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Strictly Confidential (FR) Class II FOMC

February 3, 1988

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. Economic activity continued to expand rapidly in the fourth quarter, with real GNP up more than 4 percent at an annual rate. Industrial production posted another sizable rise, supported by continued strong export demand. However, consumer spending and business investment both were down in real terms, and much of the production gain apparently went into inventories. Price inflation at year-end was held down by declines in energy prices, while wage trends generally remained stable.

Industrial production rose 0.2 percent in December, bringing the quarterly-average increase in the fourth quarter to 6-1/4 percent at an annual rate. Output in December was damped by a reduction in automobile assemblies. In addition, output of business equipment has edged lower in the past few months, after strong growth over the summer and autumn. However, production of materials and intermediate products has remained strong, and operating rates in the chemicals, textiles, and paper industries have reached quite high levels.

Labor demand remained robust in December, with payroll employment up about 325,000. Manufacturing employment rose sharply for the sixth month in a row, with hiring widespread across durable and nondurable industries, while job growth in the service-producing sector remained brisk. The civilian unemployment rate edged down to 5.8 percent in December, the lowest level since 1979. However, initial claims for unemployment insurance have risen markedly in recent weeks, suggesting that labor demand may have slowed since the December labor market surveys were conducted.

Consumer spending has been lackluster in recent months. Sales of automobiles have improved since incentives were reintroduced in mid-November, but have not been strong enough to make much of a dent in dealer inventories. Excluding motor vehicles, real outlays on goods and services were essentially flat during the last three months of 1987, and increased only about 1-1/4 percent over the year as a whole. With spending weak and disposable income up substantially in the fourth quarter, the saving rate rose to 4.9 percent.

Housing starts fell to 1.37 million units at an annual rate in December, reflecting a sharp drop in multifamily building from a surprisingly high November level and a smaller decline in the single-family area. Sales of both new and existing homes also decreased late last year. For the fourth quarter as a whole, total starts averaged 1.52 million units, with declines of about 6-1/2 percent in both the single- and multifamily sectors.

Business fixed investment fell somewhat in the fourth quarter, after an exceptionally large rise in the third quarter. Spending on information-processing equipment, which had grown rapidly in the preceding two quarters, appears to have hit a lull, and purchases of motor vehicles were lower. Meanwhile, outlays for industrial equipment continued to expand, and nonresidential construction spending rose further, with substantial increases in the office and other commercial building categories. Looking ahead, new orders for nondefense capital goods (excluding aircraft) were little changed in the fourth quarter, after appreciable gains earlier in the year, while new building commitments continued to trend up.

Inventory investment surged in October and November, with increases in constant-dollar terms averaging $56 billion at an annual rate. The step-up was concentrated in the trade sector, with notable increases at automobile dealers and at merchant wholesalers. Stocks at nonauto retailers also continued to expand and currently are larger than appears warranted by the recent pace of sales, especially at general merchandise, apparel, and furniture stores. In contrast, manufacturing inventories remain low relative to shipments.

Increases in consumer prices have been small in recent months, with the CPI up only 0.1 percent in December, after rising 0.3 percent in November. Retail energy prices fell in December, in response to earlier decreases in crude oil prices, and a further decline is likely to be reported in the January CPI. Excluding food and energy, the CPI also increased only 0.1 percent in December, as prices of consumer goods were held down by extensive markdowns on holiday merchandise and by the latest round of automobile incentives. Over 1987 as a whole, the CPI excluding food and energy increased 4.2 percent, about 1/2 percentage point faster than in 1986, with marked acceleration in some categories, such as apparel, where import prices have risen rapidly.

At the producer level, price increases for finished goods (other than food and energy) also were moderate, on net, in the past few months. At earlier stages of processing, prices of intermediate materials (excluding food and energy) continued to rise rapidly through year-end, although increases at the crude level recently have slowed. Price indexes for industrial commodities have drifted down a bit recently, but on the whole have remained in about the same range that has prevailed since the price runup of last spring.

Hourly compensation in the private nonfarm sector, as measured by the employment cost index (ECI), increased 3.3 percent in 1987, about the same pace as in 1986. According to separate data, the effective wage change for all workers covered by major collective bargaining contracts was about 3 percent in 1987, compared with 2-1/4 percent the year before; the pickup mainly reflected increases in COLAs associated with the more rapid rise in the CPI.

Outlook. The staff expects real GNP growth to slow to about 1-1/2 percent at an annual rate in the first half of 1988. Activity is anticipated to pick up after midyear, with real growth averaging about 2-3/4 percent at an annual rate through 1989. Prices, as measured by the GNP fixed-weight price index, are projected to rise 4 percent this year and 4-1/4 percent in 1989.

The financial assumptions underlying the staff projection are similar to those in the December Greenbook. Growth rates of M2 and M3 are expected in 1988 to be around the middle of the tentative ranges set by the FOMC, and to be somewhat lower in 1989. Interest rates are anticipated to be unchanged to a bit lower through midyear, and then to trend upward gradually over the remainder of the projection period as the economy gathers strength once again and potential inflationary pressures become more of a concern. The foreign exchange value of the dollar is projected to decline moderately through the end of 1989.

The federal budget deficit on a unified basis is projected to be just under $160 billion in fiscal year 1988 and about $145 billion in fiscal 1989. The fiscal 1989 estimates assume the enactment of the remaining elements of the deficit-reduction agreement reached by the administration and Congress late last year. Over the projection span as a whole, fiscal policy is interpreted as a moderately restraining influence on aggregate demand.

The anticipated deceleration in GNP growth in early 1988 is largely reflected in a sharp slowing in the pace of nonfarm inventory investment, from $54 billion at an annual rate in the fourth quarter of 1987 to $35 billion in the first quarter and $29 billion in the second. The downswing in automobile inventories is expected to be sizable, given the domestic automakers' current assembly schedules. Among the components of domestic final demand, consumer spending, which was sluggish on average in 1987, is anticipated to post only a small gain, reflecting in part the continuing adjustment to the decline in stock prices. Business fixed investment is projected to rise somewhat, because of increased spending on equipment, but the downtrend in housing starts through late 1987 points to a decline in real outlays on residential construction. The external sector though is expected to provide a considerable offset to the weakness in domestic demand, as export volumes continue to expand rapidly and real imports show little net change over the two quarters.

The staff anticipates that the production adjustments will be largely completed by midyear and that activity will rebound in the second half, with real GNP growth picking up to about a 2-3/4 percent annual rate. The rise in real output in 1989 also is projected to be around 2-3/4 percent. The primary impetus to growth throughout the projection comes from the continued strong demand for U.S. exports.

Domestic demand is expected to firm a little after mid-1988, but to grow only about 1-3/4 percent at an annual rate over the next six quarters. Growth in business fixed investment is anticipated to pick up gradually, as domestic production expands--especially in the tradeable goods sector--and modernization efforts continue. Consumer spending, however, continues to be damped by the relatively slow growth of real incomes.

Prices, as measured by the GNP fixed-weight price index, are projected to rise 4 percent over the four quarters of 1988, and about 4-1/4 percent in 1989. After a sharp rebound in 1987, prices of imported petroleum are expected to trend up slowly over the projection horizon. However, increases in nonpetroleum import prices associated with the depreciation of the dollar are likely to be substantial and to provide considerable impetus to inflation. Moreover, nominal gains in compensation are expected to pick up. Higher social security taxes probably will add nearly 1/2 percentage point to this year's rise in compensation; more generally, wage demands are expected to respond to past and prospective increases in consumer prices. With the unemployment rate not expected to fall much below 6 percent over the projection horizon, labor market tightness should place little additional upward pressure on pay rates, especially in light of the concerns in the short run about the economic outlook and of continuing efforts to improve international competitiveness.

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

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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)	
		12/9/87	2/3/88	12/9/87	2/3/88	12/9/87	2/3/88	12/9/87	2/3/88	12/9/87	2/3/88
Annual changes:											
1986	<1>	5.6	5.6	2.9	2.9	2.7	2.7	2.6	2.6	7.0	7.0
1987	<1>	5.8	5.9	2.8	2.9	3.5	3.4	2.9	3.0	6.2	6.2
1988		5.7	5.9	2.3	2.6	3.9	3.9	3.3	3.2	6.3	6.0
1989			6.6		2.8		4.2		3.8		5.8
Quarterly changes:											
1987	Q1 <1>	8.6	8.6	4.4	4.4	4.5	4.5	4.2	4.2	6.7	6.6
	Q2 <1>	6.3	6.3	2.5	2.5	4.1	4.1	3.5	3.5	6.2	6.3
	Q3 <1>	7.0	7.3	4.1	4.3	3.3	3.4	2.8	2.8	6.0	6.0
	Q4 <1>	5.4	6.7	3.0	4.2	3.7	3.7	2.5	2.7	6.0	5.9
1988	Q1	5.1	4.9	1.1	1.3	4.1	4.1	3.9	3.4	6.2	5.9
	Q2	5.0	5.2	1.6	1.7	3.8	3.8	3.4	3.5	6.3	6.0
	Q3	6.3	6.1	2.6	2.6	4.1	3.9	3.7	3.5	6.3	6.0
	Q4	7.0	6.7	2.9	2.9	4.3	4.2	3.9	3.8	6.2	6.0
989	Q1		7.0		3.0		4.3		3.9		5.9
	Q2		6.7		2.8		4.2		3.9		5.9
	Q3		6.7		2.8		4.2		3.8		5.8
	Q4		6.7		2.8		4.2		3.8		5.8
Two-quarter changes: <2>											
1987	Q2 <1>	7.5	7.5	3.4	3.4	4.4	4.4	3.9	3.9	-.7	-.6
	Q4 <1>	6.2	7.0	3.5	4.2	3.6	3.6	2.6	2.8	-.2	-.4
1988	Q2	5.1	5.1	1.4	1.5	4.0	4.0	3.7	3.4	.3	.1
	Q4	6.7	6.4	2.8	2.7	4.2	4.0	3.8	3.6	-.1	.0
1989	Q2		6.9		2.9		4.3		3.9		-.1
	Q4		6.7		2.8		4.2		3.8		-.1
Four-quarter changes: <3>											
1986	Q4 <1>	4.5	4.5	2.2	2.2	2.3	2.3	2.2	2.2	-.2	-.2
1987	Q4 <1>	6.8	7.2	3.5	3.8	4.0	4.0	3.2	3.3	-.9	-1.0
1988	Q4	5.9	5.7	2.1	2.1	4.1	4.0	3.7	3.5	.2	.1
1989	Q4		6.8		2.8		4.2		3.8		-.2

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

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

		1987		Projection 1988				Projection 1989			
	Units	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of $	4524.0	4598.0	4653.4	4712.8	4783.3	4861.6	4944.7	5025.8	5108.4	5191.7
Real GNP	Billions of 82$	3835.9	3875.1	3887.6	3903.8	3928.7	3956.4	3986.0	4013.1	4040.9	4068.8
Nominal GNP	Percent change	7.3	6.7	4.9	5.2	6.1	6.7	7.0	6.7	6.7	6.7
Real GNP		4.3	4.2	1.3	1.7	2.6	2.9	3.0	2.8	2.8	2.8
Gross domestic product		4.8	4.3	1.2	1.3	2.5	2.9	3.0	2.8	2.9	2.8
Gross domestic purchases		4.8	3.2	-1.3	.5	1.5	1.8	1.9	1.8	1.7	1.6
Final sales		6.0	.6	2.9	2.4	2.7	2.7	2.8	2.6	2.8	2.8
Private dom. final purchases		7.3	-3.2	1.3	1.6	2.0	2.0	1.8	1.8	1.9	1.9
Personal consumption expend.		5.4	-3.8	1.4	1.8	2.0	2.1	1.8	1.8	1.5	1.5
Durables		24.3	-20.4	-2.6	1.3	3.3	4.2	2.0	2.2	2.0	1.9
Nondurables		-1.5	-4.5	1.9	1.8	1.4	1.2	1.2	1.2	.7	.7
Services		5.0	2.8	2.4	1.9	2.0	2.2	2.2	2.1	1.9	1.9
Business fixed investment		25.8	-3.6	4.4	1.1	1.6	1.2	2.2	2.6	2.9	3.0
Producers' durable equipment		26.3	-7.2	5.6	1.5	2.5	2.0	3.0	3.5	4.0	4.0
Nonresidential structures		24.6	6.4	1.4	.2	-.6	-.9	.2	.2	.1	.3
Residential structures		-6.5	5.9	-7.1	.3	3.5	2.8	.4	.6	3.9	4.4
Exports		23.7	16.2	15.7	16.0	12.8	15.1	15.0	15.1	15.5	16.2
Imports		22.4	6.3	-5.6	4.3	3.5	5.5	5.6	6.6	6.4	6.8
Government purchases		2.6	12.6	-4.3	-.7	.0	.0	1.4	.7	.6	.5
Federal		4.5	23.5	-11.3	-3.7	-2.3	-2.4	.1	-1.7	-1.8	-2.1
Defense		7.5	-.7	-5.1	-5.8	-3.9	-3.5	-.6	-2.2	-2.0	-2.0
State and local		1.2	4.8	1.6	1.6	1.7	1.8	2.3	2.4	2.4	2.5
Change in business inventories	Billions of 82$	24.6	58.3	43.8	37.2	36.2	37.6	39.9	41.5	42.2	41.9
Nonfarm	Billions of 82$	12.1	53.7	35.0	29.2	27.9	30.0	32.9	35.0	36.4	36.9
Net exports	Billions of 82$	-138.4	-130.7	-105.5	-93.7	-83.7	-73.6	-63.3	-53.8	-42.8	-30.9
LOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	102.3	103.3	103.8	104.1	104.5	104.9	105.4	105.9	106.4	106.9
Unemployment rate	Percent*	6.0	5.9	5.9	6.0	6.0	6.0	5.9	5.9	5.8	5.8
Industrial production index	Percent change	8.8	6.3	1.5	2.3	4.1	4.4	4.3	4.2	4.1	4.1
Capacity utilization rate-mfg.	Percent*	81.4	82.2	81.8	81.7	81.9	82.1	82.3	82.5	82.6	82.7
Housing Starts	Millions	1.62	1.52	1.55	1.58	1.58	1.59	1.59	1.59	1.60	1.60
Auto sales	Millions	11.42	10.02	9.68	9.59	9.80	10.02	10.10	10.18	10.22	10.25
Domestic	Millions	7.84	6.63	6.60	6.59	6.80	7.00	7.10	7.18	7.22	7.25
Foreign	Millions	3.58	3.38	3.08	3.00	3.00	3.02	3.00	3.00	3.00	3.00
INCOME AND SAVING											
Nominal personal income	Percent change	5.8	10.0	5.3	4.1	4.5	7.0	8.3	6.0	6.7	7.4
Real disposable income	Percent change	4.5	5.3	3.0	-.7	.9	1.6	2.8	.8	1.5	2.2
Personal saving rate	Percent*	2.8	4.9	5.3	4.7	4.4	4.3	4.5	4.3	4.3	4.4
Corp. profits with IVA & CCAdj	Percent change	26.7	.8	-7.9	2.5	14.6	9.6	8.4	6.9	1.2	7.0
Profit share of GNP	Percent*	7.0	6.9	6.6	6.6	6.7	6.8	6.8	6.8	6.7	6.7
Federal govt. surplus/deficit	Billions of $	-135.8	-165.0	-173.0	-159.5	-155.9	-157.1	-156.1	-140.5	-127.6	-123.8
State and local govt. surplus		46.5	43.1	43.9	47.1	51.0	60.1	61.3	61.7	61.2	61.6
Exc. social insurance funds		-5.6	-10.3	-10.2	-7.7	-4.5	3.9	4.4	4.1	2.9	2.6
PRICES AND COSTS											
GNP implicit deflator	Percent change	2.8	2.7	3.4	3.5	3.5	3.8	3.9	3.9	3.8	3.8
GNP fixed-weight price index		3.4	3.7	4.1	3.8	3.9	4.2	4.3	4.2	4.2	4.2
Cons. & fixed invest. prices		3.9	3.7	3.7	4.3	4.4	4.4	4.7	4.6	4.6	4.5
CPI		4.0	3.6	3.1	4.5	4.6	4.8	4.6	4.8	4.8	4.7
Exc. food and energy		3.6	4.2	4.1	4.7	5.0	5.0	5.1	5.2	5.1	5.0
Nonfarm business sector											
Output per hour		3.6	1.0	.5	.6	1.4	1.5	1.4	1.3	1.1	1.2
Compensation per hour		3.8	3.7	4.8	3.6	3.9	4.2	4.6	4.4	4.5	4.6
Unit labor costs		.2	2.7	4.3	3.0	2.5	2.7	3.2	3.1	3.4	3.4

ot at an annual rate.

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February 3, 1988

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

	Units	1981	1982	1983	1984	1985	1986	1987	Projection 1988	1989
EXPENDITURES										
Nominal GNP	Billions of $	3052.6	3166.0	3405.7	3772.2	4010.3	4235.0	4486.2	4752.8	5067.6
Real GNP	Billions of 82$	3248.8	3166.0	3279.1	3501.4	3607.5	3713.3	3819.6	3919.1	4027.2
Real GNP	Percent change*	.6	-1.9	6.5	5.1	3.3	2.2	3.8	2.1	2.8
Gross domestic product		.3	-1.6	6.6	5.3	3.5	2.6	4.0	2.0	2.9
Gross domestic purchases		.8	-.8	8.4	6.4	4.1	2.7	3.2	.6	1.7
Final sales		.1	.3	3.7	4.7	4.6	2.6	1.9	2.7	2.8
Private dom. final purchases		-.3	.8	7.7	5.6	4.6	3.2	.9	1.7	1.8
Personal consumption expend.		.2	2.9	5.4	4.1	4.5	4.1	.6	1.8	1.7
Durables		-3.3	9.0	14.7	10.8	6.6	12.4	-3.7	1.5	2.0
Nondurables		.5	1.8	4.4	2.3	2.9	2.9	-1.7	1.6	.9
Services		.9	2.3	3.9	3.5	5.0	2.4	3.8	2.1	2.0
Business fixed investment		5.6	-11.3	10.8	13.8	4.7	-4.7	3.7	2.1	2.7
Producers' durable equipment		2.2	-12.5	20.9	14.9	7.0	.2	3.7	2.9	3.6
Nonresidential structures		11.7	-9.1	-4.8	11.8	.1	-15.4	3.7	.0	.2
Residential structures		-22.4	4.9	38.1	6.1	6.0	12.5	-2.9	-.2	2.3
Exports		2.4	-13.8	5.8	5.9	-2.7	5.9	16.9	14.9	15.4
Imports		4.9	-5.9	23.8	17.4	5.2	8.9	8.2	1.8	6.3
Government purchases		2.9	3.8	-2.7	7.9	8.7	2.4	3.0	-1.3	.8
Federal		9.5	8.2	-8.1	13.0	14.9	-.2	2.9	-5.0	-1.4
Defense		7.6	8.8	5.1	6.5	7.0	4.8	6.0	-4.6	-1.7
State and local		-1.3	.6	1.5	4.4	4.0	4.6	3.1	1.7	2.4
Change in business inventories	Billions of 82$	23.9	-24.5	-6.4	62.3	7.4	13.8	42.4	38.7	41.4
Nonfarm	Billions of 82$	19.0	-23.1	-.1	57.8	12.0	15.4	33.1	30.5	35.3
Net exports	Billions of 82$	49.4	26.3	-19.9	-84.0	-108.2	-145.8	-134.3	-89.1	-47.7
Nominal GNP	Percent change*	9.3	3.1	10.4	8.6	6.6	4.5	7.2	5.7	6.8
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	91.2	89.6	90.2	94.5	97.5	99.6	102.1	104.3	106.2
Unemployment rate	Percent	7.6	9.7	9.6	7.5	7.2	7.0	6.2	6.0	5.8
Industrial production index	Percent change*	-1.0	-7.7	14.3	6.6	1.7	1.0	5.6	3.1	4.2
Capacity utilization rate-mfg.	Percent	78.2	70.3	73.9	80.5	80.1	79.7	81.0	81.9	82.5
Housing Starts	Millions	1.10	1.06	1.71	1.77	1.74	1.82	1.64	1.57	1.59
Auto sales	Millions	8.56	8.00	9.18	10.43	11.09	11.52	10.34	9.77	10.19
Domestic	Millions	6.24	5.77	6.77	7.97	8.24	8.28	7.14	6.75	7.19
Foreign	Millions	2.32	2.23	2.41	2.46	2.84	3.25	3.21	3.02	3.00
INCOME AND SAVING										
Nominal personal income	Percent change*	9.2	5.3	7.8	8.4	6.8	5.5	7.2	5.2	7.1
Real disposable income	Percent change*	.7	1.0	5.1	4.3	2.8	3.6	2.0	1.2	1.8
Personal saving rate	Percent	7.5	6.8	5.4	6.1	4.5	4.3	3.8	4.7	4.4
Corp. profits with IVA & CCAdj	Percent change*	2.3	-19.1	70.1	7.4	4.1	1.2	12.2	4.4	5.8
Profit share of GNP	Percent	6.2	4.7	6.3	7.1	6.9	6.7	6.8	6.7	6.8
Federal govt. surplus/deficit	Billions of $	-63.8	-145.9	-176.0	-169.6	-196.0	-204.7	-152.6	-161.3	-137.0
State and local govt. surplus		34.1	35.1	47.5	64.6	63.1	56.8	45.4	50.5	61.5
Exc. social insurance funds		4.1	-1.7	4.4	19.8	16.0	7.4	-6.3	-4.6	3.5
PRICES AND COSTS										
GNP implicit deflator	Percent change*	8.7	5.2	3.6	3.4	3.1	2.2	3.3	3.5	3.8
GNP fixed-weight price index		8.5	5.0	3.9	3.7	3.6	2.3	4.0	4.0	4.2
Cons. & fixed invest. prices		8.2	4.4	3.3	3.3	3.5	2.0	4.3	4.2	4.6
CPI		9.6	4.5	3.2	4.1	3.5	1.3	4.4	4.2	4.7
Exc. food and energy		10.2	5.2	4.2	4.7	4.3	3.9	4.2	4.7	5.1
Nonfarm business sector										
Output per hour		-.6	1.0	3.6	1.5	1.0	1.5	1.6	1.0	1.2
Compensation per hour		8.3	7.3	3.3	4.2	4.8	3.4	2.9	4.1	4.5
Unit labor costs		9.0	6.2	-.3	2.6	3.7	1.9	1.3	3.1	3.2

* Percent changes are from fourth quarter to fourth quarter.

CONFIDENTIAL - FR
CLASS II FOMC

February 3, 1988

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

	1987		Projection 1988				Projection 1989				1986	1987	Projection 1988	Projection 1989
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	(fourth quarter to fourth quarter, net change)			
Real GNP	40.6	39.2	12.5	16.2	24.9	27.7	29.5	27.2	27.8	27.8	80.6	143.6	81.3	112.3
Gross domestic product	44.5	40.5	11.1	12.9	24.3	27.6	29.5	27.8	28.2	27.9	92.7	149.1	75.9	113.3
Gross domestic purchases	46.3	31.5	-12.7	4.5	14.9	17.6	19.2	17.7	16.8	15.9	103.1	122.5	24.2	69.7
Final sales	55.1	5.3	27.1	22.8	25.9	26.3	27.2	25.6	27.1	28.1	93.3	70.9	102.1	108.0
Private dom. final purchases	55.8	-25.7	10.5	12.5	15.9	16.2	14.3	14.8	14.9	15.2	97.7	26.6	55.2	59.2
Personal consumption expend.	33.2	-24.1	9.0	11.1	12.4	13.5	11.5	11.5	9.6	9.5	97.3	16.1	45.9	42.0
Durables	21.5	-22.5	-2.5	1.3	3.1	4.0	1.9	2.1	1.9	1.9	43.9	-14.6	5.8	7.9
Nondurables	-3.3	-10.1	4.1	3.9	3.0	2.6	2.6	2.6	1.5	1.5	24.6	-14.7	13.6	8.3
Services	15.0	8.5	7.4	5.9	6.3	6.9	6.9	6.7	6.1	6.1	28.6	45.5	26.5	25.8
Business fixed investment	25.9	-4.2	5.0	1.3	1.9	1.4	2.6	3.0	3.4	3.5	-22.0	16.4	9.6	12.6
Producers' durable equipment	19.1	-6.2	4.6	1.2	2.1	1.7	2.5	3.0	3.4	3.4	.6	11.8	9.6	12.3
Nonresidential structures	6.8	2.0	.4	.1	-.2	-.3	.1	.1	.0	.1	-22.6	4.6	.0	.3
Residential structures	-3.3	2.8	-3.6	.2	1.7	1.4	.2	.3	1.9	2.1	22.5	-5.9	-.4	4.5
Change in business inventories	-14.4	33.7	-14.5	-6.6	-1.0	1.4	2.3	1.6	.7	-.3	-12.8	72.7	-20.7	4.3
Nonfarm	-10.6	41.6	-18.7	-5.8	-1.3	2.1	2.9	2.1	1.4	.5	-14.4	51.4	-23.7	6.9
Farm	-3.8	-7.9	4.2	-.8	.3	-.7	-.6	-.5	-.7	-.8	1.6	21.2	3.0	-2.6
Net exports	-5.7	7.7	25.2	11.7	10.0	10.1	10.3	9.5	11.0	11.9	-22.5	21.1	57.1	42.7
Exports	22.6	16.7	16.9	17.8	15.0	18.0	18.5	19.3	20.6	22.1	21.8	65.5	67.6	80.5
Imports	28.4	8.9	-8.4	6.1	5.0	7.9	8.2	9.8	9.6	10.3	44.3	44.4	10.6	37.8
Government purchases	5.0	23.3	-8.6	-1.4	-.1	.0	2.7	1.3	1.2	1.0	18.1	23.2	-10.1	6.2
Federal	3.7	18.2	-10.4	-3.2	-2.0	-2.0	.1	-1.4	-1.5	-1.8	-.7	9.9	-17.6	-4.6
Defense	4.8	-.5	-3.5	-3.9	-2.6	-2.3	-.4	-1.4	-1.3	-1.3	11.6	15.1	-12.3	-4.4
Nondefense	-1.2	18.8	-6.9	.7	.6	.3	.5	.0	-.2	-.5	-12.3	-5.2	-5.3	-.2
State and local	1.3	5.1	1.8	1.8	1.9	2.0	2.6	2.7	2.7	2.8	18.7	13.4	7.5	10.8

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1987*	FY1988e FRB Staff	FY1989e FRB Staff	CY 1987*	CY1988e FRB Staff	1987 IV*	FRB Staff Estimates 1988 I	1988 II	1988 III	1988 IV	1989 I	1989 II	1989 III
						Not seasonally adjusted							
Budget receipts[1]	854	908	972	869	921	205	206	269	229	217	224	284	246
Budget outlays[1]	1002	1067	1118	1034	1062	285	243	266	273	281	284	284	270
Surplus/deficit(-) to be financed[1]	-148	-159	-146	-165	-142	-80	-36	2	-44	-64	-59	0	-24
Means of financing:													
Borrowing from public	150	141	137	142	138	61	32	13	36	58	52	10	17
Cash balance decrease	-5	11	0	9	7	14	6	-11	2	10	0	-5	-5
Other[2]	3	6	9	15	-4	6	-2	-4	6	-4	7	-5	11
Cash operating balance, end of period	36	25	25	22	15	22	16	27	25	15	15	20	25
Memo: Sponsored agency borrowing[3]	20	38	32	33	25	18	2	9	9	5	5	10	12
NIPA Federal Sector						Seasonally adjusted annual rates							
Receipts	894	956	1026	917	968	941	951	963	968	989	1020	1039	1056
Expenditures	1053	1119	1171	1069	1129	1106	1124	1123	1124	1146	1177	1180	1183
Purchases	374	394	401	381	394	394	394	393	394	396	401	402	404
Defense	290	299	302	295	299	300	300	298	298	298	303	303	304
Nondefense	84	94	99	85	95	94	93	95	96	97	99	99	99
All other expend.	679	726	771	689	735	712	730	730	730	751	775	777	780
Surplus/deficit(-)	-159	-163	-145	-153	-161	-165	-173	-160	-156	-157	-156	-140	-128
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-141	-158	-144	-141	-155	-164	-168	-152	-149	-152	-154	-140	-129

*--actual e--estimated

Note: Details may not add to totals due to rounding. The Administration's updated budget estimates are expected to be available around mid-February. The CBO plans to make its updates available later this week with details to follow on February 11.

1. Includes social security receipts and outlays, which are classified as off-budget under current law.
2. Checks issued less checks paid, accrued items, and other transactions.
3. Sponsored agency borrowing includes net debt issuance by Federal Home Loan Banks, the Federal Home Loan Mortgag Corporation (excluding participation certificates), the Federal National Mortgage Association (excluding mortgage-backed securities), Farm Credit Banks, the Student Loan Marketing Association, and the Financing Corporation. The Administration's definition of borrowing by these agencies is somewhat broader.

Recent Developments

Market interest rates have moved down further since the December FOMC and most are currently 1-1/2 to 2 percentage points below levels prevailing just prior to the stock market crash. Private short-term borrowing rates have registered the largest declines over the intermeeting period, as hefty premiums on commercial paper and CDs evaporated; rates on these instruments had jumped in anticipation of year-end pressures in the federal funds market that failed to materialize. Following the market, banks lowered their prime lending rate from 8-3/4 to 8-1/2 percent in February. In longer-term markets, rates have eased in response to a firmer dollar and incoming data that lessened fears of renewed inflationary pressures and stirred hopes of near-term monetary policy easing. By late January, corporate bond yields had fallen to their lowest levels in nine months. Buoyed in part by lower interest rates, stock prices have advanced 4-1/2 percent, on average, since mid-December; nonetheless, equity prices remain quite volatile.

The monetary aggregates ended the year on a sluggish note after the brief surge in liquid deposits immediately after the stock market contraction. For the year, M2 expanded 4 percent (fourth quarter to fourth quarter), well below the 5-1/2 percent lower bound of its target range. M3 growth, at 5-1/2 percent, was just at the bottom of its range. These aggregates accelerated sharply in January, however, propelled by strong growth in M1 and in most of the nontransactions components of M2. With retail deposit inflows ample relative to credit growth, banks use of managed liabilities included in M3 declined.

Total business borrowing in short-term markets strengthened in the fourth quarter largely owing to increased issuance of commercial paper by nonfinancial firms. In January, preliminary data suggest that businesses increased their borrowing from banks, while paper issuance remained relatively flat, despite a substantial drop in commercial paper rates since mid-December.

The expansion in loans and commercial paper in the fall may have reflected some substitution of short-term for long-term borrowing by corporations in response to the disturbances in securities markets. In addition, however, it appears that total corporate needs for funds rose late in the year. Preliminary data suggest that the gap between capital expenditures and internal funds widened markedly in the fourth quarter, as inventories surged and profit growth apparently moderated. Gross equity retirements also were large, totaling an estimated $25 billion in the final three months, about one-third of which were own-share repurchases by firms. After the stock market crash, nonfinancial corporations raised virtually no funds through sales of new equity. Recent declines in bond rates have spurred a revival of longer-term debt issues since year-end by investment-grade industrial firms. New junk bond offerings, nonetheless, have remained sparse, as have Eurobond issues and new equity offerings by nonfinancial firms. Risk premia on such low-rated debt and equity instruments have dissolved very slowly, apparently reflecting lingering concerns about the consequences of the crash and the weaker economic outlook.

In municipal markets, offerings of tax-exempt bonds in December fell well below the inflated year-end volumes of 1985 and 1986 when issuers had rushed to market bonds in advance of tax law changes. Although total volume remained light in January, declines in tax-exempt yields have begun to attract a few more refunding issues.

Federal sector borrowing dropped appreciably in January as the budget swung from a large deficit in December to a seasonal surplus in January. The fourth-quarter deficit was boosted in part by social security payments that usually would be made in January but this fiscal year were made on December 31, prior to the New Year holiday weekend.

Borrowing in mortgage markets slowed a bit in November, as housing activity and mortgage refinancings felt the lagged effects of higher interest rates in the early fall. Since mid-October interest rates on fixed-rate home mortgages have declined with other long rates and currently stand near 10-1/4 percent for conventional loans. Rate declines prompted the VA to lower its ceiling on fixed-rate mortgages from 10.5 to 9.5 percent, effective February 1. With rates offered on ARMs coming down only a little less than those on fixed-rate instruments, the initial rate advantage provided by adjustable-rate mortgages remains fairly wide by historical standards. Reflecting this advantage, a record 68 percent of all conventional home loans closed in early December contained adjustable-rate features. Thrift institutions tend to retain

ARMs in their portfolios, and the increased prevalence of ARM originations likely contributed to a surge in thrift holdings of mortgage loans in the fall.

Growth in consumer installment credit slowed further in November, held down by sluggish expansion of revolving and auto credit. On balance for 1987, installment credit rose an estimated 5-3/4 percent, well below gains in other recent years. While weaker spending undoubtedly has helped damp consumer credit growth, the substitution of home equity lines of credit for other forms of consumer borrowing contributed importantly to the 1987 deceleration.

Outlook

Aggregate credit growth in 1988 is projected to be little changed from the pace observed in 1987. Although Treasury debt is expected to grow somewhat more slowly, especially in the first half of this year, household financing needs likely will remain sizable and corporate borrowing may increase a bit in association with a higher financing gap and heavy merger activity. State and local borrowing is expected to ease down only slightly from its reduced pace of the last year.

In the business sector, the gap between capital expenditures and internal funds likely will remain sizable, though narrowing slightly from the fourth-quarter level. Gross equity retirements also are expected to continue in heavy volume, paced by ongoing merger and takeover activity. Although new stock offerings should rise above recent depressed levels, corporate financing will be concentrated in debt markets. Short-term borrowing, from banks and in the commercial paper market, likely will maintain its recent pickup, but, as in 1987, the bulk of corporate demands are expected to be in longer-term debt markets.

Some rebound in housing starts from the fourth quarter level, coupled with turnover of existing properties and rising home prices, should support a continued high level of mortgage borrowing by households. Consumer credit expansion, however, may be quite slow given the anticipated sluggishness in consumption spending, especially for autos and durables, and continued substitution of home equity credit for traditional lines of consumer debt.

In the public sectors, federal borrowing in the first quarter is expected to fall slightly below the heavy financings in the fourth quarter, on a seasonally adjusted basis, and probably will trend down further in the spring and summer months. State and local governments, many of which face weakened budget positions, are expected to constrain their credit use over the year. Some of these units have accumulated sizable liquid assets with proceeds from previous debt sales that might be used to help finance capital outlays that cannot be postponed. State and local governments are expected to issue more refunding bonds, but refunding activity in 1988 should fall well short of that in the past three years.

Recent developments. The weighted-average foreign exchange value of the dollar in terms of the other G-10 currencies has increased almos 2-1/2 percent since the last FOMC meeting. The dollar rose about 1 percent against the yen during the intermeeting period while it rose more than 3-1/4 percent against the mark. Early in the period, the dollar fell sharply amid reports that G-7 authorities no longer supported the Louvre accord and amid heightened concerns about the prospects for adjustment of U.S. external imbalances. Release of a statement by G-7 authorities late in December reaffirming the objective of the Louvre accord and associated intervention operations did not hav an immediate positive impact, as the dollar fell to historic lows at th end of the year. Additional visible intervention in January by central banks, including by the Desk, lent support to the perception that central bank authorities were committed to supporting exchange rates, and early in 1988 the dollar retraced its decline. The dollar strengthened further following release of better-than-expected data for the U.S. November trade balance.

The Desk purchased a total of $2.3 billion during the intermeeting period, slightly less than $1 billion against yen and the remainder against marks.

Following strong growth of real GNP in the third quarter of 1987 i most major foreign industrial nations, the pace of economic activity in these countries has been mixed. Data continue to suggest vigorous ac tivity in Japan, the United Kingdom, and Canada. Japanese industrial production, new machinery orders, and housing starts all showed further expansion in the fourth quarter. In contrast, activity appears to have slowed during the fourth quarter in Germany and France. Record current account surpluses were recorded for 1987 in both Germany and Japan; however, data for trade volumes show a small decline in Japanese export and moderate increase in imports for the year, while German data throug October report a small increase in exports but a larger increase in imports.

Under a new finance minister, Brazil in early February made a voluntary $350 million payment on overdue January interest to banks and announced its desire to normalize relations with the international finance community. In Mexico, the government implemented a comprehensive new anti-inflation program in December. At the same time, a plan was announced to exchange at discounted prices some of Mexico's debt to foreign banks for new, marketable bonds. Argentina's financial difficulties are leading to the reemergence of arrears. Colombia and its creditor banks signed a $1 billion loan on January 8, $60 million less than initially agreed upon. The Paris Club rescheduled $275 million of Ecuador's obligations to its official creditors in January.

U.S. merchandise trade data showed a substantial decline in the trade deficit, not seasonally adjusted, from October to November. On a seasonally adjusted basis, not published, the improvement from October to November remains; but the average deficit for these two months indicates a slight increase in the nominal merchandise trade deficit from the third quarter. Nonagricultural exports increased $14 billion at an annual rate in the October-November period from the third quarter; expanded exports of machinery and industrial supplies more than offset a decline (on a seasonally-adjusted basis) in exports of civilian aircraft. Agricultural exports fell $2 billion at an annual rate. Increases in various product categories of imports resulted in the total of non-oil imports rising $17 billion at an annual rate in October-November from the third quarter. Oil imports fell $4 billion, as both price and volume declined. Both export and non-oil import prices accelerated in the fourth quarter to rates experienced in the first two quarters of 1987, reversing the slowdown experienced in the third quarter.

Private foreign net sales of U.S. corporate stocks totaled $6.7 billion in November from end-October levels. This decline in holdings is four times larger than the next largest monthly decline recorded in the past decade. Private foreign holdings of U.S. Treasury securities increased by more than $5 billion, while foreign net purchases of corporate bonds remained small in November. Recorded official net purchases of U.S. assets were a moderate $1.7 billion in November, despite large purchases associated with foreign exchange market intervention. Capital inflows through banking transactions were modest in November, but increased significantly during 1987 from rates in previous years. Data for the third-quarter show that foreign direct investment in the United States continued at a record pace; the total for the first three quarters of 1987 exceeded the near-record rate of the previous year. U.S. direct investment abroad, in contrast, was at about its 1986 pace.

Outlook. With little change in our expectations for moderate growth abroad and for further moderate decline in the dollar in 1988, both of which have now been extended through 1989, we continue to project a gradual decline in the nominal trade and current account deficits in 1988 and further declines in 1989. From an expected peak of more than $170 billion at an annual rate in the second half of 1987, the current account deficit is projected to fall by about $15 billion in each of the next two years, to a level of just over $130 billion in the fourth quarter of 1989. This outlook represents a small deterioration in the 1988 projection presented in the December Greenbook, primarily owing to a worsening in the outlook for net investment income receipts and a reassessment of the implications of declining prices of business machinery for our projection of both export and import prices. We continue to expect a much stronger improvement in real net exports of goods and services in 1988 and, now, through 1989.

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

	ANNUAL			1987		1988				1989			
	1987-	1988-P	1989-P	Q3-	Q4-	Q1-	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current $, Net	-119.9	-98.9	-84.3	-123.7	-125.5	-104.5	-99.4	-97.7	-93.9	-91.9	-87.9	-82.5	-74.9
Exports of G+S	426.7	505.2	593.9	439.2	453.9	474.4	496.5	514.3	535.8	558.5	581.1	604.9	631.3
Imports of G+S	546.6	604.1	678.3	562.9	579.4	578.8	595.9	612.0	629.6	650.4	669.0	687.4	706.3
Constant 82 $, Net	-134.3	-89.1	-47.7	-138.4	-130.7	-105.5	-93.7	-83.7	-73.6	-63.3	-53.8	-42.8	-30.9
Exports of G+S	425.8	496.0	570.2	437.1	453.8	470.7	488.5	503.4	521.4	539.9	559.2	579.8	601.9
Imports of G+S	560.1	585.1	617.9	575.6	584.5	576.1	582.2	587.2	595.1	603.3	613.0	622.6	632.8
2. U.S. Merchandise Trade Balance 2/	-158.0	-140.9	-131.4	-159.3	-159.4	-141.8	-141.4	-141.4	-138.9	-138.2	-134.5	-129.7	-123.2
Exports	250.4	311.3	372.5	261.1	272.1	289.2	304.8	318.1	333.2	348.5	363.5	379.8	398.0
Agricultural	29.7	35.2	38.4	33.7	30.4	33.6	35.4	35.2	36.6	37.4	38.0	38.4	39.8
Non-Agricultural	220.7	276.2	334.1	227.4	241.7	255.6	269.5	282.9	296.6	311.1	325.5	341.5	358.2
Imports	408.4	452.2	503.9	420.4	431.5	431.0	446.2	459.6	472.1	486.7	498.0	509.5	521.2
Petroleum and Products	42.8	43.8	52.8	50.5	46.0	38.5	43.7	46.0	47.0	51.0	52.2	53.3	54.7
Non-Petroleum	365.5	408.4	451.1	369.9	385.4	392.5	402.6	413.5	425.1	435.7	445.9	456.2	466.5
3. U.S. Current Account Balance	-163.7	-148.5	-139.0	-173.5	-169.5	-151.9	-148.7	-147.4	-146.1	-145.0	-142.0	-137.6	-131.3
Of Which: Net Investment Income	8.4	5.1	3.3	-1.1	6.4	3.0	5.5	6.0	5.9	5.3	3.8	2.5	1.5
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.6	2.4	1.9	4.9	2.0	1.7	2.0	2.1	1.8	1.6	2.0	2.0	2.0
Real GNP--NonOPEC LDC 5/	3.9	4.0	4.4	3.8	3.8	3.9	4.1	4.3	4.4	4.5	4.4	4.3	4.1
Consumer Prices--Ten Ind. 4/	2.1	2.6	2.9	1.7	2.4	2.5	3.1	2.3	3.2	2.7	3.2	2.7	3.3

1/ National Income 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