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Strictly Confidential (FR) Class II FOMC

February 5, 1986

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 expanded in the fourth quarter at about the average pace seen earlier in the year, with appreciable gains in December in most major indicators of production and spending. Consumer and producer prices in the final months of 1985 were boosted by developments in markets for food and energy, but underlying price and wage trends appeared essentially unchanged.

The index of industrial production rose 0.7 percent in December, after little change, on net, over the preceding two months. Gains in output in December were widespread, with further sizable advances for consumer goods and materials. Production of business equipment, which had been particularly soft through much of 1985, edged up at year-end, partly because of an apparent firming in the high-technology area. Industrial capacity utilization increased to 80.5 percent in December, but remained below the recent high reached in mid-1984.

Employment growth picked up in the fourth quarter, with nonfarm payroll employment expanding 280,000 per month. Hiring continued to be brisk in services and finance. In addition, manufacturing payrolls rose 45,000 per month, on average, reversing about half of the loss in factory jobs that occurred over the first nine months of the year. The civilian unemployment rate, which had hovered above 7 percent for most of the year, declined to 6.9 percent in December.

Domestic automakers maintained assemblies at about an 8 million unit annual rate around the turn of the year, despite the marked slump in sales last autumn and the considerable buildup of dealer inventories. In late

December, automakers broadened substantially their financing incentive programs, and sales in the past month-and-a-half have risen to an 8-3/4 million unit annual rate. These incentives are scheduled to remain in effect through late February.

Excluding motor vehicles, gains in real consumer spending were well-maintained in the fourth quarter. Outlays for nonautomotive durable goods--such as furniture and household appliances--continued to rise vigorously, while spending for nondurable goods and services was up at almost a 3 percent annual rate. Thus despite the lull in auto sales, overall real consumption in the fourth quarter was essentially flat. With a moderate rise in disposable income, the saving rate edged up to 4 percent, only a bit above the extremely low third quarter figure.

Housing starts rebounded to a 1.84 million unit annual rate in December, with large gains in both the single and multifamily areas. The rise in single-family starts was from a depressed November level; activity in this sector in the closing months of 1985 remained in the same general range as earlier in the year. Multifamily starts in December were stronger than seemingly warranted by underlying market conditions, especially the historically high level of rental vacancy rates. Multifamily construction in late 1985 undoubtedly was influenced by the heavy volume of tax-exempt financing.

Business fixed investment increased vigorously late last year. Shipments of nondefense capital goods, which had been lackluster through much of 1985, rose 3-1/2 percent in the fourth quarter, with considerable gains for most broad categories of equipment. However, increases in equipment spending appear likely to slow again in early 1986. New orders for nondefense capital goods were unchanged in the fourth quarter, and some of the growth in spending last year probably was attributable to efforts to lock-in existing tax benefits. Outlays for nonresidential construction rose sharply in December, after little net change over the autumn.

The book value of manufacturing inventories declined $16 billion at an annual rate in December, extending the liquidation that was evident over much of the year. Faced generally with sluggish orders and low inflation, manufacturers have attempted to keep stocks lean and the factory inventory-sales ratio at year-end was historically low. In the trade sector, the sharp accumulation of nonauto retail stocks reported earlier in the autumn appears to have subsided in November, while auto inventories increased through December.

Price increases picked up a bit in late 1985. The consumer price index rose 0.6 percent in November and 0.4 percent in December, compared with an average monthly increase of 0.2 percent over the preceding six months. However, the stepup mainly reflected increases in food and energy prices that are unlikely to persist. Apart from food and energy, the rise in the CPI in the closing months of 1985 was about the same as earlier in the year. There has been no significant evidence of dollar-related price hikes in major domestic price measures through December, although increases are anticipated in coming months in light of announced rises for items such as cars and electronic equipment.

Wage increases remained moderate last year. As measured by the employment cost index for wages, pay rates in the private sector rose 4 percent in 1985, the same as in the previous year. Moreover, with employers' efforts to reduce fringe benefit costs, the ECI measure of total hourly compensation slowed to 4 percent last year--a percentage point less than in 1984.

Outlook. The staff expects that real GNP will rise at a 3-1/4 percent annual rate in the first quarter. Consumer spending should be boosted by the recent rebound in auto sales, but changes in other major categories of domestic final spending are expected to be relatively moderate.[1] In the external sector, exports are expected to post a solid rise while imports are essentially flat after the fourth-quarter surge. Inflation, as measured by the increase in the GNP fixed-weighted price index, is projected to be 4 percent, 1/2 percentage point more than the average for 1985, largely because of the bulge in food prices at the turn of the year.

The fiscal policy assumptions underlying the staff projection reflect the restraining influence on federal spending of the Gramm-Rudman-Hollings initiative. For fiscal year 1986, the projection continues to incorporate the required sequester of about $12 billion and assumes other small deficit-reducing actions as well. Nonetheless, estimated outlays for this year have been raised $10 billion since the last Greenbook to reflect cost overruns in the farm and other sectors, and the total budget deficit, including off-budget outlays, is now expected to be around $200 billion. The projection for fiscal year 1987 assumes $30 billion of deficit-reducing actions, in addition to the carry-over effects from this year's economies. Even so, the staff's estimated fiscal year 1987 deficit of about $165 billion remains well above the target deficit of $144 billion shown in the new

1. The large movements that are projected for government purchases and farm inventories in the first quarter mainly reflect a sharp drop-off in CCC activity and, taken together, have little net effect on GNP growth.

Administration Budget, primarily because of the staff's less favorable economic outlook. With respect to monetary policy, M1 growth is assumed to be near the top of the tentative range in 1986 while M2 growth is assumed to be around the middle of its range. Interest rates probably will decline some over the projection horizon.

The most significant change in the assumptions underlying the staff projections is the new path projected for oil prices. The price of imported petroleum now is assumed to fall from $26 per barrel in the fourth quarter of 1985 to $20 per barrel in the second quarter of 1986 and remain at that level through 1987. The drop in oil prices is expected to cut roughly a percentage point from consumer prices by the end of 1986. The oil price decline also is expected to have a favorable effect on real activity and probably adds around 1/2 percentage point to real GNP growth this year, offsetting much of the damping influence of the assumed fiscal restraint.

Real GNP now is projected to rise 3 percent in 1986 and 2-3/4 percent in 1987. A turnaround in the external sector is expected to provide considerable support to domestic production over the next two years. With the foreign exchange value of the dollar well below its early-1985 peak and expected to decline moderately further, exports are expected to rise briskly. Meanwhile, increases in prices of foreign goods in the U.S. should begin to limit demand for imports.

Growth of domestic demand is projected to slow to around 2-1/4 percent in 1986 and be a bit lower in 1987. With the saving rate currently around 4 percent and indebtedness historically high, gains in consumer spending are expected to slow over the projection horizon. Business fixed investment is likely to be sluggish this year and next as outlays for structures are held down by the end of the boom in office building and weakness in the energy sector. However, equipment spending should continue to expand in response to generally favorable movements in financing costs and the gradual improvement in operating rates. And with mortgage rates continuing to move down and demographic trends favorable, housing activity is expected to strengthen after three years of essentially flat activity.

The main impetus to inflation over the projection horizon continues to come from the depreciation of the dollar. In 1986, the pressure on prices from the higher cost of nonoil imports is expected to be largely offset by the sharp drop in energy prices, but in 1987 this offset should disappear as energy prices are assumed to be relatively stable. Moreover, with the civilian unemployment rate anticipated to decline to around 6-1/2 percent next year, some upward pressures on wages and prices are expected to emerge. Reflecting these influences, the GNP fixed-weighted price index is projected to rise 3-1/2 percent in 1986 for the second year in a row, and to accelerate a bit in 1987, to around 4 percent.

STAFF GNP PROJECTIONS

Percent changes, annual rate

	Nominal GNP		Real GNP		GNP fixed-weighted price index*		GNP deflator		Unemployment rate	
	12/11/85	2/5/86	12/11/85	2/5/86	12/11/85	2/5/86	12/11/85	2/5/86	12/11/85	2/5/86
Annual changes:										
1984 <1>	10.8	11.0	6.8	6.6	4.0	4.2	3.8	4.0	7.5	7.5
1985 <1>	6.2	5.8	2.5	2.3	3.6	3.6	3.6	3.3	7.2	7.2
1986	5.9	6.2	2.4	2.7	3.6	3.7	3.5	3.4	7.2	6.7
1987	—	6.5	—	2.9	—	3.8	—	3.5	—	6.5
Quarterly changes:										
1985 Q1 <1>	5.6	6.9	.3	3.7	3.6	3.5	5.4	3.0	7.3	7.3
Q2 <1>	4.5	4.5	1.9	1.1	3.7	3.6	2.6	3.3	7.3	7.3
Q3 <1>	6.7	5.8	4.3	3.0	2.8	2.7	2.3	2.9	7.2	7.2
Q4 <1>	6.3	5.9	2.6	2.4	3.4	4.5	3.7	3.3	7.1	7.0
1986 Q1	6.0	7.2	2.0	3.3	4.0	4.0	4.0	4.0	7.1	6.8
Q2	5.2	5.8	1.8	2.3	3.6	3.4	3.4	3.4	7.2	6.7
Q3	5.7	6.2	2.1	3.1	3.7	3.4	3.5	3.0	7.2	6.7
Q4	6.8	6.5	2.6	3.3	3.7	3.5	4.1	3.1	7.3	6.6
1987 Q1	—	6.4	—	2.6	—	3.8	—	3.7	—	6.6
Q2	—	6.8	—	3.1	—	4.0	—	3.6	—	6.5
Q3	—	7.0	—	3.0	—	4.2	—	3.9	—	6.5
Q4	—	7.0	—	2.6	—	4.5	—	4.3	—	6.5
Two-quarter changes: <2>										
1985 Q2 <1>	5.1	5.7	1.1	2.4	3.7	3.5	4.0	3.1	.1	.1
Q4 <1>	6.5	5.9	3.4	2.7	3.1	3.6	3.0	3.1	-.2	-.3
1986 Q2	5.6	6.5	1.9	2.8	3.8	3.7	3.6	3.7	.1	-.3
Q4	6.2	6.3	2.3	3.2	3.7	3.5	3.8	3.0	.1	-.1
1987 Q2	—	6.6	—	2.9	—	3.9	—	3.6	—	-.1
Q4	—	7.0	—	2.8	—	4.3	—	4.1	—	.0
Four-quarter changes: <3>										
1984 Q4 <1>	9.5	9.0	5.7	4.7	4.0	4.2	3.6	4.1	-1.3	-1.3
1985 Q4 <1>	5.8	5.8	2.2	2.5	3.4	3.5	3.5	3.1	-.1	-.2
1986 Q4	5.9	6.4	2.1	3.0	3.7	3.6	3.7	3.4	.2	-.4
1987 Q4	—	6.8	—	2.8	—	4.1	—	3.9	—	

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

* Previous projection is for gross domestic business product fixed-weighted price index.

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

	Units	1979	1980	1981	1982	1983	1984	1985	Projection 1986	Projection 1987
Expenditures										
Nominal GNP	Billions of $	2508.2	2732.0	3052.6	3166.0	3401.6	3774.7	3992.5	4239.2	4516.8
Real GNP	Billions of 82$	3192.4	3187.1	3248.8	3166.0	3275.2	3492.0	3573.5	3671.1	3778.7
Real GNP	Percent change*	.6	-.1	.6	-1.9	6.3	4.7	2.5	3.0	2.8
Gross domestic purchases		-.4	-1.1	.8	-.8	8.2	6.2	3.2	2.4	1.9
Final sales		2.2	-.2	.1	.3	3.6	4.3	3.6	2.4	2.9
Private dom. final purchases		1.3	-1.7	-.3	.8	7.6	5.3	3.6	3.0	2.4
Personal consumption expend.		1.4	-.1	.2	2.9	5.3	3.4	2.9	2.8	2.0
Durables		-3.8	-5.6	-3.3	9.0	14.5	9.2	5.1	5.2	2.8
Nondurables		.8	-1.4	.5	1.8	4.3	2.0	2.9	1.8	1.4
Services		3.5	2.4	.9	2.3	3.7	2.8	2.3	2.8	2.1
Business fixed investment		5.0	-4.8	5.6	-11.3	11.5	16.5	6.0	.8	3.3
Producers' durable equipment		1.6	-6.5	2.2	-12.5	20.3	17.2	5.0	3.4	4.9
Nonresidential structures		12.0	-1.8	11.7	-9.1	-2.1	15.2	7.9	-4.0	-.2
Residential structures		-7.2	-14.2	-22.4	4.9	38.5	3.5	6.4	12.1	5.2
Exports		13.7	.5	2.4	-13.8	6.9	5.1	-4.5	6.9	10.9
Imports		3.4	-8.8	4.9	-5.9	25.8	17.0	2.2	1.4	2.2
Government purchases		.1	1.0	2.9	3.8	-2.7	8.1	6.9	-2.9	.6
Federal		-.3	3.1	9.5	8.2	-7.5	14.7	11.8	-7.5	.0
Defense		3.3	3.1	7.6	8.8	5.2	7.6	6.5	.0	.5
State and local		.4	-.3	-1.3	.6	1.0	3.3	2.9	1.0	1.0
Change in business inventories	Billions of 82$	15.0	-6.9	23.9	-24.5	-5.5	62.7	7.3	19.6	19.0
Nonfarm	Billions of 82$	10.4	-2.3	19.0	-23.1	.4	55.9	10.1	21.0	19.0
Net exports	Billions of 82$	3.6	57.0	49.4	26.3	-21.9	-85.0	-105.1	-118.8	-89.0
Nominal GNP	Percent change*	9.5	9.9	9.3	3.1	10.0	9.0	5.8	6.4	6.8
Employment and Production										
Nonfarm payroll employment	Millions	89.8	90.4	91.2	89.6	90.2	94.5	97.7	100.4	102.5
Unemployment rate	Percent	5.8	7.1	7.6	9.7	9.6	7.5	7.2	6.7	6.5
Industrial production index	Percent change*	.9	-.8	-1.0	-7.7	14.3	7.2	1.6	3.4	3.2
Capacity utilization rate-mfg.	Percent	84.6	79.3	78.3	70.3	74.0	80.8	80.3	80.4	80.8
Housing Starts	Millions	1.72	1.30	1.10	1.06	1.70	1.77	1.74	1.82	1.96
Auto sales	Millions	10.68	9.04	8.56	8.00	9.18	10.43	11.09	10.73	10.70
Domestic	Millions	8.36	6.62	6.24	5.77	6.77	7.97	8.24	7.68	7.60
Foreign	Millions	2.32	2.42	2.32	2.23	2.41	2.46	2.84	3.05	3.10
Income and saving										
Nominal personal income	Percent change*	11.4	12.0	9.2	5.3	7.5	8.6	5.4	6.5	6.7
Real disposable income	Percent change*	.5	1.1	.7	1.0	5.1	3.9	1.3	3.0	1.9
Personal saving rate	Percent	6.8	7.1	7.5	6.8	5.5	6.5	4.6	4.2	4.3
Corp. profits with IVA & CCAdj	Percent change*	-10.7	-6.8	2.3	-19.1	69.5	11.6	14.8	2.8	2.3
Profit share of GNP	Percent	8.0	6.5	6.2	4.7	6.3	7.2	7.5	7.6	7.2
Federal govt. surplus/deficit	Billions of $	-16.1	-61.4	-63.9	-145.9	-179.4	-172.9	-196.9	-183.7	-156.7
State and local govt. surplus		27.6	26.8	34.1	35.1	48.6	64.4	58.3	58.4	63.1
Prices and costs										
GNP implicit deflator	Percent change*	8.9	9.9	8.7	5.2	3.5	4.1	3.1	3.4	3.9
GNP fixed-weight price index		8.8	9.8	8.5	5.0	3.8	4.2	3.5	3.6	4.1
Cons. & fixed invest. prices		9.5	10.1	8.2	4.4	3.1	3.9	3.1	3.3	4.2
CPI		12.8	12.5	9.6	4.4	3.2	4.1	3.5	3.1	4.3
Exc. food and energy		10.7	12.2	10.2	5.2	4.2	4.8	4.3	4.7	5.1
Nonfarm business sector										
Output per hour		-2.7	1.0	-.6	1.0	3.4	.8	-.1	1.0	.9
Compensation per hour		9.7	10.9	8.3	7.2	3.6	3.8	3.7	4.3	4.9
Unit labor costs		12.7	9.7	8.9	6.2	.2	2.9	3.8	3.2	4.0

* Percent changes are from fourth quarter to fourth quarter.

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

	Units	1985		Projection 1986				1987			
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Expenditures											
Nominal GNP	Billions of $	4016.9	4075.1	4146.5	4205.2	4268.7	4336.4	4404.4	4477.8	4553.9	4631.2
Real GNP	Billions of 82$	3584.1	3605.0	3634.1	3654.6	3682.9	3712.7	3737.0	3765.9	3793.8	3817.8
Real GNP	Percent change	3.0	2.4	3.3	2.3	3.1	3.3	2.6	3.1	3.0	2.6
Gross domestic purchases		5.0	3.1	2.5	2.6	2.3	2.3	1.8	1.9	2.0	2.0
Final sales		5.0	2.1	1.8	1.3	3.3	3.4	2.8	3.3	3.0	2.7
Private dom. final purchases		4.5	1.9	3.0	3.6	3.0	2.6	2.3	2.3	2.3	2.5
Personal consumption expend.		4.6	-.2	3.7	3.2	2.3	2.0	1.8	1.9	1.9	2.3
Durables		24.3	-15.7	10.4	1.9	5.5	3.4	3.0	3.0	2.6	2.8
Nondurables		1.5	1.5	2.2	2.8	1.2	1.1	1.3	1.2	1.4	1.8
Services		1.4	3.9	3.0	4.0	2.2	2.2	1.7	2.1	2.1	2.4
Business fixed investment		2.4	10.3	-1.5	1.3	1.6	2.0	3.4	3.2	3.2	3.2
Producers' durable equipment		3.0	12.4	.6	4.0	4.5	4.5	4.9	4.9	4.9	4.9
Nonresidential structures		1.2	6.4	-5.6	-3.7	-3.8	-2.9	.4	-.4	-.3	-.3
Residential structures		8.5	8.6	5.6	14.3	15.6	13.3	6.7	6.0	4.8	3.5
Exports		-5.1	8.0	4.9	3.9	8.0	10.9	11.6	11.9	11.8	8.2
Imports		12.8	13.0	-1.1	5.9	.1	1.0	2.9	.4	2.3	3.2
Government purchases		18.2	7.0	-6.3	-6.2	.0	1.0	.2	.6	.7	.7
Federal		37.3	16.1	-14.5	-14.5	-1.2	1.1	-.7	.3	.3	.0
Defense		22.0	-1.1	2.2	-3.1	-1.6	2.7	.2	.8	1.0	.0
State and local		4.7	-.1	1.2	1.2	.9	.8	.9	.9	1.1	1.3
Change in business inventories	Billions of 82$	-1.8	.1	13.5	22.5	21.5	21.0	20.0	19.0	19.0	18.0
Nonfarm	Billions of 82$	1.6	16.5	18.0	23.0	22.0	21.0	20.0	19.0	19.0	18.0
Net exports	Billions of 82$	-119.8	-127.6	-121.8	-125.3	-118.3	-109.8	-102.6	-91.8	-83.1	-78.7
Nominal GNP	Percent change	5.8	5.9	7.2	5.8	6.2	6.5	6.4	6.8	7.0	7.0
Employment and Production											
Nonfarm payroll employment	Millions	98.0	98.8	99.6	100.1	100.7	101.2	101.7	102.3	102.8	103.2
Unemployment rate	Percent*	7.2	7.0	6.8	6.7	6.7	6.6	6.6	6.5	6.5	6.5
Industrial production index	Percent change	2.0	1.3	4.7	2.2	3.1	3.5	3.2	3.6	3.4	2.7
Capacity utilization rate-mfg.	Percent*	80.3	79.9	80.3	80.3	80.4	80.6	80.7	80.8	80.9	80.8
Housing Starts	Millions	1.67	1.73	1.75	1.80	1.85	1.90	1.92	1.94	1.97	2.00
Auto sales	Millions	12.31	10.24	10.90	10.60	10.70	10.70	10.70	10.70	10.70	10.70
Domestic	Millions	9.40	6.84	7.90	7.60	7.60	7.60	7.60	7.60	7.60	7.60
Foreign	Millions	2.90	3.40	3.00	3.00	3.10	3.10	3.10	3.10	3.10	3.10
Income and saving											
Nominal personal income	Percent change	2.3	7.4	7.0	6.0	6.4	6.6	7.2	6.4	6.6	6.8
Real disposable income	Percent change	-4.5	2.4	4.5	2.8	2.7	2.0	3.5	1.2	1.3	1.5
Personal saving rate	Percent*	3.7	4.1	4.3	4.2	4.2	4.2	4.6	4.4	4.2	4.0
Corp. profits with IVA & CCAdj	Percent change	32.5	11.0	3.7	-.9	-2.2	10.9	-6.7	1.9	6.1	8.3
Profit share of GNP	Percent*	7.7	7.8	7.7	7.6	7.4	7.5	7.3	7.2	7.2	7.2
Federal govt. surplus/deficit	Billions of $	-201.3	-214.4	-206.8	-185.2	-172.3	-170.6	-172.5	-160.6	-149.6	-144.3
State and local govt. surplus		56.9	55.8	59.7	60.1	56.7	57.1	58.6	61.8	64.5	67.6
Prices and costs											
GNP implicit deflator	Percent change	2.9	3.3	4.0	3.4	3.0	3.1	3.7	3.6	3.9	4.3
GNP fixed-weight price index		2.7	4.5	4.0	3.4	3.4	3.5	3.8	4.0	4.2	4.5
Cons. & fixed invest. prices		2.4	4.2	3.7	2.6	3.3	3.6	4.1	4.2	4.4	4.4
CPI		2.4	4.1	3.7	1.9	3.1	3.6	4.1	4.2	4.3	4.4
Exc. food and energy		3.6	4.8	4.9	4.7	4.6	4.7	5.0	5.0	5.2	5.3
Nonfarm business sector											
Output per hour		.3	-1.8	1.0	.4	1.3	1.3	.7	1.1	.9	.8
Compensation per hour		2.8	3.5	4.5	4.0	4.2	4.4	4.8	4.7	4.9	5.1
Unit labor costs		2.5	5.4	3.5	3.6	2.9	3.1	4.1	3.6	4.0	4.3

* Not at an annual rate.

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1985*	FY1986e Admin. 1/	FY1986e FRB Staff	FY1987e Admin. 1/	FY1987e FRB Staff	CY 1985*	CY1986e FRB Staff	FRB staff estimates: Calendar quarters; not seasonally adjusted — 1985 IV*	1986 I	1986 II	1986 III	1986 IV	1987 I	1987 II	1987 III
Budget receipts[2]	734	777	777	850	834	745	784	177	180	227	193	184	194	249	207
Budget outlays[2]	946	980	978	994	1001	961	977	252	245	243	238	250	253	253	245
Surplus/deficit(-) to be financed[2]	-212	-203	-201	-144	-167	-216	-193	-75	-65	-15	-46	-67	-59	-3	-38
Means of financing deficit:															
Net borrowing from public	197	204	200	142	162	224	173	91	37	30	43	63	55	12	32
Decrease in cash operating balance	13	-3	-3	0	0	-13	16	-14	22	-11	1	5	0	-5	0
Other[3]	1	2	4	2	5	5	4	-2	6	-3	3	-1	4	-3	6
Cash operating balance, end of period	17	20	20	20	20	31	15	31	9	21	20	15	15	20	20
Memo: Sponsored agency borrowing[4]	20	n.a.	18	n.a.	23	20	17	6	3	4	5	5	6	6	6
NIPA Federal Sector								Seasonally adjusted annual rates							
Receipts	769	823	824	905	881	786	838	809	816	829	843	862	871	887	905
Expenditures	961	1016	1019	1044	1045	983	1021	1023	1023	1014	1016	1032	1044	1048	1054
Purchases	343	359	369	373	375	354	366	379	371	362	364	369	374	377	380
Defense	256	270	276	289	290	262	279	273	277	277	278	285	288	291	294
Nondefense	87	89	93	83	85	92	87	106	94	85	85	85	85	86	86
All other expenditures	618	657	650	671	670	629	655	645	652	653	652	663	670	671	675
Surplus/deficit(-)	-192	-193	-195	-139	-164	-197	-184	-214	-207	-185	-172	-171	-173	-161	-150
High employment surplus/deficit(-) evaluated at 6 percent unemployment	-155	n.a.	-163	n.a.	-139	-161	-154	-180	-175	-153	-143	-144	-147	-138	-129

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

1. Budget of the United States Government, Fiscal Year 1987 (February 1986).
2. Includes outlays formerly classified as off-budget (e.g. Federal Financing Bank and Strategic Petroleum Reserve) and social security receipts and outlays classified as off-budget under current law.
3. Checks issued less checks paid, accrued items and other transactions.

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

4. Sponsored agency borrowing includes net debt issuance by Federal Home Loan Banks, FHLMC (excluding participation certificates), FNMA (excluding mortgage-backed securities), Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, and Student Loan Marketing Association marketable debt on a payment basis. The Administration's definition of borrowing by these agencies is somewhat broader.

Recent developments. Interest rates are little changed on balance from levels at the time of the December FOMC meeting, despite sizable fluctuations in response to new economic information and to changing sentiment about the direction of System policy. The federal funds rate firmed around year-end, boosted by seasonal pressures, but more recently funds have traded in the vicinity of 7-3/4 percent or a little above. The spread of bank CD rates over bills edged higher over the intermeeting period as the Treasury, flush with cash, paid down bills and as investors became more concerned about bank loan portfolios in the face of renewed weakness in oil prices. At the long end of the market, corporate and Treasury bond rates late in the period returned to the reduced levels of late December, retracing earlier increases, while municipal rates fell appreciably with a sharp drop in tax-exempt volume. Mortgage rates also declined, in lagged response to the earlier rally in long-term markets.

M1 and M2 growth slowed markedly in January. M1 expansion weakened from the double-digit pace in the two previous months to about a 4 percent annual rate in January as demand deposits contracted while other checkable deposits rose at a 20 percent pace, their elevated rate of expansion over 1985. (All rates cited here are prior to benchmark and seasonal factor revisions; the revised data will appear in the Bluebook.) The slowdown in M2 occurred also in the nontransactions component of this aggregate. Overnight RPs at banks fell sharply as collateral availability was squeezed by a runoff of Treasury securities and continued high levels of the Treasury cash balance. Expansion in retail time and savings deposits remained sluggish.

M3 expanded in January at the moderate pace of the fourth quarter. With continued large credit demands pressing against diminished inflows of M2 funds, commercial banks issued a substantial amount of CDs. In contrast, issuance of CDs by FSLIC-insured thrifts dropped sharply in January from the heavy volume in late 1985 when these institutions boosted liabilities in order to raise expansion in 1986 under regulatory growth restraints.

Borrowing by domestic nonfinancial sectors has moderated from the surge in late 1985, largely reflecting lessened issuance of securities by federal, state, and local governments. Borrowing by state and local governments soared in late 1985 in an effort to beat tax reform restrictions that could significantly constrain advance refunding issues as well as private-purpose issues. Thus far in 1986, tax-exempt volume--both public and private purpose--has slowed to a relative trickle as issuers and investors are highly uncertain about the eventual tax status of offerings settled after the end of 1985. The surge in tax-exempt volume in late 1985 boosted federal government borrowing as the proceeds of many tax-exempt issues were placed in special nonmarketable Treasury securities. This, combined with an already heavy schedule of marketable borrowing, led to a jump in the Treasury's cash balance, which surpassed $40 billion in mid-January. In early 1986, net borrowing by the Treasury has moderated and has been concentrated in coupons.

In contrast, taxable borrowing by businesses and consumers early in the year appears to have continued strong. Consumer borrowing from commercial banks rose sharply in January and new automobile financing incentives likely added to auto installment borrowing from captive finance companies. In the mortgage area, the higher level of mortgage commitments outstanding at FSLIC-insured institutions at year-end and continued heavy mortgage pool activity in January point toward further strong mortgage borrowing, even though growth in real estate loans at commercial banks slackened somewhat in January; with rates on fixed-rate mortgages near their seven-year lows, borrowing again likely was weighted towards such loans. Surveys of consumer attitudes indicate that households remain willing to buy on credit despite heavy debt loads; delinquency rates in recent months have been rising on consumer credit and continue to be high on mortgage credit.

In the business sector, taxable bond offerings in January were nearly as large as the heavy December volume while funds raised through tax-exempt markets fell markedly. Short-term indebtedness of businesses was about unchanged as an increase in loans from banks was about offset by a paydown of commercial paper. Buoyant stock prices encouraged further sizable equity offerings by nonfinancial corporations. However, stock offerings again fell short of retirements associated with exceptional merger and restructuring activity which have continued to strengthen demands for debt. Underlying external financing needs, in contrast, appear to be minimal for nonfinancial corporations as capital expenditures seem to be sluggish while profits and cash flow remain strong.

Outlook. Accompanying moderate expansion of output through the spring, the staff anticipates that borrowing will continue to be strong but well below the elevated pace of the fourth quarter. Reduced borrowing likely will be most evident in the government sectors. The Treasury is expected to run a combined deficit of $65 billion in the current quarter but to tap the markets for $36 billion, drawing down its outsized cash balance for most of the remainder. In view of the likelihood of continued uncertainty about the status of tax reform and the treatment of tax-exempt securities, offerings of state and local governments are expected to remain light.

Business borrowing is likely to continue to be influenced greatly in the months ahead by demands for funds to retire shares as other external financing needs are expected to remain slim. The announcements of mergers, and restructuring and other indicators suggest activity in the near term around the exceptional pace of the past two years, although moderation could be in train later. Should long-term rates remain near their current reduced level or decline, businesses can be expected to favor longer-term borrowing to lengthen debt maturities.

Household mortgage borrowing likely will remain strong in light of favorable financing costs and further increases in residential housing activity. A large share of fixed-rate mortgage originations is likely to be sold into pools and the open market. Once auto financing incentives end, consumer loans are likely to slow with some moderation in purchases of consumer durables. Some change in lender attitudes reflecting the rise in delinquencies and concerns about debt servicing burdens might also act to damp lending to consumers.

In addition, the credit markets likely would be affected by new oil price developments and developments affecting the implementation of the Gramm-Rudman-Hollings deficit reduction law. A further drop in oil prices or the smooth implementation of Gramm-Rudman-Hollings could contribute to additional strength in long-term markets.

Recent developments. The weighted-average exchange value of the dollar has depreciated about 2-1/2 percent further since the last FOMC meeting, bringing its decline since the September 22 G-5 announcement to about 12-1/2 percent. Over the intermeeting period the dollar dropped sharply against the yen and the mark, while appreciating moderately against the Canadian dollar and sharply against sterling. The dollar's overall weakness may be attributable to various official statements or statements attributed to official sources, particularly after the January G-5 meeting, to the effect that a further moderate depreciation of the dollar would be acceptable or even welcome. Sterling's decline against all major currencies largely reflected the recent drop in oil prices, which also affected the currencies of other oil-exporting countries such as Norway, Mexico, and Venezuela.

. Monetary authorities in several countries -- the United Kingdom, Canada, Italy, and Belgium -- also acted to raise short-term interest rates to defend their currencies. In addition, Italy imposed exchange and credit controls to the same end. In contrast, the Bank of Japan took advantage of the strength of the yen in January to lower its discount rate from 5 to 4-1/2 percent.

Private foreign net purchases of U.S. securities were very large in October and November, totaling $13 billion for corporate and $5 billion for Treasury securities. For the first eleven months of 1985 private purchases of corporate and Treasury securities amounted to around $40 billion and $20 billion, respectively. There were also large net capital inflows through banks in October-November, bringing total net capital inflows through this channel to about $29 billion for the first eleven months of last year. Foreign official reserve assets held in the United States showed little net change through November of 1985, as a $7 billion decline in OPEC holdings was nearly matched by increased holdings of other countries

. U.S. official reserve assets increased by about $4 billion, reflecting mainly U.S. intervention to sustain a lower exchange value of the dollar after the September G-5 announcement.

In the fourth quarter of 1985, the merchandise trade deficit increased from the third-quarter rate and brought the deficit for the year as a whole to a record level. The staff estimates that on a revised international transactions basis the fourth-quarter deficit was $145 billion, SAAR, and for 1985 the deficit was about $120 billion. The increase in the deficit, in the fourth quarter and for the year, occurred as imports rose and exports were little changed. Much of the strength in imports in the fourth quarter was in consumer goods and automotive products; there were also increases in imports of capital goods and oil.

Since the last Greenbook, spot prices for crude oil and petroleum products have dropped sharply, by about $10 per barrel. The sharp drop was precipitated by increased production by OPEC members to a rate that is about 2 million barrels per day above their average rate in 1985.

Economic growth in major foreign industrial countries continued at a moderate pace. While growth in Japan has declined from that recorded in 1984, prompting the cut in the Bank of Japan's discount rate, economic activity in Germany and Canada appears to be strong. Industrial production in France and Italy increased in recent months, but remains fairly weak. Growth appears to have resumed in the fourth quarter in the United Kingdom. Inflation abroad remains generally moderate; Germany and Japan are recording consumer price inflation rates in the neighborhood of 2 percent or less.

Among major debtor developing countries several oil exporters, notably Mexico, Venezuela, and Nigeria, are being severely affected by the continuing decline in oil prices. Argentina, largely self-sufficient in oil, should be little affected, while Brazil will obtain some benefits from lower oil prices. The Mexican government has proposed a more austere budget for 1986 to attempt to improve Mexico's inflation and current-account performance, but both the budget deficit and the current account deficit will likely deteriorate with a further drop in oil revenues.

Outlook. The staff projects a continuing decline in the dollar, at a moderate pace over the remainder of 1986 and 1987. As the result of lower oil prices, real growth in major foreign industrial countries is now expected to be moderately higher than previously forecast, while inflation will be commensurately lower. Growth in developing countries is expected to be little affected, on balance, given the importance of oil exports for several countries. With U.S. growth now projected to be stronger in 1986, the U.S. current account deficit is expected to be somewhat larger than was last forecast, nearly $140 billion in 1986 vs. $120 billion in 1985. For 1987, the staff expects that the size of the current account deficit will begin to be reduced, largely because of the lagged effects of the dollar's depreciation. This forecast incorporates the assumption of U.S. oil import prices stabilizing at about $20 per barrel, some $6 below the average price recorded in 1985Q4.

STRICTLY CONFIDENTIAL (FR)
CLASS II FOMC

FEBRUARY 4, 1986

OUTLOOK FOR U.S. NET EXPORTS AND RELATED ITEMS
(BILLIONS OF DOLLARS, SEASONALLY ADJUSTED ANNUAL RATES)

	ANNUAL			1985		1986				1987			
	1985	1986-P	1987-P	Q3	Q4	Q1-P	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP EXPORTS AND IMPORTS 1/													
CURRENT $, NET	-74.4	-89.5	-73.9	-87.8	-97.2	-92.3	-91.8	-88.0	-85.8	-82.9	-76.2	-69.8	-66.4
EXPORTS OF G+S	370.4	391.9	448.7	363.2	369.7	377.8	385.4	395.7	408.7	424.3	440.6	457.9	472.1
IMPORTS OF G+S	444.8	481.4	522.6	451.0	466.9	470.1	477.2	483.7	494.6	507.2	516.8	527.8	538.5
CONSTANT 82 $, NET	-105.1	-118.9	-89.1	-119.8	-127.6	-121.9	-125.4	-118.4	-109.8	-102.6	-91.8	-83.1	-78.7
EXPORTS OF G+S	360.2	373.5	412.3	353.5	360.4	364.8	368.4	375.5	385.3	396.0	407.3	418.8	427.1
IMPORTS OF G+S	465.3	492.4	501.4	473.3	488.0	486.7	493.7	493.9	495.1	498.6	499.1	501.9	505.9
2. U.S. MERCHANDISE TRADE BALANCE 2/	-121.6 P	-139.5	-125.7	-132.6	-145.8 P	-142.4	-141.4	-137.6	-136.4	-133.0	-127.2	-122.6	-120.0
EXPORTS	214.8 P	228.5	272.6	209.2	214.2 P	217.2	223.3	231.6	241.7	254.3	267.2	279.2	289.9
AGRICULTURAL	29.1 P	27.5	28.5	26.1	29.1 P	28.3	27.4	27.2	27.0	27.7	28.2	28.8	29.4
NONAGRICULTURAL	185.7 P	201.0	244.1	183.2	185.1 P	189.0	195.8	204.5	214.7	226.6	238.9	250.4	260.5
IMPORTS	336.4 P	367.9	398.3	341.8	360.0 P	359.6	364.7	369.3	378.0	387.3	394.4	401.8	409.9
PETROLEUM AND PRODUCTS	49.6 P	41.5	40.3	50.2	54.1 P	45.8	42.1	38.9	39.0	39.8	39.7	40.1	41.7
NONPETROLEUM	286.8 P	326.4	358.0	291.6	305.9 P	313.8	322.5	330.4	339.0	347.5	354.7	361.7	368.2
3. U.S. CURRENT ACCOUNT BALANCE	-118.7 P	-137.9	-124.3	-121.8	-145.3 P	-140.1	-139.6	-135.8	-136.1	-133.2	-126.6	-120.3	-117.1
OF WHICH: NET INVESTMENT INCOME	20.4 P	16.3	14.1	30.2	19.7 P	18.4	17.3	15.0	14.3	13.3	13.5	14.7	14.9
4. FOREIGN OUTLOOK 3/													
REAL GNP--TEN INDUSTRIAL 4/	2.7 P	3.3	3.0	3.6	3.2 P	3.4	3.0	3.0	3.0	3.0	2.9	3.1	3.1
REAL GNP--NONOPEC LDC 5/	3.7 P	3.7	4.2	3.4	3.6 P	3.8	3.9	3.9	3.9	4.0	4.3	4.6	5.0
CONSUMER PRICES--TEN IND. 4/	4.3 P	3.1	3.1	1.4	3.2 P	3.1	3.7	2.9	3.0	3.0	3.5	3.0	3.1

1/ ECONOMIC ACTIVITY AND PRODUCT ACCOUNT DATA.
2/ INTERNATIONAL ACCOUNTS BASIS.
3/ PERCENT CHANGE, ANNUAL RATES.
4/ WEIGHTED BY MULTILATERAL TRADE-WEIGHTS OF G-10 COUNTRIES PLUS SWITZERLAND; PRICES ARE NOT SEASONALLY ADJUSTED.
5/ WEIGHTED BY SHARE IN NONOPEC LDC GNP.
P/ PROJECTED