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September 17, 1986

SUMMARY AND OUTLOOK

Prepared for the Federal Open Market Committee

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

DOMESTIC NONFINANCIAL DEVELOPMENTS

Recent developments. The pace of economic activity appears to have improved somewhat in recent months. At the same time, inflation rates are still quite moderate, despite a temporary spurt in food prices and a firming in world oil prices.

The August labor market reports show that gains in employment last month were more balanced across industries than had been the case earlier this year. Nonfarm payroll employment rose 200,000--240,000 after adjusting for strike activity. Although service-producing establishments accounted for two-thirds of the increase, construction employment also was up substantially, and manufacturing jobs rose for the first time since January. The civilian unemployment rate edged down again in August to 6.8 percent, nearly 1/2 percentage point below the second-quarter average.

Some firming in industrial activity also is apparent in revised data for the index of industrial production, which now shows that, rather than declining, output was flat in June and rose 0.3 percent in July. In August, industrial production is estimated to have edged higher by 0.1 percent. In particular, output of business as well as defense and space equipment rose considerably faster in July than previously reported, and further gains occurred in August. Production of consumer goods, other than motor vehicles, also posted solid gains over the two-month period.

Domestic auto production, however, dropped in August as General Motors lengthened their plant closings for model changeover. Excessive dealer inventories prompted GM in late August to launch a new round of financing incentives and rebates designed to clean up stocks prior to the introduction of 1987 models. Consumer response to these incentives,

which were matched by other domestic car makers, was spectacular: sales of domestic cars surged at a 17 million unit annual rate in early September. Sales of imported cars remained robust in August as well, averaging 3.3 million units (annual rate) for a second month.

Apart from autos, consumer spending looks to be remaining quite buoyant in the third quarter. Nominal retail sales of goods other than autos, gasoline, and building materials rose 1/4 percent further in August after increases of about 1/2 percent in each of the preceding two months. General merchandisers, in particular, reported another sizable gain in sales in August. Underlying the strength in consumer spending this year has been the pickup in real income growth and the lagged effects of earlier increases in household financial wealth.

Although consumers continue to report favorable attitudes toward homebuying, the backup in mortgage rates over the summer apparently cut into home sales. New home sales in July dropped to a level 16 percent below the very strong second-quarter average while existing home sales remained at about the advanced second-quarter pace. Through August, the level of residential construction was relatively well-maintained, as starts totaled 1.8 million units (annual rate). Single-family starts in August, at 1.2 million units, remained close to their vigorous first-half average while multifamily starts held fairly steady at a level significantly below the pace earlier in the year.

In the business sector, spending on structures remained sluggish through July. Although the contraction in oil and gas-well drilling shows some signs of ending, the downtrend in commercial and industrial

building is continuing, as the adjustment to high vacancy rates and expected tax reform occurs. The value of nonresidential construction put-in-place (which excludes drilling) fell in July for the fifth time in six months. Business outlays for equipment, however, appear to have improved a bit in recent months, as shipments of nondefense capital goods in July reached a level 1 percent above the second-quarter average. Moreover, new orders were up in both June and July, offsetting much of the drop during the preceding three months; computer manufacturers, notably, have experienced a rebound in bookings.

Developments in agricultural and energy markets have dominated recent news on inflation. Food prices moved up sharply over the summer owing to tighter pork supplies and weather-related disruptions in the poultry industry. The CPI for food rose 0.9 percent in July, and producer prices of food at both the finished and farm levels increased sharply during July and August. Since mid-August, however, upward pressures on meat prices appear to have eased.

The effect of rapidly rising food prices on recent inflation measures has been offset largely by weakness in energy prices. Retail prices of petroleum-based products were still falling in July. The August PPI, which was priced at mid-month, reported a double-digit jump in the wholesale price of fuel oil, but another small decline for gasoline. Apart from food and energy, price increases for most other consumer and business items remain similar to these earlier in the year. The CPI, excluding food and energy, rose 0.4 percent in July. The August PPIs for finished consumer goods other than food and energy and for capital equipment each rose 0.1

percent. Prices of intermediate materials were, on balance, down slightly.

Outlook. The staff now expects that real GNP will grow at around a 3 percent annual rate in the current quarter. In the auto sector, the step-up in purchases now under way is being met by a drawdown in stocks, and, on balance, this sector likely will be a slight drag on real GNP in the third quarter. However, continued gains in other consumer outlays, rising defense purchases, further increases in spending on homebuilding, and a strengthening in export growth are projected to combine to provide a boost to domestic production. Non-oil imports are projected to be little changed after surging in the second quarter. Inflation, as measured by the GNP fixed-weighted price index, is expected to average 2-3/4 percent--somewhat higher than last quarter--owing to the uptick in food prices and the considerably smaller declines in energy prices.

Over the remaining five quarters of the projection, the staff's outlook for real activity and inflation is essentially unchanged from the last Greenbook, as are the underlying policy assumptions. Growth rates of M2 and M3 this year are expected to be near the upper ends of their ranges and next year to be well within the tentative ranges. Interest rates are not anticipated to change substantially from current levels. For fiscal policy, the staff continues to expect a shift toward restraint next year after the deficit reaches a record \$224 billion in fiscal 1986. We assume that the Congress will meet, on paper, the requirements to avoid an automatic sequester of funds. But given our economic forecast and our assessment of the likely spending out of authorized programs, we expect the level of the deficit to turn out to be around \$175 billion in fiscal 1987.

Growth of real GNP is expected to average a bit under 4 percent in the final quarter of this year and 3 percent in 1987. In part, the slightly stronger growth anticipated for the end of 1986 reflects the projected increase in auto production between the third and fourth quarters as well as an assumption that the effect of pending tax law changes will result in some shifting of 1987 spending into 1986. Over the projection horizon, however, the key element supporting domestic production is the projected improvement in net exports. With the dollar continuing to decline at a moderate rate over the period, demand for foreign goods is expected to be limited by rising import prices, and U.S. goods are expected to become more competitive in export markets. The effect is to add more than a percentage point (annual rate) to GNP growth throughout the last five quarters of the projection.

Domestic spending is projected to decelerate over the remainder of the projection. Consumer spending is expected to expand considerably less rapidly than in recent quarters, as income growth slows and the effect of the late-1985 and early-1986 runup in household net worth fades. In the business sector, although demand for equipment is anticipated to firm a bit next year, the downswing under way in commercial construction is likely to hold overall capital spending unchanged. In contrast to 1985 and 1986, residential construction is not expected to contribute to GNP next year, as the decline in multifamily starts largely offsets a continued high level of new single-family construction. The decline in both the commercial and the multifamily areas reflects a response to high vacancy rates and assumed tax law changes.

The staff's outlook for the path of inflation continues to depend importantly on the firming in world oil prices and the anticipated acceleration in prices of non-oil imports. Owing to the rebound in crude oil prices, consumer energy prices are projected to rise at a 3 percent rate in 1987 after an expected decline of 12-1/2 percent this year. And, prices of non-oil imports, which began to move up at the end of last year, are anticipated to show double-digit rates of increase later this year and throughout 1987. Other inflation trends are projected to be more moderate: food price increases are expected to be relatively small, and unit labor costs in the nonfarm business sector are anticipated to rise at around a 2-3/4 percent rate in 1987. On balance, the GNP fixed-weighted price index is projected to rise 3-1/4 percent over the four quarters of 1987--up from a 2-1/2 percent rate this year, but still less than the 3-3/4 percent pace that prevailed from 1983 to 1985.

Details of the staff projection are shown in the accompanying tables.

September 17, 1986

CONFIDENTIAL - FR
CLASS II FOMC

STAFF GNP PROJECTIONS

Percent changes, annual rate

		Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
		8/13/86	9/17/86	8/13/86	9/17/86	8/13/86	9/17/86	8/13/86	9/17/86	8/13/86	9/17/86
Annual changes:											
1984	<1>	10.5	10.5	6.4	6.4	4.0	4.0	3.8	3.8	7.5	7.5
1985	<1>	6.2	6.2	2.7	2.7	3.7	3.7	3.3	3.3	7.2	7.2
1986		5.4	5.4	2.7	2.7	2.8	2.8	2.7	2.6	7.0	7.0
1987		5.7	5.6	3.1	3.0	2.9	2.9	2.6	2.5	6.7	6.6
Quarterly changes:											
1985	Q1 <1>	6.8	6.8	3.1	3.1	4.2	4.2	3.7	3.7	7.3	7.3
	Q2 <1>	5.8	5.8	2.3	2.3	3.6	3.6	3.3	3.3	7.3	7.3
	Q3 <1>	6.8	6.8	4.1	4.1	2.8	2.8	2.5	2.5	7.2	7.2
	Q4 <1>	5.8	5.8	2.1	2.1	4.0	4.0	3.6	3.6	7.0	7.0
1986	Q1 <1>	6.2	6.2	3.8	3.8	2.5	2.5	2.5	2.5	7.1	7.1
	Q2 <1>	3.2	3.0	1.1	.6	1.8	1.9	2.1	2.5	7.2	7.2
	Q3	5.0	5.2	2.5	3.0	2.5	2.7	2.5	2.0	7.0	6.9
	Q4	5.7	5.4	3.6	3.8	2.3	2.4	2.0	1.5	6.9	6.8
1987	Q1	6.0	5.8	3.3	2.9	3.2	3.2	2.6	2.8	6.8	6.7
	Q2	6.1	6.0	3.2	3.0	3.2	3.2	2.8	2.9	6.7	6.6
	Q3	6.1	6.0	3.2	3.0	3.2	3.2	2.9	2.8	6.7	6.6
	Q4	6.4	6.3	3.2	3.0	3.3	3.3	3.2	3.2	6.6	6.6
Two-quarter changes: <2>											
1985	Q2 <1>	6.3	6.3	2.7	2.7	3.9	3.9	3.5	3.5	.1	.1
	Q4 <1>	6.3	6.3	3.1	3.1	3.2	3.2	3.1	3.1	-.3	-.3
1986	Q2 <1>	4.7	4.6	2.4	2.2	2.3	2.3	2.3	2.5	.2	.2
	Q4	5.4	5.3	3.0	3.4	2.4	2.5	2.2	1.7	-.3	-.4
1987	Q2	6.0	5.9	3.2	3.0	3.2	3.2	2.7	2.9	-.2	-.2
	Q4	6.3	6.1	3.2	3.0	3.3	3.3	3.0	3.0	-.1	.0
Four-quarter changes: <3>											
1984	Q4 <1>	8.5	8.5	4.6	4.6	3.9	3.9	3.6	3.6	-1.3	-1.3
1985	Q4 <1>	6.3	6.3	2.9	2.9	3.6	3.6	3.3	3.3	-.2	-.2
1986	Q4	5.0	4.9	2.7	2.8	2.4	2.4	2.3	2.1	-.1	-.2
1987	Q4	6.2	6.0	3.2	3.0	3.3	3.3	2.9	2.9	-.3	-.2

<1> Actual.

<2> Percent change from two quarters earlier.

<3> Percent change from four quarters earlier.

September 17, 1986

CONFIDENTIAL - FR
CLASS II FOMCGROSS NATIONAL PRODUCT AND RELATED ITEMS
(seasonally adjusted; annual rate)

	Units	Projection									
		1985		1986				1987			
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of \$	4030.5	4087.7	4149.2	4179.8	4232.9	4288.4	4349.4	4413.5	4477.8	4546.9
Real GNP	Billions of 82\$	3603.8	3622.3	3655.9	3661.5	3688.7	3723.2	3750.1	3778.1	3806.4	3835.0
Real GNP	Percent change	4.1	2.1	3.8	.6	3.0	3.8	2.9	3.0	3.0	3.0
Gross domestic purchases		4.6	4.0	3.0	3.2	2.2	2.5	1.8	1.9	1.7	1.7
Final sales		6.1	2.7	-1.3	3.8	5.6	.9	2.3	2.6	3.0	3.0
Private dom. final purchases		4.8	3.4	.9	5.6	4.9	-6	1.8	1.8	1.7	1.7
Personal consumption expend.		5.3	1.7	3.6	6.5	5.3	-.7	2.6	2.4	1.9	1.7
Durables		23.8	-11.1	-1.8	16.4	17.9	-17.1	2.6	2.6	1.8	1.8
Nondurables		1.2	1.6	6.5	8.4	3.3	2.6	2.2	2.2	1.9	1.5
Services		3.2	6.0	3.2	2.4	3.0	2.5	3.0	2.6	1.9	1.8
Business fixed investment		.1	12.5	-15.1	-2.3	2.0	-.9	-.6	1.3	1.8	1.5
Producers' durable equipment		2.6	18.7	-17.0	19.9	7.9	1.2	1.0	3.5	3.5	3.5
Nonresidential structures		-4.6	.3	-10.8	-38.6	-11.4	-6.1	-4.9	-4.3	-2.9	-3.9
Residential structures		11.7	3.4	11.0	13.5	7.3	1.2	-2.7	-5.1	-.7	3.0
Exports		-5.8	8.2	7.1	-5.6	8.2	11.4	14.0	12.0	15.8	15.0
Imports		.3	23.3	.2	16.5	.4	-.6	2.5	1.4	2.2	2.4
Government purchases		13.9	10.0	-12.3	9.8	3.7	1.3	-1.0	.3	1.4	1.2
Federal		26.0	22.7	-27.5	11.9	6.4	1.4	-4.1	-1.2	.9	.4
Defense		15.8	-4.7	-1.0	20.3	6.7	2.7	-1.1	-.5	1.1	.8
State and local		5.1	.3	2.6	8.4	1.5	1.2	1.5	1.5	1.8	1.9
Change in business inventories	Billions of 82\$.7	-5.2	39.9	11.6	-11.5	14.3	19.8	24.0	24.0	25.0
Nonfarm	Billions of 82\$	1.4	16.1	37.0	8.2	-11.5	17.5	20.0	24.0	24.0	25.0
Net exports	Billions of 82\$	-113.8	-132.0	-125.9	-150.5	-143.8	-132.9	-123.3	-113.8	-101.4	-89.6
Real GNP	Percent change	6.8	5.8	6.2	3.0	5.2	5.4	5.8	6.0	6.0	6.3
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	97.9	98.7	99.4	99.8	100.4	100.9	101.5	102.1	102.7	103.2
Unemployment rate	Percent*	7.2	7.0	7.1	7.2	6.9	6.8	6.7	6.6	6.6	6.6
Industrial production index	Percent change	1.8	2.0	1.2	-2.1	1.6	3.5	2.8	3.1	3.2	3.3
Capacity utilization rate-mfg.	Percent*	80.1	79.9	80.0	79.5	79.6	79.8	79.9	80.0	80.1	80.2
Housing Starts	Millions	1.69	1.77	2.00	1.91	1.80	1.72	1.67	1.67	1.68	1.70
Auto sales	Millions	12.31	10.24	10.65	11.22	13.11	10.29	10.47	10.90	11.00	11.00
Domestic	Millions	9.40	6.84	7.84	8.18	9.83	6.87	7.40	7.70	7.80	7.80
Foreign	Millions	2.90	3.40	2.81	3.05	3.28	3.32	3.07	3.20	3.20	3.20
INCOME AND SAVING											
Nominal personal income	Percent change	3.0	7.4	6.0	6.4	4.0	6.3	5.9	6.2	6.7	6.3
Real disposable income	Percent change	-4.0	2.6	6.5	7.4	-.2	2.2	2.1	1.7	2.1	1.8
Personal saving rate	Percent*	4.2	4.4	5.0	5.1	3.8	4.4	4.3	4.1	4.1	4.1
Corp. profits with IVA & CCAdj	Percent change	36.2	-13.7	16.0	-6.8	-5.6	6.9	-8.0	-1.4	-3.9	2.0
Profit share of GNP	Percent*	7.4	7.0	7.1	7.0	6.8	6.8	6.6	6.5	6.3	6.2
Federal govt. surplus/deficit	Billions of \$	-197.5	-217.6	-201.6	-236.9	-201.2	-207.3	-183.7	-173.3	-167.5	-159.9
State and local govt. surplus		59.5	62.5	70.0	59.9	57.1	58.0	58.9	60.4	60.7	61.2
PRICES AND COSTS											
GNP implicit deflator	Percent change	2.5	3.6	2.5	2.5	2.0	1.5	2.8	2.9	2.8	3.2
GNP fixed-weight price index		2.8	4.0	2.5	1.9	2.7	2.4	3.2	3.2	3.2	3.3
Cons. & fixed invest. prices		2.7	4.3	1.6	.3	3.3	3.4	3.6	3.7	3.6	3.5
CPI		2.6	4.3	1.5	-1.7	2.8	3.5	3.9	3.6	3.8	3.7
Exc. food and energy		3.5	4.9	4.3	3.4	3.3	3.4	4.0	4.1	4.4	4.4
Nonfarm business sector											
Output per hour		2.2	-3.5	4.3	-.5	1.3	2.2	.4	.7	.9	1.0
Compensation per hour		3.2	3.7	3.1	2.2	2.7	3.0	3.4	3.5	3.6	3.7
Unit labor costs		1.0	7.4	-1.2	2.8	1.4	.8	3.0	2.8	2.7	2.7

Not at an annual rate.

CONFIDENTIAL - FR
CLASS II FOMCGROSS NATIONAL PRODUCT AND RELATED ITEMS
(seasonally adjusted; annual rate)

	Units	1979	1980	1981	1982	1983	1984	1985	Projection	
									1986	1987
EXPENDITURES										

Nominal GNP	Billions of \$	2508.2	2732.0	3052.6	3166.0	3405.7	3765.0	3998.1	4212.6	4446.9
Real GNP	Billions of 82\$	3192.4	3187.1	3248.8	3166.0	3279.1	3489.9	3585.2	3682.3	3792.4
Real GNP	Percent change*	.8	-.1	.6	-1.9	6.5	4.6	2.9	2.8	3.0
Gross domestic purchases		-.4	-1.1	.8	-.8	8.4	5.9	3.9	2.7	1.8
Final sales		2.2	-.2	.1	.3	3.7	4.4	4.0	2.2	2.7
Private dom. final purchases		1.3	-1.7	-.3	.8	7.7	5.3	4.2	2.7	1.8
Personal consumption expend.		1.4	-.1	.2	2.9	5.4	3.6	3.5	3.6	2.2
Durables		-3.8	-5.6	-3.3	9.0	14.7	8.8	6.2	2.8	2.2
Nondurables		.8	-1.4	.5	1.8	4.4	2.2	2.0	5.2	1.9
Services		3.5	2.4	.9	2.3	3.9	3.3	3.9	2.8	2.3
Business fixed investment		5.0	-4.8	5.6	-11.3	10.8	14.7	6.5	-4.3	1.0
Producers' durable equipment		1.6	-6.5	2.2	-12.5	20.9	16.0	8.1	2.1	2.9
Nonresidential structures		12.0	-1.8	11.7	-9.1	-4.8	12.1	3.3	-17.8	-4.0
Residential structures		-7.2	-14.2	-22.4	4.9	38.1	5.3	7.8	8.1	-1.4
Exports		13.7	.5	2.4	-13.8	5.8	5.5	-3.2	5.1	14.2
Imports		3.4	-8.8	4.9	-5.9	23.8	16.5	5.8	3.9	2.1
Government purchases		.1	1.0	2.9	3.8	-2.7	7.7	8.4	.3	.5
Federal		-.3	3.1	9.5	8.2	-8.1	14.2	14.3	-3.3	-1.0
Defense		3.3	3.1	7.6	8.8	5.1	6.8	5.9	6.9	.1
State and local		.4	-.3	-1.3	.6	1.5	3.1	3.7	3.4	1.7
Change in business inventories	Billions of 82\$	15.0	-6.9	23.9	-24.5	-6.4	59.2	9.0	13.6	23.2
Nonfarm	Billions of 82\$	10.4	-2.3	19.0	-23.1	-.1	54.3	10.9	12.8	23.3
Net exports	Billions of 82\$	3.6	57.0	49.4	26.3	-19.9	-83.6	-108.2	-138.3	-107.0
Nominal GNP	Percent change*	9.5	9.9	9.3	3.1	10.4	8.5	6.3	4.9	6.0
EMPLOYMENT AND PRODUCTION										

Nonfarm payroll employment	Millions	89.8	90.4	91.2	89.6	90.2	94.5	97.6	100.1	102.4
Unemployment rate	Percent	5.8	7.1	7.6	9.7	9.6	7.5	7.2	7.0	6.6
Industrial production index	Percent change*	.9	-.8	-1.0	-7.7	14.3	6.6	1.7	1.0	3.1
Capacity utilization rate-mfg.	Percent	84.6	79.3	78.3	70.3	74.0	80.5	80.1	79.7	80.0
Housing Starts	Millions	1.72	1.30	1.10	1.06	1.71	1.76	1.74	1.86	1.68
Auto sales	Millions	10.68	9.04	8.56	8.00	9.18	10.43	11.09	11.32	10.84
Domestic	Millions	8.36	6.62	6.24	5.77	6.77	7.87	8.24	8.20	7.68
Foreign	Millions	2.32	2.42	2.32	2.23	2.41	2.46	2.84	3.11	3.17
INCOME AND SAVING										

Nominal personal income	Percent change*	11.4	12.0	9.2	5.3	7.8	8.4	6.1	5.7	6.3
Real disposable income	Percent change*	.5	1.1	.7	1.0	5.1	4.2	1.9	3.9	1.9
Personal saving rate	Percent	6.8	7.1	7.5	6.8	5.4	6.3	5.1	4.6	4.1
Corp. profits with IVA & CCAdj	Percent change*	-10.7	-6.8	2.3	-19.1	70.1	6.6	7.8	2.2	-2.9
Profit share of GNP	Percent	8.0	6.5	6.2	4.7	6.3	7.0	7.0	6.9	6.4
Federal govt. surplus/deficit	Billions of \$	-16.1	-61.3	-63.8	-145.9	-176.0	-170.0	-198.0	-211.7	-171.1
State and local govt. surplus		27.6	26.8	34.1	35.1	47.5	68.5	61.7	61.3	60.3
PRICES AND COSTS										

GNP implicit deflator	Percent change*	8.9	9.9	8.7	5.2	3.6	3.6	3.3	2.1	2.9
GNP fixed-weight price index		8.8	9.8	8.5	5.0	3.9	3.9	3.6	2.4	3.3
Cons. & fixed invest. prices		9.5	10.1	8.2	4.4	3.3	3.6	3.4	2.1	3.6
CPI		12.7	12.5	9.6	4.5	3.3	4.1	3.5	1.5	3.8
Exc. food and energy		10.7	12.2	10.2	5.2	4.3	4.8	4.3	3.6	4.2
Nonfarm business sector										
Output per hour		-2.7	1.0	-.6	1.0	3.6	1.0	.2	1.8	.7
Compensation per hour		9.7	10.9	8.3	7.3	3.3	4.3	3.9	2.7	3.5
Unit labor costs		12.7	9.8	9.0	6.2	-.3	3.2	3.7	.9	2.8

* Percent changes are from fourth quarter to fourth quarter.

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1985*	FY1986e		FY1987e		CY 1986e		FRB Staff Estimates									
		Admin ¹	FRB Staff	Admin ¹	FRB Staff	CY 1985*	FRB Staff	1985 IV*	I*	1986				1987			
										II*	III	IV	I	II	III		
									Not seasonally adjusted								
Budget receipts ²	734	765	768	831	829	745	776	177	180	215	196	185	197	239	209		
Budget outlays ²	946	995	992	975	1006	961	990	252	241	245	254	250	250	253	254		
Surplus/deficit(-) to be financed ²	-212	-230	-224	-144	-177	-216	-213	-75	-61	-30	-57	-65	-53	-14	-45		
Means of financing deficit:																	
Borrowing from public	197	235	234	144	175	224	200	91	37	51	55	57	43	24	51		
Cash balance decrease	13	-3	-10	0	-3	-13	14	-14	19	-12	-2	10	2	-5	-10		
Other ³	1	-2	0	0	4	5	0	-2	5	-8	5	-2	8	-5	4		
Cash operating balance, end of period	17	20	27	20	30	31	17	31	12	25	27	17	15	20	30		
Memo: Sponsored agency borrowing	20	n. a.	13	n. a.	21	20	12	5	-2	5	5	4	5	6	6		
NIPA Federal Sector									Seasonally adjusted annual rates								
Receipts	771	810	810	890	866	787	819	806	800	806	828	844	860	874	887		
Expenditures	963	1025	1024	1033	1049	985	1031	1023	1002	1043	1029	1051	1043	1047	1054		
Purchases	341	367	369	375	379	354	368	381	356	367	373	376	377	379	382		
Defense	254	273	274	290	291	259	279	268	266	278	283	287	290	292	294		
Nondefense	88	94	95	84	88	95	89	113	89	89	90	89	88	87	88		
All other expend.	621	658	655	658	670	631	663	643	646	676	656	675	666	668	672		
Surplus/deficit(-)	-191	-214	-214	-143	-183	-198	-212	-218	-202	-237	-201	-207	-184	-173	-167		
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-151	n. a.	-177	n. a.	-152	-159	-175	-180	-167	-197	-163	-173	-151	-143	-140		
		*--actual			e--estimated				n. a.--not available								

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Note: Details may not add to totals due to rounding

1. Mid-Session Review of the 1987 Budget (August 1987). The Congressional Budget Office baseline estimates published in August indicated receipts of \$767 billion and \$828 billion, and outlays of \$991 billion and \$1012 billion in FY1986 and FY1987, respectively.
2. Includes outlays formerly classified as off-budget (e.g. Federal Financing Bank and Strategic Petroleum Reserve) and social security receipts and outlays classified as off-budget under current law.
3. Checks issued less checks paid, accrued items, and other transactions.
4. 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 payment basis. The Administration's definition of borrowing by these agencies is somewhat broader.

DOMESTIC FINANCIAL DEVELOPMENTS

Recent developments. Short-term interest rates fell early in the intermeeting period, after the cut in the discount rate by one-half point to 5-1/2 percent on August 20, but long-term rates were little changed. Later, however, signs of a pickup in U.S. economic activity in the context of continued strong growth in the monetary aggregates, and less weakness than previously thought in the German and Japanese economies, formed the backdrop for a reassessment by market participants of the financial outlook. Rates began to back up, particularly among longer-term securities; price declines for bonds and equities gathered considerable momentum for a brief period when inflation fears apparently mounted. On balance, short-term rates are 10 to 40 basis points below their levels at the time of the last FOMC meeting and well below previous lows for this year; long-term bond yields have risen noticeably, as much as one-half percentage point in the case of Treasury securities.

The broader monetary aggregates decelerated somewhat in August, following spurts in July, but their growth remained strong. M2 growth of 10-1/2 percent and M3 growth of 8-1/4 percent (annual rates) kept both aggregates around the upper ends of their annual growth ranges. M1 grew at a 20-1/4 percent pace in August and the 38 percent spurt in its other checkable deposit component was the largest contributor to the growth of all of the aggregates. Banks and thrifts have been hesitant to lower their offering rates on OCDs and saving accounts below the old regulatory ceilings, and MMDA rates have fallen only gradually. Consequently, the opportunity costs of holding OCDs and the other liquid components of M2 are quite narrow and these accounts seem to be drawing wealth both from

marketable instruments and from small time deposits, which registered the largest of four consecutive monthly declines.

In concert with the signs of a pickup in domestic economic activity in the current quarter, growth of nonfinancial debt also appears to be somewhat faster. In the nonfinancial business sector, short-term borrowing, particularly in the commercial paper market, increased, after being quite slack earlier in the year when the sharp decline in long-term rates was prompting firms to extend the maturity of their debt. Meanwhile, long-term bond issuance remained fairly strong in August, likely bolstered by continued heavy net equity retirements. Bond issuance has slackened thus far in September, however, with the backup in corporate rates.

In the tax-exempt sector, borrowing surged in July and rose even further in August, prompted primarily by a desire to bring public-purpose issues to market ahead of September 1 limitations on refunding and arbitrage activities that were expected to be in the tax reform bill. Heavy offerings, and uneasiness about other possible implications of tax reform, pushed tax-exempt yields to unusually high levels relative to other yields in late spring and early summer. The conclusion of the tax reform conference cleared the air and both yield spreads and issuance have dropped off sharply since mid-August.

In the household sector, net mortgage borrowing appears to have increased in the current quarter. Major mortgage lenders report a large volume of applications, despite some falloff in the pace of refinancings. Given such reports and the record rate of mortgage originations at thrifts in July, it seems likely that earlier loan processing bottlenecks have eased. The lion's share of loan growth has been in fixed-rate loans, as

borrowers have continued to prefer these instruments in an environment of comparatively low mortgage rates.

Consumer installment credit growth in July, at 11-1/2 percent, remained marginally below the pace in the first half of the year; exclusive of automobile credit, however, the recent slowing has been more marked. During the past year of repeated concessions in auto financing, growth of this component has accounted for a disproportionate share of the installment credit total. With income and employment growing unevenly across the country and total household debt growing rapidly, both mortgage and installment credit delinquencies rose in the second quarter--credit card delinquencies soaring to a record level.

In the federal sector, Treasury financing returned to normal patterns after Congress raised the debt ceiling just before Labor Day. Borrowing this quarter is likely to amount to \$54 billion (not seasonally adjusted), as the Treasury conserves its cash balance prior to seasonally large fourth-quarter needs. For the current fiscal year, the federal deficit will set a new record, and total borrowing from the public is likely to amount to \$234 billion.

Outlook. Special factors are boosting debt growth in the current quarter, particularly in the household and state and local sectors. By late in the year and early next year, however, these factors are likely to wane, slowing debt growth considerably.

The most immediate factor lifting the pace of debt growth is the special financing incentive program in place in the automobile industry. These programs, which will expire in early October, are accelerating purchases and associated borrowing, and their end should restrain growth

somewhat later in the year. Home mortgage borrowing is expected to be well sustained in coming months, given the projected strength in single-family home building. Spreads between mortgage rates and bond yields could narrow further from their historically large size as loan prepayments slow and call premiums diminish. The proposed tax reform bill has a number of provisions that might tend to affect mortgage and consumer financing in the future but no significant effect is expected in the near term.

In the state and local sector, the pace of tax-exempt bond issuance for public purposes should remain subdued after the rush to market during the summer. Private-purpose issuance of tax-exempts, however, is likely to pick up for the rest of this year as authorities will strive to utilize fully the borrowing room that is available under the 1986 caps. (Much of this private-purpose borrowing will show up in the flow-of-funds accounts as liabilities of the household or business sector beneficiaries.)

In the federal sector, borrowing is expected to slow in the new fiscal year as the deficit is reduced. The time pattern of Treasury financing could be disrupted once again, however, if congressional deliberations lead to a delay in enactment of a longer-term debt ceiling increase. Already, one auction has been postponed.

In the business sector, the pace of debt growth is likely to be steadier. The corporate financing gap is expected to widen gradually later this year, lifted a bit by more rapid inventory accumulation, and tax payments will be higher due to tax reform. The dominant factor in corporate debt growth will remain, however, large equity retirements. Corporate restructuring shows no signs of slowing, and some mergers may

be accelerated to the fourth quarter to receive the more favorable treatment of capital gains and other tax benefits under current tax law than under the new law.

INTERNATIONAL DEVELOPMENTS

Recent developments. The dollar's weighted average foreign exchange value changed little, on balance, since the last FOMC meeting. Exchange rates were mainly affected by news on prospects for economic activity in the United States and abroad. Germany and Japan did not follow the Federal Reserve's discount rate reduction, and short-term interest rates in the United States declined moderately while foreign rates were essentially unchanged. Long-term interest rates in Germany and Japan firmed somewhat after release of better-than-expected GNP figures for the second quarter, but long rates in the United States rose by substantially more.

Precious metals prices rose sharply, prompted by threatened supply disruptions in South Africa and, reportedly, by some renewed fears of future inflation in the United States. Since August 1, platinum, gold, and silver prices have risen by 27, 16, and 12 percent, respectively.

Most recent data on economic activity in foreign industrial countries have been rather encouraging. Second-quarter GNP growth rates in Germany, Japan, France, Canada, and the United Kingdom were higher than in the first quarter and generally better than expected. Domestic demand was substantially stronger than GNP in Germany and France, indicating adjustment in real net exports. In Japan, domestic demand

(excluding gold transactions) did not grow faster than GNP in the second quarter, but real net exports were substantially lower than a year ago.

Despite the reduction in real net exports in most foreign industrial countries, nominal trade and current account surpluses have continued to grow, reflecting J-curve effects of the dollar's depreciation over the past year and a half.

Economic activity in developing countries appears to be growing at around a 3 percent rate, though somewhat slower than in 1985. Inflation continues to be a major problem in many countries, and Argentina and Brazil have moved recently to tighten monetary policy. Mexico obtained a \$1.6 billion bridge loan from foreign monetary authorities and commercial banks, and, on August 31, drew \$850 million on that facility, including \$210 million on the Federal Reserve swap network. Mexico's negotiations with commercial banks for \$6 billion in new money are proceeding slowly in the face of that country's demand for substantially easier terms in the restructuring of old debt.

Preliminary figures for U.S. merchandise trade in July indicate a substantially larger deficit than in previous months as non-oil imports surged. The staff believes that much of the surge in imports will prove to be temporary.

In the second quarter, the U.S. current account was \$138.9 billion at an annual rate, marginally larger than the deficit in the first quarter (revised). Smaller net deficits in merchandise trade, military transactions and other services were more than offset by increased net portfolio (interest) payments to foreigners, increased unilateral transfers (largely U.S. government grants to developing

countries), and a reduction in income from U.S. direct investments abroad (mainly from reduced earnings of petroleum affiliates).

The value of total U.S. exports rose 2 percent in the second quarter, while the value of imports rose less than one percent. Both imports and, especially, exports, however, were distorted by gold shipments relating to Japan's minting of a commemorative gold coin. Excluding gold, the volume of nonagricultural exports declined 1/2 percent in the second quarter. The volume of non-oil imports rose 2 percent, while their prices rose at a 6-1/2 percent annual rate, the third straight quarter of such increases.

Reported capital flows in July continued to show large net foreign purchases of U.S. corporate bonds and stocks (nearly \$6 billion). Foreign net sales of U.S. Treasury securities in July were more than accounted for by the World Bank; private foreigners added \$1.4 billion to their holdings even though Japanese residents' purchases were small. Official reserve holdings in the United States increased by \$4.5 billion in July, mainly reflecting the investment of intervention purchases of dollars by G-10 countries.

Outlook. The staff continues to project a moderate decline in the value of the dollar through the end of 1987, while noting the risks of a sharper drop if market participants become discouraged over the slow pace of reductions in the U.S. external imbalances in the face of narrow long-term rate interest differentials. The outlook for the U.S. current account balance is somewhat weaker than in the last Greenbook. A substantial improvement in real net exports will be masked by substantial rises in import prices, limiting the improvement in the nominal

balance. The rebound in economic activity abroad in the second quarter was largely in accordance with staff projections and is consistent with our continued outlook for moderate growth through 1987. The U.S. current account deficit for both 1986 and 1987 is projected to average about \$145 billion; the deficit is projected to grow to about \$150 billion by 1986-Q4 and then be reduced to about \$140 billion by 1987-Q4.

September 17, 1986

Outlook for U.S. Net Exports and Related Items
(Billions of Dollars, Seasonally Adjusted Annual Rates)

	ANNUAL			1985		1986				1987			
	1985-	1986-P	1987-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	-78.9	-99.7	-97.6	-83.7	-105.3	-93.7	-100.2	-100.3	-104.5	-103.9	-101.6	-95.6	-89.4
Exports of G+S	369.7	375.2	426.2	362.3	368.2	374.8	367.9	374.2	384.1	400.4	415.4	434.7	454.4
Imports of G+S	448.6	474.9	523.8	446.0	473.6	468.5	468.1	474.5	488.6	504.3	516.9	530.3	543.8
Constant \$2 \$, Net	-108.2	-138.3	-107.0	-113.8	-132.0	-125.9	-150.5	-143.8	-132.9	-123.3	-113.8	-101.5	-89.6
Exports of G+S	362.3	371.4	413.9	355.8	362.9	369.2	363.9	371.1	381.3	394.1	405.4	420.6	435.6
Imports of G+S	470.5	509.7	520.9	469.6	494.8	495.1	514.4	514.9	514.2	517.3	519.2	522.0	525.1
2. U.S. Merchandise Trade Balance 2/	-124.4	-147.7	-146.5	-126.7	-149.4	-145.8	-144.1	-149.6	-151.2	-152.9	-149.3	-144.4	-139.3
Exports	214.4	218.0	249.9	210.0	210.9	214.6	219.2	216.3	222.0	231.8	243.0	255.7	269.3
Agricultural	29.6	25.6	27.3	26.7	28.5	28.4	24.6	23.8	25.4	26.4	26.7	27.4	28.5
Non-Agricultural	184.8	192.5	222.7	183.3	182.4	186.2	194.5	192.5	196.6	205.4	216.2	228.2	240.7
Imports	338.9	365.7	396.4	336.7	360.3	360.5	363.3	365.9	373.2	384.7	392.2	400.1	408.5
Petroleum and Products	50.5	34.4	38.7	49.5	56.5	40.1	31.3	31.2	35.1	37.8	38.3	39.0	39.7
Non-Petroleum	288.3	331.3	357.7	287.2	303.8	320.4	331.9	334.7	338.1	346.9	354.0	361.2	368.9
3. U.S. Current Account Balance	-117.7	-143.6	-146.5	-113.8	-134.8	-136.2	-138.9	-146.7	-152.8	-151.3	-150.4	-145.0	-139.3
Of Which: Net Investment Income	25.2	18.9	11.2	33.0	37.0	26.1	21.2	15.2	13.3	12.0	10.4	11.0	11.5
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.8	2.7	2.8	3.0	2.5	0.2	5.2	2.9	2.9	2.7	2.6	2.5	2.5
Real GNP--NonOPEC LDC 5/	3.4	3.2	4.1	2.9	3.0	3.0	3.3	3.6	3.9	4.1	4.4	4.7	5.0
Consumer Prices--Ten Ind. 4/	4.3	2.1	2.4	1.4	3.1	1.7	1.7	0.5	2.8	2.7	3.0	2.8	2.9

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