross business product is projected to increase 4 percent during 1986, after a rise of 3-1/2 percent during 1985.

Detailed data for these projections are in the tables shown on the following pages.

## STAFF GNP PROJECTIONS

## Percent changes, annual rate

	Nominal GNP		Real GNP		Gross domestic business product fixed-weighted price index				Unemployment rate (percent)			
					Total		Excluding food and energy					
	5/15/85	7/3/85	5/15/85	7/3/85	5/15/85	7/3/85	5/15/85	7/3/85	5/15/85	7/3/85		
<b>Annual changes:</b>												
1983	<1>	7.7	7.7	3.7	3.7	3.7	3.7	4.6	4.6	9.6	9.6	
1984	<1>	10.8	10.8	6.8	6.8	4.0	4.0	4.3	4.3	7.5	7.5	
1985		6.5	6.2	2.8	2.5	3.7	3.7	4.3	4.3	7.2	7.2	
1986		6.3	6.2	2.7	2.7	3.7	3.7	4.0	4.1	7.0	7.1	
<b>Quarterly changes:</b>												
1984	Q1	<1>	14.9	14.9	10.1	10.1	4.2	4.2	3.4	3.4	7.9	7.9
	Q2	<1>	10.7	10.7	7.1	7.1	4.1	4.1	5.4	5.4	7.5	7.5
	Q3	<1>	5.6	5.6	1.6	1.6	4.0	4.0	4.9	4.9	7.4	7.4
	Q4	<1>	7.1	7.1	4.3	4.3	3.5	3.5	3.9	3.9	7.2	7.2
	Q1	<1>	6.7	5.6	1.3	.3	3.7	3.6	5.1	4.6	7.3	7.3
	Q2		5.3	5.0	2.3	2.1	3.5	3.7	3.7	3.9	7.3	7.3
	Q3		6.3	6.4	3.5	3.5	3.3	3.2	3.6	3.8	7.2	7.2
	Q4		6.3	6.3	3.0	3.0	3.5	3.4	3.7	3.9	7.1	7.1
1986	Q1		6.5	6.4	2.6	2.7	3.8	3.7	4.0	4.0	7.0	7.1
	Q2		6.0	6.0	2.5	2.3	3.9	3.9	4.1	4.2	7.0	7.1
	Q3		6.3	6.2	2.5	2.3	4.1	4.1	4.4	4.4	7.0	7.1
	Q4		6.8	6.7	2.5	2.5	4.3	4.3	4.4	4.5	7.0	7.1
<b>Two-quarter changes: &lt;2&gt;</b>												
1984	Q2	<1>	12.8	12.8	8.6	8.6	4.2	4.2	4.4	4.4	-1.0	-1.0
	Q4	<1>	6.4	6.4	2.9	2.9	3.8	3.8	4.4	4.4	-.3	-.3
1985	Q2		6.0	5.3	1.8	1.2	3.6	3.7	4.4	4.3	.1	.1
	Q4		6.3	6.3	3.3	3.3	3.4	3.3	3.6	3.8	-.2	-.2
1986	Q2		6.3	6.2	2.6	2.5	3.8	3.8	4.1	4.1	-.1	.0
	Q4		6.5	6.5	2.5	2.4	4.2	4.2	4.4	4.4	.0	.0
<b>Four-quarter changes: &lt;3&gt;</b>												
1983	Q4	<1>	10.4	10.4	6.3	6.3	3.7	3.7	4.4	4.4	-2.1	-2.1
1984	Q4	<1>	9.5	9.5	5.7	5.7	4.0	4.0	4.4	4.4	-1.3	-1.3
1985	Q4		6.1	5.8	2.5	2.2	3.5	3.5	4.0	4.0	-.1	-.1
1986	Q4		6.4	6.3	2.5	2.5	4.0	4.0	4.3	4.3	-.1	.0

&lt;1&gt; Actual.

&lt;2&gt; Percent change from two quarters earlier.

&lt;3&gt; Percent change from four quarters earlier.

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GROSS NATIONAL PRODUCT AND RELATED ITEMS  
(Quarterly figures are seasonally adjusted. Expenditures and income  
figures are billions of current dollars at annual rates.)

	1983				1984			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Gross National Product	3173.8	3267.0	3346.6	3431.7	3553.3	3644.7	3694.6	3758.7
Gross domestic purchases	3154.2	3273.4	3363.0	3461.5	3604.8	3703.4	3785.2	3814.8
Final sales	3216.8	3286.4	3350.9	3419.0	3479.5	3594.1	3622.8	3722.1
Private	2538.0	2604.2	2661.1	2727.6	2775.1	2850.4	2861.8	2941.6
Domestic final purchases	2518.4	2610.7	2677.5	2757.4	2826.6	2909.1	2952.4	2997.6
Personal consumption expenditures	2070.4	2141.6	2181.4	2230.2	2276.5	2332.7	2361.4	2396.5
Goods	1034.6	1073.0	1095.8	1122.8	1152.2	1179.0	1178.6	1192.8
Services	1035.8	1068.6	1085.7	1107.5	1124.4	1153.7	1182.8	1203.8
Gross private domestic investment	405.0	449.6	491.9	540.0	623.8	627.0	662.8	637.8
Residential structures	113.3	129.8	142.3	143.4	151.2	155.6	155.3	153.5
Business fixed investment	334.6	339.3	353.9	383.9	398.8	420.8	435.7	447.7
Change in business inventories	-42.9	-19.4	-4.3	12.7	73.8	50.6	71.8	36.6
Nonfarm	-32.6	-5.4	11.6	14.1	60.6	47.0	63.7	27.2
Net exports of goods and services <1>	19.6	-6.5	-16.4	-29.8	-51.5	-58.7	-90.6	-56.0
Exports	328.5	328.1	342.0	346.1	358.9	362.4	368.6	367.2
Imports	308.9	334.5	358.4	375.9	410.4	421.1	459.3	423.2
Gov't. purchases of goods and services	678.8	682.2	689.8	691.4	704.4	743.7	761.0	780.5
Federal <2>	273.0	270.5	269.2	266.3	267.6	296.4	302.0	315.7
State and local	405.8	411.6	420.6	425.1	436.8	447.4	458.9	464.8
Gross national product in constant (1972) dollars	1491.0	1524.8	1550.2	1572.7	1610.9	1638.8	1645.2	1662.4
Personal income	2662.8	2714.4	2763.3	2836.5	2920.5	2984.6	3047.3	3096.2
Wage and salary disbursements	1608.1	1642.1	1671.3	1715.4	1755.7	1793.1	1819.5	1847.6
Disposable personal income	2261.4	2302.9	2367.4	2428.6	2502.2	2554.3	2606.4	2644.5
Saving rate (percent)	5.7	4.2	5.0	5.3	6.1	5.7	6.3	6.2
Corporate profits with I.V.A. and C.C. Adj.	179.1	216.7	245.0	260.0	277.4	291.1	282.8	291.6
Corporate profits before tax	161.7	198.2	227.4	225.5	243.3	246.0	224.8	228.7
Federal government surplus or deficit (-) (N.I.A. basis)	-185.7	-167.3	-180.9	-180.5	-161.3	-163.7	-180.6	-197.8
High employment surplus or deficit (-) <3>	-80.9	-74.2	-102.5	-113.1	-113.3	-129.6	-146.1	-169.3
State and local government surplus or deficit(-) (N.I.A. basis)	34.1	43.9	47.4	51.2	53.9	54.5	47.6	55.6
Excluding social insurance funds	-1.9	7.0	9.5	12.0	13.4	12.6	4.3	11.1
Civilian labor force (millions)	110.7	111.2	112.1	112.1	112.7	113.5	113.8	114.2
Unemployment rate (percent)	10.4	10.1	9.3	8.5	7.9	7.5	7.4	7.2
Nonfarm payroll employment	88.8	89.6	90.5	91.8	93.0	94.0	94.9	95.8
Manufacturing	18.1	18.3	18.5	18.9	19.2	19.4	19.5	19.6
Industrial production (1967=100)	138.5	144.5	151.8	155.5	159.8	163.1	165.6	164.7
Capacity utilization: all manufacturing (percent)	70.7	73.8	77.4	78.9	80.7	81.8	82.5	81.6
Materials (percent)	70.1	73.5	77.5	79.6	81.6	82.7	82.9	80.7
Housing starts, private (million units, A.R.)	1.64	1.67	1.79	1.72	1.95	1.86	1.66	1.60
New auto sales (millions, A.R.)	8.46	9.10	9.22	9.94	10.52	10.60	10.30	10.29
Domestic models	6.06	6.81	6.92	7.29	8.22	8.23	7.94	7.50
Foreign models	2.40	2.28	2.31	2.65	2.30	2.38	2.36	2.79

<1> Balance of payments data and details underlying these estimates are shown in the International Developments section of this part of the Greenbook.

<2> Components of purchases and total receipts and total expenditures are shown in the Federal Sector Account table which follows.

<3> Estimates in table are evaluated at a 6 percent high employment unemployment rate.

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PERCENT CHANGES IN GROSS NATIONAL PRODUCT  
AND RELATED ITEMS  
(Annual rates compounded quarterly)

	1983				1984			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<u>Constant (1972) Dollars</u>								
Gross national product	3.3	9.4	6.8	5.9	10.1	7.1	1.6	4.3
Gross domestic purchases	3.7	12.3	7.4	8.7	12.9	7.9	5.4	.9
Final sales	1.1	6.4	4.9	4.2	3.6	10.3	-1.0	7.9
Private	3.5	8.6	6.2	6.3	4.2	8.5	-2.4	8.4
Domestic final purchases	4.0	12.1	6.9	9.7	7.6	9.5	2.3	4.0
Personal consumption expenditures	2.6	10.0	3.8	6.8	4.6	7.9	.7	3.6
Goods	3.5	12.6	5.4	9.5	7.8	10.7	-1.9	3.8
Services	1.5	7.3	2.1	3.8	1.2	4.6	3.8	3.3
Gross private domestic investment	34.1	52.5	38.4	37.0	71.6	-2.2	24.9	-13.1
Residential structures	64.5	78.1	31.6	4.0	21.3	1.2	-4.6	-5.5
Business fixed investment	.0	9.6	18.7	30.6	20.6	21.3	13.7	8.5
Gov't. purchases of goods and services	-8.2	-2.6	-.5	-4.3	1.0	18.6	5.4	5.9
Federal	-17.4	-5.9	-5.3	-8.7	-2.8	45.2	6.2	15.2
National defense	6.8	7.6	-1.9	9.2	3.4	12.2	-2.3	17.5
State and local	-1.2	-.2	2.7	-1.4	3.5	3.7	4.8	-.2
Disposable personal income	2.1	3.3	7.7	8.2	8.6	6.3	3.9	3.5
<u>Current Dollars</u>								
Gross national product	8.5	12.3	10.1	10.6	14.9	10.7	5.6	7.1
Gross domestic purchases	6.7	16.0	11.4	12.2	17.6	11.4	9.1	3.2
Final sales	5.9	8.9	8.1	8.4	7.3	13.8	3.2	11.4
Personal consumption expenditures	4.8	14.5	7.6	9.2	8.6	10.2	5.0	6.1
Goods	3.6	15.7	8.8	10.2	10.9	9.6	-.1	4.9
Services	6.1	13.3	6.6	8.3	6.2	10.9	10.5	7.3
Gross private domestic investment	34.3	52.0	43.2	45.3	78.0	2.0	24.9	-14.3
Residential structures	79.3	71.9	44.4	3.3	23.6	12.1	-.6	-4.7
Business fixed investment	-5.5	5.7	18.5	38.4	16.5	23.9	14.9	11.5
Gov't. purchases of goods and services	-1.3	2.0	4.5	.9	7.8	24.3	9.6	10.7
Federal	-8.9	-3.6	-2.0	-4.3	2.0	50.5	7.8	19.4
National defense	7.9	9.8	3.3	13.2	12.5	14.7	-.8	22.1
State and local	4.2	5.8	9.0	4.4	11.5	10.0	10.7	5.2
Disposable personal income	4.3	7.5	11.7	10.7	12.7	8.6	8.4	6.0
Personal income	3.6	8.0	7.3	11.0	12.4	9.1	8.6	6.7
Wage and salary disbursements	5.6	8.7	7.3	11.0	9.7	8.8	5.9	6.5
Corporate profits with I.V.A. and C.C.Adj.	94.8	114.3	63.4	26.8	29.6	21.3	-10.9	13.0
Corporate profits before tax	16.0	125.7	73.3	-3.3	35.5	4.5	-30.3	7.1
Nonfarm payroll employment	.5	3.4	4.2	5.8	5.5	4.3	3.9	4.0
Manufacturing	-.9	5.0	6.2	7.8	6.4	4.5	2.4	1.1
Nonfarm business sector								
Output per hour	4.4	8.1	2.1	1.0	2.9	5.5	-1.1	2.2
Compensation per hour	5.7	3.5	2.2	4.1	6.1	3.7	3.6	3.7
Unit labor costs	1.3	-4.2	.1	3.0	3.1	-1.7	4.7	1.4
GNP implicit deflator <1>	5.0	2.6	3.1	4.4	4.4	3.3	3.9	2.8
Gross domestic business product								
fixed-weighted price index <2>	2.7	3.9	4.5	3.5	4.2	4.1	4.0	3.5
Excluding food and energy	4.9	3.5	5.4	3.8	3.4	5.4	4.9	3.9
Consumer price index (all urban)	.4	4.3	4.2	4.2	5.2	3.7	3.7	3.6
Industrial production	10.1	18.4	21.8	10.2	11.5	8.6	6.3	-2.3

<1> Excluding the federal pay increase, the rate of change in 1983-Q4 was 4.4 percent.

<2> Uses expenditures in 1972 as weights.

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GROSS NATIONAL PRODUCT AND RELATED ITEMS  
(Quarterly figures are seasonally adjusted. Expenditures and income  
figures are billions of current dollars at annual rates.)

	Projected							
	1985				1986			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Gross National Product	3810.6	3857.7	3917.7	3978.1	4040.5	4099.5	4161.6	4229.7
Gross domestic purchases	3885.1	3951.8	4018.2	4082.8	4143.5	4204.2	4267.7	4332.6
Final sales	3770.0	3829.0	3886.3	3945.1	4006.2	4064.9	4127.7	4196.0
Private	2978.1	3022.2	3061.8	3108.0	3156.0	3203.2	3253.6	3308.3
Domestic final purchases	3052.6	3116.4	3162.2	3212.7	3259.1	3307.9	3359.7	3411.2
Personal consumption expenditures	2446.5	2493.5	2524.8	2559.8	2595.5	2634.3	2675.7	2716.7
Goods	1212.1	1235.3	1245.8	1258.5	1272.0	1287.0	1302.9	1318.0
Services	1234.4	1258.2	1279.0	1301.3	1323.5	1347.3	1372.8	1398.7
Gross private domestic investment	646.8	651.6	668.8	685.9	697.9	708.2	718.0	728.2
Residential structures	155.2	160.0	168.0	176.5	180.0	183.0	186.0	189.0
Business fixed investment	450.9	462.9	469.4	476.4	483.6	490.6	498.1	505.5
Change in business inventories	40.7	28.7	31.4	33.0	34.3	34.6	33.9	33.7
Nonfarm	34.1	22.9	29.0	31.0	33.3	33.6	32.9	32.7
Net exports of goods and services <1>	-74.5	-94.2	-100.5	-104.7	-103.0	-104.7	-106.2	-102.9
Exports	360.7	351.3	355.5	360.3	366.2	374.1	383.2	395.7
Imports	435.2	445.5	456.0	465.0	469.3	478.8	489.3	498.6
Gov't. purchases of goods and services	791.9	806.7	824.5	837.1	850.1	861.7	874.1	887.7
Federal <2>	319.9	325.0	334.4	338.7	343.9	347.7	352.2	357.7
State and local	472.0	481.7	490.1	498.4	506.2	514.0	521.9	530.0
Gross national product in constant (1972) dollars	1663.5	1672.1	1686.6	1699.3	1710.7	1720.5	1730.4	1741.2
Personal income	3143.8	3179.2	3237.8	3293.8	3345.3	3398.7	3451.1	3508.0
Wage and salary disbursements	1882.7	1908.3	1939.0	1968.9	1998.0	2027.4	2056.4	2086.6
Disposable personal income	2654.8	2732.7	2760.0	2803.3	2855.2	2897.4	2938.8	2983.5
Saving rate (percent)	4.5	5.3	5.0	5.2	5.6	5.5	5.3	5.3
Corporate profits with I.V.A. and C.C. Adj.	292.3	293.0	292.4	293.8	291.0	290.7	292.2	296.5
Corporate profits before tax	222.3	220.0	215.9	213.3	207.0	204.2	202.7	204.5
Federal government surplus or deficit (-) (N.I.A. basis)	-165.1	-210.5	-197.8	-194.8	-192.3	-191.3	-190.2	-191.2
High employment surplus or deficit (-) <3>	-129.4	-175.3	-164.2	-162.0	-159.3	-157.2	-154.8	-155.0
State and local government surplus or deficit(-) (N.I.A. basis)	53.7	54.2	52.3	51.5	50.3	49.8	50.4	51.3
Excluding social insurance funds	8.3	8.0	5.3	3.7	1.7	.4	.2	.3
Civilian labor force (millions)	115.2	115.4	115.9	116.3	116.8	117.2	117.7	118.2
Unemployment rate (percent)	7.3	7.3	7.2	7.1	7.1	7.1	7.1	7.1
Nonfarm payroll employment	96.6	97.4	98.0	98.6	99.1	99.5	100.0	100.4
Manufacturing	19.6	19.5	19.5	19.6	19.7	19.7	19.8	19.8
Industrial production (1967=100)	165.5	165.5	166.4	167.6	168.7	169.7	170.9	172.0
Capacity utilization: all manufacturing (percent)	81.1	80.4	80.2	80.0	79.9	79.8	79.7	79.7
Materials (percent)	80.7	79.8	79.6	79.5	79.4	79.3	79.3	79.2
Housing starts, private (million units, A.R.)	1.80	1.80	1.90	1.90	1.90	1.85	1.85	1.85
New auto sales (millions, A.R.)	10.87	11.10	11.00	10.80	10.80	10.70	10.70	10.60
Domestic models	8.46	8.40	8.10	7.80	7.80	7.70	7.60	7.50
Foreign models	2.42	2.70	2.90	3.00	3.00	3.00	3.10	3.10

<1> Balance of payments data and details underlying these estimates are shown in the International Developments section of this part of the Greenbook.

<2> Components of purchases and total receipts and total expenditures are shown in the Federal Sector Account table which follows.

<3> Estimates in table are evaluated at a 6 percent high employment unemployment rate.

CONFIDENTIAL - FR  
CLASS II FOMC

PERCENT CHANGES IN GROSS NATIONAL PRODUCT  
AND RELATED ITEMS  
(Annual rates compounded quarterly)

	Projected							
	1985				1986			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<u>Constant (1972) Dollars</u>								
Gross national product	.3	2.1	3.5	3.0	2.7	2.3	2.3	2.5
Gross domestic purchases	3.9	3.1	3.6	3.0	2.4	2.0	2.0	2.0
Final sales	-3	3.8	3.3	2.9	2.6	2.4	2.4	2.6
Private	-4	3.9	3.1	3.1	2.8	2.6	2.5	2.7
Domestic final purchases	4.1	5.2	3.2	3.1	2.5	2.2	2.2	2.0
Personal consumption expenditures	5.2	4.2	2.2	2.1	2.1	2.0	2.0	1.8
Goods	5.4	5.7	2.2	2.2	2.2	2.0	1.9	1.6
Services	5.0	2.4	2.2	2.1	2.1	2.1	2.1	2.0
Gross private domestic investment	3.1	-1.1	8.2	7.6	4.1	2.8	2.2	2.4
Residential structures	5.3	10.4	17.9	17.5	4.5	2.9	2.5	2.5
Business fixed investment	-1.6	9.0	4.1	4.1	3.8	3.1	3.1	3.0
Gov't. purchases of goods and services	.3	3.6	4.3	2.0	1.8	1.3	1.9	2.3
Federal	.7	3.9	6.8	1.3	1.6	.5	1.9	2.9
National defense	-2	8.5	9.2	2.1	1.7	.8	2.5	4.1
State and local	.0	3.4	2.4	2.4	2.0	2.0	1.9	1.9
Disposable personal income	-1.6	8.3	1.2	2.9	4.0	2.0	1.4	1.7
<u>Current Dollars</u>								
Gross national product	5.6	5.0	6.4	6.3	6.4	6.0	6.2	6.7
Gross domestic purchases	7.6	7.0	6.9	6.6	6.1	6.0	6.2	6.2
Final sales	5.2	6.4	6.1	6.2	6.3	6.0	6.3	6.8
Personal consumption expenditures	8.6	7.9	5.1	5.7	5.7	6.1	6.4	6.3
Goods	6.6	7.9	3.4	4.1	4.4	4.8	5.0	4.7
Services	10.6	7.9	6.8	7.2	7.0	7.4	7.8	7.8
Gross private domestic investment	5.8	3.0	11.0	10.6	7.2	6.0	5.6	5.8
Residential structures	4.6	12.9	21.6	21.8	8.2	6.8	6.7	6.6
Business fixed investment	3.0	11.1	5.7	6.0	6.2	5.9	6.2	6.1
Gov't. purchases of goods and services	5.9	7.7	9.1	6.2	6.3	5.6	5.9	6.4
Federal	5.4	6.5	12.1	5.2	6.3	4.5	5.3	6.4
National defense	4.0	11.0	15.5	6.8	6.3	5.2	6.6	8.1
State and local	6.3	8.5	7.2	6.9	6.4	6.3	6.3	6.4
Disposable personal income	1.6	12.3	4.1	6.4	7.6	6.1	5.8	6.2
Personal income	6.3	4.6	7.6	7.1	6.4	6.5	6.3	6.8
Wage and salary disbursements	7.8	5.6	6.6	6.3	6.0	6.0	5.9	6.0
Corporate profits with I.V.A. and C.C.Adj.	1.0	1.0	-9	2.0	-3.8	-.4	2.0	6.0
Corporate profits before tax	-10.7	-4.1	-7.3	-4.6	-11.4	-5.2	-3.0	3.5
Nonfarm payroll employment	3.3	3.2	2.6	2.2	2.0	1.9	1.8	1.8
Manufacturing	.0	-2.0	1.7	1.6	1.2	1.0	1.0	.8
Nonfarm business sector								
Output per hour	-2.5	-.4	1.6	1.3	1.3	.6	.9	1.0
Compensation per hour	5.4	4.2	4.3	4.3	4.7	4.3	4.4	4.5
Unit labor costs	8.1	4.6	2.7	3.0	3.4	3.7	3.5	3.5
GNP implicit deflator <1>	5.4	2.9	2.8	3.2	3.6	3.6	3.8	4.1
Gross domestic business product								
fixed-weighted price index <2>	3.6	3.7	3.2	3.4	3.7	3.9	4.1	4.3
Excluding food and energy	4.6	3.9	3.8	3.9	4.0	4.2	4.4	4.5
Consumer price index (all urban)	3.2	4.1	3.3	3.4	3.8	4.0	4.2	4.4
Industrial production	2.0	.0	2.3	2.9	2.6	2.6	2.6	2.8

<1> Excluding Federal pay increase, the rate of change in 1985-Q1 is 5.0 percent and in 1986-Q1 is 3.5 percent.

<2> Uses expenditures in 1972 as weights.

CONFIDENTIAL - FR  
CLASS II FOMC

GROSS NATIONAL PRODUCT AND RELATED ITEMS  
(Expenditures and income figures are billions of current dollars.)

	1979	1980	1981	1982	1983	1984	---Projected---	
							1985	1986
Gross national product	2417.8	2631.7	2957.7	3069.2	3304.8	3662.8	3891.0	4132.8
Gross domestic purchases	2404.5	2607.7	2929.8	3050.2	3313.0	3727.1	3984.5	4237.0
Final sales	2403.5	2641.4	2931.7	3095.4	3318.3	3604.6	3857.6	4098.7
Private	1929.2	2103.7	2335.2	2444.9	2632.7	2857.2	3042.5	3230.3
Domestic final purchases	1915.9	2079.7	2307.2	2425.9	2641.0	2921.4	3136.0	3334.5
Personal consumption expenditures	1507.1	1668.0	1849.1	1984.9	2155.9	2341.8	2506.1	2655.6
Goods	813.4	883.5	966.1	1002.6	1081.5	1175.6	1237.9	1295.0
Services	693.7	784.5	883.0	982.2	1074.4	1166.2	1268.2	1360.6
Gross private domestic investment	423.0	401.9	484.2	414.9	471.6	637.9	663.3	713.0
Residential construction	118.5	102.9	104.3	91.3	132.2	153.9	164.9	184.5
Business fixed investment	290.2	308.8	353.9	349.6	352.9	425.8	464.9	494.4
Change in business inventories	14.3	-9.8	26.0	-26.1	-13.5	58.2	33.4	34.1
Nonfarm	8.6	-4.5	18.2	-23.9	-3.1	49.6	29.3	33.1
Net exports of goods and services <1>	13.2	23.9	28.0	19.0	-8.3	-64.2	-93.5	-104.2
Exports	281.3	338.8	369.9	348.4	336.2	364.3	357.0	379.8
Imports	268.1	314.8	341.9	329.4	344.4	428.5	450.4	484.0
Gov't. purchases of goods and services	474.4	537.8	596.5	650.5	685.5	747.4	815.1	868.4
Federal <2>	168.3	197.0	228.9	258.9	269.7	295.4	329.5	350.4
State and local	306.0	340.8	367.6	391.5	415.8	452.0	485.6	518.0
Gross national product in constant (1972) dollars	1479.4	1475.0	1512.1	1480.0	1534.7	1639.3	1680.4	1725.7
Personal income	1951.1	2165.3	2429.4	2584.6	2744.3	3012.1	3213.6	3425.8
Wage and salary disbursements	1237.6	1356.7	1493.1	1568.7	1659.2	1804.0	1924.7	2042.1
Disposable personal income	1650.2	1828.9	2041.7	2180.5	2340.1	2576.8	2737.7	2918.7
Saving rate (percent)	5.9	6.0	6.7	6.2	5.0	6.1	5.0	5.4
Corporate profits with I.V.A. and C.C.Adj.	194.8	175.4	190.0	159.2	225.1	285.8	292.9	292.6
Corporate profits before tax	252.7	234.6	221.3	165.6	203.1	235.7	217.9	204.6
Federal government surplus or deficit (-) (N.I.A. basis)	-16.1	-61.3	-64.2	-148.2	-178.6	-175.9	-192.0	-191.3
High employment surplus or deficit (-)	-20.8	-36.4	-31.3	-61.6	-92.7	-139.6	-157.7	-156.6
State and local government surplus or deficit (-) (N.I.A. basis)	30.6	30.6	37.6	32.9	44.1	52.9	52.9	50.4
Excluding social insurance funds	6.8	3.5	7.8	-.8	6.6	10.4	6.3	.6
Civilian labor force (millions)	105.0	106.9	108.7	110.2	111.6	113.5	115.7	117.5
Unemployment rate (percent)	5.8	7.1	7.6	9.7	9.6	7.5	7.2	7.1
Nonfarm payroll employment (millions)	89.8	90.4	91.2	89.6	90.2	94.5	97.7	99.7
Manufacturing	21.0	20.3	20.2	18.8	18.4	19.4	19.5	19.8
Industrial production (1967=100)	152.5	147.0	150.9	138.6	147.6	163.3	166.2	170.3
Capacity utilization: all manufacturing (percent)	86.0	79.6	79.4	71.1	75.2	81.6	80.4	79.8
Materials (percent)	87.6	80.4	80.7	70.1	75.2	82.0	79.9	79.3
Housing starts, private (million units, A.R.)	1.72	1.30	1.10	1.06	1.70	1.77	1.85	1.86
New auto sales (millions, A.R.)	10.68	9.04	8.56	8.00	9.18	10.39	10.94	10.70
Domestic models	8.36	6.62	6.24	5.77	6.77	7.95	8.19	7.65
Foreign models	2.32	2.42	2.32	2.23	2.41	2.44	2.75	3.05

<1> Balance of payments data underlying these estimates are shown in the International Developments section of this part of the Greenbook.

<2> Components of purchases and total receipts and total expenditures are shown in the Federal Sector Accounts table which follows.

CONFIDENTIAL - FR  
CLASS II FOMC

PERCENT CHANGES IN GROSS NATIONAL PRODUCT  
AND RELATED ITEMS

	1979	1980	1981	1982	1983	1984	-----Projected-----	
							1985	1986
<u>Constant (1972) Dollars</u>								
Gross national product	2.8	-.3	2.5	-2.1	3.7	6.8	2.5	2.7
Gross domestic purchases	2.0	-1.2	3.1	-1.2	4.9	8.7	3.5	2.6
Final sales	3.5	.5	1.5	-.7	3.2	5.0	3.2	2.8
Private	4.0	.1	1.6	-1.3	4.1	5.3	2.9	2.9
Domestic final purchases	2.9	-1.0	2.2	-.2	5.6	7.6	4.2	2.7
Personal consumption expenditures	2.7	.5	2.0	1.3	4.8	5.3	3.7	2.2
Goods	1.9	-1.4	1.7	.4	6.0	7.1	4.0	2.3
Services	3.7	2.7	2.3	2.5	3.4	3.2	3.4	2.1
Gross private domestic investment	-.2	-11.8	10.7	-15.9	13.7	31.2	2.0	4.3
Residential structures	-5.3	-20.3	-5.5	-14.8	41.7	12.1	4.8	8.0
Business fixed investment	7.3	-2.4	5.5	-4.6	2.5	19.8	6.5	3.9
Gov't. purchases of goods and services	1.3	2.2	.9	2.0	-.3	3.5	4.2	2.2
Federal	1.8	4.2	3.7	6.1	-.7	5.4	7.7	2.2
National defense	2.6	3.9	5.0	7.6	7.1	5.8	6.3	3.1
State and local	1.1	1.0	-.6	-.6	.0	2.2	1.8	2.2
Disposable personal income	2.7	.6	2.7	.9	3.5	6.7	3.0	2.8
<u>Current Dollars</u>								
Gross national product	11.7	8.8	12.4	3.8	7.7	10.8	6.2	6.2
Gross domestic purchases	11.1	8.5	12.3	4.1	8.6	12.5	6.9	6.3
Final sales	12.4	9.9	11.0	5.6	7.2	8.6	7.0	6.2
Personal consumption expenditures	11.9	10.7	10.9	7.3	8.6	8.6	7.0	6.0
Goods	11.7	8.6	9.3	3.8	7.9	8.7	5.3	4.6
Services	12.2	13.1	12.6	11.2	9.4	8.5	8.8	7.3
Gross private domestic investment	9.4	-5.0	20.5	-14.3	13.7	35.2	4.0	7.5
Residential structures	6.6	-13.2	1.3	-12.4	44.7	16.4	7.2	11.9
Business fixed investment	16.6	6.4	14.6	-1.2	.9	20.6	9.2	6.3
Gov't. purchases of goods and services	9.8	13.4	10.9	9.0	5.4	9.0	9.1	6.5
Federal	9.6	17.1	16.2	13.1	4.2	9.5	11.5	6.3
National defense	11.5	17.3	17.2	16.8	11.7	10.5	10.1	7.7
State and local	9.9	11.4	7.9	6.5	6.2	8.7	7.4	6.7
Disposable personal income	12.0	10.8	11.6	6.8	7.3	10.1	6.2	6.6
Personal income	12.6	11.0	12.2	6.4	6.2	9.8	6.7	6.6
Wage and salary disbursements	11.9	9.6	10.1	5.1	5.8	8.7	6.7	6.1
Corporate profits with I.V.A. and C.C.Adj.	1.2	-9.9	8.3	-16.2	41.5	26.9	2.5	-.1
Corporate profits before tax	10.3	-7.1	-5.7	-25.2	22.8	16.0	-7.6	-6.1
Nonfarm payroll employment	3.6	.6	.8	-1.7	.7	4.7	3.4	2.1
Manufacturing	2.6	-3.6	-.6	-6.9	-1.8	5.3	.7	1.1
Nonfarm business sector								
Output per hour	-1.5	-.7	1.5	.2	3.5	2.7	.2	1.0
Compensation per hour	9.0	10.3	9.6	8.0	4.9	4.1	4.3	4.4
Unit labor costs	10.7	11.1	8.0	7.7	1.4	1.4	4.2	3.4
GNP implicit deflator	8.6	9.2	9.6	6.0	3.8	3.8	3.6	3.4
Gross domestic business product								
fixed-weighted price index <1>	9.9	9.9	9.7	5.9	3.7	4.0	3.7	3.7
Excluding food and energy	8.6	8.5	9.4	7.0	4.6	4.3	4.3	4.1
Consumer price index (all urban)	11.3	13.5	10.3	6.1	3.2	4.3	3.6	3.8
Industrial production	4.4	-3.6	2.6	-8.1	6.4	10.7	1.8	2.5

<1> Uses expenditures in 1972 as weights.



July 3, 1985

FEDERAL SECTOR ACCOUNTS  
(Billions of dollars)

	Fiscal Year 1984*	FY1985 <sup>e</sup> /2/		FY1986 <sup>e</sup> /2/		CY 1984*	CY1985 FRB Staff	FRB staff estimates								
		Admin. 1/	FRB Staff	Admin. 1/	FRB Staff			Calendar quarters; not seasonally adjusted								
								1984			1985			1986		
								IV*	I*	II	III	IV	I	II	III	
Unified budget receipts	666	741	732	794	784	683	740	166	174	206	187	174	184	229	197	
Unified budget outlays	842	944	940	971	969	868	948	239	230	237	235	246	241	241	242	
Surplus/deficit(-), unified budget	-175	-203	-208	-177	-185	-184	-207	-72	-56	-31	-48	-72	-57	-12	-44	
Surplus/deficit(-), off-budget agencies <sup>3</sup>	-10	-10	-11	-1	-5	-10	-13	1	-3	-5	-4	-1	-1	-2	-1	
Combined deficit to be financed	-185	-213	-219	-177	-189	-195	-220	-71	-59	-36	-53	-73	-57	-13	-46	
Means of financing combined deficit:																
Net borrowing from public	171	201	202	179	187	199	202	64	42	45	51	64	55	21	48	
Decrease in cash operating balance	7	10	9	0	1	-5	8	13	4	-10	3	11	-5	-5	0	
Other <sup>4</sup>	8	2	7	-1	2	2	11	-6	13	1	-1	-2	8	-2	-2	
Cash operating balance, end of period	30	20	21	20	20	18	10	18	14	24	21	10	15	20	20	
Memo: Sponsored agency borrowing <sup>5</sup>	30	42	19	46	20	32	21	3	4	6	6	5	5	5	5	
<b>NIA Budget</b>								Seasonally adjusted annual rates								
Receipts	688	762	751	825	806	705	767	722	771	734	766	782	795	809	822	
Expenditures	860	945	941	990	994	881	955	920	937	944	963	976	987	1000	1012	
Purchases	283	327	324	355	346	295	330	316	320	325	334	339	344	348	352	
Defense	215	242	239	272	259	222	244	232	234	240	249	253	257	260	264	
Nondefense	68	85	85	83	87	74	86	84	86	85	86	86	87	88	88	
All other expenditures	577	618	617	635	648	586	625	604	617	619	629	637	643	652	660	
Surplus/deficit(-)	-172	-183	-194	-165	-193	-176	-193	-198	-165	-211	-198	-195	-192	-191	-190	
High employment surplus/deficit(-) evaluated at 6 percent unemployment	-126	n.a.	-160	n.a.	-158	-140	-158	-169	-129	-175	-164	-162	-159	-157	-155	
	*--actual			e--estimated				n.a.--not available								

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- O.M.B., Current Budget Estimates (April 1985) and B.E.A. translations to an NIA basis.
- The CBO baseline budget estimates show revenues of \$735 billion and \$788 billion, unified outlays of \$938 billion and \$995 billion, and deficits of \$203 billion and \$206 billion in fiscal years 1985 and 1986, respectively. Off-budget outlays are projected to be \$11 billion in fiscal 1985 and \$9 billion in fiscal 1986. (The Economic Outlook, February 1985.)

Note: Details may not add to totals due to rounding.

- Includes Federal Financing Bank, Postal Service Fund, Rural Electrification and Telephone Revolving Fund, Rural Telephone Bank and Strategic Petroleum Reserve.
- Checks issued less checks paid, accrued items and other transactions.
- Sponsored agency borrowing includes net debt issuance by Federal Home Loan Banks, FHLMC (excluding participation certificates), FNMA (excluding mortgage-backed securities), Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, and Student Loan Marketing Association marketable debt on a payment basis. The Administration's definition of borrowing by these agencies is somewhat broader.

## DOMESTIC FINANCIAL DEVELOPMENTS

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Recent developments. Federal funds since the last FOMC meeting have traded primarily in the 7-1/2 to 7-3/4 range established shortly after the cut in the discount rate. Since the meeting, Treasury bill rates have dropped around 40 basis points, while most private short-term market yields are down marginally. Short-term yields had fallen substantially further by the time banks cut their prime rate 1/2 percentage point on June 18. Subsequently, rates backed up when prospects of another cut in the discount rate waned on incoming signs of stronger economic activity; private rates increased further when concerns intensified about difficulties within the financial system. The bond markets rallied strongly before giving up a part of their gains, but on balance yields on Treasuries and corporates still are off about 40 basis points since the May FOMC meeting, perhaps reflecting favorable oil price and inflation news as well as money market developments.

The renewed decline in interest rates since mid-March probably has helped to boost demands for money. M1 growth spurted to a 16 percent annual rate over May and June combined, reflecting strengthening in all its components. M2 grew at an average rate of nearly 11 percent in May and June. The nontransactions component of M2 accelerated over this period, with sources of strength initially being overnight RPs and later MMDAs and money market mutual fund shares, as their returns lagged the downward movement in market rates. Also, savings deposits registered unusual increases in both months.

Reflecting the rebound of M2, growth in M3 averaged more than 9 percent over the past two months. Within its non-M2 component, only institutional money market mutual fund shares and thrift large CDs have expanded since April. Large time deposits outstanding at commercial banks have declined as inflows of core deposits have surged.

Business borrowing has been heavy in the past couple of months even though the underlying corporate financing gap probably has been of moderate size. Business loans at U.S. banks and foreign branches rose at about the moderate pace of the first four months of 1985, but commercial paper issuance by nonfinancial firms was stronger than it had been earlier. Furthermore, bond issuance by U.S. nonfinancial corporations soared--reaching an all-time high in June--as bond rates declined. A sizable portion of bond issues financed equity retirements associated with mergers, buyouts and share repurchases. Such retirements far outpaced an enlarged volume of new equity offerings induced by higher stock prices. Net equity retirements are estimated at around \$75 billion at an annual rate in the second quarter, which, though below the first quarter, is near the average pace of last year.

In the household sector, growth of residential mortgage debt apparently picked up over the course of the second quarter in response to declining interest rates on home loans, which have fallen a further 3/4 percentage point since the last FOMC meeting. At the lower rate levels, fixed-rate mortgages in recent months have accounted for about half of all home loans originated, despite the initial rate advantage of ARMs, and nearly all of the increased volume of pass-through security issues was backed by fixed-rate loans.

Consumer credit growth evidently continued robust through May-- buoyed in part by interest rate subsidy programs for certain auto loans at the captive finance companies. In June, consumer lending is estimated to have slowed a little at commercial banks. Banks have continued to reduce consumer loan rates but by much smaller amounts than the declines in market yields; thus a more normal spread has been restored relative to other investments of comparable maturity.

The federal budget deficit narrowed in the second quarter, but less than seasonally, and borrowings edged up, contributing to an increase in the Treasury's cash balance. State and local bond issuance was very strong in May and June, boosted by a surge in refunding issues in response to lower interest rates.

Outlook. Market interest rates are not expected to change much from current levels over the next several months, in an environment of moderate economic growth and stable inflation. This projection assumes, however, that congressional deliberations on budget cuts do not founder and thereby reverse the favorable psychological impacts engendered by earlier legislative progress.

The dimensions of the current federal fiscal imbalance will be underscored by the heavy Treasury borrowings slated for the third quarter. The pace of federal debt issuance will increase in the third quarter as the combined deficit rises and the current high cash balance level is maintained on balance in anticipation of even heavier funding needs in the fourth quarter. By contrast, state and local government borrowing is expected to move below the exceptional recent pace as the stock of

outstanding debt obligations that are candidates for refunding at present interest rates is drawn down.

Borrowing by households is expected to change little in the third quarter; a slight projected strengthening of mortgage flows accompanying the further step-up in housing activity is about offset by some moderation of consumer credit growth. The jump in consumer delinquency rates at commercial banks in the first quarter, to near the average of the past ten years, reportedly was not repeated in the spring, nor, as of the June survey, had the willingness of banks to make such loans abated. Even so, an easing of consumer credit expansion is expected to accompany the slowing of growth in consumer durables spending foreseen in the third quarter.

Finally, business credit growth is likely to remain near the recent pace over the next three months. The corporate financing gap is anticipated to widen, but merger and financial restructuring activity is assumed to fall. Bond issuance is expected to continue relatively heavy, though below the extraordinary pace of June, while use of commercial paper and bank loans will be appreciable as well.

## INTERNATIONAL DEVELOPMENTS

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Recent developments. The weighted average foreign exchange value of the dollar has fluctuated within a range of roughly 3 percent since the last FOMC meeting, and remains about 10 percent below its peak of late February. Both U.S. and foreign short-term interest rates have eased slightly over the period, and the differential has changed little.

. Foreign official accounts resumed net purchases of U.S. Treasury securities in April; there had been a large decline in official holdings of Treasuries in the first quarter,

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In April substantial purchases of Treasury securities were also made by Japanese private investors and by the World Bank, which together amounted to more than \$2-1/2 billion. Since the beginning of 1984, private Japanese investors and the World Bank have accounted for close to half of the nearly \$30 billion total foreign nonofficial purchases of Treasuries.

Capital inflows to the United States in recent months have also taken the form of repatriations of Eurodollar deposits by U.S. nonbank investors, which have declined by more than \$8 billion since March. The reduction in U.S. Eurodollar holdings has occurred mainly in deposits at the largest U.S. banks, which are funding themselves to a greater degree through retail U.S. deposits. The foreign assets of U.S. banks (consolidated to include their foreign branches) were unchanged in the first quarter.

The U.S. merchandise trade deficit widened in May, and for the April-May period combined it reached the record \$130 billion rate of the third quarter of 1984. The increase in the deficit for April-May from the first quarter reflected a widespread decline in exports, notably of agricultural products, capital goods and industrial supplies. For the year to date, nonagricultural exports to industrial countries have increased somewhat, but those to other countries have declined.

Imports in the April-May period were about unchanged, and non-oil imports were somewhat below the first quarter rate. Declines occurred in imports of machinery and industrial supplies (particularly office machines and other electronic products), steel, clothing, diamonds, gold, and a range of agricultural products; these more than offset increases in imports of passenger cars from Japan, trucks, and coffee. Oil imports rose about 10 percent in volume from the relatively low first quarter rate, with most of the addition apparently being added to inventories.

In industrial countries abroad, economic activity appears to have slowed temporarily in the first quarter. There was little growth in Japan in the first quarter, although recent data on industrial production suggest that this development was in part temporary. The level of activity fell in Germany and was flat in France, in each case in part as a result of the exceptionally severe winter. Canada, Italy and the United Kingdom continued to experience moderate growth. Unemployment remains high in major industrial countries except Japan, and only in Canada has it declined significantly this year. Inflation rates are broadly unchanged in recent months.

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Developing countries are benefitting from reduced interest rates on floating rate debt. The average cost of LIBOR-based debt is currently about 9-1/2 percent (compared with an average 12 percent for the year 1984), reflecting both the decline in LIBOR and reduced spreads under debt rescheduling agreements. The decline in interest rates may reduce external interest payments by Mexico by about \$1-1/2 billion in 1985, approximately equal to the expected reduction in oil export earnings this year. Consumer prices in Mexico rose 2-1/2 percent in May, the smallest monthly rise in four years, and the year-over-year increase in the index is now 55 percent. Interest rates on short-term deposits were raised in late May and June, resulting in positive real annual yields of roughly 5 to 10 percent. On June 1, the minimum wage was raised 18 percent to a level 53 percent above a year earlier. The Mexican peso has been under pressure in the so-called super-free market, in part because of uncertainty about oil prices and in part because of increased concern about Mexico's economic policies.

The dramatic monetary reform package announced by Argentina in mid-June, which includes an end of central bank financing of the government deficit, a wage/price freeze and the introduction of a new currency, has met an initially favorable public response: the parallel market exchange rate is close to the official rate, and some reflow of expatriate funds has occurred. Argentina has reached revised understandings with the IMF on reinstatement of its \$1.2 billion



stand-by arrangement, and Executive Board approval is expected in early August. In view of these developments the United States and 11 other countries arranged a bridge financing credit of \$483 million which is to be repaid from IMF disbursements. Argentina drew \$320 million on the bridge loan in late June and made interest payments of that amount to banks, bringing its interest on outstanding bank debt of the public sector current to end-February. Earlier in June, Argentina had made an interest payment of \$250 million from reserves.

Outlook. The staff continues to project a moderate depreciation of the dollar throughout the forecast period. The projection for economic activity in the major industrial countries for the remainder of the year is little changed, but as a result of the slow growth recorded in the first quarter GNP growth for the year as a whole is now estimated at slightly below 3 percent. Inflation rates in industrial countries are still expected to average around 4 percent.

Based on recent data for merchandise trade, and also for certain service transactions, the staff has raised its projection of the U.S. current account deficit for 1985 to \$130 billion, with some further increase projected in 1986.

JULY 2, 1985

OUTLOOK FOR U.S. NET EXPORTS AND RELATED ITEMS  
(BILLIONS OF DOLLARS, SEASONALLY ADJUSTED ANNUAL RATES)

	ANNUAL			1984		1985				1986			
	1984-	1985-P	1986-P	Q3-	Q4-	Q1-	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
<b>1. GNP EXPORTS AND IMPORTS 1/</b>													
CURRENT \$, NET	-64.2	-93.5	-104.2	-90.6	-56.0	-74.5	-94.2	-100.5	-104.7	-103.0	-104.7	-106.2	-102.9
EXPORTS OF G+S	364.3	357.0	379.8	368.6	367.2	360.7	351.3	355.5	360.3	366.2	374.1	383.2	395.7
IMPORTS OF G+S	428.5	450.4	484.0	459.3	423.2	435.2	445.5	456.0	465.0	469.3	478.8	489.3	498.6
CONSTANT 72 \$, NET	-15.0	-32.1	-30.7	-27.0	-13.4	-28.4	-32.9	-33.4	-33.6	-32.6	-31.5	-30.4	-28.3
EXPORTS OF G+S	146.0	141.7	145.7	147.4	147.1	143.7	139.9	141.0	142.1	142.9	144.4	146.4	149.3
IMPORTS OF G+S	161.1	173.7	176.4	174.4	160.5	172.1	172.8	174.4	175.7	175.4	175.9	176.9	177.6
<b>2. U.S. MERCHANDISE TRADE BALANCE 2/</b>	-108.3	-135.9	-146.3	-130.0	-98.2	-117.8	-136.9	-142.6	-146.4	-144.6	-146.8	-148.3	-145.4
EXPORTS	220.3	218.4	233.0	222.1	225.4	223.2	213.1	217.4	220.0	224.1	229.0	235.0	244.0
AGRICULTURAL	38.4	30.4	31.3	36.9	38.3	34.0	28.6	29.1	29.8	30.6	31.2	31.3	32.1
NONAGRICULTURAL	181.9	188.1	201.7	185.3	187.2	189.3	184.5	188.3	190.2	193.5	197.8	203.7	211.8
IMPORTS	328.6	354.4	379.3	352.1	323.7	341.0	349.9	360.0	366.5	368.7	375.8	383.3	389.4
PETROLEUM AND PRODUCTS	57.5	49.6	46.1	57.8	56.8	45.2	52.7	51.2	49.2	44.7	45.6	47.1	47.0
NONPETROLEUM	271.1	304.8	333.2	294.4	266.9	295.8	297.2	308.9	317.3	324.0	330.2	336.1	342.4
<b>3. U.S. CURRENT ACCOUNT BALANCE</b>	-101.5	-131.2	-139.4	-130.0	-101.9	-120.0	-130.3	-133.7	-140.7	-135.9	-139.0	-141.8	-141.0
OF WHICH: NET INVESTMENT INCOME	19.1	20.0	22.4	13.0	16.0	10.5	20.9	24.3	24.2	23.2	22.9	22.0	21.3
<b>4. FOREIGN OUTLOOK 3/</b>													
REAL GNP--TEN INDUSTRIAL 4/	3.1	2.7	2.8	4.6	3.9	0.7	3.8	3.2	2.8	2.7	2.6	2.6	2.6
REAL GNP--NONOPEC LDC 5/	4.1	4.1	4.2	4.5	4.1	3.9	3.9	3.9	4.0	4.0	4.4	4.7	5.0
CONSUMER PRICES--TEN IND. 4/	4.9	4.5	3.9	2.6	4.8	5.4	5.5	2.8	3.7	4.4	4.2	3.3	3.7

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1/ ECONOMIC ACTIVITY AND PRODUCT ACCOUNT DATA.

2/ INTERNATIONAL ACCOUNTS BASIS.

3/ PERCENT CHANGE, ANNUAL RATES.

4/ WEIGHTED BY MULTILATERAL TRADE-WEIGHTS OF G-10 COUNTRIES PLUS SWITZERLAND; PRICES ARE NOT SEASONALLY ADJUSTED.

5/ WEIGHTED BY SHARE IN NONOPEC LDC GNP.

P/ PROJECTED