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Strictly Confidential (FR) Class II FOMC

July 2, 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 has been growing at a relatively slow pace recently, with continuing signs of imbalances. Consumer spending and housing activity have been strong, supported by large gains in real income and lower interest rates. But business investment has remained sluggish, and the trade balance has continued to deteriorate. Price indexes turned up in May, as the price of gasoline has stabilized.

The index of industrial production declined 0.6 percent in May, more than offsetting the 0.4 percent rise in April. Part of the decrease in output in May was attributable to a further plunge in oil and gas drilling and a reduction in motor vehicle assembly rates. But output elsewhere also was lower, falling in May to a level 1-1/4 percent below its January peak. Declines in recent months have been widespread, with notable weakness in the production of business equipment and selected materials for durable goods.

The sluggishness in the industrial sector also has been reflected in declines in employment in manufacturing and mining, which, taken together, have totalled 200,000 since January. In contrast, employment in services and trade continued to rise briskly in May, and hiring at construction sites was stimulated by the high level of homebuilding. The civilian unemployment rate edged up to 7.3 percent in May, the upper end of the range that has prevailed over the past year.

Consumer spending rose sharply in the second quarter, with sizable gains for a broad range of goods and services. Outlays for discretionary merchandise, such as furniture, other household durables and apparel, were especially strong. In addition, domestic auto sales, which had dipped earlier in the spring, have held at around an 8-1/4 million unit rate since the enhancement of incentive financing programs in late April. Consumer spending recently has been supported by strong real income gains--attributable in large part to the plunge in energy prices—and by the substantial improvement in household wealth over the past year. In addition, consumers' evaluations of buying conditions are extremely positive, based evidently on perceptions of favorable interest rates and prices.

Housing activity generally has been brisk, with starts falling just a little in May, to a 1.9 million unit annual rate. Single-family starts have been near their highest level since the late 1970s, and the pace of house sales, although down in May, has remained relatively robust. Home prices, meanwhile, have risen sharply in response to the increased demand. Multifamily starts dropped in May from the unsustainable pace earlier in the year; vacancy rates are the highest in nearly two decades, and the previous strength in activity probably reflected the heavy issuance of tax-exempt mortgage revenue bonds in late 1985.

Business investment apparently has continued to be damped by the availability of unutilized capacity, uncertain sales prospects, and concerns about tax reform. Shipments of nondefense capital goods in May were only 1 percent above the very depressed first-quarter level. In the construction area, drilling activity has fallen sharply further, and spending for office and other commercial projects also has weakened. Advance indicators of investment spending also have been on the soft side. New orders for nondefense capital goods have stayed on a plateau and commitments for construction appear to have turned down. Moreover, the latest surveys indicate that businesses are planning little, if any, increase in nominal spending for 1986 as a whole; firms in the petroleum and mining industries have slashed budgets by roughly a fourth, while anticipated spending increases in other industries, on balance, are small.

Inventory investment appears to have continued in the second quarter at about the first-quarter pace. Stocks at auto dealers have been reduced a bit in recent months, after a sizable runup in the first quarter. In contrast, limited available information suggests that stocks at nonauto trade establishments, which already were relatively plentiful, have expanded somewhat more rapidly. Manufacturers, who are still facing sluggish demand, have continued to exhibit cautious inventory behavior.

Consumer prices rose 0.2 percent in May, after being pulled down during the preceding three months by steep declines in energy prices. Retail gasoline prices rose 2-1/2 percent in May, after falling around 25 percent between January and April, and apparently were little changed in June. Excluding food and energy, the CPI has risen at about a 3-1/2 percent annual rate this year, somewhat less than in 1985; prices of goods have been essentially flat, while there have been large increases for some types of services, especially rent and insurance. Higher prices for imports contributed particularly to the sizable rise in new car prices in May.

Outlook. The staff now estimates that real GNP grew at around a 1-1/2 percent annual rate in the second quarter and that the GNP fixed-weighted price index increased at about a 2 percent rate. As noted above, consumer spending and residential construction posted large gains. However, overall activity was held down by sharp cuts in auto production (on BEA seasonals) and in drilling activity, as well as by the lackluster performance of other types of capital spending. In addition, it is estimated that the merchandise trade balance continued to deteriorate in the second quarter; based on partial information, exports are estimated to have been essentially unchanged while imports posted a further sizable rise, in part because of a higher volume of petroleum imports.

Looking ahead, the policy assumptions underlying the projection have been changed somewhat, especially on the fiscal side. The estimated deficit for fiscal year 1986 has been raised to $215 billion, to reflect cost overruns in farm and defense spending as well as a shortfall in receipts associated with lagging income growth. The projection assumes that a tax reform plan will be passed later this year. The plan would be expected to raise revenues, all else equal, by around $15 billion in fiscal year 1987, because of higher business taxes. However, this revenue effect is expected to be partly offset by smaller outlay cuts than were specified in previous projections. Altogether, the staff is assuming that the savings from deficit-reducing actions and added revenues from tax reform will total $45 billion, implying a little more fiscal restraint than was assumed in the last Greenbook. The deficit for fiscal year 1987 is projected at $170 billion.

For monetary policy, growth in M2 and M3 in 1986 is expected to be well within the Committee's ranges, and to be at similar rates in 1987. Interest rates are not anticipated to change substantially over the projection horizon.

The staff continues to expect that the pace of economic activity will pick up, beginning in the second half. The acceleration in output has been scaled back, however, owing largely to disappointing news on business investment and foreign trade. Real GNP now is expected to rise at around a 3-1/4 percent annual rate, on average, over the forecast period, a percentage point more than in the first half.

A turnaround in net exports continues to be a key element in the projected strengthening in overall activity. With the foreign exchange value of the dollar roughly 30 percent below its early-1985 peak and expected to decline moderately further, exports are anticipated to rise briskly. Meanwhile, import demand is projected to be damped by increases in prices for foreign goods in the U.S.; import prices turned up early this year and are expected to rise appreciably in coming quarters.

Prospects for domestic demand are mixed. Consumer spending is expected to be relatively well-maintained for the next few quarters, as the substantial improvement in household asset values over the past year provides some offset to the effects of slower income growth and high debt burdens. Business investment, however, is expected to be essentially flat in the second half and to rise only a little in 1987. High vacancy rates will continue to constrain construction spending while gains in outlays for producers' durable equipment next year are likely to be damped by the elimination of the investment tax credit. For housing, single-family activity is expected to remain relatively robust through 1987, although multifamily starts will be hit hard by the combination of high vacancy rates and tax changes.

Inflation is expected to pick up a bit over the next six quarters. The effects of energy price declines, which accounted for much of the slowing in inflation in the first half, are likely to fade in coming quarters. In contrast, the impetus to inflation from rising prices for nonpetroleum imports and their domestic substitutes is expected to intensify over the projection horizon. And with the civilian unemployment rate expected to approach 6-1/2 percent by the end of 1987, some upward pressure on wages is likely to emerge. Reflecting these influences, the GNP fixed-weighted price index, after rising around 2-1/2 percent in 1986, is projected to rise about 3-1/2 percent in 1987.

July 2, 1986

STAFF GNP PROJECTIONS

Percent changes, annual rate

		Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
		5/14/86	7/2/86	5/14/86	7/2/86	5/14/86	7/2/86	5/14/86	7/2/86	5/14/86	7/2/86
Annual changes:											
1984	<1>	11.0	11.0	6.5	6.5	4.3	4.3	4.1	4.1	7.5	7.5
1985	<1>	5.7	5.7	2.2	2.2	3.6	3.6	3.3	3.3	7.2	7.2
1986		5.3	4.9	2.6	2.2	2.7	2.8	2.7	2.7	6.9	7.1
1987		6.8	5.9	3.6	3.1	3.3	3.0	3.1	2.7	6.3	6.7
Quarterly changes:											
1985	Q1 <1>	6.9	6.9	3.7	3.7	3.5	3.5	3.0	3.0	7.3	7.3
	Q2 <1>	4.5	4.5	1.1	1.1	3.6	3.6	3.3	3.3	7.3	7.3
	Q3 <1>	5.8	5.8	3.0	3.0	2.7	2.7	2.9	2.9	7.2	7.2
	Q4 <1>	4.3	4.3	.7	.7	3.9	3.9	3.3	3.3	7.0	7.0
1986	Q1 <1>	5.8	5.7	3.2	2.9	2.2	2.5	2.5	2.9	7.1	7.1
	Q2	4.1	4.0	2.1	1.5	2.2	2.0	2.1	2.4	7.1	7.2
	Q3	6.7	4.8	4.4	2.7	2.6	2.3	2.2	2.0	6.9	7.1
	Q4	7.4	6.0	4.4	3.7	3.2	2.7	2.8	2.2	6.7	6.9
1987	Q1	7.1	6.3	3.6	3.4	3.5	3.3	3.3	2.9	6.5	6.8
	Q2	6.7	6.3	3.3	3.2	3.7	3.3	3.3	3.0	6.4	6.7
	Q3	6.9	6.3	3.2	3.0	3.8	3.4	3.6	3.2	6.3	6.6
	Q4	7.2	6.6	3.1	3.0	4.1	3.7	3.9	3.5	6.2	6.6
Two-quarter changes: <2>											
1985	Q2 <1>	5.7	5.7	2.4	2.4	3.5	3.5	3.1	3.1	.1	.1
	Q4 <1>	5.0	5.0	1.9	1.9	3.4	3.4	3.1	3.1	-.3	-.3
1986	Q2	4.9	4.8	2.7	2.2	2.1	2.3	2.3	2.6	.1	.2
	Q4	7.0	5.4	4.4	3.2	2.9	2.5	2.5	2.1	-.4	-.3
1987	Q2	6.9	6.3	3.5	3.3	3.6	3.3	3.3	2.9	-.3	-.2
	Q4	7.0	6.4	3.2	3.0	3.9	3.5	3.8	3.3	-.2	-.1
Four-quarter changes: <3>											
1984	Q4 <1>	9.0	9.0	4.7	4.7	4.2	4.2	4.1	4.1	-1.3	-1.3
1985	Q4 <1>	5.4	5.4	2.1	2.1	3.5	3.5	3.1	3.1	-.2	-.2
1986	Q4	6.0	5.1	3.5	2.7	2.5	2.4	2.4	2.4	-.3	-.1
1987	Q4	7.0	6.4	3.3	3.2	3.8	3.4	3.5	3.1	-.5	-.2

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

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

		1985		1986				1987			
					Projection						
	Units	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Expenditures											
Nominal GNP	Billions of $	4016.9	4059.3	4115.7	4155.9	4204.6	4266.2	4332.0	4398.7	4466.4	4538.2
Real GNP	Billions of 82$	3584.1	3590.8	3616.9	3630.1	3654.5	3687.7	3718.3	3748.1	3776.0	3804.1
Real GNP	Percent change	3.0	.7	2.9	1.5	2.7	3.7	3.4	3.2	3.0	3.0
Gross domestic purchases		5.0	3.0	2.5	3.1	1.3	2.1	2.0	2.0	1.9	2.0
Final sales		5.0	1.3	-1.7	2.0	3.5	3.9	3.3	3.0	2.9	2.9
Private dom. final purchases		4.5	2.2	1.2	4.2	2.4	2.7	2.3	2.0	1.8	2.0
Personal consumption expend.		4.6	.1	3.8	6.0	2.5	2.7	2.5	2.2	1.8	1.7
Durables		24.3	-13.3	-.7	14.5	4.0	2.4	2.7	3.6	1.8	2.8
Nondurables		1.5	.6	6.6	6.2	1.6	2.2	2.1	1.9	1.9	1.4
Services		1.4	4.4	3.1	3.3	2.7	3.2	2.6	1.9	1.8	1.6
Business fixed investment		2.4	11.3	-13.3	-7.1	-1.9	1.1	2.5	2.5	2.3	2.5
Producers' durable equipment		3.0	13.5	-12.1	4.8	-1.0	2.0	4.0	4.0	4.0	4.0
Nonresidential structures		1.2	7.2	-15.4	-27.0	-3.7	-.8	-.5	-.7	-1.2	-.8
Residential structures		8.5	5.7	9.7	11.6	12.6	6.2	.3	-1.3	.7	3.7
Exports		-5.1	6.6	6.6	.2	10.1	12.7	11.7	12.0	13.3	12.5
Imports		12.8	24.5	2.4	13.2	-2.2	-1.6	-.8	.9	2.4	2.8
Government purchases		18.2	9.2	-13.8	1.6	.5	.8	.4	.8	1.3	1.4
Federal		37.3	23.4	-30.1	.8	.4	1.0	-.6	.1	-.1	-.4
Defense		22.0	-3.2	-5.4	4.6	4.2	2.2	.3	.7	.7	.2
State and local		4.7	-1.6	2.8	2.3	.7	.7	1.3	1.4	2.5	2.8
Change in business inventories	Billions of 82$	-1.8	-6.3	35.3	30.5	24.0	22.0	22.3	24.8	26.3	27.8
Nonfarm	Billions of 82$	1.6	18.2	36.2	31.5	25.5	23.5	23.0	25.5	27.0	28.5
Net exports	Billions of 82$	-119.8	-140.8	-138.1	-153.7	-142.0	-128.5	-116.7	-106.5	-96.5	-87.6
Nominal GNP	Percent change	5.8	4.3	5.7	4.0	4.8	6.0	6.3	6.3	6.3	6.6
Employment and Production											
Nonfarm payroll employment	Millions	97.9	98.7	99.4	99.9	100.4	101.1	101.7	102.3	102.9	103.4
Unemployment rate	Percent*	7.2	7.0	7.1	7.2	7.1	6.9	6.8	6.7	6.6	6.6
Industrial production index	Percent change	2.0	1.9	.7	-4.1	.0	3.6	3.5	3.4	2.9	3.0
Capacity utilization rate-mfg.	Percent*	80.3	80.0	79.8	78.8	78.5	78.7	78.9	79.1	79.2	79.3
Housing Starts	Millions	1.69	1.77	2.00	1.93	1.80	1.75	1.70	1.70	1.72	1.75
Auto sales	Millions	12.31	10.24	10.65	11.15	11.19	10.60	10.80	10.90	10.90	10.90
Domestic	Millions	9.40	6.84	7.84	8.05	8.09	7.50	7.80	7.80	7.80	7.80
Foreign	Millions	2.90	3.40	2.81	3.10	3.10	3.10	3.00	3.10	3.10	3.10
Nominal personal income	Percent change	2.3	6.9	5.3	5.3	4.9	6.7	6.2	6.6	6.8	6.8
Real disposable income	Percent change	-4.5	2.3	5.5	5.7	1.6	2.8	2.8	2.0	2.1	2.0
Personal saving rate	Percent*	3.7	4.0	4.4	4.2	4.0	4.0	4.0	4.0	4.0	4.0
Corp. profits with IVA & CCAdj	Percent change	32.5	-7.5	14.7	18.3	-8.4	4.1	-2.4	-.7	1.1	3.9
Profit share of GNP	Percent*	7.7	7.5	7.6	7.9	7.6	7.6	7.4	7.3	7.2	7.2
Federal govt. surplus/deficit	Billions of $	-201.3	-226.9	-208.8	-221.6	-186.7	-190.0	-174.7	-163.6	-155.9	-146.3
State and local govt. surplus		56.9	58.8	64.5	60.2	54.3	57.6	60.7	62.7	63.7	64.3
Prices and costs											
GNP implicit deflator	Percent change	2.9	3.3	2.9	2.4	2.0	2.2	2.9	3.0	3.2	3.5
GNP fixed-weight price index		2.7	3.9	2.5	2.0	2.3	2.7	3.3	3.3	3.4	3.7
Cons. & fixed invest. prices		2.4	4.4	1.2	.6	2.9	3.2	3.5	3.8	3.8	3.8
CPI		2.6	4.3	1.5	-2.0	2.7	3.5	3.7	3.8	4.0	4.1
Exc. food and energy		3.5	4.9	4.2	3.5	3.8	4.2	4.3	4.4	4.6	4.7
Nonfarm business sector											
Output per hour		.4	-4.1	3.6	1.2	.9	1.6	.9	.8	.6	.9
Compensation per hour		2.8	3.2	2.2	2.9	3.0	3.3	3.7	3.5	3.7	3.9
Unit labor costs		2.4	7.6	-1.4	1.7	2.1	1.7	2.8	2.7	3.1	3.0

* Not at an annual rate.

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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	3988.5	4185.6	4[illegible]33.8
Real GNP	Billions of 82$	3192.4	3187.1	3248.8	3166.0	3277.7	3492.0	3570.0	3647.3	3761.6
Real GNP	Percent change*	.6	-.1	.6	-1.9	6.3	4.7	2.1	2.7	3.2
Gross domestic purchases		-.4	-1.1	.8	-.8	8.2	6.2	3.2	2.3	2.0
Final sales		2.2	-.2	.1	.3	3.6	4.3	3.4	1.9	3.0
Private dom. final purchases		1.3	-1.7	-.3	.8	7.6	5.3	3.7	2.6	2.0
Personal consumption expend.		1.4	-.1	.2	2.9	5.3	3.4	3.0	3.7	2.0
Durables		-3.8	-5.6	-3.3	9.0	14.5	9.2	5.8	4.9	2.7
Nondurables		.8	-1.4	.5	1.8	4.3	2.0	2.7	4.1	1.8
Services		3.5	2.4	.9	2.3	3.7	2.8	2.4	3.1	2.0
Business fixed investment		5.0	-4.8	5.6	-11.3	11.5	16.5	6.3	-5.5	2.5
Producers' durable equipment		1.6	-6.5	2.2	-12.5	20.3	17.2	5.3	-1.8	4.0
Nonresidential structures		12.0	-1.8	11.7	-9.1	-2.1	15.2	8.1	-12.3	-.8
Residential structures		-7.2	-14.2	-22.4	4.9	38.5	3.5	5.7	10.0	.8
Exports		13.7	.5	2.4	-13.8	6.9	5.1	-4.8	7.3	12.4
Imports		3.4	-8.8	4.9	-5.9	25.8	17.0	4.7	2.8	1.3
Government purchases		.1	1.0	2.9	3.8	-2.7	8.1	7.4	-2.9	1.0
Federal		-.3	3.1	9.5	8.2	-7.5	14.7	13.6	-8.1	-.3
Defense		3.3	3.1	7.6	8.8	5.2	7.6	5.9	1.3	.4
State and local		.4	-.3	-1.3	.6	1.0	3.3	2.6	1.6	2.0
Change in business inventories	Billions of 82$	15.0	-6.9	23.9	-24.5	-5.5	62.7	5.7	28.0	25.3
Nonfarm	Billions of 82$	10.4	-2.3	19.0	-23.1	.4	55.9	10.6	29.2	26.0
Net exports	Billions of 82$	3.6	57.0	49.4	26.3	-19.4	-85.0	-108.4	-140.6	-101.8
Nominal GNP	Percent change*	9.5	9.9	9.3	3.1	10.0	9.0	5.4	5.1	6.4
Employment and Production										
Nonfarm payroll employment	Millions	89.8	90.4	91.2	89.6	90.2	94.5	97.6	100.2	102.6
Unemployment rate	Percent	5.8	7.1	7.6	9.7	9.6	7.5	7.2	7.1	6.7
Industrial production index	Percent change*	.9	-.8	-1.0	-7.7	14.3	7.2	1.8	.0	3.2
Capacity utilization rate-mfg.	Percent	84.6	79.2	78.3	70.3	74.0	80.8	80.3	79.0	79.1
Housing Starts	Millions	1.72	1.30	1.10	1.06	1.71	1.76	1.74	1.87	1.72
Auto sales	Millions	10.68	9.04	8.56	8.00	9.18	10.43	11.09	10.90	10.88
Domestic	Millions	8.36	6.62	6.24	5.77	6.77	7.97	8.24	7.87	7.80
Foreign	Millions	2.32	2.42	2.32	2.23	2.41	2.46	2.84	3.03	3.08
Income and saving										
Nominal personal income	Percent change*	11.4	12.0	9.2	5.3	7.5	8.6	5.3	5.5	6.6
Real disposable income	Percent change*	.5	1.1	.7	1.0	5.1	3.9	1.3	3.9	2.2
Personal saving rate	Percent	6.8	7.1	7.5	6.8	5.5	6.5	4.6	4.2	4.0
Corp. profits with IVA & CCAdj	Percent change*	-10.7	-6.8	2.3	-19.1	69.5	11.6	9.7	6.7	.4
Profit share of GNP	Percent	8.0	6.5	6.2	4.7	6.3	7.2	7.4	7.7	7.3
Federal govt. surplus/deficit	Billions of $	-16.1	-61.3	-63.8	-145.9	-179.4	-172.9	-200.0	-201.8	-160.1
State and local govt. surplus		27.6	26.8	34.1	35.1	48.6	64.4	59.0	59.1	62.8
Prices and costs										
GNP implicit deflator	Percent change*	8.9	9.9	8.7	5.2	3.5	4.1	3.1	2.4	3.1
GNP fixed-weight price index		8.8	9.8	8.5	5.0	3.8	4.2	3.5	2.4	3.4
Cons. & fixed invest. prices		9.5	10.1	8.2	4.4	3.1	3.9	3.2	2.0	3.7
CPI		12.7	12.5	9.6	4.5	3.3	4.1	3.5	1.4	3.9
Exc. food and energy		10.7	12.2	10.2	5.2	4.3	4.8	4.3	4.0	4.5
Nonfarm business sector										
Output per hour		-2.7	1.0	-.6	1.0	3.3	.8	-.6	1.8	.8
Compensation per hour		9.7	10.9	8.3	7.2	3.6	3.8	3.7	2.9	3.7
Unit labor costs		12.7	9.7	9.0	6.2	.3	3.0	4.3	1.0	2.9

* Percent changes are from fourth quarter to fourth quarter.

July 2, 1986

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	768	850	833	745	781	177	180	217	195	190	196	236	211
Budget outlays[2]	946	980	984	994	1003	961	984	252	241	242	248	253	253	251	246
Surplus/deficit(-) to be financed[2]	-212	-203	-215	-144	-170	-216	-203	-75	-61	-25	-54	-63	-58	-14	-35
Means of financing deficit:															
Net borrowing from public	197	204	231	142	165	224	191	91	37	51	53	50	50	23	42
Decrease in cash operating balance	12	-3	-13	0	0	-13	16	-14	19	-12	-5	15	0	-5	-10
Other[3]	1	2	-3	2	5	5	-3	-2	5	-13	6	-2	8	-4	3
Cash operating balance, end of period	17	20	30	20	30	31	15	31	12	25	30	15	15	20	30
Memo: Sponsored agency borrowing[4]	20	n.a.	14	n.a.	21	20	13	5	-2	6	5	4	5	6	6
NIPA Federal Sector								Seasonally adjusted annual rates							
Receipts	769	823	811	905	873	785	822	804	804	805	831	850	864	880	896
Expenditures	961	1016	1022	1044	1044	985	1024	1030	1013	1026	1018	1040	1039	1043	1052
Purchases	343	359	368	373	376	355	364	385	357	363	366	371	375	378	381
Defense	256	270	274	289	290	262	277	272	268	275	280	286	289	292	294
Nondefense	87	89	94	83	86	94	87	113	89	88	86	86	86	86	87
All other expenditures	618	657	654	671	668	629	660	645	656	663	652	669	664	665	671
Surplus/deficit(-)	-192	-193	-211	-139	-171	-199	-202	-227	-209	-222	-187	-190	-175	-164	-156
High employment surplus/deficit(-) evaluated at 6 percent unemployment	-153	n.a.	-168	n.a.	-135	-161	-159	-185	-168	-177	-142	-150	-137	-129	-124

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

1. Budget of the United States Government, Fiscal Year 1987 (February 1986). The Congressional Budget Office baseline estimates published in February indicated receipts of $778 billion and $844 billion, outlays of $986 billion and $1025 billion, and deficits of $208 and $181 billion in FY1986 and FY1987 respectively.
2. Includes outlays formerly classified as off-budget (e.g. Federal Financing Bank and Strategic Petroleum Reserve) and social security receipts and outlays classified as off-budget under current law.
3. Checks issued less checks paid, accrued items and other transactions.
4. Sponsored agency borrowing includes net debt issuance by Federal Home Loan Banks, 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.

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

Recent developments. Interest rates continued to rise early in the intermeeting period as economic data were fairly strong, money growth was rapid, and market observers found near-term moves to ease monetary policy unlikely. Later in the period, however, indications of continued sluggishness in real economic activity here and abroad began to accumulate and altered market sentiment. By the end of the period, most short-term interest rates had declined, on balance, by 10 to 30 basis points, while intermediate-term Treasury rates had fallen by about 50 basis points. The federal funds rate, however, was little changed.

Although longer-term markets also rallied in June, changes in yields for the longest-term capital market instruments were mixed over the the intermeeting period. Yields on the more recently auctioned 30-year Treasury bonds declined a bit less than 40 basis points, as the unusually large (negative) spread between yields on this and on somewhat shorter maturities unwound a bit. Nevertheless, yields on the newer 30-year issues remain unusually low relative to seasoned long-term issues. Meanwhile, private security yields have been held up by strong supplies and, apparently, by investor wariness of call and prepayment features, the implications of of tax reform, and near-term rate volatility generally. Thus, corporate and municipal yields remain 6 to 14 basis points above their levels at the time of the May meeting and yields on fixed-rate home mortgages, which have continued to lag other rates, are about 50 basis points higher.

Although recent declines in short-term interest rates have been relatively small, a lagged response to the strong downtrend in interest rates through April appears to be a major factor in the persistently strong growth of M1 and the most liquid components of M2. M1 growth tapered off only to about 15 percent in June from the near record 23-1/4 percent pace in May, leaving it substantially above its annual growth band. M1 velocity dropped precipitously in the second quarter. Growth of demand deposits, which remained at double-digit rates throughout the quarter, was boosted by a surge in business accounts, mainly in response to rising compensating balance requirements, according to bank officers contacted informally by Board staff in mid-June. OCD growth in June remained brisk, although off a bit from the advanced 30 percent April-May pace.

In contrast to M1, M2 and M3 remain near the midpoints of their annual target ranges. However, M2 growth in May was close to 12 percent, before moderating somewhat in June. Among the nontransactions components of M2, growth was concentrated largely in the more liquid retail accounts; small time deposits ran off in both May and June as their yields became relatively less favorable. M3 growth, on the other hand, appears to have remained subdued throughout the May-June period, as moderate credit demands and ample core deposit growth at banks reduced their need for managed liabilities, while thrifts turned increasingly to advances and other borrowings to finance growth in mortgage assets.

The rate of increase in the debt of domestic nonfinancial sectors, in the aggregate, picked up over the second quarter. Treasury borrowing rebounded to about $50 billion in the March-June period (not seasonally adjusted) while its cash balance increased sharply. Treasury debt growth was augmented by issuance of almost $10 billion of special state and local government securities (SLGS) to governments temporarily investing the proceeds of their own borrowing. Municipal borrowing picked up sharply from the depressed first-quarter pace as the pall cast by impending tax reform was lifted by the agreement that provisions pertaining to public purpose tax-exempt issuance would not be retroactive. Issuance of general obligation bonds, in particular, was accelerated, in some instances to finance projects whose tax-exempt status would subsequently be in question or subject to quantitative restrictions.

Owing to sluggish investment and only a moderate rise in the financing gap, net borrowing needs of nonfinancial firms did not grow rapidly in the second quarter. Gross bond issuance was robust, boosted by the incentive of lower interest rates to refinance higher coupon debt and to repay debt of shorter maturity. Short-term credit demands, however, were slack over most of the period, although commercial paper issuance strengthened in June. Gross equity issuance picked up in response to rising stock market prices; however, mergers and restructurings also remained strong, although below the pace of the past two years.

In the household sector, mortgage market activity continued to be spurred by refinancing. Mortgage loan originations at thrifts reached a near record level in May and new issues of mortgage pass-through securities have been flooding the market, despite processing bottlenecks that had slowed the origination of new mortgage loans in the first quarter. Thus, with vigorous residential construction and home sales, the pace of net residential mortgage lending likely picked up considerably from the 8 percent first-quarter pace. Borrowing on consumer installment credit appears to have been spurred in April and May by some strengthening of auto credit but, in contrast with mortgage lending, the total remained well below the first-quarter pace. Indeed, installment credit growth for the second quarter likely will be at the slowest rate in three years.

Outlook. Although nominal income growth is expected to pick up moderately over the balance of 1986, growth in aggregate credit demands is not expected to change much from the second-quarter pace. Borrowing by the federal government, after rebounding in the current quarter, is likely to slow, although program cost overruns and a shortfall of receipts have boosted estimates of the federal deficit for the current fiscal year. The deficit may decline in the fall, as the new fiscal year begins. Borrowing by the state and local sector should be up a bit, on net, in the current quarter but will be subject to conflicting forces after the new tax law is in place, barring a marked decline in interest rates that would spur refinancing again. With little acceleration expected in business investment and residential construction, corporate and household sector credit growth should taper off somewhat.

Nonfinancial business financing needs likely will be boosted later this year by some widening in the financing gap. Gross internal funds of domestic corporations probably will be eroded by tax reform, owing to the proposed repeal of the investment tax credit in 1986. Nevertheless, the financing gap should still be small by historical standards. With some deceleration in net equity retirements, the staff expects moderation in the growth of total nonfinancial corporate debt. Borrowing is likely to remain fairly heavily concentrated in the bond market as firms continue to take advantage of reduced interest rates to restructure their debt.

In the household sector, home mortgage credit growth over the balance of the year likely will remain above the restrained first-quarter pace, buoyed by the higher levels of housing starts and residential construction already in evidence. Although the details of tax reform provisions bearing on household finance remain uncertain, the possibility of limitations on the tax deductibility of consumer interest also may begin to tip household financing toward the use of mortgage debt. Meanwhile, a moderating tendency in consumer credit growth appears in train.

Recent developments. The weighted-average foreign exchange value of the dollar has declined 2-1/4 percent on balance since the last FOMC meeting. In the first two weeks of the intermeeting period the dollar appreciated somewhat in response to data indicating a possible strengthening of U.S. economic activity. The rise in the value of the dollar was subsequently reversed when additional data on U.S. economic performance disappointed market expectations and Japanese and German authorities indicated continued reluctance to ease monetary policy in the near term.

The differential between U.S. and the weighted-average of foreign short-term interest rates remained little changed over the intermeeting period. U.S. rates did decline relative to comparable Japanese and German rates. However, official lending rates were again reduced by several foreign countries with relatively high interest rates, including the United Kingdom, Italy, and France.

Recently released data have provided further evidence of weak economic activity in the foreign industrial countries early this year. In the first quarter, real GNP declined in both Japan and Germany. In Japan the fall in real GNP resulted primarily from decreased exports and a sharp drop in inventory accumulation. German construction spending was exceptionally depressed in the first quarter, likely a temporary response to severe winter weather. Plant and equipment spending declined in Germany also, but private consumption grew moderately. Inflation rates in the major foreign countries have moderated further or remained at low levels in recent months. Although recent data on trade volumes show adjustment to the exchange rate changes of the past year, lower import prices have led current account surpluses in Germany and Japan to continue to post new records. In contrast, during the first quarter Canada experienced its highest quarterly current account deficit on record.

The Mexican peso fell precipitously in early June in response to fears that Mexico might take unilateral steps to reduce its debt service burden. The peso rebounded after statements by U.S. and Mexican officials led to cautious optimism that continuing negotiations with the IMF would conclude successfully. Argentina received a waiver for the non-observance of some performance criteria that permitted disbursements from both the IMF and commercial banks. Brazil acted to clear some of its arrears with official creditors, and Nigeria moved closer to concluding agreements with the IMF and World Bank.

Staff estimates of April U.S. merchandise trade data adjusted to a balance-of-payments basis show a deficit somewhat larger than the average for the first quarter. The larger estimated deficit results from a decline in the value of oil imports that was more than offset by an increase in imports of other goods. Some very preliminary estimates based on the unrevised May data just released indicate that the value of exports for April and May combined was no higher than the first-quarter rate.

Net private foreign purchases of both U.S. corporate stocks and bonds continued very strong in April, totaling $8.6 billion. These flows were partially offset by an outflow of U.S. net purchases of foreign securities that was below the high March rate but still above the average for the first quarter. Foreign net purchases of U.S. Treasury securities increased moderately in April, with Japanese participation again strong.

U.S. chartered banks' claims on foreigners declined $1 billion in the first quarter of 1986. Claims on non-OPEC developing countries were reduced $1.9 billion during the quarter.

Outlook. The staff continues to project a moderate decline in the value of the dollar through the fourth quarter of 1987. After a weak first quarter, economic activity in foreign industrial countries is expected to strengthen over the remainder of the forecast horizon, particularly in Germany, somewhat less so in Japan. The weakness experienced early in the year will result in average growth abroad in the industrial countries through the projection period slightly below what had been earlier expected, but this is partially offset by additional strength now projected for some non-OPEC developing countries. The U.S. current account balance is now forecast to narrow from its average annual rate of $136 billion during the first half of this year to $125 billion in the second half of next year. A significant rise in prices of U.S. imports other than oil is projected to boost the value of imports, and as a result, the improvement in the nominal external deficit is expected to be much less than the improvement in real net exports as recorded in the GNP accounts.

Strictly Confidential (FR)
Class II FOMC

July 1, 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	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current $, Net	-78.4	-107.9	-95.0	-87.8	-113.4	-105.8	-110.4	-108.4	-107.1	-102.3	-97.6	-93.0	-87.1
Exports of G+S	369.9	383.9	440.7	363.2	367.8	374.4	374.8	386.6	399.9	414.9	431.3	449.1	467.5
Imports of G+S	448.4	491.9	535.7	451.0	481.2	480.2	485.2	495.0	507.1	517.2	528.9	542.1	554.6
Constant 82 $, Net	-108.4	-140.7	-102.0	-119.8	-140.8	-138.1	-153.9	-142.2	-128.7	-116.9	-106.6	-96.7	-87.8
Exports of G+S	359.9	372.4	414.4	353.5	359.2	365.0	365.2	374.1	385.4	396.2	407.6	420.5	433.1
Imports of G+S	468.3	513.1	516.3	473.3	500.0	503.0	519.0	516.1	514.1	513.0	514.1	517.1	520.8
2. U.S. Merchandise Trade Balance 2/	-124.4	-144.2	-129.0	-126.7	-149.4	-146.3	-144.2	-144.5	-141.5	-135.2	-131.0	-127.5	-122.3
Exports	214.4	220.5	262.4	210.0	210.9	214.2	214.9	221.7	231.3	243.8	255.9	268.2	281.5
Agricultural	29.6	26.8	28.8	26.7	28.5	28.4	26.0	26.2	26.5	27.8	28.5	29.0	30.0
Non-Agricultural	184.8	193.8	233.6	183.3	182.4	185.8	188.9	195.6	204.8	216.0	227.4	239.2	251.6
Imports	338.9	364.7	391.4	336.7	360.3	360.5	359.1	366.2	372.8	379.0	386.9	395.7	403.8
Petroleum and Products	50.5	34.5	35.9	49.5	56.5	40.1	30.3	33.1	34.4	34.4	35.0	36.3	37.7
Non-Petroleum	288.3	330.2	355.5	287.2	303.8	320.5	328.8	333.2	338.4	344.6	351.9	359.4	366.1
3. U.S. Current Account Balance	-117.7	-136.9	-129.3	-113.8	-134.8	-134.7	-137.5	-136.6	-138.9	-135.2	-131.9	-127.6	-122.3
Of Which: Net Investment Income	25.2	22.3	15.2	33.0	37.0	27.3	22.8	20.9	18.3	15.5	14.7	15.4	15.4
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.7	2.5	3.2	3.4	2.3	0.1	3.7	3.4	3.6	3.1	2.9	2.8	2.7
Real GNP--NonOPEC LDC 5/	3.4	3.1	4.1	2.9	2.9	3.0	3.2	3.5	3.8	4.1	4.4	4.7	4.9
Consumer Prices--Ten Ind. 4/	4.3	2.3	2.7	1.4	3.1	1.7	1.9	2.0	2.5	2.9	3.1	2.9	2.9

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