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September 27, 1989

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 appears to have continued growing moderately in recent months, and the staff projects real GNP to rise at an annual rate of 2-1/2 percent in the third quarter. Meanwhile, inflation has slowed, in large part because of a steep decline in energy costs and a continuing decline in prices of non-oil imports.

Private nonfarm employment (adjusted for strikes) increased about 160,000 in August, the same as in July, and the unemployment rate remained at 5.2 percent. A variety of other indicators of labor market conditions--including initial claims for unemployment insurance through mid-September--also show no cutback in aggregate labor utilization. Employment in the service sector has continued to grow briskly; in manufacturing, however, employment levels generally have held steady or fallen a bit, apart from temporary fluctuations in the auto industry.

The index of industrial production is estimated to have increased 0.3 percent in August. Much of the gain reflected a rebound in auto production after three months of decline and the return to work of most striking coal miners. The August level of industrial production was 1.7 percent (annual rate) above the second-quarter average, compared with an average increase of 2-1/2 percent (annual rate) in the first half of the year. From its recent peak in January, factory utilization has dropped 0.7 percentage point, to 84 percent in August; the bulk of the decline has occurred in primary processing industries such as primary metals, paper, and chemicals, where utilization had been very high and price pressures evident.

Significant support for current-quarter activity is coming from the consumer sector. Real personal consumption expenditures rose 1 percent in August, with much of the gain attributable to a surge in outlays for autos and light trucks. Real spending for goods and services other than motor vehicles appears to have picked up in the current quarter, rising 0.4 percent in August to a level nearly 4 percent (annual rate) above the second-quarter average. Especially large increases have been reported for apparel as well as a variety of non-auto durable goods and nonenergy services.

In the housing sector, recent indicators point to some near-term firming in demand: sales of existing homes have been on a modest uptrend since May, and sales of new homes picked up noticeably in July. However, builders apparently remain cautious, partly because of supply overhangs in some sections of the country; and, on balance, the July-August average level of starts was only slightly ahead of the second-quarter pace. Moreover, building permits, which are a roughly coincident indicator of new building activity, have shown no discernable trend in recent months.

Growth in real outlays for business fixed investment has slowed somewhat from the 7-3/4 percent pace in the first half of the year. Shipments of nondefense capital goods excluding aircraft in July and August were 0.3 percent above the second-quarter level, compared with average increases of about 3 percent per quarter in the first half. Forward-looking indicators--such as new orders for nondefense capital goods and contracts and permits for construction--point to a further deceleration in capital spending during the fourth quarter.

Business inventory investment was sizable during July. Most of the increase occurred among manufacturers, but the large buildup there reflected accumulations--likely to be temporary--at auto and aircraft firms. At the retail level, auto sales recently have been strong enough to reduce stocks on dealer lots to manageable levels. Overall, there is no evidence of inventory imbalances that might trigger significant adjustments in production.

The sharp drop in energy prices during the summer dominated monthly movements in both the consumer and producer price indexes. The CPI was unchanged in August while the PPI for finished goods fell for the third consecutive month. But even apart from energy developments, there has been a fairly widespread slowing of inflation for consumer goods. Food prices have decelerated, and the CPI for consumer commodities other than food and energy fell 1/4 percent between June and August, reflecting continued discounting of apparel and new cars; declining prices of imported goods also have helped damp consumer goods inflation. In contrast, prices of nonenergy services rose almost 0.5 percent per month in July and August. At earlier stages of processing, producer prices of intermediate materials (excluding food and energy) edged down 0.1 percent in August and have remained essentially the same during the past six months.

The only new information on wages that has become available since the last Greenbook is average hourly earnings, which tend to be quite volatile on a monthly basis. This series fell 0.1 percent in August after rising 0.8 percent in July. Looking through the monthly wiggles, average hourly earnings rose about 4 percent over the 12 months ending in August.

Outlook

The staff's projection for economic activity continues to be conditioned on the FOMC's objective of reducing the rate of inflation over time. In our view, achieving this objective will require an easing of pressures on resources and, accordingly, a period of growth of real GNP at less than potential. But even with slow growth, reducing inflation may be difficult. In the near term, this is because retail energy prices are not likely to fall much further, removing one recent source of disinflation. Over the longer run, though, the dollar plays a more substantial and complicated role.

The considerable rise in the dollar so far in 1989 has contributed significantly to restraint on inflation this year. Econometric simulations suggest that if the dollar had remained at its 1988-Q4 level, consumer inflation in 1989 would have been about 1/2 percentage point higher. We expect the dollar to come under downward pressure at some point in the projection period, as market participants see a stalling out of the improvement in our external position, and as interest rates rise abroad under the influence of anti-inflationary monetary policies. The timing is, of course, highly uncertain, and for simplicity we have assumed a steady downward path for the dollar throughout the projection period. The resultant pickup--with a lag--in import prices reverses the earlier restraining effects on domestic inflation and puts upward pressure on prices, especially in 1991, which in the forecast tends to offset the underlying disinflationary benefits from prolonged economic slack.

In the forecast, short-term interest rates are essentially unchanged in 1990 and edge up in 1991. Under these circumstances, M2 is expected to grow about in line with income after the effects of earlier declines in rates recede. Growth of M2 in 1990 is anticipated to be in the upper half of the FOMC's tentative range. M2 growth might moderate a bit in 1991 owing to the upswing in interest rates and an associated small increase in velocity. Reflecting the effects of the contraction of thrift balance sheets, M3 is expected to finish 1989 around the lower bound of its target range, to pick up only gradually in 1990 to near the middle of its tentative range, and to continue at about that pace in 1991.

Fiscal policy is expected to remain moderately restrictive in 1990 and 1991. The deficit is projected to fall from an estimated $159 billion in FY1989 to $118 billion in FY1990. This projection assumes that the Congress will enact tax and spending measures designed to cut the deficit by $27 billion, in line with the spring bipartisan budget agreement.[1] For FY1991, we have assumed new deficit reduction actions of about $30 billion--at the high end of the $15 billion to $30 billion range that has been experienced in recent years. Nonetheless, given the staff's economic outlook, such policies still imply a FY1991 deficit of around $110 billion--well above the Gramm-Rudman sequestration trigger of $74 billion. Thus, the Gramm-Rudman targets--and possibly other aspects of the law--will be further amended.

Real GNP growth is projected to taper off a bit in the fourth quarter to about a 2 percent rate. Part of the slowing reflects a further deceleration of capital spending. In addition, export growth (excluding aircraft deliveries) is projected to slow, while non-oil imports pick up as

1. In addition, part of the reduction in the FY1990 deficit is an artifact of the treatment of RTC activities, which will be financed largely off budget (by REFCORP) after FY1989.

the effects of the rise in the value of the dollar during 1988 and the first three quarters of 1989 begin to affect trade volumes.[2]

Over the four quarters of 1990, real GNP is projected to grow only 1-1/2 percent. In large part, the slow pace reflects the continued effects of the earlier rise in the dollar: growth in the volume of exports slows, while imports of non-oil merchandise account for a rising share of domestic spending. In addition, the stimulative effects on housing activity of this year's declines in interest rates are projected to wane, and defense spending is expected to remain weak. The deterioration in the external sector, along with weakness in housing and government purchases, is projected to have the usual multiplier effects on the rest of the economy as slower growth of real income damps consumer spending, while reduced sales expectations and declines in profits hold down business fixed investment and inventory accumulation.

As 1991 unfolds, the growth of domestic demand is expected to remain subdued, reflecting the effects of slow growth in real income, further

REAL GNP AND RELATED ITEMS
(Percent change)

	1989		1989	1990	1991
	Q3	Q4			
Real GNP	2.5	2.1	2.7	1.5	2.0
Gross domestic purchases	3.3	1.0	2.0	1.7	1.3
Exports	5.2	9.8	10.5	4.6	9.2
Imports	10.4	1.2	5.0	5.7	4.1

Note: Annual changes are measured from fourth quarter to fourth quarter.

2. In the staff projection, the expected increase in aircraft exports is matched by a drawdown of inventories; similarly, a decline in oil imports is offset by a reduction in domestic oil stocks. Thus, both of these special factors in the trade sector are expected to have no appreciable influence on total GNP.

fiscal restraint, and some firming of money market conditions. At the same time, the depreciation of the dollar is projected to contribute to an acceleration in exports. Owing to the improvement in the external sector, real GNP is expected to pick up somewhat in 1991--to about a 2 percent growth rate.

With output expected to grow at below-potential rates throughout the projection period, the unemployment rate is projected to rise steadily, moving above 6 percent in 1991. In the near term, with labor markets fairly tight and some of the earlier increases in consumer prices still likely to be feeding through to wage adjustments, we expect a slight acceleration in hourly compensation. By the middle of next year, however, the lagged and contemporaneous effects of a widening margin of labor market slack and the slower rise in consumer prices begin to put some downward pressure on the underlying trend in wage inflation. Employers' actual costs will be boosted in January 1990 and again in January 1991 by a mandated increase in employer contributions for social security and by our assumption of a hike in the minimum wage in each year.

Inflation during the next few months is likely to be affected by a variety of special factors. On the one hand, further declines in retail energy prices and the continuing influence of lower prices of non-oil

EMPLOYMENT COST INDEX FOR COMPENSATION OF PRIVATE INDUSTRY WORKERS
(Percent change)

	1989		1990				1991			
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
ECI	4.8	4.8	6.3	4.7	4.6	4.5	5.2	4.3	4.3	4.2
ECI - excluding social security and minimum wage effects	4.8	4.8	4.8	4.7	4.5	4.5	4.4	4.3	4.3	4.2

imports will hold down the overall rise in the CPI; on the other hand, the CPI excluding energy is expected to be boosted as end-of-season discounts on apparel disappear and as automakers attempt to get by with less generous incentive programs.

As noted above, the inflation path projected for the second half of 1990 and all of 1991 reflects two offsetting forces: downward pressure associated with emerging slack and lower labor costs, and upward pressure resulting from the assumed drop in the dollar. Consequently, the GNP fixed-weight price index is projected to rise 4-1/4 percent during 1990 and 1991--the same as expected for 1989.

As a way of gauging the effects on inflation in the forecast of the projected dollar depreciation, the staff has prepared an alternative projection that assumes an (exogenously) unchanged value of the dollar from current levels. This projection is based on the pooled results of the Board staff's quarterly econometric model of the U.S. economy and the multicountry model. To isolate the price consequences of an alternative path for the dollar, the model projections were made with an assumption that monetary policy would be adjusted so as to keep the path for real GNP during 1990 and 1991 the same in the alternative projection as in the basic Greenbook forecast. The results--shown in the table below--suggest that if the dollar were to remain unchanged, inflation (as measured by the GNP fixed-weight price index) would be 0.1 percentage point lower in 1990 and 0.4 percentage point lower over the four quarters of 1991. Effects on domestic expenditure prices, such as the CPI, would be somewhat larger. As described in the International Developments section of Part 1, the inflation improvement would be associated with an additional $29 billion deterioration in the current account deficit by the end of 1991.

ALTERNATIVE PRICE PROJECTIONS
(Percent change, fourth quarter to fourth quarter)

	1988	1989	1990	1991
GNP fixed-weight price index				
Greenbook	4.5	4.2	4.2	4.2
Alternative projection	4.5	4.2	4.1	3.8
CPI				
Greenbook	4.3	4.4	4.1	4.4
Alternative projection	4.3	4.4	3.7	3.9

Note: The alternative projection is based on the pooled results of the quarterly econometric model of the U.S. economy and the multicountry model. The alternative assumes an (exogenously) unchanged value of the dollar from current levels, with monetary policy adjusted to keep the real GNP path the same as in the Greenbook.

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STAFF GNP PROJECTIONS

Percent changes, annual rate

		Nominal GNP		Real GNP		GNP fixed-weight price index		Consumer Price Index <1>		Unemployment rate (percent)	
		8/16/89	9/27/89	8/16/89	9/27/89	8/16/89	9/27/89	8/16/89	9/27/89	8/16/89	9/27/89
Annual changes:											
1987	<2>	6.9	6.9	3.7	3.7	3.6	3.6	3.7	3.7	6.2	6.2
1988	<2>	7.9	7.9	4.4	4.4	4.2	4.2	4.1	4.1	5.5	5.5
1989		7.2	7.3	2.8	3.0	4.6	4.5	4.8	4.8	5.3	5.2
1990		6.0	5.8	1.9	1.9	4.3	4.0	4.2	3.9	5.6	5.6
1991			5.6		1.7		4.2		4.3		6.1
Quarterly changes:											
1988	Q1 <2>	6.5	6.5	4.0	4.0	3.8	3.8	3.9	3.9	5.7	5.7
	Q2 <2>	8.6	8.6	3.7	3.7	4.8	4.8	4.5	4.5	5.5	5.5
	Q3 <2>	7.5	7.5	3.2	3.2	5.2	5.2	4.5	4.5	5.5	5.5
	Q4 <2>	7.5	7.5	2.7	2.7	4.3	4.3	4.4	4.4	5.3	5.3
1989	Q1 <2>	7.9	7.9	3.7	3.7	4.8	4.8	5.4	5.4	5.2	5.2
	Q2 <2>	6.6	7.1	1.7	2.5	5.2	5.0	6.4	6.4	5.3	5.3
	Q3	5.8	6.1	2.2	2.5	3.5	3.3	3.0	2.6	5.3	5.2
	Q4	5.9	5.3	2.1	2.1	3.8	3.6	3.6	3.3	5.3	5.3
[redacted]	Q1	6.5	6.4	1.8	1.8	4.7	4.4	4.2	3.9	5.4	5.4
	Q2	5.9	5.7	1.7	1.5	4.3	4.1	4.5	4.2	5.5	5.5
	Q3	5.8	5.2	1.7	1.3	4.3	4.1	4.7	4.2	5.6	5.7
	Q4	5.8	5.3	1.8	1.5	4.3	4.1	4.7	4.3	5.7	5.9
1991	Q1		5.8		1.6		4.6		4.5		6.0
	Q2		5.7		2.1		4.0		4.3		6.1
	Q3		6.0		2.2		4.0		4.3		6.2
	Q4		5.8		2.2		4.0		4.3		6.2
Two-quarter changes: <3>											
1988	Q2 <2>	7.5	7.5	3.9	3.9	4.2	4.2	4.2	4.2	-.4	-.4
	Q4 <2>	7.5	7.5	2.9	2.9	4.8	4.8	4.4	4.4	-.2	-.2
1989	Q2 <2>	7.2	7.5	2.7	3.1	5.0	5.0	5.9	5.9	.0	.0
	Q4	5.8	5.7	2.1	2.3	3.6	3.4	3.3	2.9	.0	.0
1990	Q2	6.2	6.0	1.7	1.7	4.5	4.3	4.3	4.0	.2	.2
	Q4	5.8	5.3	1.7	1.4	4.3	4.1	4.7	4.2	.2	.4
1991	Q2		5.8		1.8		4.3		4.4		.2
	Q4		5.9		2.2		4.0		4.3		.1
Four-quarter changes: <4>											
1987	Q4 <2>	8.6	8.6	5.4	5.4	4.0	4.0	4.4	4.4	-.9	-.9
1988	Q4 <2>	7.5	7.5	3.4	3.4	4.5	4.5	4.3	4.3	-.6	-.6
1989	Q4	6.5	6.6	2.4	2.7	4.3	4.2	4.6	4.4	.0	.0
1990	Q4	6.0	5.6	1.7	1.5	4.4	4.2	4.5	4.1	.4	.6
1991	Q4		5.8		2.0		4.2		4.4		.3

[redacted] For all urban consumers.
[redacted] Actual.
<3> Percent change from two quarters earlier.
<4> Percent change from four quarters earlier.

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

	Units	1983	1984	1985	1986	1987	1988	Projection 1989	Projection 1990	Projection 1991
EXPENDITURES										
Nominal GNP	Billions of $	3405.7	3772.2	4014.9	4231.6	4524.3	4880.6	5235.2	5540.7	5853.3
Real GNP	Billions of 82$	3279.1	3501.4	3618.7	3717.9	3853.7	4024.4	4144.2	4221.6	4294.7
Real GNP	Percent change*	6.5	5.1	3.6	1.9	5.4	3.4	2.7	1.5	2.0
Gross domestic purchases		8.4	6.4	4.3	2.1	4.6	2.4	2.0	1.7	1.3
Final sales		3.7	4.7	4.6	2.7	3.3	4.4	3.0	1.3	2.1
Private dom. final purchases		7.7	5.6	4.6	2.9	2.7	3.8	2.8	1.7	1.4
Personal consumption expend.		5.4	4.1	4.6	3.8	2.2	3.8	2.6	1.8	1.3
Durables		14.7	10.8	7.0	11.5	-2.0	8.0	2.0	.6	1.3
Nondurables		4.4	2.3	3.3	2.9	1.1	2.1	1.2	1.4	.7
Services		3.9	3.5	5.0	2.1	4.4	3.6	3.7	2.5	1.7
Business fixed investment		10.8	13.8	3.7	-5.5	8.5	4.2	6.1	1.5	2.9
Producers' durable equipment		20.9	14.9	4.6	.4	11.1	7.0	8.6	2.7	3.8
Nonresidential structures		-4.8	11.8	1.9	-17.7	1.9	-3.4	-1.6	-2.7	-.3
Residential structures		38.1	6.1	5.8	11.6	-4.2	3.2	-2.0	.6	-.7
Exports		5.8	5.9	-2.4	10.6	19.1	13.9	10.5	4.6	9.2
Imports		23.8	17.4	4.5	10.0	9.6	5.3	5.0	5.7	4.1
Government purchases		-2.7	7.9	8.6	3.1	2.1	1.8	.1	.5	1.1
Federal		-8.1	13.0	13.3	.5	.7	-.3	-2.3	-1.4	.0
Defense		5.1	6.5	7.1	6.0	4.3	-1.9	-4.9	-2.9	-1.0
State and local		1.5	4.4	4.9	5.2	3.1	3.4	1.9	1.9	1.8
Change in business inventories	Billions of 82$	-6.4	62.3	9.1	5.6	23.7	27.9	17.6	18.6	17.8
Nonfarm	Billions of 82$	-.1	57.8	13.4	8.0	25.8	30.7	14.1	15.5	17.2
Net exports	Billions of 82$	-19.9	-84.0	-104.3	-129.7	-115.7	-74.9	-53.4	-59.6	-40.7
Nominal GNP	Percent change*	10.4	8.6	6.6	4.6	8.6	7.5	6.6	5.6	5.8
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	90.2	94.5	97.5	99.5	102.2	105.6	108.6	110.4	111.3
Unemployment rate	Percent	9.6	7.5	7.2	7.0	6.2	5.5	5.2	5.6	6.1
Industrial production index	Percent change*	14.3	6.6	1.7	1.0	5.8	5.0	2.1	1.5	2.6
Capacity utilization rate-mfg.	Percent	73.9	80.5	80.1	79.7	81.1	83.5	84.1	82.7	82.1
Housing starts	Millions	1.70	1.75	1.74	1.81	1.62	1.49	1.43	1.43	1.41
Auto sales	Millions	9.23	10.38	11.06	11.47	10.26	10.69	10.12	9.64	9.65
Domestic	Millions	6.82	7.92	8.22	8.22	7.06	7.55	7.21	6.91	7.05
Foreign	Millions	2.41	2.46	2.84	3.25	3.21	3.14	2.90	2.73	2.60
INCOME AND SAVING										
Nominal personal income	Percent change*	7.8	8.4	6.6	5.8	8.6	7.1	8.4	5.7	5.6
Real disposable income	Percent change*	5.1	4.3	2.7	3.3	3.0	4.0	3.7	1.4	.9
Personal saving rate	Percent	5.4	6.1	4.4	4.1	3.2	4.2	5.5	5.5	5.2
Corp. profits with IVA & CCAdj	Percent change*	70.1	7.4	9.2	-5.6	12.0	10.4	-12.1	-3.0	.4
Profit share of GNP	Percent	6.3	7.1	7.0	6.7	6.6	6.7	5.8	5.3	4.8
Federal govt. surplus/deficit	Billions of $	-176.0	-169.6	-196.9	-206.9	-161.4	-145.8	-145.9	-124.2	-101.6
State and local govt. surplus		47.5	64.6	65.1	62.8	51.3	49.7	49.4	54.0	64.5
Exc. social insurance funds		4.4	19.8	13.8	5.6	-12.4	-21.4	-28.6	-30.2	-25.7
PRICES AND COSTS										
GNP implicit deflator	Percent change*	3.6	3.4	2.9	2.6	3.0	4.0	3.8	4.0	3.8
GNP fixed-weight price index		3.9	3.7	3.3	2.6	4.0	4.5	4.2	4.2	4.2
Cons. & fixed invest. prices		3.3	3.3	3.4	2.5	4.7	4.2	4.3	4.0	4.3
CPI		3.2	4.2	3.5	1.3	4.4	4.3	4.4	4.1	4.4
Exc. food and energy		4.2	5.0	4.3	3.9	4.2	4.6	4.3	4.4	4.6
ECI hourly compensation		5.7	4.9	3.9	3.2	3.3	4.9	4.7	5.0	4.5
Nonfarm business sector										
Output per hour		3.4	1.5	1.6	1.3	2.5	1.7	.1	.8	1.2
Compensation per hour		3.1	4.2	4.6	5.0	4.0	4.9	5.3	5.7	5.2
Unit labor costs		-.4	2.6	3.0	3.6	1.5	3.1	5.2	4.9	3.9

* Percent changes are from fourth quarter to fourth quarter.

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

	Units	1987 Q1	1987 Q2	1987 Q3	1987 Q4	1988 Q1	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2
EXPENDITURES											
Nominal GNP	Billions of $	4388.8	4475.9	4566.6	4665.8	4739.8	4838.5	4926.9	5017.3	5113.1	5201.7
Real GNP	Billions of 82$	3783.0	3823.5	3872.8	3935.6	3974.8	4010.7	4042.7	4069.4	4106.8	4132.5
Real GNP		5.4	4.4	5.3	6.6	4.0	3.7	3.2	2.7	3.7	2.5
Gross domestic purchases		3.4	4.0	5.4	5.5	.7	3.0	3.4	2.5	1.8	2.1
Final sales		1.1	4.9	6.0	1.4	6.5	5.0	1.6	4.7	3.1	3.1
Private dom. final purchases		-.9	5.9	6.5	-.6	6.0	4.4	3.1	1.7	2.3	2.0
Personal consumption expend.		.1	4.8	4.7	-.7	6.2	2.5	3.3	3.0	2.0	1.9
Durables		-19.9	14.8	15.8	-13.5	21.0	6.4	-3.9	9.9	-1.1	5.5
Nondurables		1.9	.6	1.3	.5	1.7	1.2	5.0	.7	1.3	-2.3
Services		6.0	5.0	3.8	3.0	5.2	2.2	4.5	2.6	3.6	3.8
Business fixed investment		-4.3	14.4	26.7	-.1	9.5	12.3	2.6	-6.5	6.9	8.6
Producers' durable equipment		-2.0	24.1	25.9	-.3	18.2	15.8	2.9	-6.9	9.6	14.8
Nonresidential structures		-10.3	-7.8	29.3	.6	-11.8	2.3	1.6	-5.1	-1.0	-9.5
Residential structures		-5.9	1.0	-11.0	-.4	-5.7	11.2	1.9	6.3	-5.0	-12.3
Exports		12.6	21.4	21.4	21.3	30.5	1.8	9.7	15.5	14.0	13.1
Imports		-3.6	14.5	19.1	9.8	1.1	-2.2	10.2	12.6	-.4	9.3
Government purchases		.3	-.9	4.5	4.5	-8.3	4.1	-3.6	16.7	-3.3	5.4
Federal		-4.9	-4.0	7.4	5.0	-22.3	5.2	-9.5	33.7	-9.4	10.0
Defense		5.1	8.9	9.4	-5.6	-5.4	-.8	-5.5	4.4	-10.6	2.2
State and local		4.6	1.5	2.5	4.0	3.7	3.4	.9	5.7	1.5	2.2
Change in business inventories	Billions of 82$	18.1	13.3	6.8	56.6	34.3	21.5	37.5	18.3	24.5	19.1
Nonfarm	Billions of 82$	20.3	14.5	12.9	55.6	28.3	25.4	37.2	31.9	16.9	19.5
·. exports	Billions of 82$	-118.2	-115.9	-118.9	-109.8	-78.2	-72.6	-74.9	-73.8	-55.0	-51.2
nal GNP	Percent change	8.8	8.2	8.4	9.0	6.5	8.6	7.5	7.5	7.9	7.1
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	101.0	101.8	102.5	103.5	104.4	105.2	106.0	106.8	107.7	108.3
Unemployment rate	Percent*	6.6	6.3	6.0	5.9	5.7	5.5	5.5	5.3	5.2	5.3
Industrial production index	Percent change	3.2	4.2	8.8	7.0	3.9	4.6	7.1	4.6	2.1	3.2
Capacity utilization rate-mfg.	Percent*	80.0	80.5	81.4	82.3	82.7	83.2	84.0	84.4	84.4	84.4
Housing starts	Millions	1.78	1.60	1.62	1.53	1.48	1.48	1.47	1.56	1.52	1.35
Auto sales	Millions	9.57	10.19	10.98	10.32	10.76	10.69	10.32	11.00	9.72	10.31
Domestic	Millions	6.77	7.12	7.40	6.93	7.60	7.50	7.20	7.89	6.89	7.30
Foreign	Millions	2.80	3.06	3.58	3.38	3.15	3.19	3.12	3.11	2.82	3.01
INCOME AND SAVING											
Nominal personal income	Percent change	8.7	6.6	6.9	12.5	4.1	8.1	7.2	8.8	13.3	7.9
Real disposable income	Percent change	4.0	-5.8	6.7	7.8	4.6	2.4	4.9	4.3	6.6	.8
Personal saving rate	Percent*	4.3	1.8	2.3	4.3	3.9	3.9	4.3	4.6	5.6	5.4
Corp. profits with IVA & CCAdj	Percent change	7.0	21.2	29.0	-6.0	13.5	9.4	7.1	11.7	-25.3	-10.3
Profit share of GNP	Percent*	6.4	6.6	6.9	6.6	6.7	6.7	6.7	6.8	6.2	5.9
Federal govt. surplus/deficit	Billions of $	-199.4	-137.7	-143.9	-164.4	-151.8	-141.5	-122.5	-167.6	-147.5	-145.4
State and local govt. surplus		46.3	60.4	50.5	48.0	50.8	52.4	49.8	45.7	48.8	47.5
Exc. social insurance funds		-14.6	-2.5	-14.0	-18.4	-17.5	-17.9	-22.3	-28.1	-26.6	-29.6
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.2	3.8	2.8	2.4	2.0	4.8	4.4	4.7	4.0	4.6
GNP fixed-weight price index		4.3	4.1	3.8	3.8	3.8	4.8	5.2	4.3	4.8	5.0
Cons. & fixed invest. prices		5.5	5.1	3.9	4.3	3.1	4.7	4.4	4.7	4.8	5.9
CPI		5.2	5.1	3.6	3.5	3.9	4.5	4.5	4.4	5.4	6.4
Exc. food and energy		4.2	4.2	3.8	4.4	4.7	4.7	4.0	4.9	5.2	4.1
hourly compensation**		3.3	2.8	3.8	3.5	5.5	5.0	4.1	4.9	4.3	4.7
arm business sector											
⁄utput per hour		.4	3.3	3.6	2.7	3.0	-1.5	3.4	1.9	-1.3	.7
Compensation per hour		1.4	2.7	4.8	7.3	2.7	5.5	5.5	5.9	4.8	5.6
Unit labor costs		1.0	-.6	1.2	4.5	-.3	7.1	2.0	3.9	6.2	4.9

* Not at an annual rate.
** Private industry workers; seasonally adjusted by Board staff.

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CONFIDENTIAL - FR
CLASS II FOMC

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

	Units	Projection 1989 Q3	Q4	1990 Q1	Q2	Q3	Q4	1991 Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of $	5278.8	5347.3	5430.6	5506.3	5577.0	5649.0	5729.3	5809.7	5894.9	5979.1
Real GNP	Billions of 82$	4157.7	4179.8	4198.9	4214.9	4228.7	4244.0	4261.0	4282.7	4305.8	4329.3
Real GNP		2.5	2.1	1.8	1.5	1.3	1.5	1.6	2.1	2.2	2.2
Gross domestic purchases		3.3	1.0	2.9	1.7	1.3	1.1	1.2	1.4	1.3	1.3
Final sales		2.5	3.1	1.2	1.3	1.1	1.6	1.7	2.1	2.2	2.4
Private dom. final purchases		4.4	2.5	2.6	1.5	1.4	1.4	1.3	1.5	1.5	1.5
Personal consumption expend.		4.7	1.6	2.6	1.6	1.6	1.6	1.4	1.4	1.2	1.2
Durables		9.4	-5.0	3.0	-.8	-.6	.8	1.6	1.6	1.1	.8
Nondurables		4.0	1.8	2.2	1.3	1.2	1.0	.7	.7	.7	.7
Services		3.8	3.6	2.8	2.5	2.5	2.2	1.9	1.8	1.6	1.7
Business fixed investment		5.2	3.6	3.1	1.7	.7	.5	1.8	2.7	3.3	3.8
Producers' durable equipment		5.6	4.6	4.2	3.0	2.0	1.7	2.9	3.7	4.0	4.6
Nonresidential structures		4.0	.4	-.7	-2.7	-3.6	-3.6	-2.0	-.9	.8	1.1
Residential structures		-2.0	12.8	1.0	.0	.8	.6	-2.2	-.6	.0	.0
Exports		5.2	9.8	-.7	5.6	6.0	7.5	7.7	9.3	9.9	9.9
Imports		10.4	1.2	6.4	6.3	5.3	4.7	4.3	4.5	4.0	3.7
Government purchases		-1.1	-.4	.8	1.1	-.5	.7	1.2	1.1	1.0	1.0
Federal		-5.1	-3.6	-.7	.0	-3.7	-1.1	.2	.0	-.3	-.1
Defense		-5.4	-5.3	-2.9	-2.6	-3.7	-2.6	-1.3	-.5	-1.3	-1.0
State and local		2.0	2.0	1.9	2.0	1.9	1.9	1.9	1.8	1.8	1.7
Change in business inventories	Billions of 82$	18.4	8.5	15.4	18.3	20.9	19.6	18.5	18.4	18.0	16.4
Nonfarm	Billions of 82$	14.7	5.4	11.9	15.0	17.9	17.0	17.0	17.7	17.8	16.3
Net exports	Billions of 82$	-59.7	-47.7	-59.1	-61.0	-60.8	-57.2	-52.7	-45.8	-37.0	-27.3
ominal GNP	Percent change	6.1	5.3	6.4	5.7	5.2	5.3	5.8	5.7	6.0	5.8
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	109.0	109.5	110.0	110.5	110.4	110.6	110.9	111.2	111.5	111.9
Unemployment rate	Percent*	5.2	5.3	5.4	5.5	5.7	5.9	6.0	6.1	6.2	6.2
Industrial production index	Percent change	1.8	1.6	1.5	1.2	1.7	1.7	1.9	2.5	3.0	3.0
Capacity utilization rate-mfg.	Percent*	84.0	83.6	83.2	82.8	82.6	82.3	82.1	82.1	82.1	82.1
Housing starts	Millions	1.40	1.43	1.44	1.43	1.42	1.42	1.42	1.41	1.40	1.39
Auto sales	Millions	10.70	9.73	9.90	9.70	9.50	9.45	9.55	9.65	9.70	9.70
Domestic	Millions	7.76	6.90	7.05	6.90	6.85	6.85	6.95	7.05	7.10	7.10
Foreign	Millions	2.94	2.83	2.85	2.80	2.65	2.60	2.60	2.60	2.60	2.60
INCOME AND SAVING											
Nominal personal income	Percent change	6.2	6.4	6.6	5.6	5.0	5.7	6.6	5.2	4.9	5.8
Real disposable income	Percent change	5.3	2.3	3.3	.7	.4	1.1	1.8	.5	.3	1.0
Personal saving rate	Percent*	5.5	5.7	5.8	5.6	5.4	5.3	5.4	5.2	5.0	5.0
Corp. profits with IVA & CCAdj	Percent change	-12.0	1.1	-7.6	3.8	-1.3	-6.4	-18.6	6.1	14.0	3.3
Profit share of GNP	Percent*	5.6	5.6	5.4	5.4	5.3	5.1	4.8	4.8	4.9	4.9
Federal govt. surplus/deficit	Billions of $	-143.8	-146.9	-136.1	-129.2	-116.9	-114.7	-112.2	-106.1	-96.0	-92.1
State and local govt. surplus		50.6	50.8	50.4	54.1	55.4	56.2	62.3	65.2	65.0	65.6
Exc. social insurance funds		-28.4	-29.7	-31.6	-29.4	-29.6	-30.3	-25.7	-24.3	-26.0	-26.9
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.4	3.1	4.5	4.1	3.9	3.8	4.1	3.6	3.7	3.5
GNP fixed-weight price index		3.3	3.6	4.4	4.1	4.1	4.1	4.6	4.0	4.0	4.0
Cons. & fixed invest. prices		2.8	3.5	3.8	4.1	4.1	4.2	4.4	4.2	4.2	4.2
CPI		2.6	3.3	3.9	4.2	4.2	4.3	4.5	4.3	4.3	4.3
Exc. food and energy		3.7	4.4	4.3	4.4	4.4	4.5	4.8	4.5	4.5	4.5
ECI hourly compensation**		4.8	4.8	6.3	4.7	4.6	4.5	5.2	4.3	4.3	4.2
onfarm business sector											
Output per hour		.4	.7	.6	.7	.9	1.1	1.1	1.2	1.3	1.3
Compensation per hour		5.4	5.4	7.0	5.4	5.3	5.2	5.9	5.0	5.0	4.9
Unit labor costs		5.0	4.7	6.4	4.7	4.4	4.1	4.7	3.8	3.7	3.6

* Not at an annual rate.
** Private industry workers; seasonally adjusted by Board staff.

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

	1987				1988				1989		1986	1987	1988	Projection 1989
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	(fourth quarter to fourth quarter, net change)			
Real GNP	49.4	40.5	49.3	62.8	39.2	35.9	32.0	26.7	37.4	25.7	71.2	202.0	133.8	110.4
Gross domestic purchases	32.2	38.2	52.3	53.7	7.6	30.3	34.3	25.6	18.6	21.9	81.3	176.4	97.8	84.2
Final sales	10.5	45.2	55.9	13.0	61.5	48.7	16.0	45.8	31.3	31.2	99.7	124.6	172.0	120.3
Private dom. final purchases	-7.3	44.6	50.3	-4.7	46.9	35.2	25.4	14.2	19.2	16.8	86.5	82.9	121.7	93.3
Personal consumption expend.	.5	29.4	28.8	-4.2	38.5	16.0	21.3	19.6	13.3	12.7	90.9	54.5	95.4	67.3
Durables	-21.4	13.2	14.5	-14.4	19.0	6.4	-4.1	9.8	-1.2	5.6	41.1	-8.1	31.1	8.6
Nondurables	4.2	1.3	2.8	1.1	3.7	2.6	11.1	1.7	3.0	-5.3	25.2	9.4	19.1	10.8
Services	17.7	15.0	11.4	9.1	15.9	6.9	14.2	8.2	11.5	12.3	24.6	53.2	45.2	48.0
Business fixed investment	-4.8	14.7	27.2	-.1	10.9	14.2	3.2	-8.3	8.3	10.4	-25.2	37.0	20.0	29.8
Producers' durable equipment	-1.6	17.2	19.4	-.3	14.8	13.5	2.7	-6.7	8.6	13.3	1.2	34.7	24.3	31.8
Nonresidential structures	-3.3	-2.4	7.8	.2	-3.9	.7	.5	-1.6	-.3	-3.0	-26.5	2.3	-4.3	-2.0
Residential structures	-3.0	.5	-5.7	-.2	-2.8	5.1	.9	3.0	-2.5	-6.3	20.9	-6.4	6.2	-4.0
Change in business inventories	38.9	-4.8	-6.5	49.8	-22.3	-12.8	16.0	-19.2	6.2	-5.4	-28.5	77.4	-38.3	-9.8
Nonfarm	31.2	-5.8	-1.6	42.7	-27.3	-2.9	11.8	-5.3	-15.0	2.6	-34.1	66.5	-23.7	-26.5
Farm	7.7	1.0	-4.9	7.1	4.9	-9.9	4.3	-13.9	21.2	-8.1	5.6	10.9	-14.6	16.7
Net exports	17.2	2.3	-3.0	9.1	31.6	5.6	-2.3	1.1	18.8	3.8	-10.1	25.6	36.0	26.1
Exports	12.2	20.8	21.8	22.8	33.3	2.3	12.2	19.5	18.3	17.8	39.1	77.6	67.3	57.7
Imports	-5.0	18.5	24.8	13.7	1.7	-3.3	14.6	18.3	-.6	14.1	49.3	52.0	31.3	31.5
Government purchases	.6	-1.7	8.6	8.6	-17.0	7.9	-7.1	30.5	-6.7	10.6	23.3	16.1	14.3	.9
Federal	-4.3	-3.4	6.0	4.2	-21.1	4.1	-8.1	24.1	-8.4	8.1	1.8	2.5	-1.0	-7.9
Defense	3.2	5.6	6.0	-3.9	-3.7	-.5	-3.7	2.8	-7.2	1.4	14.4	10.9	-5.1	-12.7
Nondefense	-7.5	-9.0	.0	8.1	-17.4	4.6	-4.4	21.3	-1.2	6.7	-12.6	-8.4	4.1	4.8
State and local	4.9	1.6	2.7	4.4	4.1	3.8	1.0	6.4	1.7	2.5	21.5	13.6	15.3	8.8

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

	Projection											Projection		
	1989		1990				1991				1988	1989	1990	1991
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	(fourth quarter to fourth quarter, net change)			
Real GNP	25.2	22.1	19.1	16.0	13.8	15.3	17.0	21.7	23.1	23.5	133.8	110.4	64.2	85.3
Gross domestic purchases	33.7	10.1	30.6	18.0	13.6	11.7	12.4	14.9	14.3	13.8	97.8	84.2	73.8	55.4
Final sales	25.8	32.0	12.2	13.1	11.2	16.6	18.2	21.8	23.5	25.1	172.0	120.3	53.1	88.6
Private dom. final purchases	36.5	20.8	22.0	12.8	11.9	11.7	11.1	12.8	12.7	13.5	121.7	93.3	58.3	50.1
Personal consumption expend.	30.9	10.4	17.6	10.6	10.6	10.7	9.8	9.5	8.4	8.4	95.4	67.3	49.4	36.1
Durables	9.7	-5.5	3.2	-.8	-.6	.9	1.7	1.7	1.2	.8	31.1	8.6	2.7	5.4
Nondurables	9.0	4.1	5.0	3.0	2.8	2.3	1.6	1.6	1.6	1.6	19.1	10.8	13.1	6.6
Services	12.4	11.8	9.3	8.4	8.4	7.5	6.5	6.2	5.5	5.9	45.2	48.0	33.6	24.1
Business fixed investment	6.5	4.6	3.9	2.2	1.0	.7	2.4	3.6	4.4	5.1	20.0	29.8	7.8	15.4
Producers' durable equipment	5.4	4.5	4.2	3.0	2.0	1.7	3.0	3.8	4.1	4.8	24.3	31.8	11.0	15.7
Nonresidential structures	1.2	.1	-.2	-.8	-1.1	-1.1	-.6	-.2	.2	.3	-4.3	-2.0	-3.2	-.3
Residential structures	-.9	5.8	.5	.0	.4	.3	-1.1	-.3	.0	.0	6.2	-4.0	1.1	-1.4
Change in business inventories	-.7	-9.9	6.9	2.9	2.6	-1.3	-1.2	-.1	-.4	-1.6	-38.3	-9.8	11.1	-3.3
Nonfarm	-4.8	-9.3	6.5	3.1	2.9	-.9	-.1	.7	.1	-1.5	-23.7	-26.5	11.6	-.8
Farm	4.2	-.6	.4	-.2	-.3	-.4	-1.1	-.8	-.5	-.1	-14.6	16.7	-.5	-2.5
Net exports	-8.5	12.0	-11.5	-1.9	.2	3.6	4.6	6.9	8.8	9.7	36.0	26.1	-9.6	29.9
Exports	7.5	14.0	-1.1	8.3	9.1	11.4	11.9	14.6	15.8	16.2	67.3	57.7	27.7	58.5
Imports	16.0	2.0	10.3	10.2	8.9	7.9	7.3	7.7	7.0	6.5	31.3	31.5	37.3	28.6
Government purchases	-2.2	-.8	1.6	2.3	-.9	1.3	2.5	2.2	1.9	1.9	14.3	.9	4.3	8.6
Federal	-4.5	-3.1	-.6	.0	-3.1	-1.0	.2	.0	-.3	-.1	-1.0	-7.9	-4.7	-.1
Defense	-3.5	-3.4	-1.8	-1.6	-2.3	-1.6	-.8	-.3	-.8	-.6	-5.1	-12.7	-7.3	-2.5
Nondefense	-1.0	.3	1.2	1.6	-.8	.6	1.0	.3	.5	.5	4.1	4.8	2.6	2.4
State and local	2.3	2.3	2.2	2.3	2.2	2.3	2.3	2.2	2.2	2.0	15.3	8.8	9.0	8.7

FEDERAL S[illegible] ACCOUNTS[1]
(Billion[illegible]llars)

	Fiscal years				1989				1990				1991			
	1988a	1989	1990	1991	Ia	IIa	III	IV	I	II	III	IV	I	II	III	IV
BUDGET					Not seasonally adjusted											
Budget receipts[2]	909	995	1069	1137	220	308	245	229	250	325	265	250	262	341	283	267
Budget outlays[2]	1064	1154	1187	1251	280	285	298	300	298	299	291	318	311	313	308	315
Surplus/deficit(-) to be financed[2]	-155	-159	-119	-114	-61	23	-53	-71	-48	27	-26	-68	-49	28	-25	-48
(On-budget)	-194	-209	-185	-188	-77	0	-58	-80	-67	4	-41	-79	-70	3	-42	-56
(Off-budget)	39	50	66	74	16	23	5	9	19	23	15	11	22	25	17	8
Means of financing:																
Borrowing	162	140	116	111	38	10	38	63	33	6	14	65	26	4	16	43
Cash decrease	-8	14	-5	0	19	-29	14	11	5	-25	5	10	10	-25	5	10
Other[3]	1	5	8	3	4	-4	1	-3	11	-7	7	-7	13	-7	4	-5
Cash operating balance, end of period	44	30	35	35	15	44	30	20	15	40	35	25	15	40	35	25
NIPA FEDERAL SECTOR					Seasonally adjusted annual rates											
Receipts	958	1035	1114	1195	1036	1053	1055	1072	1109	1128	1145	1162	1187	1205	1227	1247
Expenditures	1103	1186	1246	1302	1184	1199	1198	1219	1245	1258	1262	1276	1299	1312	1323	1339
Purchases	377	405	412	423	399	406	408	406	413	416	414	415	422	425	431	434
Defense	297	300	299	303	299	301	300	297	301	301	300	299	302	304	308	310
Nondefense	80	105	113	120	100	105	108	109	112	115	114	116	121	122	123	124
Other expend.	726	781	834	879	785	793	791	813	832	842	848	861	877	886	892	906
Surplus/deficit	-145	-151	-132	-107	-148	-145	-144	-147	-136	-129	-117	-115	-112	-106	-96	-92
FISCAL INDICATORS[4]																
High-employment (HEB) surplus/deficit(-)	-150	-167	-139	-90	-165	-162	-160	-161	-147	-134	-114	-105	-96	-86	-72	-64
Change in HEB, percent of potential GNP	.3	.4	-.5	-.9	-.3	-.1	.0	.0	-.3	-.2	-.4	-.2	-.2	-.2	-.2	-.1
Fiscal impetus measure (FI), percent	.2 *	-4.0 *	-7.4 *	-3.3 *	-2.7	-.2	-.5	-3.0	-3.9	-.2	-1.0	-2.0	-1.3	.1	.0	.0

a--actual *--calendar year

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

1. Staff projections. The FY89 and FY90 deficits in OMB's <u>Mid-Session Review of the Budget</u> (July) are $148 billion and $99 billion, respectively. The FY89 figure omits $19 billion of on-budget RTC spending authorized in FIRREA. The FY90 estimate incorporates the Bipartisan Budget Agreement. The FY89 and FY90 deficits in CBO's <u>Economic and Budget Outlook: An Update</u> (August) are $161 billion and $118 billion, respectively, given congressional budget resolution policies and CBO's estimate of spending under FIRREA.
2. Budget receipts, outlays, and surplus/deficit include social security (OASDI) receipts, outlays and surplus, respectively. The OASDI surplus is excluded from the "on-budget" deficit and shown separately as "off-budget", as classified under current law.
3. Other means of financing are checks issued less checks paid, accrued items; and changes in other financial assets and liabilities, including Post Office surplus/deficit in FY90 and FY91.
4. HEB is the NIPA measure in current dollars with cyclically-sensitive receipts and outlays adjusted to a 6 percent unemployment rate and 2.7% potential output growth. Quarterly figures for change in HEB and FI are not at annual rates. Change in HEB, as a percent of nominal potential GNP, is reversed in sign. FI is the weighted difference of discretionary federal spending and tax changes (in 1982 dollars), scaled by real federal purchases. For change in HEB and FI, (-) indicates restraint.

Recent Developments

With economic data releases giving no clear direction to the market, most interest rates have shown only small, mixed changes on balance over the intermeeting period. This pattern has held despite a sharp drop in the dollar's exchange value late in the period.

There have been a few notable exceptions to the general pattern of small net changes in interest rates. Turmoil in the junk bond market sent prices there down abruptly, and the yield spread between low-rated bonds and comparable-maturity Treasury obligations has widened roughly 30 basis points; an apparent move toward quality and liquidity probably contributed to the 1/4 percentage point decline in the three-month Treasury bill rate over the period. In the primary and secondary mortgage markets, spreads have narrowed a bit, despite evidence of a continuing runoff of mortgage assets by thrift institutions; apparently, commercial banks, government agencies, and other investors are quickly stepping into the breach.

In August, the household component of M2--that is, M2 less demand deposits and overnight RPs and Eurodollars--continued to grow at close to the double-digit rate of the previous month, and preliminary data for September show that growth has remained rapid. The decline in opportunity costs during the summer has boosted these household balances, but the decline has not been uniform, so that deposit flows have been increasingly skewed both toward the more liquid accounts and toward commercial bank accounts. Offering rates on deposits at thrifts have been restrained in part by the RTC's actions to reduce intervened thrifts' bidding for funds, as well as by a recognition by capital-deficient savings institutions that they will have to shrink their balance sheets to comply with new capital standards.

As suggested by the strength of its retail component, M2 as a whole appears to have been little affected by the thrift situation: the funds have flowed instead into commercial banks, money funds, and the healthier thrifts. The advance in overall M2 last month was held to a 7-1/2 percent annual rate, partly because of a renewed decline in demand deposits, which also pulled M1 growth down to a rate under 1 percent. In September, M1 appears to have picked up, and M2 is continuing at about its August pace, lifting that broader aggregate a little further above the lower end of its annual target range.

The effort to shrink thrift assets is most apparent in the M3 figures, as massive runoffs in managed liabilities at insolvent and poorly capitalized thrift institutions helped hold M3 growth down to just a 2 percent rate in August. According to preliminary data for September, M3 growth remained in that vicinity, and growth for the year edged down toward the 3-1/2 percent lower bound of its target range.

Overall nonfinancial business borrowing apparently softened in August: C&I loan growth moderated, commercial paper outstanding declined, and gross public bond issuance fell a bit from the already reduced July pace. Recently, the financial difficulties of some major issuers sent junk bond prices sharply lower; spreads over Treasury securities reached a decade-high level of more than 5-3/4 percentage points, before receding a bit. In this environment, only a few new junk bonds have come to market. Investment-grade borrowers, by contrast, have become more active recently, with commercial paper growing again in September and bond issuance picking up.

Treasury borrowing increased markedly in August and September, largely reflecting the effort to fund the RTC on budget in fiscal 1989. Borrowing by government agencies also was influenced by the thrift situation. In particular, the Federal Home Loan Banks have been paying down their outstanding obligations as the demand for advances by member thrifts has ebbed. FNMA, on the other hand, has been raising funds as current spreads in the mortgage markets have encouraged it to purchase mortgage loans for portfolio.

Offerings in the municipal market strengthened in August, bolstered by a large amount of short-term issues. More recently, long-term issuance has picked up, perhaps reflecting a concern that the upturn in rates from early-August lows will cumulate.

Available evidence suggests that borrowing by households also strengthened in August. Buoyed by brisk incentive-related sales of new cars, consumer loans at banks accelerated to a 7-1/4 percent pace. Real estate lending by commercial banks rose to a 15 percent annual rate, although no doubt part of this gain represented market share taken from thrift institutions. On balance, in keeping with the firming in home sales this summer, home mortgage debt outstanding may have accelerated a little. And that growth has been accommodated at spreads that, while wider than at the turn of the year, have remained well within the ranges of recent years.

Outlook

The staff economic projection anticipates little change in money market conditions over the next year. Eventually, as we move into 1991, some upward move in short-term interest rates may be required to hold inflationary pressures in check in the face of the assumed weakening in the dollar. Under such circumstances, long-term rates may well edge up slightly even before then, as the market comes to anticipate the shift in money market rates.

Debt of nonfinancial businesses is expected to continue to grow at roughly its current pace through the end of this year. Thereafter, it should slow a bit, in part reflecting a lessening of net equity retirements. Net equity retirements already have fallen off from their record levels around the beginning of the year, and the rising cost of leveraging may restrain such activity in coming quarters. Tempering the effect of this trend on business borrowing is a widening of the financing gap of nonfinancial corporations, which reflects in part the weak profit outlook.

Growth in household debt is forecast to moderate only marginally over the forecast period. With housing activity projected to remain around its current levels, the expansion of mortgage credit is likely to be well maintained. Embodied in the outlook is the staff assumption, borne out by evidence to date, that the cost and availability of home mortgage credit will not deteriorate further as a result of the ongoing contraction of the thrift industry in the wake of FIRREA. Growth of the other major component of household debt, consumer credit, is likely to tail off over the period ahead, in line with the expected slow growth of spending on consumer goods.

At all levels of government, the growth of borrowing is expected to continue its declining trend of the last several years. The federal government's borrowing needs should grow more slowly as a result of efforts to bring down the deficit, and, in the near term, as the funding for thrift resolutions by RTC moves off budget, to be financed by REFCORP. State and local authorities will continue to borrow for infrastructure investment, but net issuance will ebb as retirements trend up, partly reflecting the advance refundings of some years ago.

With slowing trends apparent in most of its components, the debt of domestic nonfinancial sectors, after increasing about 8 percent this year, is projected to grow on the order of 7 percent in 1990. Some additional slowing is foreseen for 1991.

Recent developments

The dollar's foreign exchange value declined sharply after the release of the G-7 communique on September 23 and the ensuing visible co-ordinated intervention by the central banks of all the G-7 and several other European countries. This decline more than offset the dollar's earlier rise, which had occurred in the wake of reports of strong U.S. employment gains in August and U.S. merchandise trade figures that were better-than-expected. For the intermeeting period as a whole, the dollar depreciated by 2-1/4 percent against a weighted average of other G-10 currencies. The dollar depreciated more against the German mark than against the Japanese yen, in part because of expectations of an imminent monetary tightening by the Bundesbank.

Economic growth in major foreign industrial countries slowed sharply in the second quarter from the very rapid first quarter pace. In Japan and Germany, however, special factors distorted the quarterly pattern, and data so far for the third quarter appear to indicate a return to stronger growth. The decline in second quarter GDP in the

United Kingdom is indicative of an underlying trend in that country as the effects of the very sharp monetary tightening in 1988 take hold.

Recorded inflation rates abroad have stabilized or declined in recent months, after surging in the second quarter under the impact of higher energy prices and, in several countries, the imposition of new indirect taxes. Labor market conditions remain tight in a number of countries, however, and monetary authorities remain concerned with the risks of worsening underlying inflation pressures.

Among developing countries, Mexico reached agreement with its Bank Advisory Committee on the detailed term sheet for its new financing package. This agreement enabled Mexico to draw $1.6 billion on its $2 billion bridge loan from U.S. monetary authorities, other G-10 countries, and Spain. Mexico drew $784 million on its swap lines with the Federal Reserve, including $84 million on its special swap facility, and $384 million on its arrangement with the Treasury's Exchange Stabilization Fund on September 25. Mexico's current stabilization program seems to have revived confidence in that country, and economic activity is proving significantly stronger than was projected at the beginning of the year.

The U.S. merchandise trade deficit in July was $7.6 billion (SA, Census basis), compared with a revised $8.0 billion in June. July's further improvement followed reductions in the deficit in both the first and second quarters. The trade balance so far in 1989 has been significantly affected by positive J-curve effects of the dollar's appreciation this year.

Exports in July, though somewhat below June's strong rate, were 5 percent above first quarter rates. For the first seven months of this year, the value of exports was 15 percent above that of a year earlier, with most of this reflecting an increase in volume.

Total imports declined 2.5 percent in July, despite a 1.8 percent rise in the value of oil imports. During the first 7 months of this year, the value of non-oil imports was 7 percent higher than in the first 7 months of 1988.

Non-oil import prices again edged lower in August, continuing a decline since the first quarter. Oil import prices declined moderately in both July and August, following their surge in the first and second quarters. Nonagricultural export prices declined in July and August as chemicals and metals prices fell substantially; the price of other exports rose moderately.

Outlook

The staff has incorporated a projected moderate rate of decline in the dollar's exchange value over the forecast period, although the level of the path is somewhat higher than in the last Greenbook. The forecast decline of the dollar is based on an evaluation of longer run trends in our external accounts, a projected stalling of the global external adjustment process during 1990-91 in the absence of a decline in the dollar, and the likely prospect of higher interest rates abroad as foreign monetary authorities continue to restrain above-potential growth of demand and its consequent inflationary pressures.

Growth in foreign industrial countries is projected to decline to 2-3/4 percent in 1990 and 1991 from the 3-3/4 percent average rate of the first half of this year. Inflation is also projected to moderate over the forecast period and remain below U.S. rates. Growth in developing countries is expected to be at around a 3 to 4 percent rate, somewhat above recent rates of growth.

Abstracting from an expected bulge in aircraft exports in the fourth quarter of this year, the U.S. merchandise trade balance is expected to show little change over the six quarters to the end of 1990 from the $112 billion deficit (annual rate) in the first half of this year, as the effects of the recent strength of the dollar are about offset by the continuation of foreign GNP growth in excess of that of the United States. Some moderate reduction of the trade deficit is projected during 1991, reflecting the effects of the projected decline in the dollar. Oil import prices are projected through 1990 at around the $17.00 per barrel currently estimated for the third quarter, then to rise in line with the rate of inflation. The current account deficit (excluding capital gains and losses) is projected to worsen a bit through 1990 as income payments abroad grow, but to improve to a $96 billion rate of deficit by the fourth quarter of 1991, reflecting the projected reduction of the trade deficit in that year.

Given the lack of a convincing explanation for the extraordinary and surprising strength of the dollar so far this year, the staff examined the alternative of an unchanged dollar. Model simulations, with monetary policy accomodating to maintain the Greenbook path of real GNP, imply a sharp worsening of the current account under this alternative beginning in mid-1990, amounting to nearly $30 billion by 1991Q4.

CURRENT ACCOUNT BALANCE
(Excluding capital gains and losses, $ billions)

	Greenbook	Alternative Projection
1988Q4*	-130.6	-130.6
1989Q4	-99.2	-97.2
1990Q4	-110.4	-115.0
1991Q4	-95.6	-124.8

*--actual

Note: The alternative projection is based on the pooled results of the quarterly econometric model of the U.S. economy and the multicountry model. The alternative assumes an (exogenously) unchanged value of the dollar from current levels, with monetary policy adjusted to keep the real GNP path the same as in the Greenbook.

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Class II FOMC

September 26, 1989

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

	ANNUAL			1989		1990				1991			
	1989-P	1990-P	1991-P	Q3-P	Q4-P	Q1	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current $, Net	-47.8	-44.6	-30.7	-48.9	-37.7	-46.0	-45.6	-45.0	-41.9	-39.1	-34.8	-28.2	-20.4
Exports of G+S	630.2	675.3	750.6	636.4	652.6	654.2	667.2	681.4	698.6	717.1	738.5	761.5	785.1
Imports of G+S	677.9	719.9	781.1	685.2	690.2	700.1	712.7	726.2	740.3	756.1	773.3	789.6	805.4
Constant 82 $, Net	-53.4	-59.6	-40.7	-59.7	-47.7	-59.1	-61.0	-60.8	-57.2	-52.7	-45.8	-37.0	-27.3
Exports of G+S	590.3	621.6	671.6	595.0	609.1	607.9	616.2	625.3	636.8	648.7	663.3	679.1	695.3
Imports of G+S	643.7	681.1	712.3	654.7	656.7	667.0	677.3	686.2	694.0	701.4	709.1	716.1	722.6
2. Merchandise Trade Balance 2/	-108.5	-109.8	-104.9	-110.2	-99.6	-108.2	-109.9	-110.9	-110.2	-110.3	-108.2	-103.6	-97.4
Exports	365.9	389.3	433.7	368.4	380.0	377.7	384.4	392.4	402.5	412.8	425.5	440.3	456.0
Agricultural	41.2	41.6	44.1	39.0	39.9	40.7	41.4	41.9	42.3	43.0	43.8	44.4	45.2
Non-Agricultural	324.7	347.7	389.6	329.4	340.1	337.0	343.0	350.6	360.3	369.8	381.7	395.8	410.8
Imports	474.4	499.1	538.5	478.6	479.5	485.9	494.2	503.4	512.7	523.1	533.7	543.8	553.4
Petroleum and Products	50.3	51.9	55.5	53.9	50.2	51.0	51.6	52.1	52.7	53.8	54.9	56.1	57.2
Non-Petroleum	424.1	447.2	483.0	424.7	429.4	434.9	442.6	451.2	460.0	469.3	478.8	487.8	496.3
3. Other Current Account Transactions													
Capital Gains and Losses 3/	-8.9	1.6	1.7	-1.3	-1.5	1.6	1.6	1.6	1.5	1.7	1.7	1.7	1.7
Other D.I. Income, Net	35.7	36.2	40.4	35.6	35.3	35.1	35.5	36.3	37.9	39.5	40.2	40.9	41.1
Portfolio Income, Net	-36.6	-44.6	-50.9	-37.2	-40.1	-42.1	-43.8	-45.5	-47.1	-48.6	-50.0	-51.7	-53.2
Other Current Account, Net	5.1	9.9	14.2	6.5	5.1	8.8	10.4	11.3	9.1	13.0	14.2	15.5	14.0
4. U.S. Current Account Balance													
Including Capital G/L	-113.2	-106.8	-99.4	-106.6	-100.7	-104.9	-106.2	-107.2	-108.8	-104.6	-102.0	-97.1	-93.9
Excluding Capital G/L	-104.3	-108.3	-101.1	-105.3	-99.2	-106.4	-107.7	-108.8	-110.4	-106.3	-103.7	-98.8	-95.6
5. Foreign Outlook 4/													
Real GNP--Ten Industrial 5/	3.3	2.7	2.8	3.2	2.7	2.9	2.9	2.8	2.6	2.5	2.8	3.2	2.7
Real GNP--NonOPEC LDC 6/	2.7	3.8	3.8	3.1	3.7	4.2	4.1	3.9	3.7	3.5	3.8	4.1	4.4
Consumer Prices--Ten Ind. 5/	4.1	3.7	3.4	2.7	3.6	3.5	4.5	2.8	3.1	3.4	4.2	2.7	3.1

1/ National Income and Product Account data.
2/ International accounts basis.
3/ The net of gains (+) or losses (-) on foreign-currency denominated assets due to their revaluation at current exchange rates and other valuation adjustments.
4/ Percent change, annual rates.
5/ Weighted by multilateral trade-weights of G-10 countries plus Switzerland; prices are not seasonally adjusted.
6/ Weighted by share in NonOPEC LDC GNP.
P/ Projected