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Strictly Confidential (FR) Class II FOMC

Part 1

June 25, 1997

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Summary and Outlook

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

Strictly Confidential (FR) Class II FOMC

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SUMMARY AND OUTLOOK

Prepared for the Federal Open Market Committee
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Domestic Developments

Overview

Real GDP growth appears to have slowed in the second quarter about as we predicted in the last Greenbook--probably to somewhere around 2 percent at an annual rate. Nonetheless, we have raised our projection for activity in coming quarters. In part, we are impressed by the momentum of industrial production, which is being sustained by strong demand for durable goods and the low level of inventories relative to sales. And although retail sales lagged this spring, surveys indicate that consumers are feeling extraordinarily upbeat; they clearly have the wherewithal, including substantial wealth and ample credit lines, to support hefty spending gains. Exuberance marks the financial markets as well, and stock and bond prices have climbed even more than we anticipated last month; this remains a highly liquid economy. All told, we see little to prevent domestic demand from maintaining a fairly brisk growth pace into the second half.

We now project that real GDP will grow just a little less than 3 percent, at an annual rate, over the second half of 1997, 1/2 percentage point faster than predicted in the last Greenbook. However, activity is projected to decelerate substantially over the course of 1998, with GDP increasing only a touch more than the 2 percent predicted last month. We believe this forecast better balances the risks in the outlook for real growth than has been the case in our recent baseline forecasts. Even so, we remain concerned that we may still be understating the near-term strength of the economy--and the potential for more of a boom-bust pattern, with a buildup of inflationary pressures prompting a marked tightening of monetary policy. In this forecast, inflation gathers speed only gradually, and we have once again assumed no further snugging of money market conditions until well into 1998.

Indeed, even though the higher output path in this Greenbook implies a somewhat tighter labor market, we have trimmed our forecast of inflation slightly. The recent news on consumer prices has been on track with our earlier prediction, but the emerging balance of supply and demand in the agricultural and energy sectors has tilted a bit more favorably than we anticipated. In addition, we have given greater weight this time to the damping effect in goods markets of the rapid growth of productive capacity in manufacturing. The resultant milder increase in living costs suggests less pressure on nominal wages and a general muting of inflation expectations. All told, overall CPI inflation is expected to be only about 2-1/4 percent this year and to remain below 3 percent in 1998.

Background Factors in the Forecast

As in prior forecasts, we have assumed that the federal funds rate holds at the present level until about the middle of next year, when, as inflation picks up, the FOMC initiates a moderate increase to avert a decline in real short rates. Long-term interest rates have fallen noticeably over the past month, reflecting the cumulating evidence of more moderate growth and restrained inflation and the growing conviction among financial market participants that the FOMC will hold policy steady over the near term. Over time, however, market wariness about increased inflation, related in particular to the pressures in the labor market, is likely to contain such enthusiasm and to be reflected in some firming in bond yields. Long-term rates are projected to rise a bit further as the System tightens next year.

Meanwhile, equity prices have continued to outstrip our expectations and now stand substantially above the levels we had expected in the last Greenbook. The market is likely to remain skittish, but we see nothing in the near-term outlook that will prick what increasingly is looking to be a speculative bubble--and we have built into our forecast a modest further market advance in the second half of the year, despite the presence of already historically high price-earnings multiples. However, we are anticipating a considerable retreat in share values in 1998 as the "new paradigm" that is currently ascendant among analysts is called into question by a squeeze on corporate profit margins and an updrift in inflation. Actual and anticipated Fed actions to combat that inflation are expected to weigh on the market as well.

On the fiscal front, we have edged up our projections for the unified budget deficit to $59 billion in fiscal 1997 and $85 billion in fiscal 1998, compared with projections of $57 billion and $77 billion in the May Greenbook. This moderate increase in the deficit follows five years of steady declines. The increase is primarily due to a projected slowing in the growth of receipts, reflecting both a slowing in the growth of nominal incomes and the absence of any further outsized revenue gains such as have occurred in each of the past two years.[1] Outlays, on the other hand, continue to grow at around the same pace of recent years.

We have also made some adjustments to our fiscal policy assumptions to reflect the thrust of the emerging budget legislation. In particular, we have raised discretionary spending in fiscal 1998 to reflect the proposed raising of the spending caps included in the congressional budget resolution. Although the specifics of the tax

1. The higher level of payments associated with this year's tax surprise is assumed to persist in 1998, but we have assumed no additional surprise that would boost the growth of receipts.

legislation remain in flux, it now seems likely that some key tax cuts will go into effect later than we had assumed. In addition, the child tax credit will probably be more generous than we had built into our previous projection. All told, we now expect this year's spending and tax legislation to increase the budget deficit $1 billion in fiscal 1998, whereas the package we had assumed in May would have lowered the deficit $1 billion.

In the external sector, growth in foreign economic activity, in the aggregate, appears to be roughly in line with our expectations for the first half of 1997, and we have retained our forecast that foreign GDP will rise about 4 percent this year and next. Recent developments in foreign exchange markets have also been about as expected, with the trade-weighted value of the dollar in terms of other G-10 currencies continuing to fluctuate in a narrow range after having soared over the first part of the year. Looking ahead, we still expect the dollar to edge down over the next year and a half and to end 1998 about 2 percent below recent levels. Meanwhile, crude oil prices have dropped over the past month, and the spot price of West Texas intermediate currently stands just below $19 per barrel. With worldwide stocks high relative to projected demand, the WTI price may settle around $18.50 in the second half of 1997, $1 lower than in the May Greenbook. We anticipate that the price will drift up to $19.50 by the second half of 1998, the same level as in the May Greenbook.

The Current Quarter

We now estimate that real GDP will have grown at an annual rate of 2.2 percent in the current quarter, only a bit more rapidly than we had predicted last month. Although consumer spending has decelerated more sharply than we had anticipated, other components of final demand appear to be growing faster than previously projected, and we no longer foresee much drag from inventory investment. Aggregate hours also point to only a moderate gain in output this quarter, on balance: Employment growth has remained brisk, after one cuts through the noise associated with statistical problems in April, but the average workweek has dropped back.

The dataset for the expenditure side still contains many important gaps. Nonetheless, the figures we do have in hand indicate that personal consumption expenditures have slowed appreciably after their first-quarter surge. Spending on light vehicles, which has bounced around this year in part because of a mild winter and strike-related supply constraints, edged down, on balance, during April and May. Non-auto retail sales have been lackluster over the past few months as well, with demand for seasonal merchandise widely reported to have been damped by the unusually cool spring. Retailers have indicated that sales picked up in June; given these reports and the very positive fundamentals in the household sector, we are anticipating a sizable rebound in spending this month. Even so, total consumption is still expected to grow only about 1-1/2 percent at an annual rate for the quarter as a whole.

Housing activity appears to have been well maintained of late. Although single-family starts dipped to 1.1 million units (annual rate), on average, in April and May, the decline was from a first-quarter level that doubtless was boosted by weather considerations. Permits, which typically are less affected by weather, have been essentially flat over the past several months. Other recent indicators, such as homebuilders' surveys and loan applications, also suggest that demand has held up well--and potential homebuyers are being lured by mortgage rates (thirty-year, fixed-rate loans) that last week were about 40 basis points below those prevailing, on average, over the preceding three months.

In the business sector, we are projecting a big increase in real outlays for producers' durable equipment. The recent data on orders and shipments have been strong, and steep declines in computer prices should provide an extra boost when the nominal figures are translated into estimates of real spending. In addition, shipments of aircraft to domestic carriers, which had sagged in the first quarter, have surged in

Summary of the Near-Term Outlook
(Percent change at annual rate except as noted)

Measure	1997:Q1			1997:Q2	
	May GB	BEA[p]	June GB	May GB	June GB
Real GDP	**6.0**	**5.8**	**5.8**	**1.8**	**2.2**
Private domestic final purchases	6.7	6.5	6.3	3.5	3.0
Personal consumption expenditures	5.8	5.7	5.7	2.2	1.4
Residential investment	6.4	6.0	6.0	1.3	4.4
Business fixed investment	12.2	11.5	10.3	12.2	13.0
Government outlays for consumption and investment	-.1	.1	.2	2.0	3.1
	Change in billions of chained (1992) dollars				
Inventory investment	35.2	34.3	30.0	-13.3	-5.6
Net exports	-30.1	-28.4	-22.0	-12.5	-11.9

p Preliminary.

recent months. Meanwhile, nonresidential construction put-in-place fell in March and April, but the earlier slippage in contracts has been reversed and surveys of market conditions remain positive; accordingly, we expect construction outlays to rebound in May and June and to post a small real gain over the quarter as a whole.

We now expect the pace of stockbuilding to drop only a little this quarter from a level of inventory investment in the first quarter that is a bit lower than previously estimated. In fact, the rise in the book value of stocks (excluding motor vehicles) in April, at an annual rate of $37 billion, was a bit above the average monthly increase in the first quarter. Nonetheless, inventories were still relatively lean at the end of April, and with manufacturing output projected to increase substantially this quarter, we expect accumulation to remain brisk in May and June.

As for prices, the incoming data have been in line with our projection that the total CPI will rise at an annual rate of only about 1 percent this quarter. The index was up only 0.1 percent per month in April and May, held down by a steep drop in energy prices and only a small rise, on net, in food prices over the two months. The increases in the CPI excluding food and energy averaged 1/4 percent per month in April and May. Assuming an increase of 0.2 percent in June, the core CPI is expected to rise nearly 3 percent (annual rate) this quarter, up from 2-1/4 percent in the first quarter. On the wage front, average hourly earnings rose 0.3 percent in May after inching up only 0.1 percent in April; over the past twelve months, average hourly earnings have risen 3-3/4 percent, 1/2 percentage point more than over the year ended May 1996.

The Longer-Run Outlook

As indicated in the overview, we raised our forecast of aggregate demand growth over the next few quarters largely on the basis of our assessment of the implications of the prevailing ebullience among households and businesses and the friendly conditions in the financial markets. Nonetheless, we continue to anticipate considerable deceleration in economic activity in 1998. The slowing is evident in both household and business expenditures and largely reflects the already high rates of real asset accumulation and the less favorable financial environment anticipated for 1998. In addition, nonfarm inventory investment is expected to be a fairly neutral influence on GDP growth hereafter, having contributed 3/4 percentage point, on average, to real growth over the first half of 1997. Declining real net exports are expected to remain a drag on domestic production over the forecast period.

The unemployment rate is projected to fall only a couple of tenths further over the next few quarters and then, as GDP decelerates in 1998, it levels out at just over 4-1/2 percent. In this extremely tight labor market, we expect that employers are going to have to boost compensation increases to attract and retain the workers they need. Productivity growth appears to have picked up in the past year, but we continue to think that this improvement is mainly a short-run reflection of the acceleration in output and thus are projecting only moderate increases in output per hour through next year. Consequently, rising unit labor costs are likely to be squeezing profit margins, but ample productive capacity in the manufacturing sector is expected to limit the ability of firms to pass the higher costs through to prices.

Consumer spending. We have raised our projection of real PCE growth in the second half of 1997 to a bit more than 3-1/2 percent (annual rate), which is 1/2 percentage point faster than in the May Greenbook and about matches our current

Summary of Staff Projections
(Percent change, compound annual rate)

Measure	1997:H1	1997:H2	1998
Real GDP	**4.0**	**2.9**	**2.1**
Previous	3.9	2.4	2.0
Final sales	3.2	3.2	2.1
Previous	3.2	2.8	2.0
PCE	3.5	3.6	2.5
Previous	4.0	3.1	2.6
Residential investment	5.1	-1.6	-2.0
Previous	3.8	-1.8	-1.9
BFI	11.6	9.2	6.3
Previous	12.2	8.2	5.6
Government purchases	1.6	1.1	.8
Previous	.9	1.3	.1
	Change in billions of chained (1992) dollars		
Inventory change	24.4	-12.6	2.5
Previous	21.9	-13.6	-1.0
Net exports	-33.9	-12.0	-23.8
Previous	-42.6	-11.4	-23.4

estimate for spending growth over the first half. We have been influenced mainly by the recent trends in the fundamentals: Job increases remain sizable, real wages are rising, consumer sentiment is buoyant, and the record-setting stock market has pushed the household sector wealth-to-income ratio sharply higher, providing additional wherewithal for household purchases.

We still expect spending growth to fall to 2-1/2 percent in 1998 as the projected moderation of job gains slows the growth in real disposable income. And although lagged responses to this year's run-up in share prices are likely to be a plus for consumer demand well into the year, the stock market decline we are projecting may begin cutting into spending by year-end--via the direct effect on household wealth and through a contribution to some decline in sentiment. In addition, although lenders seem to be getting a handle on the problem of credit card delinquencies, charge-offs on various types of credit to households are likely to be high enough to induce banks and other intermediaries to tighten up further on their lending to relatively risky borrowers.

We continue to expect outlays for durables to be the strongest component of spending. Declining relative prices and the availability of innovative products will continue to lift demand for home electronic equipment. However, sales of light motor vehicles are likely to remain near their recent level of around 15 million units per year through mid-1998 and edge down thereafter. In addition, our forecast of some softening in housing construction should restrain the growth in demand for household goods.

Residential investment. Cutting through the ups and downs in the data, housing activity has been essentially flat over the past few quarters, and we see little reason to expect much change over the rest of 1997. Income and employment conditions are likely to remain supportive; households' perceptions of homebuying conditions are extremely favorable; and the recent declines in mortgage rates have increased cash-flow affordability. We still expect the demand for single-family houses to decline a bit over the course of 1998 as income growth slows and mortgage rates turn up. Consequently, starts of these units are projected to average 1.12 million units in the second half of 1997, similar to the average since the fourth quarter of 1996, and then to drop about 5 percent next year.

We also expect multifamily starts to edge down next year. The projected rise in interest rates and the slowing of the economy are key factors. In addition, vacancy rates remain high on a national basis, thereby limiting the opportunities for profitable construction--and perhaps prompting lenders to be a bit more cautious in providing credit to builders. Manufactured housing likely will remain an important alternative in the lower-cost portion of the residential market.

Business fixed investment. Business fixed investment should remain strong in the near term. Orders are still on a marked uptrend, and reports from some companies suggest that the plunge in computer prices is likely to intensify. Investment spending continues to be boosted as well by positive sales expectations in many industries, healthy cash flow, and a perceived opportunity, if not a necessity, to install new technology in order to remain competitive. As the economy slows later this year and in 1998, these macro influences will likely become somewhat less conducive to growth of investment. Nonetheless, gains in real BFI are expected to continue outpacing overall growth of the economy by a substantial margin: We are projecting that a rise of 10-1/2 percent this year will be followed by an increase of about 6-1/2 percent in 1998.

We expect equipment spending to decelerate noticeably over the next several quarters. Growth of computer outlays is expected to remain around 25 percent to 30 percent per year over the next couple of quarters before tapering off somewhat in 1998. We expect spending for communications equipment also to remain brisk in light of the intense pressures to add capacity to accommodate the growth of networking, the rapid pace of technological advance, especially in wireless communications, and regulatory changes. Orders outside the high-tech categories also point to sizable increases in outlays over the next few quarters; however, investment next year will be damped by the deceleration of output, a flattening of profits, and a rising cost of debt and equity capital. The general increase in interest rates is expected to be modest, especially in real terms. But our projected leveling off of corporate earnings--which would come as a disappointment to financial markets--could disproportionately raise costs of external finance for higher-risk enterprises, which have recently been enjoying liberal access to funds at increasingly thin spreads and with looser covenants.

Prospects for nonresidential construction remain bright, with projected growth in real outlays of about 4-1/2 percent per year over 1997-98. Contracts firmed, on balance, in April and May, after having softened earlier in the year, and other indicators suggest that spending will remain robust over the next few quarters. Vacancy rates have been falling and rents improving, and financing for commercial construction reportedly is in abundant supply--especially with money flooding into REIT coffers. Office buildings and hotels look to be areas of notable strength.

Inventory investment. We have raised the inventory projection to reflect the higher path of final sales in this Greenbook. Nonetheless, we continue to foresee some slowing in the pace of stockbuilding in an environment where sales growth is dropping to trend, shortages and bottlenecks are limited, and firms remain focused on tight inventory control. The stock-sales ratio is still expected to remain in the low range into which it fell in the latter part of 1996 and early 1997.

Government spending. We have raised our forecast of real federal expenditures on consumption and gross investment to reflect the higher caps on discretionary spending in the recently enacted congressional budget resolution. We now anticipate that these outlays will be little changed, on net, over the four quarters of 1997 and will decline about 2 percent over the course of 1998. Most of the additional spending is for nondefense programs, which are now expected to grow a little in real terms over the next two years. As for defense, we expect real outlays to drop back in the third quarter after a transitory upward blip in the current quarter and to decline about 1 percent over 1997 as a whole. Real defense purchases are projected to decrease 3-1/2 percent in 1998.

Real purchases by state and local governments are projected to rise about 2-1/2 percent in 1997 and 1998, similar to the average gains of the past few years. Although most states are enjoying hefty revenue inflows and strong financial positions, they appear to be adhering to conservative spending strategies. According to a recent survey by the National Association of State Budget Officers, states have planned only small increases in real spending in fiscal 1998 (which begins July 1 in most states), responding both to the public's reluctance to pay for governmental programs and to concerns about the prospects for federal grants. Also, a number of states have enacted small tax cuts.

Net exports. Even though we project real exports of goods and services to rise fairly briskly from mid-1997 through the end of 1998, imports likely will continue to increase even faster. On net, the changes in exports and imports from mid-1997 forward result in real GDP growth that is about 1/3 percentage point less than the growth of gross domestic purchases. (A fuller discussion of the prospects for the external sector is contained in the *International Developments* section.)

Labor markets. Measured productivity rose substantially in the first quarter of 1997, and we are estimating a respectable gain in the current quarter as well. We continue to hear reports that a new wave of efficiency gains, based in part on advances in computer and communications hardware and software, is taking hold. But whether these innovations are adding appreciably to aggregate productivity growth, or are just part of a long sequence of purported break-throughs that do not pan out, is not yet clear. Moreover, some temporary acceleration in productivity is to be expected when output surges as it has recently. Under the circumstances, we have kept our estimate of the underlying, trend of growth in output per hour in the nonfarm business sector at a bit less than 1 percent per year; this estimate continues to be based on the assumption that output and productivity gains for the past few years will be revised upward. Productivity is projected to increase at roughly its trend rate over the next few quarters, on average, but then to decelerate as output growth slows and well-qualified workers become an even scarcer commodity.

Thus, businesses will need to maintain a brisk pace of hiring to meet the growth in sales and production we are forecasting. Payroll employment growth is projected to run close to 200,000 per month over the remainder of 1997 and about 160,000 per month in 1998. The strength in hiring should, in turn, draw some additional workers into the labor force and help sustain the recent uptrend in the participation rate. Combining the two elements, we expect the unemployment rate to move down only a little further over the second half of 1997 and to level out at 4.6 percent in 1998.

The Outlook for the Labor Market
(Percent change, Q4 to Q4, except as noted)

Measure	1995	1996	1997	1998
Output per hour, nonfarm business	-.1	.9	1.5	.8
Previous	-.1	.9	1.2	.9
Nonfarm payroll	2.0	2.1	2.1	1.6
Previous	2.0	2.2	1.9	1.3
Household employment survey	.6	2.0	2.3	1.4
Previous	.6	2.0	2.2	1.2
Labor force participation rate[1]	66.5	66.9	67.3	67.4
Previous	66.5	66.9	67.3	67.4
Civilian unemployment rate[1]	5.6	5.3	4.7	4.6
Previous	5.6	5.3	4.8	4.8

1. Percent, average for the fourth quarter.

Wages and prices. All else being equal, one would expect the higher levels of resource utilization in the current projection to be reflected in an upward revision to the inflation forecast. However, we have lowered the projection for food and energy prices somewhat, which will be feeding into wages through formal or informal cost-of-living adjustments. Moreover, the continued subdued behavior of industrial prices suggests that the ongoing rapid expansion of industrial capacity may be restraining inflation to a greater extent than we had thought. Accordingly, the inflation forecast has been revised down slightly. Nonetheless, we still anticipate a gradual acceleration of both hourly compensation and prices over the period ahead.

Our forecast for hourly compensation now shows the ECI for private industry workers increasing 3.3 percent in 1997 and 3.4 percent in 1998, after having risen 3.1 percent in 1996. To be sure, as we discussed in the May Greenbook, compensation practices may well have changed in ways that bring greater flexibility to company wage structures (for example, firms may be targeting pay increases to workers with scarce skills), and other payments (for example, hiring bonuses) may not show up in the standard measures of compensation. Moreover, these innovations may have altered the timing or magnitude of the responses of hourly compensation to labor market slack. However, we continue to think that some further acceleration in compensation

Staff Inflation Projections
(Percent change, Q4 to Q4, except as noted)

Measure	1995	1996	1997	1998
Consumer price index	2.6	3.2	2.2	2.8
Previous	2.6	3.2	2.4	2.9
Food	2.6	4.2	1.7	2.6
Previous	2.6	4.2	2.1	2.7
Energy	-1.7	7.6	-2.6	1.8
Previous	-1.7	7.6	-1.3	1.3
Excluding food and energy	3.0	2.6	2.7	3.0
Previous	3.0	2.6	2.7	3.1
PCE chain-weighted price index	2.1	2.5	2.1	2.6
Previous	2.1	2.5	2.3	2.7
Excluding food and energy	2.3	2.0	2.4	2.7
Previous	2.3	2.0	2.5	2.8
ECI for compensation of private industry workers[1]	2.6	3.1	3.3	3.4
Previous	2.6	3.1	3.4	3.6
Prices of non-oil merchandise imports	.8	-2.9	-.5	.7
Previous	.8	-2.9	.0	.6

1. December to December.

is in the offing, given the extraordinarily tight labor market, the further increase in the minimum wage scheduled for September, and the likelihood of a small upturn in health benefit costs before too long. Although the ECI continued to show no change in employer-paid health benefits through the first quarter, private surveys generally show increases of a couple of percentage points this year. The anecdotal evidence points to a further step-up in premiums in 1998 as individuals seek out more flexible--and presumably more expensive--managed care plans and insurers and providers try to rebuild diminished profit margins.

On the price side, we have left the projection for core CPI inflation in 1997 at 2.7 percent and trimmed a tenth from the projection for 1998, which now stands at 3.0 percent. This acceleration is projected to occur despite growth in manufacturing capacity that remains fast enough to prevent bottlenecks--in fact, fast enough to produce a slight decline in the utilization rate. Rather, with labor markets running exceedingly tight, we still expect the higher labor costs to impart upward pressure to core price increases. That tendency will be reinforced by the anticipated leveling out of the dollar and an associated firming in non-oil import prices.

As noted, we have lowered the projections for prices in the food and energy sectors. After some further decline in the near term, retail energy prices are expected to rise gradually and end this year 2-1/2 percent lower than in the fourth quarter of 1996; in the last Greenbook, we had anticipated a 1-1/4 percent decline. Next year, retail energy prices are expected to drift up, reflecting, in part, the anticipated firming in crude oil prices. Meanwhile, we have lowered the projected rise in food prices this year to 1-3/4 percent to reflect the favorable progress of crops to date. On net, food prices rose only a little at retail over the first five months of 1997, but moderate increases are anticipated over the balance of the year. The forecast for 1998 has food price increases picking up from the 1997 pace, moving back into closer alignment with inflation in general.

We are projecting that the overall CPI will rise 2-1/4 percent over the four quarters of 1997 after moving up 3-1/4 percent during 1996 when developments in food and energy markets were adverse. The CPI is projected to increase 2-3/4 percent next year.

Monetary and Credit Flows

Over the second half of 1997, growth of the broad monetary aggregates is expected to be about in line with the pace in the first half. Growth in M2 is expected to remain below that of nominal GDP both this year and next, in part because of the effects of the increase in the funds rate last March and those increases assumed to occur during 1998. The projected continued strong performance of the stock market during the balance of 1997 and the associated flows into capital market investments may also continue to damp slightly the expansion of M2. M3 growth is expected to slow next year but remain on a faster track than nominal GDP, with institution-only money funds continuing to be attractive for liquidity management. Debt of domestic nonfinancial sectors is expected to grow about 5 percent in both 1997 and 1998, which would about match the increase in nominal GDP this year and be slightly higher next year.

The relatively small deficit in the federal budget is expected to hold federal debt growth to around 2 percent this year, the slowest since 1973. In 1998, a somewhat larger deficit is expected to lift federal debt growth to 3 percent.

With profits flattening, businesses' external financing needs will grow with the rise in outlays for plant and equipment. However, the financing gap of nonfinancial corporations is not projected to reach large proportions by historical standards when scaled by capital outlays or gross product. Business borrowing will continue to be buoyed by a high level of merger and acquisition activity and associated large-scale share retirements. A sustained high level of share repurchases will also help keep equity retirements well above the issuance of new shares.

Household debt growth is forecast to slow in the second half of 1997 and in 1998. Nonetheless, debt is still expected to expand faster than nominal income over the forecast period. Banks appear to have pulled back a bit on consumer lending. However, credit seems to be available at attractive terms for all but the riskiest borrowers, and we expect little slowing of such lending in the period ahead. Moreover, the recent rapid expansion of home equity credit suggests that such borrowing remains an attractive source of funds for many homeowners. Overall, growth of home mortgage debt is expected to slow as nominal outlays on housing flatten out.

Growth of state and local government debt should remain low over the remainder of 1997 and in 1998. The generally favorable fiscal position in which most governments find themselves is more likely to prompt tax relief than to result in significant increases in capital spending. Higher interest rates should also reduce the incentive for advance refunding of existing obligations.

Alternative Simulations

The alternative simulations this month are based on different paths for the federal funds rate. In the first simulation, the rate is held at its current level through the end of 1998. Because this assumption about the federal funds rate differs from the baseline assumption only for the latter half of 1998--and then only mildly--effects on the economy within the forecast period are negligible. Real GDP in 1998 rises just a tenth more than in the baseline forecast, and the effects on unemployment and inflation are imperceptible. Nonetheless, we have reason for showing this simulation: Although our baseline forecast has real GDP growth moderating in 1998, we do not believe that maintenance of a stable nominal funds rate in the face of an upcreep in inflation is likely to create a path for the real rate that is consistent with further output deceleration in 1999. Consequently, the forces necessary to ultimately turn inflation back down would not emerge.

Alternative Federal Funds Rate Assumptions
(Percent change, Q4 to Q4, except as noted)

Measure	1996	1997	1998
Real GDP			
Baseline	3.1	3.4	2.1
No further change	3.1	3.4	2.2
Tighter policy	3.1	3.3	1.5
Civilian unemployment rate[1]			
Baseline	5.3	4.7	4.6
No further change	5.3	4.7	4.6
Tighter policy	5.3	4.7	4.9
CPI excluding food and energy			
Baseline	2.6	2.7	3.0
No further change	2.6	2.7	3.0
Tighter policy	2.6	2.7	2.8

1. Average for the fourth quarter.

The second alternative involves a more aggressive approach for capping inflation--preemptive, as it were. The federal funds rate is raised 125 basis points further in a series of steps by the middle of 1998 and then held steady through the end of next year. Growth of real GDP in 1998 is appreciably smaller in this alternative, the unemployment rate ends up about 1/4 percentage point higher than it is in the baseline forecast, and acceleration of core inflation is largely forestalled. Given the pressures on resource utilization that remain at the end of the period, however, a continuation of the high real rate of interest associated with this scenario might be necessary in 1999 to fully stabilize inflation.

Strictly Confidential <FR>
Class II FOMC

June 25, 1997

STAFF PROJECTIONS OF CHANGES IN GDP, PRICES, AND UNEMPLOYMENT
(Percent, annual rate)

Interval		Nominal GDP		Real GDP		GDP chain-weighted price index		Consumer price index[1]		Unemployment rate[2]	
		5/15/97	6/25/97	5/15/97	6/25/97	5/15/97	6/25/97	5/15/97	6/25/97	5/15/97	6/25/97
ANNUAL											
1994		5.8	5.8	3.5	3.5	2.3	2.3	2.6	2.6	6.1	6.1
1995		4.6	4.6	2.0	2.0	2.5	2.5	2.8	2.8	5.6	5.6
1996		4.4	4.4	2.4	2.4	2.1	2.1	3.0	3.0	5.4	5.4
1997		5.5	5.5	3.5	3.7	2.3	2.2	2.5	2.4	5.0	4.9
1998		4.4	4.5	2.1	2.4	2.5	2.4	2.8	2.6	4.8	4.6
QUARTERLY											
1995	Q1	3.8	3.8	0.4	0.4	3.3	3.3	2.7	2.7	5.5	5.5
	Q2	3.1	3.1	0.7	0.7	2.4	2.4	3.5	3.5	5.6	5.6
	Q3	6.0	6.0	3.8	3.8	2.1	2.1	2.1	2.1	5.7	5.7
	Q4	2.3	2.3	0.3	0.3	2.1	2.1	2.6	2.6	5.6	5.6
1996	Q1	4.2	4.2	2.0	2.0	2.3	2.3	3.2	3.2	5.6	5.6
	Q2	6.5	6.5	4.7	4.7	2.2	2.2	3.4	3.4	5.4	5.4
	Q3	3.8	3.8	2.1	2.1	2.0	2.0	2.8	2.8	5.3	5.3
	Q4	5.3	5.3	3.8	3.8	1.9	1.9	3.3	3.3	5.3	5.3
1997	Q1	8.1	8.1	6.0	5.8	2.8	2.8	2.3	2.3	5.3	5.3
	Q2	3.9	3.9	1.8	2.2	2.1	1.9	1.2	1.1	5.0	4.9
	Q3	4.6	4.8	2.5	2.9	2.3	2.1	2.7	2.4	4.9	4.8
	Q4	4.5	4.7	2.3	2.8	2.4	2.2	3.1	2.8	4.8	4.7
1998	Q1	4.5	4.6	2.1	2.5	2.6	2.5	2.8	2.7	4.8	4.6
	Q2	4.4	4.5	2.0	2.3	2.7	2.5	2.9	2.8	4.8	4.6
	Q3	4.3	4.2	1.9	2.0	2.7	2.6	3.0	3.0	4.8	4.6
	Q4	4.3	4.0	1.9	1.8	2.7	2.6	3.0	2.9	4.8	4.6
TWO-QUARTER[3]											
1995	Q2	3.5	3.5	0.6	0.6	2.9	2.9	3.0	3.0	0.0	0.0
	Q4	4.1	4.1	2.0	2.0	2.1	2.1	2.3	2.3	0.0	0.0
1996	Q2	5.4	5.4	3.3	3.3	2.2	2.2	3.4	3.4	-0.2	-0.2
	Q4	4.6	4.6	3.0	3.0	2.0	2.0	3.0	3.0	-0.1	-0.1
1997	Q2	6.0	6.0	3.9	4.0	2.5	2.3	1.8	1.8	-0.3	-0.4
	Q4	4.6	4.7	2.4	2.9	2.4	2.1	2.9	2.6	-0.2	-0.2
1998	Q2	4.4	4.5	2.1	2.4	2.7	2.5	2.9	2.7	-0.0	-0.1
	Q4	4.3	4.1	1.9	1.9	2.7	2.6	3.0	2.9	0.0	-0.0
FOUR-QUARTER[4]											
1994	Q4	5.9	5.9	3.5	3.5	2.3	2.3	2.7	2.7	-1.0	-1.0
1995	Q4	3.8	3.8	1.3	1.3	2.5	2.5	2.6	2.6	0.0	0.0
1996	Q4	5.0	5.0	3.1	3.1	2.1	2.1	3.2	3.2	-0.3	-0.3
1997	Q4	5.3	5.4	3.1	3.4	2.4	2.2	2.4	2.2	-0.5	-0.6
1998	Q4	4.4	4.3	2.0	2.1	2.7	2.5	2.9	2.8	0.0	-0.1

1. For all urban consumers.
2. Level, except as noted.
3. Percent change from two quarters earlier; for unemployment rate, change in percentage points.
4. Percent change from four quarters earlier; for unemployment rate, change in percentage points.

Strictly Confidential <FR>
Class II FOMC

REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS, ANNUAL VALUES
(Seasonally adjusted annual rate)

June 25, 1997

Item	Units[1]	1990	1991	1992	1993	1994	1995	1996	- Projected - 1997	1998
EXPENDITURES										
Nominal GDP	Bill. $	5743.8	5916.7	6244.4	6553.0	6935.7	7253.8	7576.1	7994.2	8351.7
Real GDP	Bill. Ch. $	6136.3	6079.4	6244.4	6386.1	6608.4	6742.2	6906.8	7159.3	7334.1
Real GDP	% change	-0.2	0.4	3.6	2.2	3.5	1.3	3.1	3.4	2.1
Gross domestic purchases		-0.8	0.0	4.0	2.9	3.7	1.0	3.3	4.0	2.4
Final sales		0.6	-0.4	3.9	2.0	2.9	1.9	3.1	3.2	2.1
Priv. dom. final purchases		-0.7	-0.8	4.9	3.4	4.0	2.3	3.6	4.3	2.7
Personal cons. expenditures		0.5	-0.2	4.2	2.5	3.1	1.9	2.7	3.5	2.5
Durables		-3.2	-3.1	9.4	7.3	7.0	1.3	5.4	8.7	4.7
Nondurables		-0.5	-1.0	3.4	1.5	3.5	1.1	1.8	2.0	1.7
Services		2.0	0.9	3.6	2.1	2.0	2.4	2.6	3.2	2.3
Business fixed investment		-2.5	-6.0	5.5	8.5	10.1	6.4	9.5	10.4	6.3
Producers' dur. equipment		-2.0	-2.6	9.6	11.5	12.6	6.9	9.7	12.6	6.9
Nonres. structures		-3.5	-12.5	-3.4	1.5	3.7	5.1	9.0	4.5	4.3
Residential structures		-15.1	1.1	16.9	8.1	5.7	-1.5	3.8	1.7	-2.0
Exports		7.2	8.6	4.1	4.8	9.9	7.4	7.4	9.9	7.3
Imports		0.5	4.1	7.4	10.5	11.8	4.2	8.3	13.6	8.5
Gov't. cons. & investment		2.6	-0.7	1.7	-0.5	0.0	-1.3	1.9	1.4	0.8
Federal		1.6	-3.1	1.3	-5.4	-3.1	-6.7	1.5	-0.4	-2.0
Defense		0.3	-5.3	-1.3	-6.8	-5.7	-6.8	0.2	-1.2	-3.6
State & local		3.3	1.0	2.0	3.1	2.2	2.1	2.1	2.4	2.4
Change in bus. inventories	Bill. Ch. $	10.4	-3.0	7.0	19.0	58.9	32.7	13.6	39.8	35.9
Nonfarm		7.8	-1.2	2.0	26.4	46.8	37.2	17.1	39.0	33.6
Net exports		-61.9	-22.3	-29.5	-72.0	-105.7	-107.6	-113.6	-136.6	-166.6
Nominal GDP	% change	4.4	3.8	6.3	4.8	5.9	3.8	5.0	5.4	4.3
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	109.4	108.3	108.6	110.7	114.1	117.2	119.5	122.1	124.1
Unemployment rate	%	5.6	6.8	7.5	6.9	6.1	5.6	5.4	4.9	4.6
Industrial prod. index	% change	-0.6	-0.0	3.9	3.0	5.7	1.8	3.9	4.3	1.8
Capacity util. rate - mfg.	%	81.4	78.0	79.5	80.8	83.1	83.1	82.1	82.6	82.2
Housing starts	Millions	1.19	1.01	1.20	1.29	1.46	1.35	1.48	1.44	1.36
Light motor vehicle sales		14.05	12.52	12.85	13.87	15.02	14.77	15.03	15.07	14.88
North Amer. produced		10.85	9.74	10.51	11.72	12.88	12.85	13.32	13.18	13.06
Other		3.20	2.77	2.34	2.15	2.13	1.91	1.70	1.89	1.83
INCOME AND SAVING										
Nominal GNP	Bill. $	5764.9	5932.4	6255.5	6563.5	6931.9	7246.7	7567.1	7964.0	8311.4
Nominal GNP	% change	4.6	3.5	6.2	4.7	5.7	3.9	4.9	5.1	4.2
Nominal personal income		6.4	3.7	7.3	3.6	4.9	5.6	5.7	5.5	4.6
Real disposable income		1.1	0.8	4.0	0.9	2.4	3.1	2.7	3.1	2.5
Personal saving rate	%	5.3	6.0	6.2	4.8	4.0	4.6	4.9	4.9	4.8
Corp. profits, IVA & CCAdj.	% change	5.5	4.5	11.3	18.8	9.6	6.2	6.7	8.7	-1.2
Profit share of GNP	%	6.9	6.9	6.8	7.5	8.0	8.3	8.9	9.1	8.7
Excluding FR Banks	%	6.5	6.6	6.6	7.3	7.7	8.0	8.6	8.8	8.4
Federal surpl./deficit	Bill. $	-154.7	-196.0	-280.9	-255.6	-190.2	-161.7	-127.1	-73.2	-85.2
State & local surpl./def.		80.1	75.8	86.3	94.9	99.7	95.0	93.0	94.6	92.9
Ex. social ins. funds		20.2	11.5	18.3	28.0	36.9	36.8	37.4	42.0	41.1
PRICES AND COSTS										
GDP implicit deflator	% change	4.7	3.4	2.6	2.5	2.4	2.4	1.8	1.9	2.1
GDP chn.-wt. price index		4.7	3.3	2.6	2.5	2.3	2.5	2.1	2.2	2.5
Gross Domestic Purchases chn.-wt. price index		5.2	2.7	2.7	2.3	2.4	2.3	2.2	1.9	2.5
CPI		6.3	3.0	3.1	2.7	2.7	2.6	3.2	2.2	2.8
Ex. food and energy		5.3	4.4	3.5	3.1	2.8	3.0	2.6	2.7	3.0
ECI, hourly compensation[2]		4.6	4.4	3.5	3.6	3.1	2.6	3.1	3.3	3.4
Nonfarm business sector										
Output per hour		-0.6	2.2	3.5	-0.3	0.3	-0.1	0.9	1.5	0.8
Compensation per Hour		5.8	4.8	4.5	1.8	2.3	3.6	3.6	3.7	3.7
Unit labor cost		6.4	2.5	1.0	2.1	2.0	3.7	2.6	2.3	2.9

1. Changes are from fourth quarter to fourth quarter.
2. Private-industry workers.

Strictly Confidential <FR>
Class II FOMC

REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS, QUARTERLY VALUES
(Seasonally adjusted, annual rate except as noted)

June 25, 1997

Item	Units	1994 Q1	1994 Q2	1994 Q3	1994 Q4	1995 Q1	1995 Q2	1995 Q3	1995 Q4	1996 Q1	1996 Q2
EXPENDITURES											
Nominal GDP	Bill. $	6776.1	6890.5	6993.1	7083.2	7149.8	7204.9	7309.8	7350.6	7426.8	7545.1
Real GDP	Bill. Ch. $	6508.5	6587.4	6644.8	6692.9	6700.2	6712.7	6775.8	6780.2	6813.8	6892.1
Real GDP	% change	2.5	4.9	3.5	2.9	0.4	0.7	3.8	0.3	2.0	4.7
Gross domestic purchases		3.5	5.3	3.7	2.4	1.5	0.7	2.6	-0.7	3.0	5.2
Final sales		1.2	3.0	4.2	3.5	0.6	2.1	3.6	1.4	3.0	4.1
Priv. dom. final purchases		3.8	4.4	3.8	4.0	2.2	2.3	3.1	1.5	4.6	4.0
Personal cons. expenditures		2.8	3.5	2.8	3.1	1.0	3.1	2.4	1.1	3.5	3.4
Durables		5.8	4.3	5.6	12.4	-8.9	7.0	9.3	-1.0	8.2	11.4
Nondurables		3.9	3.2	3.8	3.2	2.4	1.8	0.5	-0.4	3.7	1.3
Services		1.6	3.5	1.6	1.2	2.4	3.0	2.0	2.3	2.4	2.7
Business fixed investment		7.3	7.1	13.8	12.2	15.4	3.5	4.9	2.5	11.6	3.8
Producers' dur. equipment		15.5	4.1	19.4	11.9	17.4	3.5	4.3	3.0	13.1	6.7
Nonres. structures		-11.8	15.7	0.2	13.0	9.9	3.4	6.3	1.0	7.7	-3.7
Residential structures		12.8	12.7	-1.8	-0.1	-6.3	-13.4	9.2	6.4	7.4	16.3
Exports		-1.5	15.9	9.7	16.5	2.6	5.9	10.7	10.7	1.8	5.6
Imports		8.2	18.4	10.7	10.3	11.2	4.5	-0.0	1.6	10.6	9.9
Gov't. cons. & investment		-4.3	-0.8	7.0	-1.4	-1.2	0.8	-0.6	-4.3	1.6	7.7
Federal		-11.4	-5.3	11.5	-5.9	-6.5	-1.4	-5.6	-13.2	6.0	9.4
Defense		-17.4	0.7	13.5	-16.1	-7.4	0.6	-7.6	-12.3	4.1	10.0
State & local		0.7	2.2	4.2	1.6	2.3	2.1	2.7	1.5	-0.9	6.7
Change in bus. inventories	Bill. Ch. $	40.8	74.7	64.6	55.6	53.7	29.9	33.5	13.7	-3.5	6.7
Nonfarm		29.7	54.0	50.5	53.0	57.4	33.7	38.5	19.0	2.9	11.7
Net exports		-99.3	-107.3	-111.7	-104.4	-122.5	-121.4	-101.6	-84.9	-104.0	-114.7
Nominal GDP	% change	5.3	6.9	6.1	5.3	3.8	3.1	6.0	2.3	4.2	6.5
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	112.6	113.7	114.7	115.6	116.5	116.9	117.4	117.9	118.5	119.2
Unemployment rate	%	6.6	6.2	6.0	5.6	5.5	5.6	5.7	5.6	5.6	5.4
Industrial prod. index	% change	6.2	6.7	4.4	5.6	3.9	-0.7	3.2	0.8	1.6	6.2
Capacity util. rate - mfg.	%	82.0	83.0	83.3	84.0	84.2	83.1	82.9	82.3	81.7	82.1
Housing starts	Millions	1.39	1.47	1.45	1.47	1.32	1.29	1.42	1.41	1.46	1.50
Light motor vehicle sales		15.05	14.86	14.95	15.20	14.72	14.42	14.94	14.98	15.19	15.02
North Amer. produced		12.92	12.71	12.74	13.15	12.68	12.46	13.08	13.20	13.51	13.32
Other		2.13	2.15	2.21	2.05	2.04	1.96	1.86	1.79	1.68	1.70
INCOME AND SAVING											
Nominal GNP	Bill. $	6781.0	6888.3	6986.9	7071.4	7146.8	7202.4	7293.4	7344.3	7426.6	7537.5
Nominal GNP	% change	5.4	6.5	5.9	4.9	4.3	3.1	5.1	2.8	4.6	6.1
Nominal personal income		-2.2	11.2	4.6	6.4	7.2	4.7	4.8	5.7	4.9	6.8
Real disposable income		-4.0	7.4	2.6	3.8	3.7	0.2	4.3	4.3	2.0	1.4
Personal saving rate	%	3.3	4.2	4.1	4.2	4.8	4.1	4.5	5.1	4.8	4.3
Corp. profits, IVA & CCAdj.	% change	-33.6	74.5	12.9	10.4	-7.7	0.6	38.4	-1.1	22.6	6.8
Profit share of GNP	%	7.2	8.1	8.3	8.4	8.1	8.1	8.6	8.6	8.9	8.9
Excluding FR Banks	%	6.9	7.9	8.0	8.1	7.8	7.8	8.3	8.3	8.6	8.6
Federal surpl./deficit	Bill. $	-212.7	-169.6	-188.5	-190.1	-172.6	-161.1	-158.5	-154.5	-155.2	-126.7
State & local surpl./def.		94.8	105.2	99.6	99.3	99.0	99.0	93.9	88.1	91.0	101.0
Ex. social ins. funds		29.0	41.1	37.9	39.4	40.2	40.9	35.8	30.5	34.1	44.6
PRICES AND COSTS											
GDP implicit deflator	% change	2.8	1.9	2.5	2.3	3.4	2.4	2.1	2.0	2.2	1.8
GDP chn.-wt. price index		2.9	1.9	2.4	2.1	3.3	2.4	2.1	2.1	2.3	2.2
Gross Domestic Purchases chn.-wt. price index		2.4	2.3	3.0	2.0	2.8	2.8	1.6	1.9	2.3	2.1
CPI		1.9	2.8	3.6	2.4	2.7	3.5	2.1	2.6	3.2	3.4
Ex. food and energy		2.9	2.9	3.1	2.3	3.3	3.3	2.8	2.7	2.7	2.7
ECI, hourly compensation[1]		3.0	3.4	3.3	2.3	2.9	2.6	2.6	2.9	2.5	3.5
Nonfarm business sector											
Output per hour		-1.9	1.0	1.6	0.3	-2.2	1.5	1.5	-1.0	2.1	0.4
Compensation per hour		3.0	1.2	1.7	3.3	2.9	4.0	3.6	4.1	3.4	3.7
Unit labor cost		4.9	0.2	0.1	2.9	5.2	2.5	2.1	5.2	1.3	3.3

1. Private-industry workers.

Strictly Confidential <FR>
Class II FOMC

REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS, QUARTERLY VALUES
(Seasonally adjusted, annual rate except as noted)

June 25, 1997

Item	Units	1996 Q3	1996 Q4	1997 Q1	1997 Q2	1997 Q3	1997 Q4	1998 Q1	1998 Q2	1998 Q3	1998 Q4
					- - - - - - - -	- - - - Projected	- - - -	- - - - - - - -			
EXPENDITURES											
Nominal GDP	Bill. $	7616.3	7716.1	7868.1	7943.1	8036.3	8129.3	8220.7	8311.1	8396.1	8479.0
Real GDP	Bill. Ch. $	6928.1	6993.3	7092.3	7130.9	7181.8	7232.3	7276.6	7318.3	7354.4	7386.9
Real GDP	% change	2.1	3.8	5.8	2.2	2.9	2.8	2.5	2.3	2.0	1.8
Gross domestic purchases		3.3	1.6	7.0	2.7	3.8	2.5	3.1	2.5	2.8	1.2
Final sales		0.5	4.9	4.1	2.4	2.9	3.6	2.2	2.3	1.5	2.5
Priv. dom. final purchases		2.3	3.3	6.3	3.0	4.7	3.4	3.3	2.9	2.4	2.3
Personal cons. expenditures		0.5	3.4	5.7	1.4	4.0	3.2	3.1	2.7	2.2	2.1
Durables		-2.6	5.0	19.3	-0.5	9.4	7.5	6.3	5.1	3.8	3.7
Nondurables		0.4	1.8	4.7	-2.0	3.3	2.1	2.1	1.8	1.5	1.4
Services		1.3	3.8	3.3	3.6	3.2	2.6	2.7	2.5	2.0	1.9
Business fixed investment		17.5	5.5	10.3	13.0	11.3	7.2	7.2	6.3	6.0	5.7
Producers' dur. equipment		20.9	-0.9	11.7	17.3	13.7	8.0	8.1	7.0	6.6	6.2
Nonres. structures		8.4	25.8	6.5	1.7	4.8	5.0	4.5	4.5	4.3	4.1
Residential structures		-5.2	-1.8	6.0	4.4	-2.5	-0.8	-1.4	-1.8	-2.6	-2.3
Exports		-0.9	25.0	10.7	13.8	4.0	11.3	4.9	9.9	3.4	11.2
Imports		9.3	3.3	19.7	17.3	10.4	7.6	9.5	10.0	8.9	5.8
Gov't. cons. & investment		-0.6	-0.9	0.2	3.1	-0.3	2.5	0.7	0.5	2.0	0.0
Federal		-3.5	-5.3	-3.1	4.5	-5.0	2.4	-2.2	-2.9	1.2	-4.1
Defense		-5.5	-6.9	-10.0	10.6	-5.8	1.8	-4.7	-5.2	0.8	-5.1
State & local		1.1	1.9	2.2	2.2	2.5	2.6	2.4	2.4	2.4	2.4
Change in bus. inventories	Bill. Ch. $	34.1	17.1	47.1	41.5	41.8	28.9	34.4	34.4	43.2	31.4
Nonfarm		34.6	19.3	47.7	40.8	40.3	27.3	32.3	32.2	40.8	29.1
Net exports		-137.4	-98.4	-120.4	-132.3	-149.5	-144.3	-158.0	-162.0	-178.3	-168.1
Nominal GDP	% change	3.8	5.3	8.1	3.9	4.8	4.7	4.6	4.5	4.2	4.0
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	119.9	120.5	121.1	121.8	122.4	122.9	123.4	123.9	124.4	124.8
Unemployment rate	%	5.3	5.3	5.3	4.9	4.8	4.7	4.6	4.6	4.6	4.6
Industrial prod. index	% change	3.3	4.5	4.4	4.8	4.2	3.6	2.1	2.0	1.7	1.7
Capacity util. rate - mfg.	%	82.3	82.3	82.5	82.7	82.8	82.6	82.4	82.3	82.1	81.9
Housing starts	Millions	1.49	1.42	1.47	1.44	1.44	1.41	1.39	1.37	1.34	1.34
Light motor vehicle sales		15.07	14.82	15.45	14.61	15.14	15.08	15.05	14.97	14.82	14.68
North Amer. produced		13.38	13.07	13.50	12.79	13.22	13.20	13.19	13.13	13.01	12.89
Other		1.69	1.75	1.95	1.83	1.92	1.88	1.86	1.84	1.81	1.79
INCOME AND SAVING											
Nominal GNP	Bill. $	7598.9	7705.6	7840.0	7915.6	8005.1	8095.3	8182.8	8271.4	8354.6	8436.9
Nominal GNP	% change	3.3	5.7	7.2	3.9	4.6	4.6	4.4	4.4	4.1	4.0
Nominal personal income		5.7	5.4	7.3	5.1	4.8	4.8	5.0	4.6	4.5	4.4
Real disposable income		4.9	2.6	4.2	3.4	2.4	2.3	4.4	2.0	1.8	1.9
Personal saving rate	%	5.3	5.1	4.8	5.2	4.8	4.7	5.0	4.8	4.7	4.7
Corp. profits, IVA & CCAdj.	% change	3.1	-4.2	34.8	3.2	0.2	0.3	-2.1	0.5	-0.4	-2.8
Profit share of GNP	%	8.9	8.7	9.2	9.2	9.1	9.0	8.9	8.8	8.7	8.5
Excluding FR Banks	%	8.6	8.4	8.9	8.9	8.8	8.7	8.6	8.5	8.4	8.3
Federal surpl./deficit	Bill. $	-120.8	-105.9	-80.0	-73.3	-65.2	-74.3	-90.9	-83.5	-80.8	-85.8
State & local surpl./def.		89.2	90.9	95.6	92.0	96.2	94.5	94.1	93.5	92.0	91.9
Ex. social ins. funds		33.8	36.9	42.7	39.3	43.7	42.2	42.0	41.6	40.3	40.4
PRICES AND COSTS											
GDP implicit deflator	% change	1.7	1.5	2.2	1.6	1.8	1.8	2.0	2.1	2.1	2.2
GDP chn.-wt. price index		2.0	1.9	2.8	1.9	2.1	2.2	2.5	2.5	2.6	2.6
Gross Domestic Purchases chn.-wt. price index		1.9	2.6	2.2	1.2	1.9	2.3	2.5	2.4	2.5	2.5
CPI		2.8	3.3	2.3	1.1	2.4	2.8	2.7	2.8	3.0	2.9
Ex. food and energy		2.4	2.7	2.2	2.9	2.6	2.9	2.9	2.9	3.0	3.0
ECI, hourly compensation[1]		2.8	2.8	2.5	3.7	3.6	3.5	2.9	3.6	3.7	3.6
Nonfarm business sector											
Output per hour		-0.2	1.3	2.8	1.3	0.7	1.2	1.1	1.0	0.7	0.5
Compensation per hour		3.5	3.7	4.9	3.0	3.4	3.9	3.7	3.7	3.7	3.7
Unit labor cost		3.6	2.4	2.1	1.7	2.7	2.6	2.6	2.7	3.0	3.2

1. Private-industry workers.

CONTRIBUTIONS TO GROWTH IN REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS

June 25, 1997

Item	1996 Q4	1997 Q1	1997 Q2	1997 Q3	1997 Q4	1998 Q1	1998 Q2	1998 Q3	1998 Q4	96Q4/ 95Q4	97Q4/ 96Q4	98Q4/ 97Q4
Real GDP	3.8	5.8	2.2	2.9	2.8	2.5	2.3	2.0	1.8	3.1	3.4	2.1
Gross dom. purchases	1.6	7.1	2.7	3.8	2.5	3.2	2.5	2.8	1.2	3.3	4.0	2.4
Final sales	4.9	4.0	2.4	2.9	3.6	2.1	2.3	1.5	2.5	3.1	3.2	2.1
Priv. dom. final purchases	2.8	5.2	2.5	3.9	2.9	2.7	2.4	2.0	1.9	2.9	3.6	2.3
Personal cons. expenditures	2.3	3.8	0.9	2.7	2.1	2.1	1.8	1.5	1.4	1.8	2.4	1.7
Durables	0.4	1.6	-0.0	0.8	0.7	0.6	0.5	0.4	0.4	0.5	0.8	0.4
Nondurables	0.4	1.0	-0.4	0.7	0.4	0.4	0.4	0.3	0.3	0.4	0.4	0.3
Services	1.5	1.2	1.3	1.2	1.0	1.0	0.9	0.8	0.7	1.0	1.2	0.9
Business fixed investment	0.6	1.1	1.4	1.3	0.8	0.8	0.8	0.7	0.7	1.0	1.2	0.8
Producers' dur. equip.	-0.1	1.0	1.4	1.2	0.7	0.7	0.6	0.6	0.6	0.8	1.1	0.6
Nonres. structures	0.7	0.2	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1
Residential structures	-0.1	0.2	0.2	-0.1	-0.0	-0.1	-0.1	-0.1	-0.1	0.2	0.1	-0.1
Net exports	2.2	-1.3	-0.7	-1.0	0.3	-0.8	-0.2	-0.9	0.6	-0.2	-0.7	-0.3
Exports	2.6	1.3	1.6	0.5	1.4	0.6	1.3	0.5	1.5	0.9	1.2	1.0
Imports	-0.4	-2.6	-2.3	-1.5	-1.1	-1.4	-1.5	-1.4	-0.9	-1.1	-1.9	-1.3
Government cons. & invest.	-0.2	0.0	0.5	-0.0	0.5	0.1	0.1	0.3	0.0	0.4	0.3	0.1
Federal	-0.4	-0.2	0.3	-0.3	0.2	-0.1	-0.2	0.1	-0.3	0.1	-0.0	-0.1
Defense	-0.3	-0.5	0.4	-0.3	0.1	-0.2	-0.2	0.0	-0.2	0.0	-0.1	-0.2
Nondefense	0.0	0.2	-0.1	-0.1	0.1	0.1	0.0	0.0	-0.1	0.1	0.0	0.0
State and local	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Change in bus. inventories	-1.0	1.7	-0.3	0.0	-0.7	0.3	-0.0	0.5	-0.6	0.1	0.2	0.0
Nonfarm	-0.9	1.6	-0.4	-0.0	-0.7	0.3	-0.0	0.5	-0.6	0.0	0.1	0.0
Farm	-0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
GDP residual	-0.5	-0.3	-0.2	-0.4	-0.4	-0.3	-0.3	-0.3	-0.4	-0.3	-0.3	-0.3

Note. Components may not sum to totals because of rounding.

Strictly Confidential (FR)
Class II FOMC

STAFF PROJECTIONS OF FEDERAL SECTOR ACCOUNTS AND RELATED ITEMS
(Billions of dollars except as noted)

June 25, 1997

Item	Fiscal year[5]				1996				1997				1998			
	1995[a]	1996[a]	1997	1998	Q1[a]	Q2[a]	Q3[a]	Q4[a]	Q1							
UNIFIED BUDGET					Not seasonally adjusted											
Receipts[1]	1352	1453	1564	1612	322	446	362	346	349	493	376	354	359	503	396	370
Outlays[1]	1516	1560	1623	1697	393	392	395	405	401	406	412	427	421	424	425	475
Surplus/deficit[1]	-164	-107	-59	-85	-72	54	-33	-59	-52	87	-36	-73	-62	79	-28	-105
On-budget	-226	-174	-128	-165	-84	14	-36	-76	-69	57	-40	-85	-76	32	-36	-118
Off-budget	62	67	68	81	12	39	2	18	17	30	4	12	14	47	8	13
Surplus excluding deposit insurance[2]	-182	-116	-73	-89	-75	52	-35	-65	-56	85	-36	-74	-63	78	-30	-106
Means of financing																
Borrowing	171	130	61	103	80	-23	39	49	48	-69	34	58	61	-60	45	82
Cash decrease	-2	-6	9	-4	-1	-16	-6	11	-1	-17	15	6	10	-15	-5	10
Other[3]	-5	-16	-11	-14	-7	-14	0	-1	5	-1	-13	10	-8	-4	-11	13
Cash operating balance, end of period	38	44	36	40	22	38	44	33	33	50	36	30	20	35	40	30
NIPA FEDERAL SECTOR					Seasonally adjusted annual rate											
Receipts	1459	1544	1663	1730	1523	1576	1582	1619	1656	1679	1700	1719	1715	1734	1752	1766
Expenditures	1629	1683	1745	1813	1678	1702	1703	1725	1736	1752	1765	1794	1806	1817	1833	1852
Consumption expend.	455	457	462	471	454	464	461	458	463	465	462	468	471	472	476	474
Defense	304	303	305	308	299	307	305	305	303	307	305	307	308	306	308	307
Nondefense	151	155	157	164	155	156	157	153	160	158	157	160	163	165	167	167
Other expenditures	1175	1226	1283	1341	1225	1239	1241	1268	1273	1287	1303	1326	1335	1346	1358	1378
Current account surplus	-171	-139	-81	-82	-155	-127	-121	-106	-80	-73	-65	-74	-91	-83	-81	-86
Gross investment	65	63	62	64	65	66	64	61	58	64	63	64	64	63	64	63
Current and capital account surplus	-236	-202	-143	-146	-220	-193	-185	-167	-138	-137	-129	-138	-154	-146	-144	-149
FISCAL INDICATORS[4]																
High-employment (HEB) surplus/deficit	-257	-228	-211	-244	-239	-226	-221	-214	-204	-213	-213	-230	-251	-247	-247	-252
Change in HEB, percent of potential GDP	-.1	-.4	-.2	.4	.1	-.2	-.1	-.1	-.1	.1	0	.2	.3	0	0	.1
Fiscal impetus (FI), percent, cal. year	-5.5	-2	-2.3	-1	1.3	1.8	-.4	-2.2	-.1	0	-1.2	-.4	1	-.9	.1	-2.1

1. OMB's February 1997 deficit estimates (assuming the enactment of the President's proposals) are $126 billion in FY97 and $121 billion in FY98. CBO's March 1997 baseline deficit estimates are $115 billion in FY97 and $122 billion in FY98. Budget receipts, outlays, and surplus/deficit include corresponding social security (OASDI) categories. The OASDI surplus is excluded from the on-budget deficit and shown separately as off-budget, as classified under current law. The Postal Service deficit is included in off-budget outlays beginning in FY90.

2. OMB's February 1997 deficit estimates (assuming the enactment of the President's proposals), excluding deposit insurance spending, are $138 billion in FY97 and $125 billion in FY98. CBO's March 1997 baseline deficit estimates, excluding deposit insurance, are $128 billion in FY97 and $126 billion in FY98.

3. Other means of financing are checks issued less checks paid, accrued items, and changes in other financial assets and liabilities.

4. HEB is the NIPA current and capital account surplus in current dollars, with cyclically sensitive receipts and outlays adjusted to the level of potential output generated by 1.8 percent real (chain-weighted) growth and an associated unemployment rate of 6 percent. Quarterly figures for change in HEB and FI are not at annual rates. Change in HEB, as a percent of nominal potential GDP, is reversed in sign. FI is the weighted difference of discretionary changes in federal spending and taxes in chained (1992) dollars, scaled by real federal consumption plus investment. For change in HEB and FI, negative values indicate restraint.

5. Fiscal year data for the unified budget come from OMB; quarterly data come from the Monthly Treasury Statement and may not sum to OMB fiscal year totals.

a--Actual.
b--Preliminary.

Strictly Confidential Class II FOMC
June 25, 1997

Change in Debt of the Domestic Nonfinancial Sectors
(Percent)

Period[1]	Total[2]	Federal government[3]	Nonfederal: Total[4]	Nonfederal: Households: Total	Nonfederal: Households: Home mortgages	Nonfederal: Households: Consumer credit	Nonfederal: Business	Nonfederal: State and local governments	Memo: Nominal GDP
Year									
1986	12.1	13.6	11.7	11.4	13.8	9.2	12.2	10.8	5.0
1987	9.2	8.0	9.6	12.2	16.3	5.1	6.7	12.1	7.4
1988	9.0	8.0	9.3	9.6	10.9	8.6	9.7	6.5	7.6
1989	7.6	7.0	7.8	8.7	10.1	6.0	7.5	5.7	6.4
1990	6.6	11.0	5.3	7.9	10.1	2.0	3.1	4.9	4.4
1991	4.4	11.1	2.4	5.1	6.7	-1.7	-1.8	8.2	3.8
1992	4.8	10.9	2.8	5.3	6.2	0.6	0.5	2.0	6.3
1993	5.3	8.3	4.2	6.4	5.5	7.7	1.5	5.7	4.8
1994	5.0	4.7	5.1	8.7	6.7	14.6	3.5	-3.4	5.9
1995	5.5	4.1	5.9	8.2	6.2	14.3	6.0	-3.5	3.8
1996	5.4	4.0	5.9	8.0	8.4	8.2	4.6	1.2	5.0
1997	5.0	1.9	6.0	6.6	7.2	6.2	6.3	2.3	5.4
1998	5.2	3.3	5.8	5.9	6.5	6.0	6.4	2.9	4.3
Quarter									
1996:1	6.4	6.6	6.3	9.4	10.0	10.8	4.3	-0.3	4.2
2	5.1	1.7	6.3	8.1	8.0	7.8	4.5	4.1	6.5
3	5.0	4.3	5.2	7.1	7.0	7.9	5.7	-5.7	3.8
4	4.8	3.1	5.4	6.5	7.5	5.4	3.7	6.7	5.3
1997:1	5.1	2.5	6.0	7.2	7.4	6.5	5.5	1.9	8.1
2	4.3	-2.3	6.5	6.4	7.0	5.9	6.8	5.8	3.9
3	4.7	3.4	5.2	6.1	6.8	5.9	5.9	-2.3	4.8
4	5.4	3.8	5.9	6.0	6.7	5.9	6.3	3.7	4.7
1998:1	5.1	3.6	5.6	5.9	6.5	5.8	6.4	1.1	4.6
2	4.4	-0.7	6.1	5.8	6.4	5.8	6.4	6.7	4.5
3	5.1	4.1	5.4	5.8	6.3	5.8	6.2	0.4	4.2
4	5.8	6.1	5.7	5.7	6.2	5.8	6.2	3.2	4.0

Note. Quarterly data are at seasonally adjusted annual rates.

1. Data after 1997:Q1 are staff projections. Changes are measured from end of the preceding period to end of period indicated except for annual nominal GDP growth, which is calculated from Q4 to Q4.
2. On a monthly average basis, total debt grew 5.4 percent in 1996, 4.9 percent in 1997, and 5.1 percent in 1998.
3. On a monthly average basis, federal debt rose 3.8 percent in 1996, 1.9 percent in 1997, and 2.9 percent in 1998.
4. On a monthly average basis, nonfederal debt increased 5.9 percent in 1996, 5.9 percent in 1997, and 5.8 percent in 1998.

2.6.3 FOF

Flow of Funds Projections: Highlights
(Billions of dollars except as noted)

Category	Calendar year				Seasonally adjusted annual rates 1997				1998			
	1995	1996	1997	1998	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Net funds raised by domestic nonfinancial sectors												
1 Total	645.9	670.6	630.2	711.9	658.8	539.1	602.9	720.2	709.1	607.0	707.7	823.9
2 Net equity issuance	-73.8	-81.2	-94.6	-87.8	-84.8	-94.0	-104.8	-94.8	-77.2	-80.8	-96.8	-96.4
3 Net debt issuance	719.7	751.8	724.8	799.7	743.6	633.1	707.7	815.0	786.3	687.8	804.5	920.3
Borrowing sectors												
Nonfinancial business												
4 Financing gap [1]	60.6	18.0	42.9	77.3	39.9	42.2	46.5	43.1	62.3	72.5	88.4	85.8
5 Net equity issuance	-73.8	-81.2	-94.6	-87.8	-84.8	-94.0	-104.8	-94.8	-77.2	-80.8	-96.8	-96.4
6 Credit market borrowing	232.4	190.5	270.5	295.9	237.5	298.1	262.8	283.4	292.1	297.6	295.1	298.6
Households												
7 Net borrowing [2]	381.9	403.4	359.3	344.7	391.4	357.1	343.5	345.2	344.2	342.7	345.7	346.2
8 Home mortgages	198.6	282.3	261.5	255.2	271.5	260.0	256.9	257.7	256.7	255.2	254.2	254.7
9 Consumer credit	141.6	93.2	75.7	77.5	80.2	73.3	74.3	75.0	76.0	77.0	78.0	79.0
10 Debt/DPI (percent) [3]	91.2	93.9	95.6	96.7	95.0	95.5	95.9	96.2	96.1	96.5	96.9	97.3
State and local governments												
11 Net borrowing	-39.0	12.9	25.1	32.0	21.0	64.2	-25.8	41.0	12.4	74.8	4.4	36.4
12 Current surplus [4]	108.4	115.1	117.0	116.0	115.9	109.6	124.0	118.5	116.5	116.4	115.3	115.7
Federal government												
13 Net borrowing	144.4	145.0	70.0	127.2	93.7	-86.4	127.2	145.4	137.6	-27.3	159.3	239.1
14 Net borrowing (quarterly, n.s.a.)	144.4	145.0	70.0	127.2	48.0	-69.5	34.0	57.5	60.6	-60.1	44.8	81.9
15 Unified deficit (quarterly, n.s.a.)	146.3	110.6	73.5	116.3	52.0	-87.4	35.7	73.3	61.8	-78.8	28.5	104.8
Depository institutions												
16 Funds supplied	274.6	233.3	288.4	266.9	315.7	360.4	215.4	262.2	256.0	264.2	273.2	274.2
Memo (percentage of GDP)												
17 Domestic nonfinancial debt [5]	186.5	188.3	187.7	188.8	187.2	187.6	187.6	187.7	188.1	188.3	188.6	189.3
18 Domestic nonfinancial borrowing	9.9	9.9	9.1	9.6	9.5	8.0	8.8	10.0	9.6	8.3	9.6	10.9
19 Federal government [6]	2.0	1.9	0.9	1.5	1.2	-1.1	1.6	1.8	1.7	-0.3	1.9	2.8
20 Nonfederal	7.9	8.0	8.2	8.1	8.3	9.1	7.2	8.2	7.9	8.6	7.7	8.0

Note. Data after 1997:Q1 are staff projections.
1. For corporations: Excess of capital expenditures over U.S. internal funds.
2. Includes change in liabilities not shown in lines 8 and 9.
3. Average debt levels in the period (computed as the average of period-end debt positions) divided by disposable personal income.
4. NIPA surplus less changes in retirement fund assets plus consumption of fixed capital.
5. Average debt levels in the period (computed as the average of period-end debt positions) divided by nominal GDP.
6. Excludes government-insured mortgage pool securities.

International Developments

Recent Developments

The weighted-average foreign exchange value of the dollar in terms of the other G-10 currencies is little changed on balance since the day before the May FOMC meeting. The dollar appreciated around 3/4 percent against the mark and other major continental European currencies and somewhat more against the Canadian dollar, but it depreciated about 2 percent against the yen and the pound.

Continental European currencies weakened as the chances of Italy, Spain, and Portugal joining EMU at its outset increased. The victorious French Socialist Party had been on record as favoring both broad EMU membership and greater flexibility in achieving Maastricht fiscal standards.[1] The flawed and failed attempt to revalue the Bundesbank's gold and foreign exchange holdings to help meet the Maastricht fiscal standards in 1997 also called into question Germany's commitment to their strict interpretation. The yen strengthened on concerns about the rising Japanese external surpluses and Japan-U.S. trade relations. The pound rose late in the period in anticipation of another tightening by the Bank of England after that on June 6.

Short-term interest rates in most of the foreign G-7 countries were little changed over the intermeeting period, except in the United Kingdom where they rose nearly 40 basis points. Long-term rates fell about 30 basis points in Italy as prospects for EMU membership increased and inflation in Italy declined further. Canadian long-term rates fell nearly 40 basis points on news of the reappointment of the fiscally conservative Finance Minister Paul Martin after Canada's Liberal Party retained a narrow majority in the recent federal election. Long-term rates elsewhere were little changed on balance.

. The Desk did not intervene.

Recent data support our view that economic activity in the major foreign industrial countries has strengthened, on balance, during the first half of 1997. In Germany, GDP grew moderately in the first quarter, and manufacturing orders surged in April. French GDP was sluggish in the first quarter and Italian GDP declined, but both countries showed strong increases in industrial production in April. U.K. GDP grew at nearly a 4 percent annual rate in the first quarter, and industrial production jumped in April. Japanese GDP rose at a stronger-than-expected 6-1/2 percent annual

1. The French election results appeared to increase the risk that EMU would not go forward on schedule. However, at the ensuing EU summit meeting in Amsterdam, all parties concerned reaffirmed their commitment to moving to Stage Three on January 1, 1999.

rate in the first quarter, led by a surge in private consumption ahead of the April 1 consumption tax increase. Some payback in the second quarter is inevitable, as reflected in declines in Japanese auto registrations through May as well as by declines in industrial production and housing starts through April. However, business sentiment among large manufacturers continued to improve. Canadian GDP advanced at a 3-1/2 percent annual rate in the first quarter; manufacturing orders and retail sales showed robust growth in April; and employment was strong through May.

Consumer price inflation (on a twelve-month basis through May) was running at 1 to 1-1/2 percent in most of the foreign G-7 countries and 2-1/2 percent in the United Kingdom.

Among the major developing countries, GDP growth slowed noticeably in the first quarter in Korea, Mexico, and Brazil but remained strong elsewhere. The causes of slowing were transitory in Korea (strikes) and Mexico (statistical/working day factors), and we expect growth to rebound in the second quarter--a view supported by strong advances in industrial production in those countries in April. Economic and financial difficulties in Thailand worsened, and the government imposed capital controls but has not yet taken decisive action on more fundamental macroeconomic policy measures.

The nominal U.S. trade deficit on goods and services widened somewhat in the first quarter despite a drop in the value of oil imports, partly because automotive imports surged from strike-depressed levels in the fourth quarter. The current account deficit widened more than the trade deficit because of a decline in net investment income. However, the level of the current account deficit in the first quarter--$164 billion at an annual rate--was nearly $20 billion less than we had projected in May, largely because of revisions to historical data.[2]

The trade deficit narrowed in April as exports moved well above their first-quarter level, led by increases in exports of machinery and aircraft. Imports rose strongly, with all major trade categories increasing except oil. Whereas the value of oil imports declined, the quantity of oil imports rose, reflecting a higher-than-normal seasonal inventory build. Preliminary Department of Energy statistics indicate that oil imports remained strong in May as inventory accumulation continued.

Preliminary oil import prices for May were little changed, after declining sharply earlier this year because of mild weather and increased Iraqi production. The

2. One of the more important revisions resulting from the recent benchmark survey of U.S. portfolio investments abroad was a substantial increase in the estimated income from these investments (nearly $10 billion in 1996).

price of non-oil imports fell 3.8 percent (annual rate) in April-May compared with the first quarter, reflecting in part the effects of the appreciation of the dollar earlier this year. Prices of agricultural exports, notably grains and oilseeds, dropped sharply while those of nonagricultural exports were about unchanged on average.

Outlook

The basic staff projection is little changed from that in the May Greenbook. The growth of real output in our foreign trading partners (weighted by bilateral shares in U.S. nonagricultural exports) appears to be a bit stronger in the second quarter than we had projected in May, reversing transitory factors in Italy, Mexico, and Korea in the first quarter. We still expect growth to average about a 4 percent annual rate over the next six quarters. The forecast again has the dollar drifting down slightly over this period. We have revised up slightly the growth of real imports and exports, but the downward trajectory of real net exports remains about the same as it was in May. The decline subtracts about 1/3 percentage point from the annual rate of GDP growth in the second half of 1997 and during 1998.

Summary of Staff Projections
(Percentage change from end of previous period)

Measure	1997				1998
	Q1	Q2	Q3	Q4	
Foreign output	3.3	4.6	4.0	4.1	3.9
Previous	4.0	3.9	3.9	3.9	3.9
Real exports	10.7	13.8	4.0	11.3	7.3
Previous	7.9	7.9	2.1	10.3	6.9
Real imports	19.7	17.3	10.4	7.6	8.5
Previous	20.9	12.2	9.2	5.9	8.1

The dollar. We project that the foreign exchange value of the dollar in terms of the other G-10 currencies will weaken a small amount over the forecast period as the widening U.S. current account deficit and Japanese current account surplus depress the dollar, particularly against the yen. The dollar is projected to be essentially unchanged against the currencies of prospective EMU members as the influence of the deteriorating U.S. current account is offset by uncertainties associated with the introduction of the euro. We assume that the spillover effects of financial turbulence in Thailand will be contained and that the dollar will depreciate at a moderate rate in CPI-adjusted terms against the currencies of key developing countries.

Foreign G-7 countries. Growth of real GDP in the foreign G-7 countries is projected to average nearly 3 percent at an annual rate during the second quarter of 1997 and over the ensuing six quarters, about the same as in the May Greenbook forecast. The projected growth rates are somewhat above our estimates of potential growth except in Italy.

In Japan, we project GDP will grow at a little more than a 2 percent rate in the second half of 1997 after a small decline in the second quarter. This expansion will be restrained by contractionary fiscal policy but will be supported by strong real net exports resulting from earlier depreciation of the yen. Next year, we expect growth to increase as the contribution of domestic demand rises and that of net exports diminishes. Real GDP in Germany and France is projected to grow around 2-1/2 percent over the forecast period, led by net exports and investment.

We are now assuming that Italy will make it into the first round of EMU.[3] This assumption has led us to revise down significantly the projected paths of Italian interest rates to be in line with those of other EMU members by the end of the forecast period. Projected GDP growth in Italy has been raised but still lags behind that in Germany and France because of the relatively large fiscal contraction Italy is expected to implement.

We have raised our projection for U.K. real output growth this year in response to buoyant retail sales. However, the continued strength of sterling and our expectation that the Bank of England will tighten even more than we had assumed previously has led us to shade down our projection of U.K. GDP growth during 1998. In Canada, continued rapid growth in investment spending and relatively strong consumer demand should support vigorous output expansion over the forecast period.

Inflation in the foreign G-7 countries (weighted by bilateral U.S. non-oil import shares) is projected to rise a bit on average this year because of the transitory effect on Japanese inflation of the rise in the consumption tax. In 1998, average inflation in the foreign G-7 countries should again edge below a 1-1/2 percent rate.

The forecast assumes that the average level of short-term interest rates in foreign G-7 countries will change little over the second half of 1997 as rates in Italy drop further and those in the United Kingdom are raised again. We expect a moderate

3. Previously we had not assumed that Italy, Spain, and Portugal would be charter members of EMU. We now expect that Stage Three of EMU will begin as scheduled with 11 members: Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Portugal, Finland, Ireland, and Luxembourg.

increase in rates in 1998 in the foreign G-7 countries other than Italy as economic expansions build. We assume long-term rates will rise marginally on balance over the forecast period, with higher rates in some countries, particularly Japan, offset by some further declines in Italian rates.

Other countries. The real GDP of major developing-country trading partners of the United States is projected to increase slightly less than 6 percent per year in 1997-98 (Q4/Q4), roughly the same as in the May Greenbook.

Real GDP in our major trading partners in Latin America is expected to grow 4-1/2 percent in 1997 and 4-1/4 percent in 1998. Mexico should expand at a slightly faster pace than the average for Latin America. This growth in Mexico's GDP, combined with a strengthening of the real value of the peso, is expected to result in a widening of that country's current account deficit from less than $2 billion in 1996 to $6 billion (1-1/2 percent of GDP) in 1997. The mid-term elections, scheduled for July 7, do not thus far appear to be causing significant investor concerns about the prospects for 1997 growth or the value of the peso. Recent data have led us to mark up our near-term projection for Argentina a bit (to 4-3/4 percent this year, Q4/Q4) and to mark down that for Brazil (to 2-1/2 percent).

Real output in our major developing-country trading partners in Asia is expected to grow between 6-1/2 percent and 7 percent during 1997 and 1998. We assume that the recent appreciation of the yen will support a relatively robust growth of exports over the forecast period, particularly in Korea and Taiwan. At the same time, Thailand's difficulties have introduced a little extra uncertainty into our outlook for some countries in this region, including those with financial fragilities of their own (notably Korea).

We project China's GDP to continue to expand about 10 percent per year and Hong Kong's growth to average more than 5 percent this year and next, on the assumption that the return of the country to China on July 1 goes smoothly. Financial markets appear to be sanguine about the near-term prospects for Hong Kong; there has been no downward pressure on the Hong Kong dollar or asset prices generally, even with the transfer clearly in sight.

We expect inflation in Mexico to continue to recede toward single-digit levels over the forecast period. Inflation in the Asian developing countries is expected to remain moderate.

U.S. real exports and imports. We project real exports of goods and services to grow at a 7-1/2 percent annual rate over the next six quarters, compared with an estimated rate of 12 percent during the first half of this year. We judge that the depreciation of the dollar during 1994-95 was still imparting some net stimulus to exports in the first half of 1997. Even so, export growth for that period (based on data through April) was in excess of historical relationships. Core exports (goods other than agricultural products, computers, and semiconductors) are projected to slow from about a double-digit rate of expansion during the first half of 1997 to a 2 percent rate over the period ahead, reflecting the lagged response of these exports to the appreciation of the dollar over the past year and a return to what we perceive to be more typical behavior. The slowdown in core exports is partly offset by a speedup of agricultural shipments next year and faster growth in service receipts. Service receipts, which tend to respond to exchange rate changes with a shorter lag than core exports, should be depressed this year, but not next, by the appreciation of the dollar. The projected growth of total exports is elevated by the continued rapid expansion of real exports of computers and semiconductors.

The growth of real imports of goods and services should slow substantially from high rates recorded earlier this year. The growth of demand for core imports (goods other than oil, computers, and semiconductors) will drop with the slowing of U.S. aggregate demand. Nevertheless, imports will continue to be stimulated for much of this year by recent declines in the relative price of imports stemming from the strong dollar. Imports of computers and semiconductors will slow from the exceptionally rapid expansion seen in the first quarter but are nevertheless expected to continue growing strongly. On balance, we see the growth of total imports slowing from an estimated annual rate of 18 percent during the first half of 1997 to about half that over the next six quarters.

Oil prices. We have marked down the forecast for oil prices somewhat because OPEC has maintained production at a rate higher than we had anticipated, allowing oil inventories to recover from near historic lows. For the second half of this year we have revised down the WTI spot price roughly $0.75 per barrel, to a level of $16.35 per barrel. We project the WTI spot price and the oil import unit value to return gradually to $19.50 and $17.00, respectively, as demand picks up and increases in OPEC production slow.

Prices of non-oil imports and exports. The appreciation of the dollar through early May has depressed the prices of non-oil imports. We expect the more recent and projected depreciation to have the opposite effect, resulting in a swing in non-oil import prices from a 2-1/2 percent annual rate of decline in the first half of 1997 to a 1-3/4 percent annual rate of increase in the second half. A transitory rise in commodity prices (primarily coffee and metals prices) will also contribute to this turnaround. In 1998, the anticipated reversal of these price increases and the slower rate of depreciation of the dollar should damp the increase in non-oil import prices. Prices of nonagricultural exports are projected to rise slowly over the forecast period in line with comparable U.S. producer prices.

Selected Trade Prices
(Percentage change from end of previous period except as noted; seasonally adjusted)

Trade category	Projection				
	1997				1998
	Q1	Q2	Q3	Q4	
Exports					
Nonagricultural	-1.0	-3.0	-1.2	-0.0	0.9
Agricultural	0.7	1.4	2.8	-3.3	1.6
Imports					
Non-oil	-2.7	-2.5	0.7	2.8	0.7
Oil (level, dollars per barrel)	21.37	17.82	17.22	17.10	17.00

NOTE. Prices for exports and non-oil imports of goods are on a NIPA chain-weighted basis.

The price of imported oil for multiquarter periods is the price for the final quarter of the period.

Nominal trade and current account balances. The nominal trade deficit for goods and services is projected to widen over the forecast period, from a little more than $115 billion in the first quarter of 1997 to $140 billion in the fourth quarter of 1998. The deficit on net investment income is expected to widen this year and next as well. Accordingly, the current account deficit, which averaged $148 billion in 1996, is projected to rise to about $210 billion, or 2-1/2 percent of GDP, in 1998.

OUTLOOK FOR FOREIGN REAL GDP AND CONSUMER PRICES: SELECTED COUNTRIES
(Percent, Q4 to Q4)

Measure and country	1990	1991	1992	1993	1994	1995	1996	--Projected-- 1997	1998
REAL GDP									
Canada	-1.9	0.0	0.5	3.1	4.9	0.7	2.3	3.5	3.2
France	1.4	1.3	0.0	-0.6	4.3	0.3	2.1	2.7	2.4
Germany (1)	6.8	3.3	1.0	-0.2	3.4	0.8	2.2	2.4	2.7
Italy	0.7	1.9	-0.8	0.1	2.7	2.5	0.1	1.8	2.3
Japan	5.1	2.5	0.1	0.4	0.8	2.6	3.0	2.6	2.4
United Kingdom	-0.7	-1.5	0.3	2.8	4.2	1.9	2.6	3.1	2.2
Average weighted by 1987-89 GDP	2.8	2.8	0.2	0.7	2.8	1.7	2.2	2.6	2.5
Average weighted by share of U.S. nonagricultural exports									
Total foreign	2.5	2.9	1.9	3.2	5.1	1.7	4.0	4.0	3.9
Foreign G-7	0.6	1.5	0.3	1.8	3.8	1.3	2.4	3.1	2.8
Developing Countries	6.2	6.4	5.1	6.0	7.0	2.1	6.8	5.7	5.9
CONSUMER PRICES									
Canada	4.9	4.1	1.8	1.8	0.0	2.1	2.0	1.4	1.6
France	3.5	3.0	1.8	2.1	1.6	1.9	1.7	1.4	1.9
Germany (1)	3.0	4.0	3.4	4.2	2.6	1.7	1.4	1.6	1.6
Italy	6.4	6.1	4.9	4.1	3.8	5.9	2.7	1.8	2.0
Japan	3.2	3.2	0.9	1.2	0.8	-0.8	0.1	1.5	0.6
United Kingdom (2)	9.2	5.7	3.7	2.7	2.2	2.9	3.2	2.6	2.7
Average weighted by 1987-89 GDP	4.7	2.6	2.4	2.5	1.8	1.7	1.5	1.7	1.5
Average weighted by share of U.S. non-oil imports	4.3	2.8	1.9	2.0	1.0	1.1	1.3	1.6	1.3

1. West German data through 1991, all Germany thereafter.
2. CPI excluding mortgage interest payments which is the targeted inflation rate.

June 25, 1997

OUTLOOK FOR FOREIGN REAL GDP AND CONSUMER PRICES: SELECTED COUNTRIES
(Percent, quarterly change at an annual rate)

						------ Projected	------	------	------	------	------	------
	1996				1997				1998			
Measure and country	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
REAL GDP												
Canada	1.4	1.4	3.3	2.9	3.4	3.6	3.6	3.4	3.2	3.2	3.2	3.1
France	5.2	-0.7	3.1	0.8	0.8	5.0	2.7	2.4	2.6	2.4	2.3	2.3
Germany	-0.4	6.1	3.0	0.3	1.8	3.3	2.0	2.4	2.6	2.9	2.8	2.7
Italy	0.8	-1.5	2.2	-0.9	-1.2	4.0	2.2	2.2	2.2	2.2	2.4	2.4
Japan	8.4	-1.1	1.3	3.8	6.6	-0.4	1.9	2.3	2.4	2.2	2.4	2.4
United Kingdom	2.5	2.1	2.6	3.4	3.8	3.3	2.8	2.7	2.2	2.2	2.1	2.1
Average weighted by 1987-89 GDP	4.0	0.7	2.3	2.0	3.2	2.4	2.4	2.5	2.5	2.4	2.5	2.5
Average weighted by share of U.S. nonagricultural exports												
Total foreign	4.7	1.8	4.6	4.8	3.3	4.6	4.0	4.1	4.0	3.9	3.8	3.7
Foreign G-7	3.0	1.2	2.8	2.6	3.6	2.8	2.9	2.9	2.8	2.8	2.8	2.8
Developing Countries	8.9	1.6	7.7	9.2	3.9	7.2	5.9	6.0	5.9	5.9	5.8	5.8
CONSUMER PRICES (1)												
Canada	1.4	1.4	1.4	2.0	2.1	1.6	1.7	1.4	1.4	1.5	1.7	1.6
France	2.1	2.4	1.8	1.7	1.5	1.0	1.3	1.4	1.6	1.6	1.8	1.9
Germany	1.6	1.5	1.4	1.4	1.7	1.5	1.5	1.6	1.6	1.6	1.6	1.6
Italy	5.0	4.2	3.5	2.7	2.4	1.7	1.8	1.8	2.0	2.0	2.0	2.0
Japan	-0.3	0.1	0.0	0.1	0.0	1.5	1.5	1.5	1.7	0.2	0.4	0.6
United Kingdom (2)	2.9	2.8	2.9	3.2	2.9	2.6	2.6	2.6	2.7	2.7	2.7	2.7
Average weighted by 1987-89 GDP	1.7	1.7	1.5	1.5	1.4	1.6	1.7	1.7	1.8	1.3	1.5	1.5
Average weighted by share of U.S. non-oil imports	1.1	1.2	1.1	1.3	1.3	1.6	1.6	1.6	1.7	1.1	1.3	1.3

1. Percent change from same period a year earlier.
2. CPI excluding mortgage interest payments which is the targeted inflation rate.

Strictly Confidential (FR)
Class II FOMC

June 25, 1997

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	1990	1991	1992	1993	1994	1995	1996	-- Projected -- 1997	1998
NIPA REAL EXPORTS and IMPORTS									
	Percentage point contribution to GDP growth, Q4/Q4								
Net Goods & Services	0.6	0.4	-0.4	-0.7	-0.4	0.3	-0.2	-0.7	-0.3
Exports of G&S	0.6	0.8	0.4	0.5	1.0	0.8	0.9	1.2	1.0
Imports of G&S	-0.0	-0.4	-0.8	-1.1	-1.4	-0.5	-1.1	-1.9	-1.3
	Percentage change, Q4/Q4								
Exports of G&S	7.2	8.6	4.1	4.8	9.9	7.4	7.4	9.9	7.3
Services	8.9	7.1	-0.9	3.9	4.8	5.1	3.0	1.8	4.9
Agricultural Goods	-7.3	10.1	10.4	-5.4	17.1	-3.1	4.0	-3.1	3.2
Computers	12.3	21.7	25.2	22.7	28.8	49.4	32.8	61.5	35.4
Semiconductors	61.5	41.8	64.8	45.1	68.7	29.7	4.9	21.4	28.7
Other Goods 1/	6.0	7.0	2.3	3.6	7.4	5.3	7.7	7.9	1.7
Imports of G&S	0.5	4.1	7.4	10.5	11.8	4.2	8.3	13.6	8.5
Services	5.8	-2.7	1.4	3.7	0.8	4.1	4.7	10.3	2.6
Oil	-15.8	8.1	12.1	10.1	-0.2	0.9	-1.9	-9.5	9.5
Computers	2.9	35.9	45.1	38.8	37.3	43.8	23.9	49.1	29.4
Semiconductors	60.9	55.3	42.0	44.9	47.4	57.1	-13.6	41.8	31.6
Other Goods 2/	-0.3	2.5	5.4	9.5	12.5	-1.2	10.0	10.2	4.5
	Billions of chained 1992 dollars								
Net Goods & Services	-61.9	-22.3	-29.5	-72.0	-105.7	-107.6	-113.6	-136.6	-166.6
Exports of G&S	564.4	599.9	639.4	658.2	712.0	775.4	825.9	917.7	987.7
Imports of G&S	626.3	622.2	669.0	730.2	817.6	883.0	939.5	1054.3	1154.2
	Billions of dollars								
US CURRENT ACCOUNT BALANCE	-91.9	-5.6	-56.4	-90.8	-133.5	-129.1	-148.2	-174.2	-209.2
Net Goods & Services (BOP)	-81.2	-31.0	-39.2	-72.3	-104.4	-101.9	-111.0	-118.8	-142.6
Exports of G&S (BOP)	537.1	581.1	617.5	643.5	699.6	794.6	848.8	917.6	966.2
Imports of G&S (BOP)	618.4	612.2	656.7	715.8	804.1	896.5	959.9	1036.5	1108.9
Net Investment Income	23.9	20.2	18.0	19.7	9.7	6.8	2.8	-14.7	-24.8
Direct, Net	55.9	55.6	51.6	55.7	50.8	60.0	66.8	66.1	70.5
Portfolio, Net	-31.9	-35.4	-33.6	-36.0	-41.0	-53.2	-63.9	-80.8	-95.3
Net Transfers	-34.6	5.1	-35.2	-38.1	-38.8	-34.0	-40.0	-40.7	-41.8

1. Merchandise exports excluding agricultural products, computers, and semiconductors.
2. Merchandise imports excluding oil, computers, and semiconductors.

Strictly Confidential (FR)
Class II FOMC

June 25, 1997

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	1996				Projected 1997				Projected 1998			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NIPA REAL EXPORTS and IMPORTS												
Percentage point contribution to GDP growth												
Net Goods & Services	-1.1	-0.6	-1.3	2.3	-1.3	-0.7	-1.0	0.3	-0.8	-0.2	-0.9	0.6
Exports of G&S	0.2	0.7	-0.1	2.7	1.3	1.6	0.5	1.4	0.6	1.3	0.5	1.4
Imports of G&S	-1.3	-1.3	-1.2	-0.4	-2.5	-2.3	-1.5	-1.1	-1.4	-1.5	-1.3	-0.9
Percentage change from previous period, SAAR												
Exports of G&S	1.8	5.6	-0.9	25.0	10.7	13.8	4.0	11.3	4.9	9.9	3.4	11.2
Services	2.7	2.8	-3.8	10.8	1.2	1.2	1.5	3.3	4.8	5.2	4.9	4.8
Agricultural Goods	9.3	-33.7	8.7	48.7	-26.3	-9.9	8.0	22.8	3.3	3.2	1.6	4.8
Computers	58.7	21.0	18.3	36.8	90.4	70.0	49.1	41.1	36.0	36.0	34.8	34.8
Semiconductors	-0.0	-20.7	2.6	48.8	15.4	13.7	28.7	28.7	28.7	28.7	28.7	28.7
Other Goods 1/	-4.1	14.0	-2.7	26.7	12.1	15.8	-3.0	7.8	-2.0	6.4	-5.2	8.1
Imports of G&S	10.6	9.9	9.3	3.3	19.7	17.3	10.4	7.6	9.5	10.0	8.9	5.8
Services	13.0	1.3	2.6	2.3	24.3	9.5	5.2	3.4	2.9	2.8	2.5	2.4
Oil	-22.2	59.9	7.0	-30.5	-12.4	22.4	-7.6	-32.1	24.6	46.3	19.4	-33.8
Computers	27.7	23.0	22.2	22.6	56.6	60.8	43.8	36.3	31.3	28.8	28.8	28.8
Semiconductors	4.6	-38.5	-19.0	6.8	50.3	36.6	44.3	36.6	31.6	31.6	31.6	31.5
Other Goods 2/	12.2	11.6	11.8	4.7	15.8	12.6	6.7	6.1	5.1	4.8	4.4	3.8
Billions of chained 1992 dollars												
Net Goods & Services	-104.0	-114.7	-137.4	-98.4	-120.4	-132.3	-149.5	-144.3	-158.0	-162.0	-178.3	-168.1
Exports of G&S	806.7	817.9	816.1	862.9	885.1	914.2	923.2	948.2	959.6	982.6	990.9	1017.6
Imports of G&S	910.7	932.6	953.5	961.3	1005.5	1046.4	1072.6	1092.5	1117.5	1144.6	1169.2	1185.7
Billions of dollars					Projected							
US CURRENT ACCOUNT BALANCE	-131.5	-142.3	-171.3	-147.5	-163.9	-163.7	-179.4	-190.0	-198.0	-201.7	-219.2	-217.9
Net Goods & Services (BOP)	-98.1	-111.1	-130.1	-104.8	-116.5	-112.7	-124.7	-121.4	-136.5	-138.5	-154.2	-141.3
Exports of G&S (BOP)	828.4	848.6	840.3	878.0	898.1	919.6	916.3	936.7	944.3	963.4	967.5	989.9
Imports of G&S (BOP)	926.6	959.7	970.4	982.8	1014.5	1032.2	1041.0	1058.1	1080.8	1101.9	1121.7	1131.1
Net Investment Income	8.2	3.5	-5.5	5.0	-12.6	-12.1	-15.7	-18.6	-22.5	-24.2	-26.0	-26.6
Direct, Net	66.2	64.2	60.3	76.4	65.0	66.6	66.2	66.7	66.4	68.5	71.5	75.5
Portfolio, Net	-57.9	-60.7	-65.7	-71.4	-77.5	-78.7	-81.9	-85.3	-88.8	-92.7	-97.5	-102.2
Net Transfers	-41.6	-34.8	-35.8	-47.7	-34.8	-39.0	-39.0	-50.0	-39.0	-39.0	-39.0	-50.0

1. Merchandise exports excluding agricultural products, computers, and semiconductors.
2. Merchandise imports excluding oil, computers, and semiconductors.