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September 25, 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

## DOMESTIC NONFINANCIAL DEVELOPMENTS

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Recent developments. Economic activity appears to have expanded moderately in the third quarter. Auto sales have increased sharply since mid-August, reducing the stocks of 1985 cars. But outlays for other types of consumer and investment goods have been sluggish in recent months. At the same time, recent increases in prices and wages have been relatively small.

The index of industrial production rose 0.3 percent in August, but with downward revisions to earlier months, was only 1/2 percent above the second-quarter average. Increases in August were largest for consumer durable goods--mainly because of a spurt in assemblies of light trucks--and for defense and space equipment. Output of consumer goods other than motor vehicles has shown little net change in recent months. Industrial capacity utilization--at 80-1/2 percent in August--has been essentially flat since spring.

Labor demand picked up in August, with nonfarm payroll employment expanding nearly 300,000--well above the average monthly increment in the preceding four months. Hiring continued to be brisk in services, trade, and finance. In addition, manufacturing employment rose for the first time since January, although much of the reported increase may reflect seasonal adjustment difficulties during the model changeover period in the motor vehicles industry. The civilian unemployment rate, which had held at 7.3 percent since February, dropped to 7.0 percent in August.

Consumer spending rose sharply in August, mainly because of the surge in auto sales that followed the introduction in mid-August of wide-ranging incentives for 1985 models. Sales of domestic autos, which had been sluggish earlier in the summer, rose to a 9-1/2 million unit annual rate in August and to a record 12 million unit rate in the first twenty days of September. Outlays for consumer goods other than autos, which had posted vigorous gains at the start of the year, have been lackluster since early spring. Nonetheless, with real income virtually flat, on balance, over the past half-year, the saving rate since June has been below 4 percent, compared with an average of around 6 percent over the past decade.

Sales of new homes continued to trend up through July, and sales of existing homes registered a sizable advance in August. In contrast, construction of new single-family houses has remained at around a 1.05 million unit annual rate since early spring despite sharply lower mortgage interest rates. Multifamily housing activity, however, has remained relatively buoyant even though vacancy rates in many areas are at record levels.

Indicators of business fixed investment point to sluggish performance in the second half. Although shipments of nondefense capital goods bounced back in August, new orders, excluding the volatile aircraft category, fell 3-1/4 percent. Bookings for high-technology items did post a substantial increase in August, but orders for these types of equipment have not grown much over the past year. Moreover, spending for nonresidential structures has fallen in recent months, with particular

weakness in outlays for "other" commercial buildings such as stores and warehouses and for industrial structures.

Inventory investment in July continued at about the slow second-quarter pace. Faced with sluggish orders and shipments, manufacturers have held their stocks unchanged this year. In the trade sector, stocks at nonauto retailers also have shown little change, on balance, in recent months, although they continue to appear a bit high in relation to sales. At automobile dealers, stocks of 1985 models are being drawn down by the special financing incentives; given current production schedules and an expected sales "payback" in coming months, an accumulation of 1986 models is likely in the fourth quarter.

Recent price and wage data suggest that inflation is holding steady at rates somewhat lower than earlier in the year. The consumer price index rose 0.2 percent for a fourth month in August, below the average monthly change between December and April. Retail food and energy prices, on balance, have been virtually flat since early spring. Prices of goods other than food and energy were little changed in August after declining for three months, in part because of continuing competition from low-priced imports; increases in prices of services, however, remain sizable. Wage rates, as measured by the index of average hourly earnings, were flat in July and August, and now stand just 3 percent above the level of a year earlier.

Outlook. The staff estimates that real GNP rose at a 3 percent annual rate in the third quarter, compared with a 1 percent rate in the first half. Growth in domestic final demand appears to have been

well-maintained, largely because of the surge in auto sales; the rise in outlays for other goods and services probably was small. At the same time, inventory investment excluding autos is projected to remain near the reduced second-quarter pace; and in the external sector, little change is expected to have occurred in either exports or imports. It should be noted that the overall rise in production this quarter largely reflects developments in the automobile and farm sectors, which together account for more than a third of the estimated rise in real GNP. Prices, as measured by the gross business product fixed-weighted price index, are estimated to have risen at around a 2-3/4 percent rate, almost a percentage point less than in the first half.

The most significant change in the assumptions underlying the staff projections of real activity and inflation is the new path projected for the foreign exchange value of the dollar. In light of the recent G-5 announcement, the dollar now is expected to be considerably lower in the near term than previously assumed and still to decline moderately further next year.

With respect to monetary policy, the staff is assuming a slowing in the growth of M1 during the remainder of this year, although growth over the second half is expected to be above the 3 to 8 percent target range. For 1986, M1 still is assumed to grow at around the midpoint of the tentative range. Interest rates are anticipated to be unchanged to slightly lower over the projection horizon. For fiscal policy, the staff continues to assume the implementation of much of the Congressional

Budget Resolution that was passed in August, although the assumed reductions in outlays for defense, human resources, and farm programs are a bit smaller than the congressional targets. The federal budget deficit on a unified budget basis is now estimated at \$200 billion in fiscal year 1985 and is projected to decline only a bit, to around \$192 billion in fiscal year 1986. After four years of rapid growth, the structural deficit is likely to show little change in 1986.

Real GNP growth is expected to average around 2-3/4 percent over the next five quarters--a bit more than in the last Greenbook. The principal changes to this projection reflect the lower exchange rate. In particular, imports of goods and services are now projected to stabilize during 1986, owing to anticipated large increases in prices of foreign goods. In addition, increased competitiveness for U.S. exports is expected to be a stimulus to domestic production next year. Thus, despite a projected moderation in domestic final demand to a 2 percent rate during 1986, domestic production is projected to pick up somewhat.

For domestic demand, the smaller gains projected for 1986 reflect the absence of incremental fiscal stimulus, the diminishing backlog of pent-up demands for household durables, and continued slow growth of business investment. With the saving rate currently below 4 percent and indebtedness historically high, consumer spending is expected to slow to a pace more in line with underlying income growth. Auto sales, in particular, are expected to be well maintained at around 10-3/4 million units next year, but to make no further net contribution to gains in household spending. Growth in business fixed investment also is projected to

remain slow. Although the incentive to invest in new technologies remains strong, gains in the equipment area are likely to be inhibited by the substantial margin of existing unused capacity, and outlays for structures are anticipated to be held down by the end of the boom in office building. In contrast, homebuilding is projected to provide some impetus to growth.

The outlook for inflation also is affected by the revised path for the dollar. Incoming information on prices and wages has been quite favorable, and resource utilization rates are anticipated to be little changed over the projection horizon. However, the forces restraining inflationary pressures are anticipated to be more than offset by rising costs associated with the sharper depreciation of the dollar. In addition, food prices, which are expected to be essentially flat in 1985, are projected to rise nearly as much as overall prices in 1986. Reflecting these influences, the fixed-weighted price index for gross business product is projected to increase 4-1/4 percent next year, an acceleration from the 3-1/4 percent rise expected this year that is sharper than shown in the last Greenbook.

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



I-7  
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			
		8/14/85	9/25/85	8/14/85	9/25/85	8/14/85	9/25/85	8/14/85	9/25/85	8/14/85	9/25/85
<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		6.1	6.1	2.4	2.4	3.6	3.6	4.2	4.2	7.3	7.3
1986		6.2	6.3	2.6	2.7	3.7	3.6	4.1	4.2	7.1	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
1985	Q1 <1>	5.6	5.6	.3	.3	3.6	3.6	4.6	4.6	7.3	7.3
	Q2 <1>	4.6	4.5	1.7	1.9	3.5	3.7	3.3	3.8	7.3	7.3
	Q3	5.9	6.2	3.0	3.0	3.3	2.8	3.9	3.7	7.3	7.2
	Q4	6.4	5.8	3.2	3.0	3.5	2.8	3.9	3.5	7.2	7.2
1986	Q1	6.3	5.6	2.5	2.5	3.8	3.5	4.1	4.0	7.1	7.2
	Q2	6.3	7.1	2.5	2.7	3.9	4.3	4.2	4.7	7.1	7.1
	Q3	6.2	7.3	2.4	2.8	4.1	4.3	4.4	4.7	7.1	7.0
	Q4	6.9	7.6	2.6	2.9	4.3	4.5	4.5	4.8	7.1	7.0
<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 <1>	5.1	5.1	1.0	1.1	3.5	3.7	4.0	4.2	.1	.1
	Q4	6.1	6.0	3.1	3.0	3.4	2.8	3.9	3.6	-.1	-.1
1986	Q2	6.3	6.3	2.5	2.6	3.8	3.9	4.1	4.4	-.1	-.1
	Q4	6.5	7.4	2.5	2.9	4.2	4.4	4.5	4.8	.0	-.1
<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	5.6	5.5	2.0	2.0	3.5	3.2	3.9	3.9	.0	.0
1986	Q4	6.4	6.9	2.5	2.7	4.0	4.2	4.3	4.6	-.1	-.2

&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	10.2	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 (1977=100)	103.3	106.8	111.7	114.9	119.3	121.5	123.4	123.1
Capacity utilization: all manufacturing (percent)	70.2	72.5	75.8	77.4	79.8	80.8	81.6	81.0
Materials (percent)	71.4	73.6	77.0	79.3	82.0	82.6	83.0	81.4
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	-1.2	4.4	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	3.4	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	11.5	14.0	19.8	12.0	16.0	7.6	6.4	-.7

<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.)

	1985				Projected 1986			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Gross National Product	3810.6	3853.1	3911.2	3967.2	4021.5	4091.1	4163.6	4240.3
Gross domestic purchases	3885.2	3947.1	4005.9	4073.0	4138.2	4200.0	4267.4	4335.4
Final sales	3770.0	3835.2	3907.6	3933.6	3988.5	4057.5	4129.2	4205.5
Private	2978.1	3024.3	3070.2	3084.7	3130.6	3189.6	3247.4	3308.2
Domestic final purchases	3052.6	3118.3	3164.8	3190.5	3247.3	3298.5	3351.2	3403.3
Personal consumption expenditures	2446.5	2493.0	2536.0	2550.2	2596.5	2636.7	2677.0	2717.6
Goods	1212.1	1231.1	1246.5	1235.9	1255.4	1269.5	1283.4	1296.9
Services	1234.4	1261.9	1289.5	1314.3	1341.1	1367.2	1393.6	1420.7
Gross private domestic investment	646.8	643.2	632.4	673.8	683.8	695.4	708.6	720.5
Residential structures	155.2	158.0	160.5	167.1	170.3	174.4	179.5	183.4
Business fixed investment	450.9	467.3	468.3	473.2	480.5	487.4	494.7	502.3
Change in business inventories	40.7	17.9	3.6	33.5	33.1	33.6	34.4	34.8
Nonfarm	34.1	11.4	1.0	31.4	31.4	32.4	33.2	33.6
Net exports of goods and services <sup>1</sup>	-74.5	-94.0	-94.6	-105.8	-116.7	-108.9	-103.8	-95.1
Exports	360.7	347.7	346.6	358.0	363.0	375.2	387.5	402.8
Imports	435.2	441.6	441.3	463.8	479.7	484.1	491.3	497.9
Gov't. purchases of goods and services	791.9	810.9	837.4	848.9	857.9	867.9	881.8	897.3
Federal <sup>2</sup>	319.9	324.2	339.1	342.7	344.0	346.5	352.6	360.0
State and local	472.0	486.7	498.3	506.2	513.9	521.4	529.2	537.3
Gross national product in constant (1972) dollars	1663.5	1671.3	1683.6	1696.3	1706.8	1718.3	1730.3	1742.9
Personal income	3143.8	3174.7	3202.0	3264.2	3317.9	3371.9	3429.7	3490.6
Wage and salary disbursements	1882.7	1910.6	1933.4	1963.4	1993.1	2023.9	2055.3	2087.6
Disposable personal income	2654.8	2726.5	2718.5	2771.1	2826.7	2869.0	2915.0	2963.4
Saving rate (percent)	4.5	5.1	3.2	4.4	4.6	4.5	4.5	4.6
Corporate profits with I.V.A. and C.C. Adj.	292.3	298.5	319.4	311.2	301.5	308.0	313.3	319.7
Corporate profits before tax	222.3	221.0	240.6	232.0	222.8	228.3	232.1	237.0
Federal government surplus or deficit (-) (N.I.A. basis)	-165.1	-214.1	-192.9	-198.7	-204.8	-195.7	-190.3	-189.0
High employment surplus or deficit (-) <sup>3</sup>	-129.4	-178.3	-157.3	-163.4	-169.2	-160.1	-155.4	-155.0
State and local government surplus or deficit(-) (N.I.A. basis)	53.7	50.3	48.6	48.9	50.3	52.0	52.7	53.9
Excluding social insurance funds	6.3	4.2	1.6	1.1	1.7	2.6	2.5	2.7
Civilian labor force (millions)	115.2	115.2	115.4	116.0	116.6	117.1	117.6	118.1
Unemployment rate (percent)	7.3	7.3	7.2	7.2	7.2	7.1	7.0	7.0
Nonfarm payroll employment	96.6	97.3	98.0	98.6	99.1	99.7	100.3	100.8
Manufacturing	19.6	19.4	19.4	19.5	19.5	19.6	19.6	19.7
Industrial production (1977=100)	123.8	124.2	124.7	125.6	126.4	127.3	128.3	129.2
Capacity utilization: all manufacturing (percent)	80.5	80.3	80.2	80.1	80.1	80.0	80.1	80.1
Materials (percent)	81.5	80.4	79.9	79.9	79.8	79.8	79.7	79.7
Housing starts, private (million units, A.R.)	1.80	1.77	1.73	1.80	1.80	1.80	1.80	1.80
New auto sales (millions; A.R.)	10.87	10.92	12.10	9.90	10.70	10.70	10.70	10.60
Domestic models	8.46	8.27	9.20	6.90	7.70	7.70	7.60	7.50
Foreign models	2.42	2.65	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)

	1985				Projected			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<u>Constant (1972) Dollars</u>								
Gross national product	.3	1.9	3.0	3.0	2.5	2.7	2.8	2.9
Gross domestic purchases	3.9	3.2	2.9	2.7	2.4	1.8	2.1	2.0
Final sales	-.3	4.6	4.6	-.1	2.7	2.7	2.8	3.0
Private	-.4	4.8	3.2	-.5	3.3	3.2	2.8	2.8
Domestic final purchases	4.1	6.4	3.1	-.8	3.2	2.1	2.0	1.7
Personal consumption expenditures	5.2	4.8	4.3	-2.0	3.2	1.7	1.5	1.3
Goods	5.4	5.4	5.1	-5.8	3.9	1.5	1.1	.8
Services	5.0	4.2	3.4	2.6	2.4	2.0	1.9	1.8
Gross private domestic investment	3.1	-3.5	-9.8	24.7	2.0	3.4	4.0	3.1
Residential structures	5.3	6.4	3.9	13.0	3.7	6.1	8.3	4.9
Business fixed investment	-1.6	14.5	-2.6	1.6	2.8	2.8	2.8	2.8
Gov't. purchases of goods and services	.3	3.7	10.8	1.4	.2	.8	2.8	3.6
Federal	.7	-.4	20.0	.2	-2.6	-1.2	3.3	5.4
National defense	-.2	7.2	8.3	2.1	2.1	2.1	2.9	3.3
State and local	.0	6.7	4.4	2.2	2.2	2.1	2.3	2.3
Disposable personal income	-1.6	8.2	-3.7	3.5	4.0	1.5	1.8	1.8
<u>Current Dollars</u>								
Gross national product	5.6	4.5	6.2	5.8	5.6	7.1	7.3	7.6
Gross domestic purchases	7.6	6.5	6.1	6.9	6.6	6.1	6.6	6.5
Final sales	5.2	7.1	7.8	2.7	5.7	7.1	7.3	7.6
Personal consumption expenditures	8.6	7.8	7.1	2.3	7.5	6.3	6.3	6.2
Goods	6.6	6.4	5.1	-3.4	6.5	4.6	4.4	4.3
Services	10.6	9.2	9.0	7.9	8.4	8.0	8.0	8.0
Gross private domestic investment	5.8	-2.2	-6.5	28.9	6.1	7.0	7.8	6.8
Residential structures	4.6	7.4	6.5	17.5	7.9	10.0	12.2	9.0
Business fixed investment	3.0	15.3	.9	4.3	6.3	5.9	6.1	6.2
Gov't. purchases of goods and services	5.9	10.0	13.7	5.6	4.3	4.8	6.6	7.2
Federal	5.4	5.6	19.7	4.3	1.5	2.9	7.2	8.7
National defense	4.0	12.8	9.8	7.3	6.5	5.6	7.3	7.2
State and local	6.3	13.0	9.9	6.5	6.2	6.0	6.1	6.3
Disposable personal income	1.6	11.2	-1.2	8.0	8.3	6.1	6.6	6.8
Personal income	6.3	4.0	3.5	8.0	6.7	6.7	7.0	7.3
Wage and salary disbursements	7.8	6.1	4.9	6.4	6.2	6.3	6.4	6.4
Corporate profits with I.V.A. and C.C.Adj.	1.0	8.8	31.4	-9.9	-11.9	8.9	7.1	8.4
Corporate profits before tax	-10.7	-2.3	40.5	-13.5	-14.9	10.2	6.8	8.7
Nonfarm payroll employment	3.3	2.9	2.7	2.3	2.4	2.3	2.3	2.1
Manufacturing	.0	-2.7	.0	1.2	.8	.8	1.0	1.0
Nonfarm business sector								
Output per hour	-3.1	1.0	1.0	.7	1.2	.9	1.2	1.2
Compensation per hour	5.0	3.3	3.0	3.9	4.8	4.3	4.5	4.7
Unit labor costs	8.4	2.3	2.0	3.2	3.6	3.4	3.3	3.5
GNP implicit deflator <sup>1</sup>	5.4	2.6	3.1	2.7	3.0	4.3	4.3	4.5
Gross domestic business product								
fixed-weighted price index <sup>2</sup>								
Excluding food and energy	3.6	3.7	2.8	2.8	3.5	4.3	4.3	4.5
Excluding food and energy	4.6	3.8	3.7	3.5	4.0	4.7	4.7	4.8
Consumer price index (all urban)	3.2	4.2	2.3	2.9	4.1	4.5	4.6	4.8
Industrial production	2.1	1.4	1.7	2.9	2.6	2.8	3.0	3.1

1. Excluding Federal pay increase, the rate of change in 1985-Q1 is 5.0 percent and in 1986-Q1 is 2.9 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	3885.5	4129.1
Gross domestic purchases	2404.5	2607.7	2929.8	3050.2	3313.1	3727.0	3977.7	4235.2
Final sales	2403.5	2641.4	2931.7	3095.4	3318.3	3604.6	3861.6	4095.2
Private	1929.2	2103.7	2335.2	2444.9	2632.7	2857.2	3039.3	3219.0
Domestic final purchases	1915.9	2079.7	2307.2	2425.9	2641.0	2921.4	3131.6	3325.1
Personal consumption expenditures	1507.1	1668.0	1849.1	1984.9	2155.9	2341.8	2506.4	2656.9
Goods	813.4	883.5	966.1	1002.6	1081.5	1175.7	1231.4	1276.3
Services	693.7	784.5	883.0	982.2	1074.4	1166.1	1275.0	1380.6
Gross private domestic investment	423.0	401.9	484.2	414.9	471.6	637.8	649.1	702.1
Residential construction	118.5	102.9	104.3	91.3	132.2	153.9	160.2	176.9
Business fixed investment	290.2	308.8	353.9	349.6	352.9	425.7	464.9	491.2
Change in business inventories	14.3	-9.8	26.0	-26.1	-13.5	58.2	23.9	34.0
Nonfarm	8.6	-4.5	18.2	-23.9	-3.1	49.6	19.5	32.6
Net exports of goods and services <sup>1</sup>	13.2	23.9	28.0	19.0	-8.3	-64.2	-92.2	-106.1
Exports	281.3	338.8	369.9	348.4	336.2	364.3	353.3	382.1
Imports	268.1	314.8	341.9	329.4	344.4	428.5	445.5	488.2
Gov't. purchases of goods and services	474.4	537.8	596.5	650.5	685.5	747.4	822.3	876.2
Federal <sup>2</sup>	168.3	197.0	228.9	258.9	269.7	295.4	331.5	350.8
State and local	306.0	340.8	367.6	391.5	415.8	452.0	490.8	525.4
Gross national product in constant (1972) dollars	1479.4	1475.0	1512.1	1480.0	1534.7	1639.3	1678.7	1724.6
Personal income	1951.1	2165.3	2429.4	2584.6	2744.2	3012.1	3196.2	3402.5
Wage and salary disbursements	1237.6	1356.7	1493.1	1568.7	1659.2	1804.0	1922.5	2040.0
Disposable personal income	1650.2	1828.9	2041.7	2180.5	2340.1	2576.8	2717.7	2893.5
Saving rate (percent)	5.9	6.0	6.7	6.2	5.0	6.1	4.3	4.6
Corporate profits with I.V.A. and C.C.Adj.	194.8	175.4	189.9	159.1	225.2	285.7	305.3	310.6
Corporate profits before tax	252.7	234.6	221.2	165.5	203.2	235.7	228.9	230.0
Federal government surplus or deficit (-) (N.I.A. basis)	-16.1	-61.2	-64.3	-148.2	-178.6	-175.8	-192.7	-194.9
High employment surplus or deficit (-)	-20.8	-36.4	-31.3	-61.6	-92.7	-139.6	-157.1	-160.0
State and local government surplus or deficit (-) (N.I.A. basis)	30.4	30.6	37.6	32.9	44.1	52.9	50.4	52.2
Excluding social insurance funds	6.6	3.5	7.8	-.8	6.6	10.4	3.8	2.4
Civilian labor force (millions)	105.0	106.9	108.7	110.2	111.6	113.5	115.4	117.3
Unemployment rate (percent)	5.8	7.1	7.6	9.7	9.6	7.5	7.3	7.1
Nonfarm payroll employment (millions)	89.8	90.4	91.2	89.6	90.2	94.5	97.6	100.0
Manufacturing	21.0	20.3	20.2	18.8	18.4	19.4	19.5	19.6
Industrial production (1977=100)	110.7	108.6	111.0	103.1	109.2	121.8	124.6	127.8
Capacity utilization: all manufacturing (percent)	84.6	79.3	78.3	70.3	74.0	80.8	80.3	80.1
Materials (percent)	87.1	81.1	81.1	71.7	75.3	82.3	80.4	79.8
Housing starts, private (million units, A.R.)	1.72	1.30	1.10	1.06	1.70	1.77	1.77	1.80
New auto sales (millions, A.R.)	10.68	9.04	8.56	8.00	9.18	10.43	10.94	10.68
Domestic models	8.36	6.62	6.24	5.77	6.77	7.97	8.20	7.63
Foreign models	2.32	2.42	2.32	2.23	2.41	2.46	2.74	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.

	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	2.4	2.7
Gross domestic purchases	2.0	-1.2	3.1	-1.2	5.0	8.7	3.4	2.4
Final sales	3.5	.5	1.5	-.7	3.2	5.0	3.3	2.5
Private	4.0	.1	1.6	-1.3	4.1	5.3	2.9	2.5
Domestic final purchases	2.9	-1.0	2.2	-.2	5.6	7.6	4.2	2.2
Personal consumption expenditures	2.7	.5	2.0	1.4	4.8	5.3	3.8	1.8
Goods	1.9	-1.4	1.7	.4	6.0	7.1	3.7	1.3
Services	3.7	2.7	2.3	2.5	3.4	3.2	4.0	2.5
Gross private domestic investment	-.2	-11.8	10.7	-15.8	13.7	31.2	.2	4.5
Residential structures	-5.3	-20.3	-5.5	-14.8	41.7	12.2	2.1	6.7
Business fixed investment	7.3	-2.4	5.6	-4.7	2.5	19.8	6.4	2.5
Gov't. purchases of goods and services	1.3	2.2	1.0	2.0	-.3	3.5	5.0	2.5
Federal	1.8	4.2	3.6	6.1	-.6	5.4	8.4	2.2
National defense	2.6	3.9	5.1	7.6	7.1	5.8	6.0	3.3
State and local	1.1	1.0	-.6	-.6	.0	2.2	2.7	2.7
Disposable personal income	2.7	.6	2.7	.9	3.5	6.7	2.3	2.3
<u>Current Dollars</u>								
Gross national product	11.7	8.8	12.4	3.8	7.7	10.8	6.1	6.3
Gross domestic purchases	11.1	8.4	12.3	4.1	8.6	12.5	6.7	6.5
Final sales	12.4	9.9	11.0	5.6	7.2	8.6	7.1	6.0
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	4.7	3.6
Services	12.2	13.1	12.6	11.2	9.4	8.5	9.3	8.3
Gross private domestic investment	9.4	-5.0	20.5	-14.3	13.7	35.2	1.8	8.2
Residential structures	6.6	-13.2	1.4	-12.4	44.7	16.4	4.1	10.4
Business fixed investment	16.6	6.4	14.6	-1.2	.9	20.6	9.2	5.7
Gov't. purchases of goods and services	9.8	13.4	10.9	9.0	5.4	9.0	10.0	6.6
Federal	9.6	17.1	16.2	13.1	4.2	9.5	12.2	5.8
National defense	11.3	17.3	17.2	16.8	11.7	10.5	9.8	7.4
State and local	9.9	11.4	7.9	6.5	6.2	8.7	8.6	7.1
Disposable personal income	12.0	10.8	11.6	6.8	7.3	10.1	5.5	6.5
Personal income	12.6	11.0	12.2	6.4	6.2	9.8	6.1	6.5
Wage and salary disbursements	11.9	9.6	10.1	5.1	5.8	8.7	6.6	6.1
Corporate profits with I.V.A. and C.C.Adj.	1.2	-9.9	8.3	-16.2	41.5	26.9	6.9	1.7
Corporate profits before tax	10.3	-7.1	-5.7	-25.2	22.8	16.0	-2.9	.5
Nonfarm payroll employment	3.6	.6	.8	-1.7	.7	4.7	3.4	2.4
Manufacturing	2.6	-3.6	-.6	-6.9	-1.8	5.3	.3	.6
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	3.9	4.2
Unit labor costs	10.7	11.1	8.0	7.7	1.4	1.4	3.7	3.1
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 <sup>1</sup>	9.9	9.9	9.7	5.9	3.7	4.0	3.6	3.6
Excluding food and energy	8.6	8.5	9.4	7.0	4.6	4.3	4.2	4.2
Consumer price index (all urban)	11.3	13.5	10.3	6.1	3.2	4.3	3.4	3.9
Industrial production	3.9	-1.9	2.2	-7.1	5.9	11.6	2.3	2.6

1. Uses expenditures in 1972 as weights.

FEDERAL SECTOR ACCOUNTS  
(Billions of dollars)

	Fiscal Year 1984*	FY1985 <sup>e</sup> 2/3/		FY1986 <sup>e</sup> 2/3/		CY1985 <sup>e</sup>		FRB staff estimates							
		Admin. 1/	FRB Staff	Admin. 1/	FRB Staff	CY 1984*	FRB Staff	Calendar quarters; not seasonally adjusted							
								1984 IV*	I*	II*	III	IV	I	II	III
Unified budget receipts	646	736	736	780	775	683	744	166	174	207	189	175	181	224	195
Unified budget outlays	842	937	936	955	967	868	942	239	230	234	234	244	241	241	242
Surplus/deficit(-), unified budget	-175	-201	-200	-175	-192	-184	-197	-72	-56	-27	-45	-69	-60	-16	-47
Surplus/deficit(-), off-budget agencies <sup>4</sup>	-10	-10	-11	-2	-5	-10	-13	1	-3	-5	-4	-1	-1	-2	-1
Combined deficit to be financed	-185	-211	-211	-178	-197	-195	-210	-71	-59	-32	-49	-70	-61	-18	-48
Means of financing combined deficit:															
Net borrowing from public	171	203	197	180	199	199	202	64	42	45	46	69	52	31	46
Decrease in cash operating balance	7	10	13	0	-8	-6	2	13	4	-10	7	2	0	-10	0
Other <sup>5</sup>	8	-2	1	-2	6	2	5	-6	13	-3	-4	-1	8	-3	2
Cash operating balance, end of period	30	20	18	20	25	18	15	18	14	24	18	15	15	25	25
Memo: Sponsored agency borrowing <sup>6</sup>	30	n.a.	21	n.a.	19	30	21	4	4	9	4	4	5	5	5
<b>NIA Budget</b>								Seasonally adjusted annual rates							
Receipts	688	756	749	809	795	705	764	722	771	734	770	780	784	801	817
Expenditures	860	946	942	978	993	881	956	920	937	948	963	979	989	996	1007
Purchases	283	326	325	343	347	295	331	316	320	324	339	343	344	347	353
Defense	215	238	238	255	257	222	243	232	234	241	247	251	255	259	263
Nondefense	68	88	86	88	89	74	88	84	86	83	92	92	89	88	89
All other expenditures	577	620	617	635	646	586	625	604	617	624	624	636	645	650	655
Surplus/deficit(-)	-172	-188	-193	-169	-198	-176	-193	-198	-165	-214	-193	-199	-205	-196	-190
High employment surplus/deficit(-) evaluated at 6 percent unemployment	-126	n.a.	-159	n.a.	-162	-140	-157	-169	-129	-178	-157	-163	-169	-160	-155

\*--actual

e--estimated

n.a.--not available

1. Mid-session Review, August 30, 1985.
2. The Congressional Budget Resolution, passed August 1, 1985, shows revenues of \$737 billion and \$796 billion, combined unified and off-budget outlays of \$946 billion and \$968 billion, and total deficits of \$210 billion and \$172 billion in fiscal years 1985 and 1986, respectively.
3. The latest CBO budget estimates that incorporates the Budget Resolution policy assumptions and the August 1985 CBO economic forecast show revenues of \$737 billion and \$790 billion, combined unified and off-budget outlays of \$946 billion and \$965 billion, and total deficits of \$210 billion and \$175 billion in fiscal years 1985 and 1986, respectively.

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

4. Includes Federal Financing Bank, Postal Service Fund, Rural Electrification and Telephone Revolving Fund, Rural Telephone Bank and Strategic Petroleum Reserve.
5. Checks issued less checks paid, accrued items and other transactions.
6. 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. Interest rates have recorded generally small mixed changes on net since the August FOMC meeting. The federal funds market has been a touch firmer, with trading mostly in the 7-3/4 to 8 percent range, but fluctuations in rates over the intermeeting period have been influenced more by incoming economic news. Most recently, short-term rates have eased somewhat with the announcement by financial officials of the five major industrial countries of policies aimed at lowering the value of the dollar.

Supply conditions and credit quality concerns meanwhile have had some notable effects on the structure of market rates. Yields on short-dated Treasury bills, for example, have declined about 1/4 percentage point, owing in large part to constraints imposed on bill issuance by the federal debt ceiling. Municipal bond rates have risen relative to taxable rates under the pressure of continued heavy supply. The perceived riskiness of debt of some federal agencies has been increased in recent weeks by discussion of the Farm Credit System's problems and of means of assisting the FSLIC; the deterioration in yield spreads for Farm Credit securities has been especially marked. In the mortgage sector, the problems of the EPIC partnerships led to some weakening of the market for pass-through securities that rely on private insurance. Mortgage-backed securities of federally sponsored agencies, however, experienced only transitory rate pressures, and available evidence suggests that the home mortgage market overall has not been significantly affected by the EPIC situation.

The monetary aggregates surged again in August, after some deceleration in July. M1 increased in August at more than a 20 percent

pace and growth continued rapid in early September, leaving M1 appreciably above its 3 to 8 percent target range. The lower opportunity cost of holding money balances no doubt has continued to boost M1 growth, but the rise in this aggregate greatly exceeds what would be expected based on historical relationships linking M1 to income and interest rates. Growth in M2 jumped to 11-1/4 percent in August, reflecting the strength in M1. Among other M2 components, inflows to MMDAS and savings deposits continued strong while small time deposits contracted further as depositors shifted to more liquid assets. M3, expanding at an 8-1/2 percent annual rate, remained well within its annual growth range. In addition to the strength of its M2 component, large time deposits in M3 increased in August after declining sharply in June and July.

Borrowing by domestic nonfinancial sectors seems to have slowed a little in the third quarter, owing primarily to a temporary easing in federal government demands. By drawing down cash balances built up in July, the Treasury limited its net borrowing from the public to \$16 billion in August. As noted above, federal borrowing has been constrained in September by the debt ceiling, which forced the Treasury not only to pay down bills but also to postpone its normal end-of-quarter financing.

In the household sector, the growth in consumer installment credit in June and July was appreciably below the 20 percent pace earlier in the year, owing to a sharp slowdown in revolving credit. Consumer lending at banks weakened further in August, reflecting in part stiffer competition from auto finance company sales programs. However, given the reported slowing in retail sales of goods other than autos, installment credit expansion may have continued at a reduced pace in August. Growth in

mortgage indebtedness has been well maintained, with the sale of mortgage-backed securities to diversified investors accounting for a large share of the credit flow.

Nonfinancial businesses in August and September concentrated their still heavy borrowing in long-term markets, as yields on corporate bonds--though continuing to back up a bit--remained close to the 6-year lows reached at midyear. Gross volume in August and September continued near the strong second-quarter rate with an increased portion of new issues carrying maturities of 20 years or more. Short-term borrowing, in contrast, has slowed appreciably except for a spurt in commercial paper issuance in early August. A great part of recent long-term borrowing by business firms appears to be for purposes of balance sheet restructuring and financing mergers and acquisitions. Despite increased offerings of new equity, stock retirements continued to exceed new stock issuance by a large margin.

Municipal market activity has been particularly robust in the third quarter, with tax-exempt volume buoyed by a heavy slate of refunding issues. Private-purpose revenue bonds have constituted the major portion of tax-exempt volume. Sales of industrial development bonds have accelerated, and those of housing revenue bonds remain strong.

Outlook. The staff anticipates that interest rates generally will fluctuate around present levels over the remainder of the year, with market participants closely assessing incoming data for signs of strength or weakness in economic activity. Total credit expansion is expected to remain brisk and even increase in the fourth quarter, bolstered by heavy federal borrowing and increased issuance in tax-exempt markets. Looking further ahead, however, the credit market pressures could ease a bit, producing a decline in interest rates. Government demands on the credit

market should diminish somewhat after the fourth quarter, and the household sector likely will move to a more sustainable saving posture.

The Treasury is expected to run a combined deficit of \$70 billion in the fourth quarter, which probably will be financed almost entirely by borrowing from the public. Another bulge in debt issuance by state and local governments--both for public and private purposes--is expected in the final months of 1985. As in several recent years, legislative proposals to limit or eliminate certain types of tax-exempt financing have created incentives to rush issues to market prior to year-end. Even in the absence of legislative action on the tax reform proposals, the volume of municipal offerings is likely to fall off appreciably after year-end, as potential issuers employ the proceeds of late 1985 offerings and await clarification of the nature and timing of possible restrictions.

The volume of merger activity and stock retirements will continue to inflate corporate borrowing in the fourth quarter. In addition, the gap between capital outlays and internal funds, which appears to have turned negative in the third quarter, is expected to become moderately positive again in coming months as inventory accumulation picks up and cash flow slows. Borrowers probably will continue to place emphasis on long-term financing, but bank borrowing may strengthen somewhat from the recent weak pace.

The termination of interest rate concession programs on autos and some slowing in other durable expenditure categories likely will damp further the pace of consumer credit growth in coming months. However, home mortgage borrowing is expected to pick up as activity in the single-family housing market responds to earlier interest rate declines. Mortgage

pools are apt to remain an important vehicle for mortgage flows, as thrift institutions restrain their asset growth to avoid tighter regulatory net worth restrictions.

Recent developments. After increasing by 5 percent from the last FOMC meeting through mid-September, the weighted average foreign exchange value of the dollar began to decline, with movements in the dollar during this period continuing to be strongly influenced by shifting views about the strength of U.S. economic activity. Following the announcement on September 22 by the G-5 finance ministers and central bank governors that exchange rates should better reflect fundamental economic conditions, the dollar fell sharply, resulting in an overall decrease of about 2 percent since the August FOMC meeting. In their announcement, the G-5 financial officials expressed their belief that in view of present and prospective fundamental economic conditions and policy actions, some further orderly appreciation of foreign currencies against the dollar was desirable, and that they stood ready to encourage such exchange rate movements when it would be helpful to do so.

. The New York Desk sold a total of \$276 million against yen and marks on September 23 and 24.

In July, foreign official purchases of U.S. Treasury securities fell off from their second-quarter pace, but foreign private net purchases -- primarily by Japanese residents -- rose sharply. Similarly, net foreign purchases of U.S. corporate securities were up significantly from their second-quarter rate. Foreign net purchases of

U.S. corporate bonds exceeded \$4 billion in July, bringing the total for the first seven months of the year to nearly \$22 billion. Available banking data suggest a sizable net inflow into U.S. banking offices from abroad during the third quarter.

U.S. chartered banks' claims on foreigners resumed their decline in the second quarter of 1985, decreasing about \$9 billion (2 percent). As was generally the case last year, the drop in total claims was concentrated on the major industrial countries and offshore banking centers. Since the beginning of 1984, U.S. bank claims on the non-OPEC developing countries have been essentially unchanged; there was a small decline in such claims in the first half of this year.

The U.S. current account recorded a deficit of \$127 billion, s.a.a.r., in the second quarter of 1985, slightly larger than in the first quarter. A larger merchandise trade deficit -- exports dropped by 4-1/2 percent and imports increased slightly -- was partly offset by increased income receipts from investment abroad. Most of the increase in income receipts was from U.S. direct investment abroad and was accounted for by a shift from large capital losses to small capital gains, primarily as a consequence of the decline in the exchange value of the dollar.

In July, the U.S. merchandise trade deficit (s.a.a.r.) was smaller than that registered in June and for the second quarter, resulting from a sharp drop in imports that was offset somewhat by a moderate decline in exports. The decline in imports was widespread across major commodity groups, including oil. Much of the July drop in exports was in agricultural commodities, particularly wheat. While

nonagricultural exports decreased from June levels, they were about the same as the second-quarter rate, as a decline in machinery exports was offset by increases in exports of aircraft and of automotive products to Canada.

The pace of economic activity in the major foreign industrial countries has rebounded on balance since the first quarter, but growth remains uneven and influenced by special factors. Inflation abroad has remained low. The current accounts in Japan and Germany have strengthened so far this year.

Among the major developing countries, Mexico has fallen out of compliance with its IMF program and will have to forgo the last three drawings under its present IMF arrangement. Argentina has completed the process leading to the initial disbursement from its \$4.2 billion bank credit and is expected soon to reduce sharply its arrears, but difficulties loom ahead regarding compliance with the end-September IMF performance tests. The prospects that Brazil will succeed in negotiating an IMF program in the near term were dealt a setback when the finance minister and the central bank president resigned. The Philippines did not meet the qualitative targets for the second IMF program review, and the September IMF drawing is being delayed.

Outlook. The staff is now projecting a more substantial depreciation of the dollar than previously, in the near term, followed by a continued moderate rate of decline. The projected level of the dollar at the end of the forecast period is about 5 percent less than in the last Greenbook. The staff projection for economic activity in the



foreign industrial countries is essentially the same as in the last Greenbook, but somewhat slower growth is now expected in the developing countries. Based on recent data for merchandise trade and other transactions (which suggest some offsetting adjustments in the components) and the recent decline in the dollar, the staff has reduced somewhat its projection of the current account deficit for 1985, to \$130 billion, and for 1986, to about \$140 billion.

SEPTEMBER 24, 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-	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP EXPORTS AND IMPORTS 1/													
CURRENT \$, NET	-64.2	-92.3	-106.2	-90.6	-56.0	-74.5	-94.0	-94.7	-105.9	-116.8	-109.0	-103.9	-95.2
EXPORTS OF G+S	364.3	353.3	382.1	368.6	367.2	360.7	347.7	346.6	358.0	363.0	375.2	387.5	402.8
IMPORTS OF G+S	428.5	445.5	488.2	459.3	423.2	435.2	441.6	441.3	463.8	479.7	484.1	491.3	497.9
CONSTANT 72 \$, NET	-15.0	-32.1	-27.5	-27.0	-13.4	-28.4	-33.8	-33.8	-32.6	-32.5	-28.9	-26.2	-22.4
EXPORTS OF G+S	146.0	140.1	146.2	147.4	147.1	143.7	137.9	137.3	141.6	141.9	144.5	147.3	151.1
IMPORTS OF G+S	161.1	172.4	173.8	174.4	160.5	172.1	171.8	171.2	174.3	174.4	173.5	173.6	173.6
2. U.S. MERCHANDISE TRADE BALANCE 2/	-108.3	-133.5	-148.3	-130.0	-98.2	-118.1	-132.0	-134.5	-149.5	-156.3	-150.8	-146.2	-140.0
EXPORTS	220.3	214.7	232.5	222.1	225.4	222.8	213.0	210.1	213.1	219.5	227.2	236.2	246.9
AGRICULTURAL	38.4	28.9	29.8	36.9	38.3	33.5	28.3	25.6	28.0	29.2	29.9	30.0	30.2
NONAGRICULTURAL	181.9	185.9	202.6	185.3	187.2	189.4	184.6	184.5	185.0	190.3	197.3	206.2	216.7
IMPORTS	328.6	348.3	380.8	352.1	323.6	341.0	345.0	344.6	362.6	375.8	378.0	382.4	386.9
PETROLEUM AND PRODUCTS	57.5	48.4	46.3	57.8	56.8	45.2	52.8	48.1	47.3	47.1	45.5	46.5	46.1
NONPETROLEUM	271.1	299.9	334.5	294.4	266.9	295.7	292.2	296.5	315.3	328.7	332.4	335.9	340.8
3. U.S. CURRENT ACCOUNT BALANCE	-101.5	-129.9	-141.7	-130.0	-101.9	-121.3	-127.3	-129.0	-142.2	-151.1	-143.6	-138.8	-133.4
OF WHICH: NET INVESTMENT INCOME	19.1	19.9	19.2	13.0	16.0	10.1	22.3	21.8	25.4	20.5	19.8	18.8	17.7
4. FOREIGN OUTLOOK 3/													
REAL GNP--TEN INDUSTRIAL 4/	3.1	2.7	2.8	5.0	3.5	0.5	4.0	3.1	2.7	2.7	2.6	2.6	2.6
REAL GNP--NONOPEC LDC 5/	4.1	3.7	3.8	4.3	3.8	3.4	3.4	3.5	3.6	3.7	4.0	4.3	4.6
CONSUMER PRICES--TEN IND. 4/	4.9	4.5	3.9	2.6	4.8	5.4	5.7	2.7	3.6	4.3	4.3	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