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Strictly Confidential (FR) Class II FOMC

February 4, 1987

SUMMARY AND OUTLOOK

Prepared for the Federal Open Market Committee
By the staff of the Board of Governors of the Federal Reserve System

Recent developments. Incoming data, on balance, suggest that economic activity has continued to expand at a moderate pace. Basic trends in wage and price inflation appear to have changed little in recent months, although world oil prices and industrial commodity prices have turned up.

The industrial sector of the economy showed some vigor toward the end of the year. The index of industrial production rose 0.5 percent in December, and for the fourth quarter as a whole was up at a 3-1/4 percent annual rate--the largest quarterly increase since late 1984. The recent gains were widespread, with particularly sharp increases in home goods and defense and space equipment. In contrast, production of business equipment has yet to show any improvement from its generally lackluster performance of the past year.

Employment growth strengthened in the fourth quarter, with nonfarm payroll employment increasing about 260,000 per month. Hiring in finance and services again provided the bulk of the new jobs. However, employment in the manufacturing sector posted average monthly gains of nearly 30,000 last quarter, after declining throughout much of the year, and the factory workweek remained at a high level. The civilian unemployment rate declined 0.2 percentage point in December to 6.7 percent.

Consumer spending in real terms declined slightly in the fourth quarter, reflecting a drop in new car and truck sales from the torrid pace of the third quarter. Excluding motor vehicles, spending for other goods and services advanced at nearly a 2-1/2 percent annual rate, about the same pace as in the third quarter but considerably less than earlier in the year. With both income and outlays in the household sector estimated to have edged down in the fourth quarter, the personal saving rate remained at a low 2-3/4 percent. After a brief tax-related surge in December, sales of domestically produced new autos averaged just 5-1/2 million units at an annual rate in the first 20 days of January, leading automakers to announce a new round of sales incentives.

Capital outlays for equipment also were depressed by a falloff in business purchases of autos and trucks in the fourth quarter. However, the decline in motor vehicles purchases was nearly offset by a small pickup in other equipment spending, which was motivated, at least in part, by efforts to take advantage of the more favorable depreciation schedules that were in effect for some types of equipment placed in service by January 1. Looking forward, new orders for nondefense capital goods other than aircraft dropped last quarter, suggesting there is likely to be a lull in spending in the early months of the year. Outlays for nonresidential construction have continued on a downtrend in recent months, and the value of construction put-in-place in December was more than 10 percent below a year earlier.

Manufacturers' inventories resumed their decline in December, after increasing slightly in the previous month. Inventories in the nonauto retail sector, which had accumulated at a brisk pace in September and October, declined in November, owing in part to the strength of sales in the retail control group of stores. However, abstracting from month-to-month variation, the overall inventory picture has changed little in recent months, and there is no evidence of significant imbalances in either manufacturing or trade.

Activity in the housing sector picked up toward year-end. Sales of both new and existing homes rose in December in response to lower mortgage interest rates and--in the case of existing home sales--a tax incentive to realize capital gains before the end of the year. In addition, housing starts jumped to a 1.8 million unit annual rate in December, after drifting lower since early spring. Single-family starts returned to near the pace seen earlier in the year. Multifamily starts also rebounded in December, but declined 10 percent for the fourth quarter as a whole. Given the high vacancy rates and the negative effects of tax law changes on rental housing, the December rise in multifamily starts should prove to be transitory.

The consumer price index rose 0.3 percent in November and 0.2 percent in December, remaining within the range of monthly increases that has been evident since late summer. World crude oil prices jumped in mid-December, in response to the latest agreement by OPEC members to restrict output. Although retail energy prices also turned up in December, the bulk of the effect of higher oil prices is likely to show up in the first half of this year. In contrast, increases in consumer food prices slowed in December, following several months of sharp gains. Apart from food and energy, consumer prices rose 0.3 percent in both November and December, about in line with the 3-3/4 percent pace registered for the year as a whole.

Wage increases, as measured by a wide variety of broad indexes, slowed in 1986. Compensation per hour in the nonfarm business sector rose 2-3/4 percent last year, nearly 1-1/4 percentage points less than in 1985. At the same time, productivity in the nonfarm business sector rose about 3/4 percent. With wages decelerating further and productivity remaining on a slow uptrend, unit labor costs were well-contained over the year.

Outlook. The staff expects real GNP to increase about 2-1/4 percent at an annual rate in the first quarter. Further gains in exports are projected to provide a significant stimulus to real GNP. In contrast, domestic demands are expected to rise at only a 1 percent annual rate in the current quarter, virtually the same sluggish pace as in the fourth quarter. Inflation, as measured by the GNP fixed-weighted price index, is projected to accelerate a bit, to about a 3 percent annual rate, reflecting sharp increases in energy prices.

In terms of domestic demands, the primary impetus to activity is expected to come from consumer spending for items other than autos, which should continue to increase at the moderate pace posted in the second half of 1986. Demand in other sectors likely will be sluggish. Business fixed investment is expected to fall in the current quarter, as some equipment purchases were advanced into the fourth quarter of last year; moreover, nonresidential construction outlays are expected to move lower. In addition, residential construction expenditures are projected to decline in lagged response to the earlier drop in starts. New car sales are projected to decline further in the current quarter; but with assemblies likely to run ahead of sales, the weakness in sales will be partially offset by a buildup in auto inventories.

The policy assumptions underlying the staff projection are much the same as in the last Greenbook. With respect to monetary policy, M2 and M3 are assumed to grow at rates well within their tentative ranges this year and grow a bit more slowly in 1988. Interest rates are projected to change little in the near term, but to drift a bit higher by the end of the projection period. Congress is assumed to enact deficit-reducing measures for fiscal year 1988 similar in magnitude to those enacted last year, leading fiscal policy to exert a restraining influence on aggregate demand over the projection horizon. The federal budget deficit, which reached $221 billion in fiscal year 1986, is projected to decline to about $180 billion and $150 billion in fiscal years 1987 and 1988, respectively.

Real GNP is projected to increase about 2-3/4 percent in both 1987 and 1988. The growth activity over this period is driven, in large measure, by the anticipated effects of the depreciation of the foreign exchange value of the dollar. Increased competitiveness in world markets is expected to propel U.S. export growth at double-digit rates over the next two years. Moreover, the projected increase in import prices, occasioned by the drop in the value of the dollar, is likely to shift domestic demand away from foreign production and toward goods and services produced in the United States.

Meanwhile, the growth in domestic demands is expected to slow to a 1-1/2 percent annual rate, on average, in both 1987 and 1988. With the rise in import prices likely to damp real income gains, consumer spending is projected to slow to about a 1-1/2 percent rate across the projection horizon, well below the 3-1/2 to 4 percent average rate of increase over the past four years. Government purchases also slow considerably, reflecting the restrictive turn in fiscal policy. In contrast, equipment spending is projected to grow moderately, as domestic production expands, modernization efforts continue, and the cost of capital edges lower. In the near term, residential construction activity is expected to be held down by the influence of tax law changes on multifamily construction; but by midyear, multifamily starts should have reached bottom. Single-family construction is expected to provide some stimulus to overall activity over the next two years. Overbuilding in the office sector probably will continue to depress nonresidential construction outlays over the projection horizon.

The contours of the staff price projection are shaped importantly by the depreciation of the exchange rate and a firming of world oil prices. The GNP fixed-weighted price index is projected to accelerate from about 2-1/2 percent in 1986 to about 3 percent in 1987 and 3-3/4 percent in 1988. Increases in nonpetroleum import prices are expected to rise further in 1987 and maintain a double-digit pace throughout 1988. Moreover, world oil prices, which had averaged about $12.25 per barrel in the second half of last year, are expected to average near $17.00 per barrel over the projection horizon—somewhat below their current market levels. However, the adverse effects of these developments on inflation are damped somewhat by the remaining margin of slack in labor and product markets.

February 4, 1987

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STAFF GNP PROJECTIONS

Percent changes, annual rate

	Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
	12/10/86	2/4/87	12/10/86	2/4/87	12/10/86	2/4/87	12/10/86	2/4/87	12/10/86	2/4/87
Annual changes:										
1985 <1>	6.2	6.2	2.7	2.7	3.7	3.7	3.3	3.3	7.2	7.2
1986 <1>	5.4	5.3	2.6	2.5	2.6	2.8	2.6	2.7	7.0	7.0
1987	5.1	4.9	2.6	2.4	2.7	2.8	2.4	2.5	6.8	6.7
1988		6.2		2.8		3.5		3.3		6.5
Quarterly changes:										
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>	2.6	2.6	.6	.6	1.7	1.7	1.8	1.8	7.2	7.1
Q3 <1>	6.4	6.4	2.9	2.8	2.4	2.6	3.6	3.6	6.9	6.9
Q4 <1>	3.9	2.6	3.1	1.7	2.1	2.6	.8	1.0	7.0	6.9
1987 Q1	5.2	5.0	2.4	2.2	3.0	2.9	2.8	2.6	6.9	6.7
Q2	5.5	5.9	2.7	2.8	3.0	3.1	2.7	3.0	6.9	6.7
Q3	5.6	6.1	2.9	2.9	2.8	3.1	2.6	3.0	6.8	6.6
Q4	5.7	6.1	3.0	3.0	2.8	3.1	2.6	3.0	6.7	6.6
1988 Q1		6.4		2.7		4.0		3.5		6.6
Q2		6.2		2.6		3.7		3.4		6.6
Q3		6.0		2.6		3.7		3.3		6.5
Q4		6.2		2.7		3.7		3.5		6.5
Two-quarter changes: <2>										
1986 Q2 <1>	4.3	4.3	2.2	2.2	2.1	2.1	2.1	2.1	.2	.0
Q4 <1>	5.2	4.5	3.0	2.3	2.3	2.6	2.2	2.3	-.2	-.2
1987 Q2	5.4	5.4	2.5	2.5	3.0	3.0	2.8	2.8	-.1	-.2
Q4	5.7	6.1	3.0	3.0	2.8	3.1	2.6	3.0	-.2	-.1
1988 Q2		6.3		2.7		3.9		3.5		.0
Q4		6.1		2.6		3.7		3.4		-.1
Four-quarter changes: <3>										
1985 Q4 <1>	6.3	6.3	2.9	2.9	3.6	3.6	3.3	3.3	-.2	-.2
1986 Q4 <1>	4.8	4.4	2.6	2.2	2.2	2.4	2.2	2.2	.0	-.2
1987 Q4	5.5	5.8	2.8	2.8	2.9	3.1	2.7	2.9	-.3	-.3
1988 Q4		6.2		2.7		3.8		3.4		-.1

<1> Actual.
<2> Percent change from two quarters earlier.
<3> Percent change from four quarters earlier.

February 4, 1987

CONFIDENTIAL - FR
CLASS II FOMC

GROSS NATIONAL PRODUCT AND RELATED ITEMS
(Seasonally adjusted; annual rate)

				Projection							
		1986		1987				1988			
	Units	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of $	4240.7	4268.4	4320.3	4383.0	4448.1	4514.1	4584.1	4653.4	4721.9	4794.0
Real GNP	Billions of 82$	3686.4	3702.4	3722.9	3749.0	3776.3	3804.5	3830.3	3855.4	3880.6	3906.1
Nominal GNP	Percent change	6.4	2.6	5.0	5.9	6.1	6.1	6.4	6.2	6.0	6.2
Real GNP		2.8	1.7	2.2	2.8	2.9	3.0	2.7	2.6	2.6	2.7
Gross domestic product		2.6	2.1	2.5	3.0	3.0	3.1	2.8	2.7	2.5	2.7
Gross domestic purchases		3.7	.9	1.0	1.6	1.7	1.7	1.5	1.3	1.4	1.7
Final sales		4.5	3.0	-.1	2.6	2.7	3.0	2.7	2.6	2.8	2.6
Private dom. final purchases		5.6	-.5	-.8	2.1	2.1	2.0	1.7	1.3	1.6	1.7
Personal consumption expend.		6.7	-.5	-.3	2.4	2.1	1.9	1.7	1.2	1.3	1.4
Durables		44.6	-10.1	-10.6	3.4	3.7	2.8	2.7	.0	.0	.2
Nondurables		-.9	.4	2.0	1.9	1.1	1.4	1.6	1.2	1.5	1.6
Services		2.4	2.3	1.6	2.4	2.4	2.0	1.6	1.6	1.6	1.6
Business fixed investment		-2.1	-3.0	-2.5	3.1	2.2	2.1	2.2	2.1	2.2	2.2
Producers' durable equipment		1.2	-2.8	-2.1	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Nonresidential structures		-9.8	-3.4	-3.5	.8	-2.3	-2.5	-2.5	-2.7	-2.7	-2.7
Residential structures		9.7	4.3	-3.6	-3.8	1.9	3.0	.6	1.1	3.7	5.4
Exports		13.3	16.1	9.0	8.3	11.0	12.7	11.3	12.4	13.3	10.7
Imports		17.3	4.8	-1.5	-2.1	-.2	.9	-.1	.6	1.9	2.4
Government purchases		4.5	13.2	-2.7	-1.3	-.9	.4	.3	1.0	1.4	1.5
Federal		2.5	30.2	-7.8	-5.5	-4.7	-2.2	-2.4	-1.3	-.3	-.1
Defense		17.2	-4.4	3.0	.0	-2.8	-3.2	-3.4	-2.0	-1.3	-.3
State and local		6.1	1.1	1.8	2.2	2.3	2.6	2.4	2.8	2.8	2.8
Change in business inventories	Billions of 82$	-.3	-11.5	9.8	11.9	13.9	14.5	14.6	15.2	13.5	13.7
Nonfarm	Billions of 82$	-8.6	4.2	13.8	14.9	14.9	15.5	15.6	16.2	14.5	14.7
Net exports	Billions of 82$	-163.3	-155.6	-145.0	-134.3	-123.5	-112.2	-100.5	-88.3	-76.6	-67.9
PLOYMENT AND PRODUCTION											
arm payroll employment	Millions	100.3	101.1	101.5	102.0	102.5	103.0	103.5	103.9	104.4	104.8
nemployment rate	Percent*	6.9	6.9	6.7	6.7	6.6	6.6	6.6	6.6	6.5	6.5
Industrial production index	Percent change	1.9	3.3	4.9	3.2	3.4	3.4	3.4	3.4	3.5	3.4
Capacity utilization rate-mfg.	Percent*	79.7	79.9	80.4	80.6	80.8	81.0	81.2	81.3	81.4	81.5
Housing Starts	Millions	1.75	1.67	1.65	1.66	1.70	1.72	1.73	1.74	1.74	1.74
Auto sales	Millions	12.91	11.32	10.23	10.70	10.90	10.95	11.00	11.00	11.00	11.00
Domestic	Millions	9.43	7.66	7.29	7.50	7.60	7.65	7.70	7.70	7.70	7.70
Foreign	Millions	3.47	3.66	2.94	3.20	3.30	3.30	3.30	3.30	3.30	3.30
INCOME AND SAVING											
Nominal personal income	Percent change	1.8	4.0	6.9	4.0	5.2	6.6	6.6	5.1	5.6	6.1
Real disposable income	Percent change	-3.1	-.5	6.9	-2.4	2.5	2.4	2.4	-.1	1.8	1.1
Personal saving rate	Percent*	2.8	2.7	4.4	3.2	3.3	3.4	3.5	3.2	3.3	3.3
Corp. profits with IVA & CCAdj	Percent change	12.7	7.3	-6.4	-3.7	15.3	15.4	-6.4	9.6	7.1	13.1
Profit share of GNP	Percent*	7.1	7.2	7.0	6.8	7.0	7.1	6.9	7.0	7.0	7.1
Federal govt. surplus/deficit	Billions of $	-197.4	-191.4	-224.2	-173.4	-173.3	-175.6	-174.0	-154.4	-151.7	-146.8
State and local govt. surplus		64.0	50.4	56.1	55.3	58.4	60.9	63.3	63.6	65.0	66.8
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.6	1.0	2.6	3.0	3.0	3.0	3.5	3.4	3.3	3.5
GNP fixed-weight price index		2.6	2.6	2.9	3.1	3.1	3.1	4.0	3.7	3.7	3.7
Cons. & fixed invest. prices		3.0	3.2	3.8	3.5	3.4	3.5	4.1	4.2	4.1	4.2
CPI		2.6	2.8	4.6	3.5	3.6	3.7	4.2	4.1	4.3	4.4
Exc. food and energy		3.6	4.1	3.3	3.6	4.1	4.1	4.7	4.6	4.8	4.9
Nonfarm business sector											
Output per hour		-.3	-1.7	2.0	1.0	1.1	1.3	1.1	1.0	.9	1.0
Compensation per hour		2.3	3.1	3.0	3.1	3.2	3.3	4.9	3.6	3.9	4.2
'nit labor costs		2.6	4.9	1.0	2.1	2.1	2.0	3.8	2.6	3.0	3.2

: at an annual rate.

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February 4, 1987

GROSS NATIONAL PRODUCT AND RELATED ITEMS
(Seasonally adjusted; annual rate)

	Units	1980	1981	1982	1983	1984	1985	1986	Projection 1987	Projection 1988
EXPENDITURES										
Nominal GNP	Billions of $	2732.0	3052.6	3166.0	3405.7	3765.0	3998.1	4208.5	4416.4	4688.4
Real GNP	Billions of 82$	3187.1	3248.8	3166.0	3279.1	3489.9	3585.2	3676.5	3763.2	3868.1
Real GNP	Percent change*	-.1	.6	-1.9	6.5	4.6	2.9	2.2	2.8	2.7
Gross domestic product		.3	.3	-1.6	6.6	4.9	3.1	2.5	2.9	2.7
Gross domestic purchases		-1.1	.8	-.8	8.4	5.9	3.9	2.8	1.5	1.5
Final sales		-.2	.1	.3	3.7	4.4	4.0	2.4	2.0	2.7
Private dom. final purchases		-1.7	-.3	.8	7.7	5.3	4.2	2.8	1.3	1.6
Personal consumption expend.		-.1	.2	2.9	5.4	3.6	3.5	4.0	1.5	1.4
Durables		-5.6	-3.3	9.0	14.7	8.8	6.2	9.9	-.4	.7
Nondurables		-1.4	.5	1.8	4.4	2.2	2.0	3.4	1.6	1.5
Services		2.4	.9	2.3	3.9	3.3	3.9	2.6	2.1	1.6
Business fixed investment		-4.8	5.6	-11.3	10.8	14.7	6.5	-5.4	1.2	2.2
Producers' durable equipment		-6.5	2.2	-12.5	20.9	16.0	8.1	-.6	2.5	4.0
Nonresidential structures		-1.8	11.7	-9.1	-4.8	12.1	3.3	-15.7	-1.9	-2.6
Residential structures		-14.2	-22.4	4.9	38.1	5.3	7.8	9.8	-.7	2.7
Exports		.5	2.4	-13.8	5.8	5.5	-3.2	6.2	10.2	11.9
Imports		-8.8	4.9	-5.9	23.8	16.5	5.8	9.3	-.7	1.2
Government purchases		1.0	2.9	3.8	-2.7	7.7	8.4	3.3	-1.1	1.1
Federal		3.1	9.5	8.2	-8.1	14.2	14.3	1.8	-5.1	-1.0
Defense		3.1	7.6	8.8	5.1	6.8	5.9	7.2	-.8	-1.8
State and local		-.3	-1.3	.6	1.5	3.1	3.7	4.6	2.2	2.7
Change in business inventories	Billions of 82$	-6.9	23.9	-24.5	-6.4	59.2	9.0	10.8	12.5	14.3
Nonfarm	Billions of 82$	-2.3	19.0	-23.1	-.1	54.3	10.9	10.9	14.8	15.3
Net exports	Billions of 82$	57.0	49.4	26.3	-19.9	-83.6	-108.2	-149.7	-128.8	-83.3
Nominal GNP	Percent change*	9.9	9.3	3.1	10.4	8.5	6.3	4.4	5.8	6.2
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	90.4	91.2	89.6	90.2	94.5	97.6	100.2	102.2	104.2
Unemployment rate	Percent	7.1	7.6	9.7	9.6	7.5	7.2	7.0	6.7	6.5
Industrial production index	Percent change*	-.8	-1.0	-7.7	14.3	6.6	1.7	1.1	3.7	3.5
Capacity utilization rate-mfg.	Percent	79.3	78.3	70.3	74.0	80.5	80.1	79.8	80.7	81.3
Housing Starts	Millions	1.30	1.10	1.06	1.71	1.76	1.74	1.83	1.68	1.74
Auto sales	Millions	9.04	8.56	8.00	9.18	10.43	11.09	11.52	10.69	11.00
Domestic	Millions	6.62	6.24	5.77	6.77	7.97	8.24	8.28	7.51	7.70
Foreign	Millions	2.42	2.32	2.23	2.41	2.46	2.84	3.25	3.18	3.30
INCOME AND SAVING										
Nominal personal income	Percent change*	12.0	9.2	5.3	7.8	8.4	6.1	4.4	5.7	5.9
Real disposable income	Percent change*	1.1	.7	1.0	5.1	4.2	1.9	2.4	2.3	1.3
Personal saving rate	Percent	7.1	7.5	6.8	5.4	6.3	5.1	3.9	3.6	3.3
Corp. profits with IVA & CCAdj	Percent change*	-6.8	2.3	-19.1	70.1	6.6	7.8	7.6	4.6	5.6
Profit share of GNP	Percent	6.5	6.2	4.7	6.3	7.0	7.0	7.1	7.0	7.0
Federal govt. surplus/deficit	Billions of $	-61.3	-63.8	-145.9	-176.0	-170.0	-198.0	-204.0	-186.6	-156.7
State and local govt. surplus		26.8	34.1	35.1	47.5	68.5	61.7	60.8	57.7	64.7
PRICES AND COSTS										
GNP implicit deflator	Percent change*	9.9	8.7	5.2	3.6	3.6	3.3	2.2	2.9	3.4
GNP fixed-weight price index		9.8	8.5	5.0	3.9	3.9	3.6	2.4	3.1	3.8
Cons. & fixed invest. prices		10.1	8.2	4.4	3.3	3.6	3.4	2.0	3.6	4.2
CPI		12.5	9.6	4.5	3.3	4.1	3.5	1.3	3.8	4.2
Exc. food and energy		12.2	10.2	5.2	4.3	4.8	4.3	3.8	3.8	4.8
Nonfarm business sector										
Output per hour		1.0	-.6	1.0	3.6	1.0	.2	.7	1.4	1.0
Compensation per hour		10.9	8.3	7.3	3.3	4.3	3.9	2.7	3.1	4.1
Unit labor costs		9.8	9.0	6.2	-.3	3.2	3.7	2.0	1.8	3.1

* Percent changes are from fourth quarter to fourth quarter.

February 4, 1987

CONFIDENTIAL - FR
CLASS II FOMC

GROSS NATIONAL PRODUCT AND RELATED ITEMS
(Net changes, billions of 1982 dollars)

			Projection										Projection	
	1986		1987				1988				1985	1986	1987	1988
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	(fourth quarter to fourth quarter, net change)			
Real GNP	25.0	16.0	20.5	26.1	27.3	28.2	25.9	25.1	25.1	25.5	101.9	80.1	102.1	101.6
Gross domestic product	23.2	19.3	23.0	27.0	27.3	28.7	25.8	25.1	24.1	25.5	107.6	87.9	106.0	100.6
Gross domestic purchases	34.4	8.3	10.0	15.4	16.5	16.8	14.2	13.0	13.4	16.8	141.2	103.7	58.6	57.3
Final sales	40.4	27.2	-.8	24.0	25.3	27.6	25.8	24.5	26.8	25.3	141.1	86.4	76.1	102.4
Private dom. final purchases	41.6	-4.2	-6.2	15.9	16.2	15.4	13.5	10.4	12.4	13.6	122.5	85.3	41.3	49.9
Personal consumption expend.	39.6	-2.9	-1.5	14.4	12.8	11.6	10.7	7.5	8.1	8.5	80.0	93.4	37.2	34.7
Durables	34.5	-10.3	-10.5	3.1	3.4	2.6	2.5	.0	.0	.2	20.2	34.3	-1.4	2.7
Nondurables	-1.9	.8	4.3	4.1	2.4	3.0	3.5	2.6	3.4	3.5	16.7	29.0	13.7	12.9
Services	7.0	6.6	4.7	7.2	7.0	6.0	4.8	4.9	4.7	4.7	43.1	30.1	24.9	19.1
Business fixed investment	-2.4	-3.4	-2.8	3.4	2.5	2.4	2.5	2.4	2.5	2.5	29.3	-25.9	5.5	9.9
Producers' durable equipment	1.0	-2.3	-1.7	3.2	3.2	3.2	3.3	3.3	3.3	3.4	24.4	-1.9	7.9	13.2
Nonresidential structures	-3.4	-1.1	-1.1	.2	-.7	-.8	-.8	-.9	-.8	-.8	4.9	-24.0	-2.4	-3.3
Residential structures	4.5	2.1	-1.8	-1.9	.9	1.4	.3	.5	1.8	2.7	13.2	17.8	-1.4	5.3
Change in business inventories	-15.4	-11.2	21.3	2.1	2.0	.6	.1	.6	-1.7	.2	-39.1	-6.3	26.0	-.8
Nonfarm	-19.6	12.8	9.6	1.1	.0	.6	.1	.6	-1.7	.2	-17.8	-11.9	11.3	-.8
Farm	4.2	-24.0	11.7	1.0	2.0	.0	.0	.0	.0	.0	-21.3	5.6	14.7	.0
Net exports	-9.4	7.7	10.6	10.7	10.8	11.3	11.7	12.1	11.7	8.8	-39.3	-23.6	43.4	44.3
Exports	11.4	14.1	8.4	7.9	10.6	12.5	11.5	12.9	14.3	12.0	-12.1	22.4	39.4	50.7
Imports	20.9	6.3	-2.1	-2.8	-.3	1.2	-.1	.8	2.6	3.2	27.1	46.0	-4.0	6.5
Government purchases	8.2	23.7	-5.2	-2.6	-1.7	.8	.6	1.9	2.7	2.9	57.9	24.7	-8.7	8.2
Federal	2.0	22.6	-7.1	-4.9	-4.1	-1.9	-2.0	-1.1	-.3	-.1	43.4	6.3	-18.0	-3.4
Defense	10.1	-2.9	1.9	.0	-1.8	-2.1	-2.2	-1.3	-.8	-.2	13.4	17.2	-2.0	-4.5
Nondefense	-8.0	25.5	-9.0	-4.9	-2.3	.2	.2	.2	.5	.1	30.0	-10.9	-16.0	1.1
State and local	6.2	1.1	1.9	2.3	2.4	2.7	2.6	3.0	3.0	3.0	14.5	18.4	9.3	11.6

CONFIDENTIAL FR CLASS II — February 4, 1987

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1986*	FY1987e Admin[1]	FY1987e FRB Staff	FY1988e Admin[1]	FY1988e FRB Staff	CY 1986*	CY1987e FRB Staff	1986 IV*	FRB Staff Estimates 1987 I	1987 II	1987 III	1987 IV	1988 I	1988 II	1988 III
								Not seasonally adjusted							
Budget receipts[2]	769	842	828	917	898	782	836	190	197	236	206	198	208	266	226
Budget outlays[2]	990	1016	1009	1024	1046	992	1014	254	250	250	255	259	261	258	268
Surplus/deficit(-) to be financed[2]	-221	-173	-181	-108	-148	-210	-177	-64	-53	-14	-49	-61	-54	9	-42
Means of financing:															
Borrowing from public	236	162	177	107	144	215	153	69	31	26	51	45	56	-1	44
Cash balance decrease	-14	11	6	0	0	0	16	1	19	-8	-5	10	0	-5	-5
Other[3]	-1	0	-3	1	4	-5	9	-5	3	-3	3	6	-2	-3	3
Cash operating balance, end of period	31	20	25	20	25	31	15	31	12	20	25	15	15	20	25
Memo: Sponsored agency borrowing[4]	14	n.a.	15	n.a.	20	14	15	5	1	4	5	5	5	5	5
NIPA Federal Sector								Seasonally adjusted annual rates							
Receipts	815	875	862	968	926	826	873	852	842	874	879	896	920	940	949
Expenditures	1025	1061	1052	1089	1090	1030	1059	1043	1066	1048	1053	1071	1094	1094	1100
Purchases	368	385	381	395	387	367	382	376	381	383	382	383	387	388	390
Defense	275	291	288	301	293	278	290	282	289	291	291	291	293	293	294
Nondefense	94	94	93	94	94	89	92	94	93	92	91	92	94	95	95
All other expend.	657	676	672	694	703	663	677	667	685	665	670	689	707	706	711
Surplus/deficit(-)	-211	-186	-191	-121	-164	-204	-187	-191	-224	-173	-173	-176	-174	-154	-152
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-173	n.a.	-151	n.a.	-129	-166	-148	-151	-184	-133	-135	-139	-139	-120	-118

*--actual   e--estimated   n.a.--not available

Note: Details may not add to totals due to rounding

1. Budget of the United States Government, Fiscal Year 1988 (January 1987). The Congressional Budget Office baseline estimates published in January indicated receipts of $834 and $900 billion, outlays of $1008 and $1069 billion, and deficits of $174 and $169 billion in FY1987 and FY1988, 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, Federal Home Loan Mortgage Corporation (excluding participation certificates), Federal National Mortgage Association (excluding mortgage-backed securities), Farm Credit Banks, and Student Loan Marketing Association marketable debt. The Administration's definition of borrowing by these agencies is somewhat broader.

<u>Recent developments</u>. Short-term interest rates generally have returned to about the levels prevailing at the time of the mid-December FOMC meeting, having retraced the run-up through late December associated with the tax-related surge in financial transactions and with quarter-end balance sheet positioning by depository institutions and other firms. In longer-term markets, bond rates reacted little to year-end pressures and to the drop in the exchange value of the dollar. More recently, however, Treasury bond rates have moved nearly 15 basis points above their December FOMC levels, given market reactions to incoming economic news in the context of the approaching midquarter refunding. Long-term corporate rates have fallen on balance since the last FOMC meeting, reflecting a moderation in bond issuance and expectations that a falloff in merger activity may reduce downgradings in coming months. Tax-exempt bond yields have declined by even more than corporates as private-purpose issuance slowed abruptly in January.

A bulge in demand deposits in December that accompanied a tax-related surge in bank lending and other financial transactions propelled M1 growth to nearly a 30 percent annual rate. As the special factors waned in January, demand deposits ran off, and M1 growth was cut by almost two-thirds despite a further acceleration of currency and NOW accounts. M2 growth likewise was boosted to double-digits in December, with its slowing in January restrained by a pickup of inflows to its nontransactions component. M3 growth in January remained close to its higher December pace as commercial bank issuance of large CDs spurted to help fund the further surge in bank loans.

Much of this strength in bank credit in December and in January was in the business loan component. Business borrowing was elevated to finance share retirements associated with the flurry of merger activity and other corporate restructurings late in December. In addition, the rise around year-end in Eurodollar and commercial paper rates above the prime rate induced corporations to substitute business loans at U.S. banking offices for borrowing from foreign branches of U.S. banks and the commercial paper market. The overall strength in short-term borrowing since November has more than offset some weakening on balance in bond issuance by nonfinancial corporations. New stock offerings by nonfinancial firms strengthened further in December but receded in January, as issuers had not yet responded to the advance in stock prices last month.

Mortgage activity picked up late last year, prompted by further declines in interest rates and by incentives to sell appreciated real estate before year-end, when less favorable capital gains and depreciation provisions became effective. Federally related issuance of mortgage pass-through securities increased in December to establish a new record in the fourth quarter. Real estate lending at commercial banks swelled in December and continued heavy in January, evidently owing in part to the growing use of home equity lines of credit, which substitute in many cases for consumer credit. Revolving credit, which is mostly credit card debt, actually declined in December. Overall consumer credit outstanding edged up in December only because of a step-up in auto credit associated with tax-related spike in car sales that month.

Gross tax-exempt bond issuance temporarily strengthened in December on sizable offerings of private-purpose housing and industrial development bonds permitted under 1986 volume limits. As such issues fell off in January, gross offerings of municipal securities retreated last month, despite continued large issuance of refunding bonds. A more than seasonal slackening in federal borrowing was evident in January, when Treasury bills were paid down. The federal deficit in January was narrowed by unusually large tax payments by individuals on capital gains realized late last year.

Outlook. The growth of debt of nonfinancial sectors through the current quarter is likely to remain well below the bloated pace of late last year. Federal borrowing over the rest of this quarter will be restrained by a rundown in the Treasury's unusually large cash balance and by the boost to revenues from the final installment on March 15 of higher corporate taxes stemming from the retroactive repeal of the investment tax credit. Borrowing by state and local governments probably will remain subdued. Even with rates on municipal bonds near the lowest levels in more than seven years, refunding issues could taper off as the initial reactions to recent interest rate declines play out.

For nonfinancial corporations, the gap between capital expenditures and internal funds is likely to widen somewhat from the fourth-quarter level, but net share retirements should remain substantially below their fourth-quarter pace. On net, business demands for credit probably will be lighter this quarter, with the drop-off occurring in the short-term area, especially at U.S. offices of commercial banks as more typical patterns of borrowing in the commercial paper market and at offshore bank branches are fully restored. The current lower levels of corporate bond rates, if maintained, could elicit some moderate strengthening of long-term debt issuance from the reduced January pace, perhaps enough to cause the amount this quarter to exceed that of the fourth quarter. The persistence of higher stock prices would encourage increased flotation of new equities, while retirements from mergers and other corporate restructurings stay subdued.

Households are likely to maintain relatively strong mortgage borrowing over the rest of this quarter. Turnover of existing homes is expected to remain heavy, though below the frantic pace of late last year; rates quoted on conventional fixed-rate mortgages have moved down almost to 9 percent, which is in more normal alignment with prevailing long-term Treasury yields. The general downward trend of consumer credit growth in recent months is anticipated to continue this quarter in association with the projected softness of spending on consumer durables and the evident growing popularity of home equity loans.

Beyond the first quarter, aggregate domestic debt growth is projected to remain below the 1986 pace—although not quite so "slow" as in the opening months of the year. Federal borrowing will pick up in the spring, although Treasury cash needs for the year as a whole will be reduced by the diminishing budget deficit. State and local borrowing should be restrained by the large amount of funds raised in 1985-86 in anticipation of later uses. Business borrowing will be comparable to the 1986 volume, as a somewhat larger financing gap is offset by a reduced volume of merger-related share retirements. And overall household debt growth is unlikely to be much different from the 1986 rate, with mortgage debt stronger and consumer debt growth being held down in part by substitution of home equity credit.

Recent developments. The trade-weighted average foreign exchange value of the dollar against G-10 currencies has declined about 8 percent, on balance, since the December FOMC meeting. The dollar declined sharply in early January, following release of preliminary trade data that suggested a substantial worsening of the U.S. merchandise trade balance in November and a variety of public statements by U.S. and foreign officials regarding the appropriate value of the dollar. Subsequently, the dollar recovered somewhat in response to the release of data giving a more favorable-than-expected December deficit and revised data for November that indicate a narrower deficit in that month. Since the December meeting, the dollar has declined 10 percent against the mark, about 7 percent against the yen, and about 3-3/4 percent against the Canadian dollar.

. The Desk intervened for the U.S. account on one occasion, purchasing $50 million against yen, which was split evenly between the System and the Exchange Stabilization Fund. A realignment of parities within the European monetary grid was announced on January 11; the German mark and Dutch guilder were revalued by 3 percent and the Belgian franc was revalued by 2 percent against all other currencies in the exchange-rate system.

Indicators of real economic activity in the major foreign industrial countries continue to show low rates of expansion.

Provisional data estimate real GNP growth in 1986 at 2.5 percent in Germany and 2 percent in France. In Japan industrial production in the fourth quarter averaged 1 percent below its level in the preceding quarter while in Germany the fourth-quarter average of industrial production was 0.3 percent below the third-quarter level. The Japanese cabinet has adopted a budget for the fiscal year beginning April 1 that calls for only a slight increase in total nominal expenditure. Tax reform measures have been proposed that would lower marginal tax rates, but offsetting increases in indirect taxes will leave revenue unchanged for the coming fiscal year. On January 23 the Bundesbank lowered its discount and Lombard rates 1/2 percentage point each. The Bundesbank also raised reserve requirements and lowered quotas for discount borrowing in order to absorb part of the large inflow of funds that occurred prior to the EMS realignment. On balance, these measures were intended to bring about a lower level of market interest rates in Germany.

Real GDP growth in the major developing countries was uneven in 1986. Brazil adopted measures late in the year to slow its 7.7 percent growth of real GDP while Argentina and Venezuela experienced relatively strong growth of 5-1/2 percent and 3 percent, respectively, and Mexico suffered a decline in real GDP of about 4 percent. Argentina has reached agreement with the IMF management for a stand-by arrangement, and Nigeria's arrangement with the IMF has received final approval by the Executive Board. Both Brazil and the Philippines in January concluded reschedulings of external debt with Paris Club creditors. Efforts are continuing to complete commitments to the $7.7 billion financing package for Mexico by the banks that have been reluctant to participate.

U.S. merchandise trade data recently released indicate a substantially lower November deficit than was originally suggested by the preliminary figures and, based on preliminary data, a reduced deficit in December. The staff estimates that when all the data have been revised, seasonally adjusted, and are put on a balance-of-payments basis, the trade deficit in the fourth quarter will be about $157 billion (s.a.a.r.), slightly larger than in the third quarter. The value of both exports and non-oil imports appear to have increased about 4 percent. Oil imports rose slightly in value, but declined in volume. These data by themselves suggest there could be some upward revision to the figure published for real GNP growth in the fourth quarter.

Growth of official reserve assets in the United States tapered off to $1.4 billion in October and was negligible in November after averaging $4 billion per month in the second and third quarters. Net purchases of U.S. Treasury obligations by foreigners other than official reserve holders also fell in October and November, with a net outflow in the latter month largely the result of net sales of $2 billion by nonmonetary international organizations. Private net foreign purchases of U.S. corporate stocks and bonds also slowed in October and November. Offsetting these reductions in capital inflows were net sales of foreign securities by U.S. residents totalling $3.4 billion in October.

Outlook. The staff projects a moderate decline in the value of the dollar that will continue through the end of 1988, but notes the risk of a sharper fall, as occurred in January, if market participants are disappointed with the pace of adjustment of U.S. economic developments. The staff outlook for the current account is for the deficit to be reduced gradually after peaking in the current quarter. In the first quarter, a rise in the price of oil imports is expected to increase their value to well above the fourth-quarter rate, largely accounting for the increase in the current account deficit. For the year 1987 as a whole, the current account deficit is projected to be about $150 billion, slightly larger than the estimated outcome for 1986. By the fourth quarter of 1988, the current account balance in nominal terms is projected to improve by more than $30 billion from the fourth quarter of 1986, with most of the improvement occurring during 1988. Since import prices are expected to rise considerably faster than export prices in 1987, the small change in nominal terms masks a substantial rise in real net exports. In 1988, similar improvement is expected in both nominal and real terms.

Strictly Confidential (FR)
Class II FOMC

February 3, 1987

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

	ANNUAL			1986		1987				1988			
	1986-	1987-P	1988-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	-105.7	-115.9	-89.9	-108.9	-115.6	-125.9	-118.6	-112.1	-106.9	-101.5	-93.1	-85.3	-79.8
Exports of G+S	373.0	415.2	487.7	370.8	383.4	393.2	405.6	422.0	440.1	457.4	476.8	498.4	518.0
Imports of G+S	478.7	531.1	577.6	479.7	499.0	519.1	524.1	534.1	547.1	559.0	569.9	583.7	597.9
Constant 82 $, Net	-149.7	-129.0	-83.6	-163.3	-155.6	-145.3	-134.6	-123.8	-112.4	-100.8	-88.6	-76.9	-68.2
Exports of G+S	371.4	408.0	456.0	371.2	385.3	393.7	401.5	412.1	424.7	436.2	449.1	463.4	475.4
Imports of G+S	521.0	536.9	539.6	534.5	540.8	538.9	536.1	535.8	537.0	536.9	537.7	540.2	543.5
2. U.S. Merchandise Trade Balance 2/	-149.0	-152.1	-130.4	-150.7	-156.7	-162.4	-154.2	-148.5	-143.5	-139.5	-132.3	-127.0	-122.8
Exports	221.6	255.6	310.5	221.3	230.0	237.3	249.1	261.5	274.5	288.9	303.6	318.2	331.4
Agricultural	27.0	26.9	29.1	25.9	29.0	27.1	27.1	26.7	26.8	27.9	28.8	29.8	30.1
Non-Agricultural	194.6	228.7	281.4	195.4	201.0	210.2	222.0	234.8	247.7	261.0	274.9	288.4	301.3
Imports	370.6	407.7	440.9	371.9	386.7	399.7	403.3	410.0	418.1	428.4	435.9	445.2	454.2
Petroleum and Products	34.0	40.2	44.4	32.0	32.7	41.3	38.8	39.3	41.3	42.9	43.4	45.3	45.8
Non-Petroleum	336.6	367.6	396.6	340.0	354.0	358.4	364.5	370.7	376.7	385.5	392.5	399.9	408.4
3. U.S. Current Account Balance	-142.8	-150.8	-127.6	-145.1	-152.5	-158.7	-153.1	-147.1	-144.3	-137.5	-129.9	-122.8	-120.1
Of Which: Net Investment Income	21.9	13.0	11.2	22.0	18.2	14.8	12.8	12.6	11.7	11.4	10.9	11.6	11.0
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.3	2.2	2.1	1.7	1.9	1.7	2.5	2.1	2.0	1.7	2.4	2.3	2.2
Real GNP--NonOPEC LDC 5/	4.1	3.9	4.1	4.1	3.9	3.8	3.8	3.9	3.9	4.0	4.3	4.6	5.0
Consumer Prices--Ten Ind. 4/	2.0	2.2	2.9	0.1	2.0	2.8	2.9	2.5	2.8	2.9	3.2	3.0	3.2

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.
Projected