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Strictly Confidential (FR) Class II FOMC

May 13, 1987

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. Available indicators suggest that aggregate activity is expanding moderately this quarter despite some softness in the industrial sector. Although wage inflation remained subdued in the early months of 1987, prices accelerated--boosted in large part by higher world oil prices and the effects of dollar depreciation.

Payroll employment rose more than 300,000 in April--appreciably faster than the pace in the first quarter. As has been the case for some time, much of the increase occurred in a variety of service-producing industries: retail trade, finance, insurance, and real estate, and business and health services. In contrast, manufacturing employment was little changed, and the factory workweek dropped sharply in April. At least part of the workweek decline likely reflected the observance of religious holidays during the survey week; accordingly, a rebound is anticipated in the May figures. The unemployment rate fell to 6.3 percent--0.4 percentage point below its first-quarter average.

Industrial production fell 0.3 percent in March, and the limited physical product data available so far, coupled with the information on labor inputs, point to another decline in April. Auto production fell 9 percent in April, and truck production also was down considerably, as motor-vehicle manufacturers attempted to control inventories. However, despite the cutback in assemblies and a small increase in domestic auto sales to a 7.7 million unit annual rate in April, auto inventories fell only a bit from their uncomfortably high levels. Outside of autos, trade inventories do not appear excessive, while inventory-sales ratios in manufacturing are near historical lows.

Incoming data on retail sales suggest that real consumption spending, excluding autos, will be revised down somewhat from the just under 3 percent annual rate in BEA's preliminary first-quarter estimate. In April, spending continued to trend up, as sales at the so-called retail control category posted a 0.4 percent nominal increase, but February and March figures were revised downward.

Business fixed investment has shown signs of improvement after the early-year "payback" from a tax-induced bulge in purchases in the fourth quarter. Shipments of nondefense capital goods rose in February and March, and orders also inched up over these two months. Outlays for construction of commercial and industrial structures have continued trending down in recent months; however, new commitments have firmed recently, suggesting that the slide in this sector may be easing.

Total housing starts rose to a 1.74 million unit rate in the first quarter as mortgage rates reached a nine-year low in March. Since then, however, mortgage rates have risen almost 1-1/2 percentage points (on fixed-rate loans) and are likely to damp housing activity in the spring, especially in the single-family sector where the first-quarter strength was concentrated. Multifamily starts have trended down since the beginning of 1986 under the influence of high vacancy rates and the elimination of some tax advantages for investment in income properties.

Inflation picked up as the CPI rose at a 6.2 percent annual rate between December and March—up from a 2.5 percent annual rate in 1986-Q4. Much of the first-quarter acceleration was caused by the rebound in energy prices, which now appear to reflect the bulk of the year-end runup in the price of imported crude. Larger price increases also were posted for a variety of consumer goods and probably reflect the influence of higher import prices. At the producer level, too, larger-than-usual price increases have been noted in a few industries with strong import competition such as chemicals and paper. Commodity prices began moving higher in the latter part of 1986 and have risen noticeably since March.

Wage growth is continuing at relatively moderate rates. The rise in the employment cost index of hourly compensation in the past quarter was about the same as a year earlier, and the 12-month change remained just a touch above 3 percent.

Outlook. The staff projects that real GNP will rise at about a 2-1/2 percent annual rate in the current quarter. Spending is projected to increase for consumption, business equipment, exports and government purchases. Exports, in particular, are expected to resume the rapid growth rate that was evident in the second half of last year. On the negative side, the auto sector is projected to subtract more than 1 percentage point from GNP growth as assemblies have been cut sharply in an attempt to pare excess inventories. Also, petroleum imports, which fell by $12 billion in the first quarter, are expected to return to more normal levels.

Financial assumptions have been altered a bit in response to recent developments. M2 and M3 are assumed to grow at rates in the lower part of the 1987 target range and at about the same pace in 1988. The staff forecast now anticipates generally higher levels of nominal interest rates and a somewhat weaker dollar than was previously the case.

The staff continues to assume that fiscal policy will be relatively restrictive over the next year and a half. The first-year effects of tax reform and budget cuts enacted last year are now expected to reduce the

FY1987 deficit to about $173 billion. This is somewhat more of a reduction than assumed in the last Greenbook and reflects new estimates of the one-time effects of capital gains realizations during the 1986 tax year. In fiscal 1988, the deficit is projected to fall further--to $159 billion--with the assumed enactment of deficit reduction measures totaling about $25 billion.

Real GNP is projected to increase almost 3 percent in 1987 and then about 2-1/2 percent in 1988. The staff continues to expect that the primary contributor to growth will be the foreign sector, which is anticipated to show substantial improvement both this year and next. The decline in the value of the dollar should make American products more competitive abroad—overriding the influence of relatively weak foreign economic growth. Though it takes time to enlarge the share of world trade, the sizable gains in export volume, on average, since mid-1986 are some evidence that this process is under way. Similarly, higher prices for foreign goods should reduce real spending on imports. Increases in import prices apparently have been tempered by the willingness of foreign suppliers to cut margins, but the tenor of recent evidence suggests that import prices have begun to move upward more strongly. All told, the improvement in net exports is expected to add about 1 percentage point to GNP growth in 1987 and about 1-1/2 percentage points to GNP growth in 1988.

As the higher import prices are reflected in domestic consumption prices, growth rates for real disposable personal income and hence consumption are expected to decline. Other key factors retarding the growth of gross domestic purchases are the constraints on government spending, and the high vacancy rates in the office and rental housing markets. Business equipment spending is projected to resume a moderate uptrend over the projection horizon as domestic capacity grows to support an increasingly export-based market. Construction of single-family homes is expected to soften in response to higher mortgage rates.

Inflation, as measured by the GNP fixed-weighted price index, is expected to move up to about a 3-1/2 percent annual rate in 1987 and then to about a 4 percent pace in 1988. The speedup in inflation this year results from the effects of the recent rebound of crude oil prices, as well as the projected acceleration in import prices. Next year, continued sharp increases in import prices provide a further boost to inflation. The consumer price index, which directly includes imported goods and gives a higher weight to energy, is projected to rise 4-1/2 percent in 1987 and 4-3/4 percent in 1988.

With output growing close to the rate of potential GNP, the unemployment rate should level off at about 6-1/4 percent—a rate at which slack in labor markets probably would have little dampening effect on wage pressures. The step-up in price inflation begins to feed faster wage growth in 1988.

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

May 13, 1987

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STAFF GNP PROJECTIONS

Percent changes, annual rate

	Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
	3/25/87	5/13/87	3/25/87	5/13/87	3/25/87	5/13/87	3/25/87	5/13/87	3/25/87	5/13/87
Annual changes:										
1985 <1>	6.2	6.2	2.7	2.7	3.7	3.7	3.3	3.3	7.2	7.2
1986 <1>	5.2	5.2	2.5	2.5	2.8	2.8	2.7	2.7	7.0	7.0
1987	4.9	5.4	2.4	2.6	2.8	3.0	2.4	2.7	6.7	6.5
1988	5.9	6.1	2.7	2.6	3.5	3.8	3.1	3.4	6.6	6.3
Quarterly changes:										
1986 Q1 <1>	6.2	6.2	3.8	3.8	2.5	2.5	2.5	2.5	7.1	7.1
Q2 <1>	2.6	2.6	.6	.6	1.7	1.7	1.8	1.8	7.1	7.1
Q3 <1>	6.4	6.4	2.8	2.8	2.6	2.6	3.6	3.6	6.9	6.9
Q4 <1>	1.7	1.7	1.1	1.1	2.7	2.7	.7	.7	6.9	6.9
1987 Q1 <1>	6.0	7.8	3.2	4.3	3.1	3.6	2.8	3.5	6.7	6.7
Q2	5.7	6.3	2.6	2.5	3.1	3.5	3.0	3.6	6.7	6.4
Q3	5.7	5.5	2.6	2.2	3.1	3.3	3.0	3.2	6.7	6.4
Q4	5.5	5.5	2.8	2.8	3.1	3.2	2.6	2.6	6.7	6.4
1988 Q1	6.0	6.5	2.6	2.6	3.8	4.1	3.3	3.7	6.6	6.3
Q2	6.0	6.3	2.6	2.6	3.7	4.0	3.3	3.6	6.6	6.3
Q3	6.3	6.4	2.8	2.7	3.7	4.1	3.4	3.7	6.5	6.2
Q4	6.2	6.6	2.7	2.7	3.7	4.3	3.4	3.8	6.5	6.2
Two-quarter changes: <2>										
1986 Q2 <1>	4.3	4.3	2.2	2.2	2.1	2.1	2.1	2.1	.0	.0
Q4 <1>	4.0	4.0	1.9	1.9	2.6	2.6	2.1	2.1	-.2	-.2
1987 Q2	5.9	7.0	2.9	3.4	3.1	3.5	2.9	3.6	-.2	-.5
Q4	5.6	5.5	2.7	2.5	3.1	3.3	2.8	2.9	.0	.0
1988 Q2	6.0	6.4	2.6	2.6	3.8	4.0	3.3	3.7	-.1	-.1
Q4	6.3	6.5	2.8	2.7	3.7	4.2	3.4	3.8	-.1	-.1
Four-quarter changes: <3>										
1985 Q4 <1>	6.3	6.3	2.9	2.9	3.6	3.6	3.3	3.3	-.2	-.2
1986 Q4 <1>	4.2	4.2	2.0	2.0	2.4	2.4	2.1	2.1	-.2	-.2
1987 Q4	5.7	6.2	2.8	2.9	3.1	3.4	2.9	3.2	-.2	-.5
1988 Q4	6.1	6.5	2.7	2.6	3.8	4.1	3.4	3.7	-.2	-.2

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

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CLASS II FOMC

May 13, 1987

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

				Projection							
		1986		1987				1988			
	Units	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of $	4240.7	4258.7	4339.2	4405.5	4464.6	4524.5	4596.0	4666.3	4739.7	4816.4
Real GNP	Billions of 82$	3686.4	3696.1	3735.2	3758.0	3778.7	3804.8	3829.6	3853.9	3879.3	3905.2
Nominal GNP	Percent change	6.4	1.7	7.8	6.3	5.5	5.5	6.5	6.3	6.4	6.6
Real GNP		2.8	1.1	4.3	2.5	2.2	2.8	2.6	2.6	2.7	2.7
Gross domestic product		2.6	1.5	4.5	2.5	2.3	2.9	2.7	2.7	2.7	2.8
Gross domestic purchases		3.7	-.6	2.7	2.1	.9	1.3	1.0	1.0	1.0	1.2
Final sales		4.5	4.2	-2.2	4.7	3.0	1.4	2.4	2.5	2.8	2.5
Private dom. final purchases		5.6	.5	-2.8	3.7	1.7	.4	1.0	.9	1.1	1.1
Personal consumption expend.		6.7	-.4	-.4	3.9	1.8	.2	1.0	.9	1.0	.9
Durables		44.6	-11.0	-17.5	15.1	5.4	-5.9	.2	.3	1.3	.6
Nondurables		-.9	-.1	1.2	1.5	.9	1.4	1.0	1.0	.7	.7
Services		2.4	3.2	4.3	2.4	1.4	1.2	1.3	1.1	1.0	1.1
Business fixed investment		-2.1	3.0	-12.8	6.3	3.6	2.9	2.3	1.8	2.3	1.8
Producers' durable equipment		1.2	6.6	-9.6	8.7	4.5	4.0	4.0	3.3	4.0	3.3
Nonresidential structures		-9.8	-5.4	-21.0	.3	1.2	-.1	-2.3	-2.5	-2.5	-2.5
Residential structures		9.7	5.2	-7.2	-5.1	-4.4	-2.4	-2.7	-1.4	.5	1.8
Exports		13.3	16.7	-1.6	10.3	15.2	17.1	15.9	15.0	15.3	13.4
Imports		17.3	-.5	-11.1	5.5	1.7	1.9	.7	.5	.7	1.0
Government purchases		4.5	10.5	-6.3	6.8	1.6	-1.8	-.2	.7	1.1	1.1
Federal		2.5	23.2	-17.4	13.1	.7	-6.7	-3.2	-1.4	-.7	-.8
Defense		17.2	-10.2	9.7	4.2	-.8	-2.4	-5.1	-3.1	-1.6	-1.1
State and local		6.1	1.1	3.8	2.0	2.3	2.3	2.2	2.4	2.5	2.6
nge in business inventories	Billions of 82$	-.3	-28.5	31.0	11.0	3.7	16.3	18.8	19.5	18.5	20.0
nfarm	Billions of 82$	-8.6	-9.8	27.7	14.8	10.5	18.3	21.3	22.0	21.0	22.5
exports	Billions of 82$	-163.3	-148.0	-134.2	-131.7	-119.8	-105.9	-90.8	-75.8	-60.2	-46.5
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	100.3	101.1	101.8	102.5	102.9	103.4	103.8	104.2	104.7	105.1
Unemployment rate	Percent*	6.9	6.9	6.7	6.4	6.4	6.4	6.3	6.3	6.2	6.2
Industrial production index	Percent change	1.9	3.2	2.6	.1	3.6	3.9	3.9	3.9	4.0	4.0
Capacity utilization rate-mfg.	Percent*	79.7	79.8	79.9	79.4	79.6	79.9	80.2	80.4	80.6	80.7
Housing Starts	Millions	1.76	1.70	1.81	1.66	1.63	1.62	1.61	1.60	1.60	1.60
Auto sales	Millions	12.91	11.32	9.66	10.65	11.30	10.75	10.75	10.80	10.85	10.85
Domestic	Millions	9.43	7.66	6.86	7.53	8.05	7.50	7.50	7.55	7.60	7.60
Foreign	Millions	3.47	3.66	2.80	3.12	3.25	3.25	3.25	3.25	3.25	3.25
INCOME AND SAVING											
Nominal personal income	Percent change	1.8	3.4	6.7	6.3	5.4	6.7	6.9	4.7	6.0	6.5
Real disposable income	Percent change	-3.1	-1.5	4.0	-8.0	13.5	2.3	.7	-1.1	1.6	1.0
Personal saving rate	Percent*	2.8	2.5	3.6	.6	3.2	3.7	3.6	3.1	3.3	3.3
Corp. profits with IVA & CCAdj	Percent change	12.7	12.8	37.4	-8.6	3.5	8.8	-10.1	9.9	7.0	12.3
Profit share of GNP	Percent*	7.1	7.3	7.8	7.5	7.4	7.5	7.2	7.3	7.3	7.4
Federal govt. surplus/deficit	Billions of $	-197.4	-188.8	-177.6	-114.4	-198.3	-190.6	-177.9	-155.7	-154.8	-149.4
State and local govt. surplus		64.0	59.4	48.6	56.4	56.9	58.7	60.7	61.8	62.9	64.3
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.6	.7	3.5	3.6	3.2	2.6	3.7	3.6	3.7	3.8
GNP fixed-weight price index		2.6	2.7	3.6	3.5	3.3	3.2	4.1	4.0	4.1	4.3
Cons. & fixed invest. prices		3.0	3.3	4.4	4.1	3.8	3.6	4.4	4.4	4.7	4.8
CPI		2.5	2.6	5.3	4.4	4.0	3.8	4.4	4.7	4.9	4.9
Exc. food and energy		3.7	3.8	4.4	4.4	4.4	4.4	4.9	5.2	5.4	5.4
farm business sector											
tput per hour		-.3	-1.5	1.7	1.0	1.1	1.2	1.1	1.0	1.1	1.1
ompensation per hour		2.3	2.7	.1	5.0	3.2	3.3	5.0	3.8	4.4	4.7
Unit labor costs		2.6	4.2	-1.6	4.0	2.1	2.1	3.9	2.8	3.2	3.6

* Not at an annual rate.

May 13, 1987

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

	Units	1980	1981	1982	1983	1984	1985	1986	Projection 1987	Projection 1988
EXPENDITURES										
Nominal GNP	Billions of $	2732.0	3052.6	3166.0	3405.7	3765.0	3998.1	4206.1	4433.4	4704.6
Real GNP	Billions of 82$	3187.1	3248.8	3166.0	3279.1	3489.9	3585.2	3674.9	3769.2	3867.0
Real GNP	Percent change*	-.1	.6	-1.9	6.5	4.6	2.9	2.0	2.9	2.6
Gross domestic product		.3	.3	-1.6	6.6	4.9	3.1	2.3	3.0	2.7
Gross domestic purchases		-1.1	.8	-.8	8.4	5.9	3.9	2.4	1.7	1.0
Final sales		-.2	.1	.3	3.7	4.4	4.0	2.7	1.7	2.6
Private dom. final purchases		-1.7	-.3	.8	7.7	5.3	4.2	3.1	.7	1.0
Personal consumption expend.		-.1	.2	2.9	5.4	3.6	3.5	4.0	1.4	1.0
Durables		-5.6	-3.3	9.0	14.7	8.8	6.2	9.6	-1.5	.6
Nondurables		-1.4	.5	1.8	4.4	2.2	2.0	3.3	1.3	.8
Services		2.4	.9	2.3	3.9	3.3	3.9	2.8	2.3	1.1
Business fixed investment		-4.8	5.6	-11.3	10.8	14.7	6.5	-4.0	-.3	2.0
Producers' durable equipment		-6.5	2.2	-12.5	20.9	16.0	8.1	1.7	1.7	3.6
Nonresidential structures		-1.8	11.7	-9.1	-4.8	12.1	3.3	-16.2	-5.4	-2.5
Residential structures		-14.2	-22.4	4.9	38.1	5.3	7.8	10.0	-4.8	-.5
Exports		.5	2.4	-13.8	5.8	5.5	-3.2	6.3	10.0	14.9
Imports		-8.8	4.9	-5.9	23.8	16.5	5.8	7.9	-.7	.7
Government purchases		1.0	2.9	3.8	-2.7	7.7	8.4	2.7	.0	.7
Federal		3.1	9.5	8.2	-8.1	14.2	14.3	.4	-3.2	-1.5
Defense		3.1	7.6	8.8	5.1	6.8	5.9	5.5	2.6	-2.7
State and local		-.3	-1.3	.6	1.5	3.1	3.7	4.6	2.6	2.4
Change in business inventories	Billions of 82$	-6.9	23.9	-24.5	-6.4	59.2	9.0	6.6	15.5	19.2
Nonfarm	Billions of 82$	-2.3	19.0	-23.1	-.1	54.3	10.9	7.4	17.8	21.7
Net exports	Billions of 82$	57.0	49.4	26.3	-19.9	-83.6	-108.2	-147.8	-122.9	-68.3
Nominal GNP	Percent change*	9.9	9.3	3.1	10.4	8.5	6.3	4.2	6.2	6.5
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	90.4	91.2	89.6	90.2	94.5	97.6	100.2	102.7	104.5
Unemployment rate	Percent	7.1	7.6	9.7	9.6	7.5	7.2	7.0	6.5	6.3
Industrial production index	Percent change*	-.8	-1.0	-7.7	14.3	6.6	1.7	1.1	2.5	3.9
Capacity utilization rate-mfg.	Percent	79.3	78.3	70.3	74.0	80.5	80.1	79.8	79.7	80.5
Housing Starts	Millions	1.30	1.10	1.06	1.71	1.77	1.74	1.82	1.68	1.60
Auto sales	Millions	9.04	8.56	8.00	9.18	10.43	11.09	11.52	10.59	10.81
Domestic	Millions	6.62	6.24	5.77	6.77	7.97	8.24	8.28	7.49	7.56
Foreign	Millions	2.42	2.32	2.23	2.41	2.46	2.84	3.25	3.10	3.25
INCOME AND SAVING										
Nominal personal income	Percent change*	12.0	9.2	5.3	7.8	8.4	6.1	4.3	6.3	6.0
Real disposable income	Percent change*	1.1	.7	1.0	5.1	4.2	1.9	2.2	2.7	.5
Personal saving rate	Percent	7.1	7.5	6.8	5.4	6.3	5.1	3.8	2.8	3.3
Corp. profits with IVA & CCAdj	Percent change*	-6.8	2.3	-19.1	70.1	6.6	7.8	9.0	9.1	4.4
Profit share of GNP	Percent	6.5	6.2	4.7	6.3	7.0	7.0	7.1	7.5	7.3
Federal govt. surplus/deficit	Billions of $	-61.3	-63.8	-145.9	-176.0	-170.0	-198.0	-203.3	-170.2	-159.4
State and local govt. surplus		26.8	34.1	35.1	47.5	68.5	61.7	63.1	55.2	62.4
PRICES AND COSTS										
GNP implicit deflator	Percent change*	9.9	8.7	5.2	3.6	3.6	3.3	2.1	3.2	3.7
GNP fixed-weight price index		9.8	8.5	5.0	3.9	3.9	3.6	2.4	3.4	4.1
Cons. & fixed invest. prices		10.1	8.2	4.4	3.3	3.6	3.4	2.0	4.0	4.6
CPI		12.5	9.6	4.5	3.2	4.1	3.5	1.3	4.4	4.7
Exc. food and energy		12.2	10.2	5.2	4.2	4.7	4.3	3.9	4.4	5.2
Nonfarm business sector										
Output per hour		1.0	-.6	1.0	3.6	1.0	.2	.7	1.2	1.1
Compensation per hour		10.9	8.3	7.3	3.3	4.3	3.9	2.6	2.9	4.5
Unit labor costs		9.8	9.0	6.2	-.3	3.2	3.7	1.8	1.6	3.4

* Percent changes are from fourth quarter to fourth quarter.

CONFIDENTIAL - FR
CLASS II FOMC

May 13, 1987

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

	1986		1987				1988				1985	1986	1987	1988
			Projection								(fourth quarter to fourth quarter, net change)		Projection	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Real GNP	25.0	9.7	39.1	22.8	20.7	26.1	24.8	24.3	25.4	25.9	101.9	73.8	108.7	100.4
Gross domestic product	23.2	13.4	40.3	22.8	21.5	27.2	25.6	25.0	25.5	26.3	107.6	82.0	111.8	102.4
Gross domestic purchases	34.4	-5.6	25.3	20.3	8.8	12.2	9.7	9.3	9.9	12.1	141.2	89.8	66.6	41.0
Final sales	40.4	37.8	-20.4	42.9	28.0	13.5	22.3	23.6	26.4	24.4	141.1	97.0	64.0	96.7
Private dom. final purchases	41.6	3.6	-21.8	27.9	13.1	3.1	7.6	7.2	8.8	8.5	122.5	93.1	22.3	32.0
Personal consumption expend.	39.6	-2.2	-2.7	23.6	11.2	1.0	6.2	5.9	5.9	5.6	80.0	94.1	33.1	23.6
Durables	34.5	-11.2	-17.9	13.0	5.0	-5.7	.2	.2	1.2	.6	20.2	33.4	-5.6	2.2
Nondurables	-1.9	-.3	2.6	3.3	2.0	3.2	2.1	2.2	1.5	1.5	16.7	27.9	11.1	7.4
Services	7.0	9.2	12.7	7.3	4.2	3.5	3.9	3.4	3.2	3.5	43.1	32.7	27.7	14.0
Business fixed investment	-2.4	3.4	-15.4	6.8	4.0	3.2	2.6	2.0	2.6	2.1	29.3	-19.1	-1.4	9.3
Producers' durable equipment	1.0	5.2	-8.2	6.8	3.6	3.3	3.3	2.8	3.4	2.8	24.4	5.6	5.5	12.2
Nonresidential structures	-3.4	-1.8	-7.3	.1	.4	.0	-.7	-.8	-.8	-.8	4.9	-24.7	-6.	-3.0
Residential structures	4.5	2.5	-3.7	-2.5	-2.1	-1.2	-1.3	-.7	.2	.8	13.2	18.2	-9.5	-.9
Change in business inventories	-15.4	-28.2	59.5	-20.0	-7.3	12.6	2.5	.7	-1.0	1.5	-39.1	-23.3	44.8	3.7
Nonfarm	-19.6	-1.2	37.5	-12.9	-4.3	7.8	3.0	.7	-1.0	1.5	-17.8	-25.9	28.1	4.2
Farm	4.2	-27.0	22.1	-7.2	-3.0	4.8	-.5	.0	.0	.0	-21.3	2.6	16.7	-.5
Net exports	-9.4	15.3	13.8	2.5	11.9	13.9	15.1	15.0	15.6	13.7	-39.3	-16.0	42.1	59.4
Exports	11.4	14.6	-1.6	9.5	14.1	16.4	16.0	15.6	16.5	15.1	-12.1	22.9	38.5	63.2
Imports	20.9	-.7	-15.4	7.0	2.2	2.5	.9	.6	1.0	1.3	27.1	39.0	-3.7	3.8
Government purchases	8.2	18.9	-12.4	12.5	3.0	-3.5	-.4	1.4	2.1	2.1	57.9	19.9	-.4	5.3
Federal	2.0	17.7	-16.3	10.4	.6	-5.9	-2.8	-1.2	-.6	-.7	43.4	1.4	-11.2	-5.2
Defense	10.1	-6.9	5.9	2.7	-.5	-1.6	-3.4	-2.0	-1.0	-.7	13.4	13.2	6.5	-7.1
Nondefense	-8.0	24.6	-22.2	7.7	1.1	-4.3	.6	.8	.4	.0	30.0	-11.8	-17.7	1.9
State and local	6.2	1.2	3.9	2.1	2.4	2.4	2.4	2.6	2.7	2.8	14.5	18.5	10.8	10.5

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1986*	FY1987e Admin[1]	FY1987e FRB Staff	FY1988e Admin[1]	FY1988e FRB Staff	CY 1986*	CY1987e FRB Staff	1986 IV*	FRB Staff Estimates 1987 I*	1987 II	1987 III	1987 IV	1988 I	1988 II	1988 III
								Not seasonally adjusted							
Budget receipts[2]	769	842	842	917	894	782	855	190	194	252	206	203	201	265	224
Budget outlays[2]	990	1016	1015	1024	1053	991	1034	253	252	254	255	273	249	261	270
Surplus/deficit(-) to be financed[2]	-221	-173	-173	-108	-159	-209	-179	-63	-59	-2	-49	-70	-47	4	-46
Means of financing:															
Borrowing from public	236	162	164	107	155	215	148	69	28	26	41	54	49	4	48
Cash balance decrease	-14	11	6	0	0	0	16	0	22	-21	5	10	0	-5	-5
Other[3]	-1	0	3	1	4	-6	15	-6	9	-3	3	6	-2	-3	3
Cash operating balance, end of period	31	20	25	20	25	31	15	31	9	30	25	15	15	20	25
Memo: Sponsored agency borrowing[4]	14	n.a.	11	n.a.	18	13	11	4	-2	5	4	4	4	5	5
NIPA Federal Sector								Seasonally adjusted annual rates							
Receipts	815	875	889	968	930	827	899	855	872	954	877	891	928	947	955
Expenditures	1025	1061	1059	1089	1100	1030	1069	1043	1050	1068	1075	1082	1106	1103	1110
Purchases	368	385	382	395	387	366	385	372	369	392	396	383	387	389	391
Defense	275	291	289	301	297	278	293	279	288	293	295	296	297	297	298
Nondefense	94	94	93	94	90	89	92	93	81	99	100	87	90	91	92
All other expend.	657	676	677	694	713	664	684	671	681	677	680	699	719	715	719
Surplus/deficit(-)	-211	-186	-170	-121	-170	-203	-170	-189	-178	-114	-198	-191	-178	-156	-155
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-173	n.a.	-131	n.a.	-136	-165	-134	-146	-140	-75	-162	-156	-144	[illegible]	-123

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

Note: Details may not add to totals due to rounding

1. Budget of the United States Government, Fiscal Year 1988 (January 1987). The Congressional Budget Office baseline estimates published in February indicated receipts of $834 and $901 billion, outlays of $1010 and $1071 billion, and deficits of $176 and $171 billion in FY1987 and FY1988, 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, Federal Home Loan Mortgage Corporation (excluding participation certificates), Federal National Mortgage Association (excluding mortgage-backed securities), Farm Credit Banks, and Student Loan Marketing Association marketable debt. The Administration's definition of borrowing by these agencies is somewhat broader.

Recent Developments. Financial markets turned volatile and interest rates generally rose during the intermeeting period, amid concerns about dollar depreciation, inflationary risks and the seeming inability of governments to resolve trade and economic policy issues. Long-term bond rates have climbed about a percentage point since the March 31 FOMC, while rates on short-term instruments have advanced by less. The federal funds rate rose for a short time above 7 percent around the end of April, but subsequently has dropped back to 6-3/4 percent. Major banks have increased the prime rate twice during the intermeeting period, by a total of 1/2 percentage point.

The monetary aggregates, which generally had been weak since year-end, exhibited renewed vigor around mid-April, evidently in connection with heavy tax payments by individuals during the month. M1 accelerated to an annual rate of 18 percent in April, as growth in both demand and other checkable deposits picked up sharply. By month-end, however, there were indications of a reversal in this buildup as checks sent to the IRS began to clear in volume. Growth in M2, at 6 percent in April, was attributable largely to the rise in M1 components. MMDAs ran off, partly owing to tax payments and in response to lagged adjustments to rates on alternative instruments. Small time deposits likewise ran down, and general purpose MMMFs were almost flat. Savings deposits, however, advanced at a 30 percent rate.

M3 growth--also about 6 percent in April--likewise was driven mainly by its transactions components, with institution-only MMMFs and term Eurodollars showing large declines. Growth in large time deposits was entirely at commercial banks; at thrift institutions time deposits contracted at more than a 20 percent annual rate. Repurchase agreements and commercial paper and note issuance through affiliates reportedly have become important sources of funds for a number of large thrifts, and some institutions--especially those whose access to the markets has been diminished--are relying more on FHLB advances.

Bank credit growth picked up in April to more than a 13 percent pace, almost twice the first-quarter rate. Both loan and securities growth were stronger than earlier in the year. Small banks, especially, were substantial purchasers of U.S. government securities. Total loan growth in April was around 14 percent, again almost double the first-quarter rate, as business lending turned around after several weak months in response to less attractive conditions for bond and stock issuance. Real estate lending remained brisk in April, and consumer loans accelerated a bit from the low first-quarter pace.

Borrowing by nonfinancial corporations slowed somewhat in April and shifted into shorter-term markets. In addition to the growth in business loans at banks, net issuance of commercial paper strengthened. Retirements of equities in connection with corporate restructurings, reinforced by the decline in new equity offerings, provided continued impetus for business debt growth. After a strong March, gross bond issuance dropped precipitously in April to the lowest level since October 1985. Offerings of low-grade debt were relatively well maintained, however, accounting for about one-half of nonfinancial issues during the month.

The federal government's total deficit appears likely to shrink to only about $2 billion during the second quarter, reflecting the heavy surge of personal tax payments in April. Nonetheless, the Treasury is expected to borrow nearly $26 billion, and its cash balance will rise substantially on net over the quarter. Most of the borrowing will be in marketable issues, but around $7 billion may be obtained from nonmarketables, mainly SLGS issued to state and local governments in connection with their refunding operations. Federally sponsored agencies are expected to borrow, net, around $5 billion during the quarter, of which the major part is by the Federal Home Loan Banks, responding to demands for advances by thrift institutions.

In municipal markets, gross tax-exempt volume dropped about one-third in April, and some issues have been postponed or cancelled in response to interest rate increases. Pressures in the tax-exempt market reportedly were heightened by substantial liquidations by investors in long-term bond funds around mid-April, and by efforts of funds themselves to build up cash assets.

Interest rates on mortgages rose by more than those on Treasuries of comparable maturity during the intermeeting period; the contract rate on 30-year conventional mortgages climbed 145 basis points over the six weeks ending May 8, and the Veterans Administration has raised its ceiling in two steps from 8-1/2 to 10 percent. Initial rates on 1-year ARMs rose only a little during the period, and the spread between adjustable- and fixed-rate mortgages almost doubled compared with the March experience. The growth in mortgage lending in the first quarter slowed to an estimated 10 percent. Most of the decline was concentrated in commercial mortgages, but early indications for April suggest a weakening of residential lending as well, and some shift toward ARMs.

Consumer installment debt was about unchanged in March, and for the first quarter growth was at an annual rate only a little above 1 percent. The decline in consumer durables outlays in the first quarter and the recent tax changes favoring home-equity lending appear to be contributing to this weakness in consumer credit; however, a significant deceleration already was emerging late last year, and some slackening in credit use was anticipated on the basis of the sizable installment debt burdens amassed earlier by households. Increasing quantities of consumer credit have been "securitized" in recent months, including $400 million in revolving loans which were packaged and sold by Bank of America in March.

Outlook. The turbulence in money and capital markets during April has led to substantial changes in long-term rates and a steepening of the yield curve. However, the markets are expected to settle a bit and, if rates behave as anticipated in the staff forecast, overall debt growth and patterns of borrowing likely will not differ markedly from the trends that were visible earlier.

Debt growth appears to be slowing to a pace consistent with the FOMC's monitoring range for 1987. In part this reflects the reduction in the size of the federal deficit in the current fiscal year. Federal debt growth is estimated to be rising sharply on a seasonally adjusted basis in the second quarter as the Treasury allows its cash balance to soar. But federal borrowing should be less than seasonal in the summer, again holding down overall debt expansion.

State and local borrowing also may pick up a little from the depressed April rate, but should remain moderate by the standards of recent years; given the backup in interest rates, refunding activity in particular is not expected to rival the volume earlier this year.

In the business sector, the economic projection implies only a small financing gap for nonfinancial corporations in the months ahead; however, even a rebound in new share offerings, which we anticipate, will leave net share retirements sizable, owing to continuing restructuring activity. With fairly stable long-term interest rates, businesses probably will return to the bond markets and rely less heavily on bank credit and short-term paper than has been the case in the past month.

Evidence of the effect of the recent rate backup on mortgage flows is not yet available. Our presumption is that home mortgage borrowing has dropped off and will continue to be damped by the higher rates now prevailing. ARMs should account for a larger share of loans than was the case through early April, owing to greater ease of borrower qualification and more attractive rate spreads. Consumer credit growth is expected to pick up only a little from the recent weak pace as auto sales exceed the depressed first-quarter level.

Recent developments. The dollar was under substantial downward pressure over most of the inter-meeting period, but towards the end of the period was bolstered by a "snugging" of monetary policy in the United States and some easing of a monetary conditions in Japan, Germany, and the United Kingdom. On balance, the dollar dropped by about 1 percent, with declines of about 4 percent against the yen and 3-1/2 percent against sterling, the two strongest currencies over this interval. Sterling was in strong demand as a result of favorable budget announcements, firming oil prices, and an improved electoral picture for the incumbent government. The yen's strength fundamentally reflected the huge current account imbalances of Japan and the United States; as the dollar moved below 150 yen, which the market had understood as a floor agreed to by the G-5 in February, market participants concluded that monetary authorities were not willing to act to insure that exchange rates would be stabilized, and Japanese investors reportedly shifted large amounts of funds out of dollars and into yen.

Since the March meeting of the FOMC, three-month interest rates declined about 20, 25, and 100 basis points in Japan, Germany, and the United Kingdom, respectively, while rising by about 60 basis points in the United States. Over the same period, long-term bond rates fell by 150 basis points in Japan, 20 basis points in Germany, and 25 basis points in the United Kingdom, whereas bond rates rose by 100 basis points in the United States.

The Desk purchased $1,549 million against yen and $240 million against marks, for System and Treasury accounts combined.

Economic activity in most major foreign industrial economies continued to be sluggish in the first quarter. The average level of industrial production for the latest three months was below that of a year ago in Germany and was little changed in Canada, Japan, and France. Only in the United Kingdom and Italy did industrial production show any strength. Retail sales and housing starts in Japan rose in February after falling in January; in Germany retail sales showed little strength in March, and new domestic orders in manufacturing increased moderately in February-March.

Brazil moved to stabilize its deteriorating economic situation by devaluing its currency by 7-1/2 percent. Its new finance minister articulated several policy goals -- a 3 to 3-1/2 percent real GDP growth (down from a previous goal of 7 percent), maintenance of positive real interest rates, restoration of a substantial trade surplus in the medium term, and measures to reduce the fiscal deficit -- toward the end of reconciliation with commercial banks on a financing package and perhaps an eventual understanding with the IMF. Argentina and the Philippines completed agreements with commercial banks to reschedule foreign debt of $30 billion and $13 billion, respectively; these agreements contained several innovative elements. Venezuela's financial picture worsened with accelerating wage and price inflation, as wages were boosted by 25 percent and a price freeze was imposed. Chile reached agreement with its Paris Club creditors to reschedule most of its bilateral credits maturing in 1987-88, which completes its financing package through 1988.

The U.S. merchandise trade deficit for January-February was about the same as the fourth-quarter rate, with the value of both exports and imports somewhat lower than in the fourth quarter. Recent data on prices of non-oil imports indicate fairly strong increases in the prices of manufactured consumer and capital goods, which would imply an increase in competitiveness of U.S. manufacturers of these goods. (March trade figures will be covered in the Greenbook Supplement.)

Outlook. The staff now projects that the dollar against other G-10 currencies will decline over the forecast period at about its average rate of the last two years. This is a somewhat faster rate of decline than had been incorporated in recent forecasts and is based on an assessment that there is a growing impatience with the pace of decline of the U.S. current account deficit, that there will be less assistance in the adjustment process from growth abroad, and that the political process appears to be demanding a larger ultimate adjustment of the deficit. The staff has lowered its forecast of GNP growth in major foreign industrial economies, to about 1-1/2 percent on average in 1987-88, in large part reflecting the lower dollar, but also the seeming unwillingness of foreign policymakers to take major actions to stimulate domestic demand in their countries. The U.S. current account forecast is little changed, on balance, from last time, under these offsetting influences. The deficit is projected at around $150 billion for this year and $135 billion for 1988, but with a somewhat stronger adjustment in real net exports and higher import prices, both reflecting the lower forecast for the dollar's exchange value.

Strictly Confidential (FR)
Class II FOMC

May 13, 1987

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

	ANNUAL			1986		1987				1988			
	1986-	1987-P	1988-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	-104.3	-110.7	-89.2	-108.9	-110.2	-112.0	-115.3	-110.3	-105.3	-100.2	-93.1	-85.5	-77.7
Exports of G+S	373.0	408.9	492.8	370.8	383.5	384.8	396.9	415.9	437.8	459.2	480.8	504.2	527.0
Imports of G+S	477.3	519.6	581.9	479.7	493.7	496.8	512.1	526.3	543.1	559.4	573.9	589.7	604.7
Constant 82 $, Net	-147.8	-122.9	-68.3	-163.3	-148.0	-134.2	-131.7	-119.8	-105.9	-90.8	-75.8	-60.2	-46.5
Exports of G+S	371.5	402.5	464.0	371.2	385.8	384.2	393.7	407.9	424.3	440.2	455.8	472.4	487.4
Imports of G+S	519.2	525.4	532.3	534.5	533.8	518.4	525.4	527.7	530.1	531.0	531.6	532.6	533.9
2. U.S. Merchandise Trade Balance 2/	-147.7	-155.9	-136.4	-148.6	-153.5	-156.9 P	-160.4	-155.6	-150.5	-145.9	-139.5	-133.4	-126.6
Exports	221.8	246.4	306.1	223.1	229.3	230.0 P	238.0	251.5	266.2	281.9	298.0	314.4	330.2
Agricultural	26.9	26.1	28.8	26.0	28.4	26.3 P	25.4	26.1	26.5	27.4	28.4	29.5	29.8
Non-Agricultural	194.8	220.3	277.3	197.0	200.9	203.7 P	212.6	225.4	239.7	254.6	269.6	284.9	300.3
Imports	369.5	402.3	442.5	371.7	382.8	386.9 P	398.4	407.2	416.7	427.9	437.5	447.7	456.7
Petroleum and Products	33.9	37.9	42.6	31.9	32.2	34.1 P	38.3	39.5	39.7	41.3	41.7	43.4	43.9
Non-Petroleum	335.6	364.4	399.9	339.7	350.6	352.8 P	360.1	367.7	377.0	386.6	395.8	404.3	412.9
3. U.S. Current Account Balance	-140.6	-150.7	-134.4	-141.2	-147.3	-146.9 P	-154.6	-152.3	-149.0	-143.7	-137.6	-131.1	-125.4
Of Which: Net Investment Income	22.9	17.4	9.8	24.6	19.6	22.3 P	18.7	15.3	13.4	11.8	10.2	9.2	7.7
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.3	1.8	1.4	2.2	1.5	1.2 P	1.7	1.5	1.5	1.2	1.3	1.5	1.5
Real GNP--NonOPEC LDC 5/	4.2	3.8	4.1	4.0	3.8	3.6 P	3.7	3.8	3.9	4.0	4.3	4.7	5.0
Consumer Prices--Ten Ind. 4/	2.0	2.0	2.5	0.1	2.1	2.5 P	2.4	2.1	2.0	2.4	3.1	2.8	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