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Confidential (FR) Class III FOMC

July 1, 1987

RECENT DEVELOPMENTS

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 moderate pace in recent months as gains in net exports apparently have counterbalanced some softness in domestic spending. Producer and consumer prices slowed a bit in May, after sizable increases earlier in the year that were associated, in part, with higher energy prices.

The index of industrial production rose 0.5 percent in May and, with the upward revision to the three preceding months, it stood 2-1/2 percent (annual rate) above the first-quarter average. The recent growth reflects, in part, increased production of business equipment, especially high-technology capital goods. The output of consumer goods also was up in May, with increases widespread. In the motor-vehicle sector, auto assemblies have slowed in recent months owing to the overhang of dealers' stocks, while production of trucks was sluggish in the second quarter after the brisk pace of assemblies in the first quarter.

The growth in the industrial sector so far this year has led to some small gains in manufacturing employment. The service-producing industries have continued to account for the preponderance of employment growth, however, adding an average 200,000 nonfarm payroll jobs per month. The civilian unemployment rate remained at 6.3 percent in May, after dropping 0.4 percentage point in April.

Consumer spending in real terms has been sluggish in recent months. Domestic auto sales since early May have averaged only about a 7 million unit annual rate, considerably below the pace in the past few years, and sales of Japanese imports have been falling short of their voluntary export limits. Excluding autos, outlays for durables have been flat, on balance, since the end of last year, while spending on nondurable goods has edged down. In contrast, outlays for services continue to advance steadily. Wage and salary income has grown moderately in recent months, but in April and May total personal income gains were cut by a dropoff in farm subsidy payments, and real spending power has continued to be eroded by consumer price increases.

Housing activity has dropped back from its elevated pace early this year. Total housing starts fell to 1.62 million units in May, about 10 percent below their first-quarter pace. Single-family starts were down appreciably, reflecting the runup in mortgage interest rates from the nine-year low reached in March. Multifamily starts rose some in May, but remained below the first-quarter average.

Business fixed investment has rebounded after a large tax-induced decline in the first quarter. Shipments of nondefense capital goods were about flat in April and May but, given earlier advances, the average level of shipments during these two months was about 1-3/4 percent above the first-quarter average. Outlays for nonresidential structures turned up in May, with the gains fairly widespread; and petroleum drilling activity has continued to recover. In addition, advance indicators of investment spending have shown signs of improvement. New orders for nondefense capital goods (excluding the aircraft group, where lead times run several years) picked up in the spring; and, despite high vacancy rates in several sectors, new commitments for nonresidential construction have moved up slightly, suggesting some near-term firming in activity. The latest surveys of capital spending plans point to an even more substantial pickup in nominal outlays over the remainder of this year; however, these surveys have tended to exhibit an upward bias in recent years.

Inventory investment appears to have slowed in the second quarter from its rapid first-quarter pace. Production cutbacks have stemmed the buildup in auto inventories, which had accounted for more than two-thirds of the first-quarter accumulation in nonfarm business stocks. Nevertheless, as of the end of May, the level of dealers' stocks was still high by historical standards. Among nonauto establishments, inventory changes have been relatively small in recent months, and inventory-sales ratios generally appear comfortable. The available information for May indicates that manufacturers continue to maintain a conservative inventory stance.

The consumer price index rose 0.3 percent in May, after more rapid increases earlier this year. Increases in retail energy prices, which had boosted prices during the first quarter, were smaller in recent months and accounted for much of the slowing in consumer price inflation. However, crude oil costs have risen further since mid-April, portending some further upward adjustment in retail energy prices in the near future. Excluding food and energy, the CPI has risen at a 5 percent annual rate so far this year, more than one percentage point above last year's pace. The pickup in this component of inflation can be traced, in part, to more rapid increases in categories of consumer goods that have higher import proportions. Wage inflation, meanwhile, has remained quite low so far this year.

Outlook. The staff now estimates that real GNP grew at around a 2-1/4 percent annual rate in the second quarter and that the GNP fixed-weighted price index increased at about a 3-3/4 percent rate. Growth in GNP was retarded by cutbacks in automobile production, but output appears to have been buoyed by a rise in net exports and a rebound in spending on producers' durable equipment.

Looking ahead, the policy assumptions underlying the staff projection have been altered in some respects. In light of emerging evidence on inflation, associated, in part, with the impulse from the dollar's depreciation, interest rates now are anticipated to drift up a bit faster over the projection period. Although M3 is expected to grow at a rate well within its target range for 1987, and to continue at about the same pace in 1988, M2 growth now is expected to pick up only a little from the relatively low pace of the first half of this year. The exchange value of the dollar against other G-10 currencies is expected to decline, on average, at somewhat less than a 10 percent annual rate from recent levels.

The stance of federal fiscal policy still is viewed as moderately restrictive. The FY1987 deficit is now expected to fall from last year's $221 billion to just below $170 billion, reflecting the budget restraint enacted last year and the substantial one-time windfall in revenues this year from tax reform. For FY1988, revenues no longer will be benefiting from the tax-reform windfall, and the deficit is expected to remain in the $170 billion range, despite the assumption of $25 billion in deficit-reduction measures. The FY1988 deficit has been revised up about $9 billion since the last Greenbook, reflecting evidence that corporate tax receipts will be lower than previously anticipated under the new tax code, the recently announced reduction in the federal unemployment tax rate beginning in January, and higher projected outlays for interest.

The staff continues to expect real GNP to increase at about a 2-1/2 percent annual rate over the second half of 1987. However, the growth of GNP in 1988 has been scaled back to 2-1/4 percent, owing to the slightly steeper climb in interest rates and the slower projected decline in the value of the dollar.

Projected improvements in the external sector are expected to drive overall output growth. With the competitiveness of U.S. products improving, real exports of goods and services are anticipated to rise at a fairly robust pace during the next year and a half. In addition, real imports of goods and services are expected to be essentially unchanged, as declines in the volume of non-oil merchandise imports are offset by increases in oil imports and in payments on our expanding liabilities to foreigners.

In contrast, growth in domestic demand is anticipated to be sluggish over the forecast period. In particular, the expected rise in import prices associated with the fall in the dollar will continue to hold down real income gains, limiting the growth in consumer spending. At the same time, government purchases at both the federal and state and local levels are expected to be damped by budgetary limitations. Business equipment spending should rise moderately in coming quarters, reflecting continued modernization efforts and expanding domestic production. Nevertheless, growth in overall business investment is expected to remain quite sluggish, as high office vacancy rates and excess capacity in the public utility sector continue to constrain nonresidential construction activity. Residential construction activity likely will be relatively soft as well, owing to the influence of higher interest rates on the demand for single-family homes and the effects of high rental vacancy rates on multifamily building.

Inflation rates are expected to edge down over the second half of this year but then to move up again in 1988. The effects of energy price increases, which accounted for much of the pickup in inflation earlier this year, are likely to be less of a force in coming quarters. In contrast, increases in nonpetroleum import prices associated with the expected dollar depreciation will be substantial and will provide continuing impetus to inflation over the projection period; moreover, with the civilian unemployment rate projected to remain close to 6-1/4 percent, labor market slack no longer will provide an offset to these inflationary pressures. Reflecting these influences, the GNP fixed-weighted price index is projected to rise 3-1/2 percent in 1987 and 4-1/4 percent in 1988.

Details of the staff projection are shown on the tables that follow.

CONFIDENTIAL - FR
CLASS II FOMC

July 1, 1987

STAFF GNP PROJECTIONS

Percent changes, annual rate

		Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
		5/13/87	7/1/87	5/13/87	7/1/87	5/13/87	7/1/87	5/13/87	7/1/87	5/13/87	7/1/87
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		5.4	5.7	2.6	2.7	3.0	3.2	2.7	3.0	6.5	6.4
1988		6.1	6.0	2.6	2.4	3.8	3.9	3.4	3.5	6.3	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>	7.8	9.1	4.3	4.8	3.6	3.9	3.5	4.2	6.7	6.7
	Q2	6.3	6.1	2.5	2.2	3.5	3.7	3.6	3.8	6.4	6.3
	Q3	5.5	5.9	2.2	2.6	3.3	3.6	3.2	3.2	6.4	6.3
	Q4	5.3	5.3	2.8	2.5	3.2	3.3	2.6	2.8	6.4	6.3
1988	Q1	6.5	6.3	2.6	2.4	4.1	4.2	3.7	3.8	6.3	6.3
	Q2	6.3	6.0	2.6	2.3	4.0	4.0	3.6	3.6	6.3	6.3
	Q3	6.4	6.3	2.7	2.3	4.1	4.2	3.7	3.9	6.2	6.3
	Q4	6.6	6.5	2.7	2.4	4.3	4.3	3.8	4.0	6.2	6.3
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	7.0	7.6	3.4	3.5	3.5	3.8	3.6	4.0	-.5	-.6
	Q4	5.5	5.6	2.5	2.6	3.3	3.5	2.9	3.0	.0	.0
1988	Q2	6.4	6.1	2.6	2.3	4.0	4.1	3.7	3.7	-.1	.0
	Q4	6.5	6.4	2.7	2.4	4.2	4.3	3.8	3.9	-.1	.0
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	6.2	6.6	2.9	3.0	3.4	3.6	3.2	3.5	-.5	-.6
1988	Q4	6.5	6.3	2.6	2.3	4.1	4.2	3.7	3.8	-.2	.0

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

CONFIDENTIAL - FR
CLASS II FOMC

July 1, 1987

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

	Units	1986 Q3	1986 Q4	1987 Q1	1987 Q2	Projection 1987 Q3	1987 Q4	1988 Q1	1988 Q2	1988 Q3	1988 Q4
EXPENDITURES											
Nominal GNP	Billions of $	4240.7	4258.7	4352.1	4417.4	4481.4	4540.1	4609.5	4677.4	4749.3	4824.7
Real GNP	Billions of 82$	3686.4	3696.1	3739.4	3760.0	3784.4	3807.8	3830.3	3852.1	3874.0	3897.2
Nominal GNP	Percent change	6.4	1.7	9.1	6.1	5.9	5.3	6.3	6.0	6.3	6.5
Real GNP		2.8	1.1	4.8	2.2	2.6	2.5	2.4	2.3	2.3	2.4
Gross domestic product		2.6	1.5	4.6	2.3	2.7	2.6	2.5	2.4	2.4	2.5
Gross domestic purchases		3.7	-.6	3.1	1.3	1.7	1.3	1.0	.9	.9	1.0
Final sales		4.5	4.2	-2.7	4.6	3.9	1.5	2.0	2.3	2.4	2.4
Private dom. final purchases		5.6	.5	-2.7	2.6	3.1	.7	.8	1.0	1.1	1.1
Personal consumption expend.		6.7	-.4	-1.1	2.5	3.6	.6	.8	1.0	1.0	1.0
Durables		44.6	-11.0	-19.8	11.0	12.2	-1.8	-1.4	.4	.6	.3
Nondurables		-.9	-.1	.0	-2.0	1.9	.7	.7	.7	.8	.6
Services		2.4	3.2	4.6	3.3	2.3	1.3	1.6	1.4	1.4	1.5
Business fixed investment		-2.1	3.0	-9.7	7.8	4.7	2.4	2.1	1.8	2.1	1.9
Producers' durable equipment		1.2	6.6	-9.2	10.2	6.6	3.9	3.7	3.3	3.7	3.3
Nonresidential structures		-9.8	-5.4	-10.5	1.4	-.1	-1.4	-2.3	-2.4	-2.2	-2.2
Residential structures		9.7	5.2	-4.7	-7.2	-6.1	-2.5	-2.8	-1.4	-.5	1.0
Exports		13.3	16.7	11.8	9.1	13.0	15.9	15.1	14.1	13.0	12.8
Imports		17.3	-.5	-2.6	.7	3.4	3.8	2.3	1.3	1.3	1.1
Government purchases		4.5	10.5	-9.6	7.9	1.8	-1.2	.0	.6	.6	.5
Federal		2.5	23.2	-24.2	16.0	1.3	-5.4	-3.3	-1.6	-1.7	-2.1
Defense		17.2	-10.2	5.3	6.1	-1.1	-2.8	-5.3	-3.3	-3.0	-2.9
State and local		6.1	1.1	4.0	2.0	2.3	2.3	2.6	2.3	2.3	2.4
Change in business inventories	Billions of 82$	-.3	-28.5	40.7	19.1	7.9	17.7	21.7	21.4	20.9	21.4
Nonfarm	Billions of 82$	-8.6	-9.8	32.8	19.9	11.7	19.2	23.2	22.9	22.4	22.9
Net exports	Billions of 82$	-163.3	-148.0	-133.7	-125.8	-117.7	-107.0	-94.6	-81.4	-68.8	-55.6
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	99.8	100.4	101.1	101.7	102.1	102.5	102.9	103.3	103.8	104.2
Unemployment rate	Percent*	6.9	6.9	6.7	6.3	6.3	6.3	6.3	6.3	6.3	6.3
Industrial production index	Percent change	1.9	3.2	3.3	2.1	3.9	3.8	3.4	3.3	3.5	3.5
Capacity utilization rate-mfg.	Percent*	79.7	79.8	80.2	80.1	80.4	80.6	80.8	80.9	80.9	81.0
Housing Starts	Millions	1.76	1.70	1.80	1.64	1.61	1.60	1.58	1.57	1.56	1.56
Auto sales	Millions	12.91	11.32	9.66	10.08	11.00	10.70	10.40	10.50	10.70	10.70
Domestic	Millions	9.43	7.66	6.86	7.09	7.76	7.50	7.30	7.40	7.55	7.55
Foreign	Millions	3.47	3.66	2.80	2.99	3.24	3.20	3.10	3.10	3.15	3.15
INCOME AND SAVING											
Nominal personal income	Percent change	1.8	3.4	7.0	5.6	5.4	6.9	7.0	4.7	5.9	6.8
Real disposable income	Percent change	-3.1	-1.5	2.9	-4.0	7.2	2.3	2.5	-.8	1.7	1.2
Personal saving rate	Percent*	2.8	2.5	3.5	2.0	2.8	3.2	3.5	3.1	3.2	3.3
Corp. profits with IVA & CCAdj	Percent change	12.7	12.8	34.9	3.5	3.8	3.0	-9.7	6.2	6.5	7.6
Profit share of GNP	Percent*	7.1	7.3	7.7	7.7	7.6	7.6	7.3	7.3	7.3	7.3
Federal govt. surplus/deficit	Billions of $	-197.4	-188.8	-170.4	-153.6	-186.9	-185.2	-186.0	-164.7	-163.3	-158.1
State and local govt. surplus		64.0	59.4	50.2	60.5	56.5	58.1	59.6	60.6	62.2	64.2
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.6	.7	4.2	3.8	3.2	2.8	3.8	3.6	3.9	4.0
GNP fixed-weight price index		2.6	2.7	3.9	3.7	3.6	3.3	4.2	4.0	4.2	4.3
Cons. & fixed invest. prices		3.0	3.3	4.7	4.7	4.0	3.7	4.4	4.4	4.7	4.8
CPI		2.5	2.6	5.3	5.1	4.4	4.0	4.3	4.6	4.8	5.0
Exc. food and energy		3.7	3.8	4.4	5.0	4.6	4.6	4.8	5.2	5.3	5.5
Nonfarm business sector											
Output per hour		-.3	-1.5	.5	.5	1.4	1.5	1.2	.9	.9	1.0
Compensation per hour		2.3	2.7	.0	5.1	3.4	3.6	5.0	4.1	4.5	4.7
Unit labor costs		2.6	4.2	-.5	4.6	2.0	2.1	3.8	3.2	3.6	3.7

* Not at an annual rate.

CONFIDENTIAL - FR
CLASS II FOMC

July 1, 1987

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

	Units	1980	1981	1982	1983	1984	1985	1986	Projection 1987	1988
EXPENDITURES										
Nominal GNP	Billions of $	2732.0	3052.6	3166.0	3405.7	3765.0	3998.1	4206.1	4447.8	4715.2
Real GNP	Billions of 82$	3187.1	3248.8	3166.0	3279.1	3489.9	3585.2	3674.9	3772.9	3863.4
Real GNP	Percent change*	-.1	.6	-1.9	6.5	4.6	2.9	2.0	3.0	2.3
Gross domestic product		.3	.3	-1.6	6.6	4.9	3.1	2.3	3.1	2.4
Gross domestic purchases		-1.1	.8	-.8	8.4	5.9	3.9	2.4	1.8	1.0
Final sales		-.2	.1	.3	3.7	4.4	4.0	2.7	1.8	2.3
Private dom. final purchases		-1.7	-.3	.8	7.7	5.3	4.2	3.1	.9	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	-.5	.0
Nondurables		-1.4	.5	1.8	4.4	2.2	2.0	3.3	.2	.7
Services		2.4	.9	2.3	3.9	3.3	3.9	2.8	2.8	1.5
Business fixed investment		-4.8	5.6	-11.3	10.8	14.7	6.5	-4.0	1.1	2.0
Producers' durable equipment		-6.5	2.2	-12.5	20.9	16.0	8.1	1.7	2.6	3.5
Nonresidential structures		-1.8	11.7	-9.1	-4.8	12.1	3.3	-16.2	-2.8	-2.3
Residential structures		-14.2	-22.4	4.9	38.1	5.3	7.8	10.0	-5.1	-.9
Exports		.5	2.4	-13.8	5.8	5.5	-3.2	6.3	12.4	13.7
Imports		-8.8	4.9	-5.9	23.8	16.5	5.8	7.9	1.3	1.5
Government purchases		1.0	2.9	3.8	-2.7	7.7	8.4	2.7	-.5	.4
Federal		3.1	9.5	8.2	-8.1	14.2	14.3	.4	-4.2	-2.2
Defense		3.1	7.6	8.8	5.1	6.8	5.9	5.5	1.8	-3.6
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	21.3	21.4
Nonfarm	Billions of 82$	-2.3	19.0	-23.1	-.1	54.3	10.9	7.4	20.9	22.9
Net exports	Billions of 82$	57.0	49.4	26.3	-19.9	-83.6	-108.2	-147.8	-121.0	-75.1
Nominal GNP	Percent change*	9.9	9.3	3.1	10.4	8.5	6.3	4.2	6.6	6.3
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	90.4	91.2	89.6	90.2	94.5	97.5	99.6	101.9	103.5
Unemployment rate	Percent	7.1	7.6	9.7	9.6	7.5	7.2	7.0	6.4	6.3
Industrial production index	Percent change*	-.8	-1.0	-7.7	14.3	6.6	1.7	1.1	3.3	3.4
Capacity utilization rate-mfg.	Percent	79.3	78.3	70.3	74.0	80.5	80.1	79.7	80.3	80.9
Housing Starts	Millions	1.30	1.10	1.06	1.71	1.77	1.74	1.82	1.66	1.57
Auto sales	Millions	9.04	8.56	8.00	9.18	10.43	11.09	11.52	10.36	10.58
Domestic	Millions	6.62	6.24	5.77	6.77	7.97	8.24	8.28	7.30	7.45
Foreign	Millions	2.42	2.32	2.23	2.41	2.46	2.84	3.25	3.06	3.13
INCOME AND SAVING										
Nominal personal income	Percent change*	12.0	9.2	5.3	7.8	8.4	6.1	4.3	6.2	6.1
Real disposable income	Percent change*	1.1	.7	1.0	5.1	4.2	1.9	2.2	2.0	1.1
Personal saving rate	Percent	7.1	7.5	6.8	5.4	6.3	5.1	3.8	2.9	3.3
Corp. profits with IVA & CCAdj	Percent change*	-6.8	2.3	-19.1	70.1	6.6	7.8	9.0	10.5	2.4
Profit share of GNP	Percent	6.5	6.2	4.7	6.3	7.0	7.0	7.1	7.6	7.3
Federal govt. surplus/deficit	Billions of $	-61.3	-63.8	-145.9	-176.0	-170.0	-198.0	-203.3	-174.0	-168.0
State and local govt. surplus		26.8	34.1	35.1	47.5	68.5	61.7	63.1	56.3	61.7
PRICES AND COSTS										
GNP implicit deflator	Percent change*	9.9	8.7	5.2	3.6	3.6	3.3	2.1	3.5	3.8
GNP fixed-weight price index		9.8	8.5	5.0	3.9	3.9	3.6	2.4	3.6	4.2
Cons. & fixed invest. prices		10.1	8.2	4.4	3.3	3.6	3.4	2.0	4.3	4.6
CPI		12.5	9.6	4.5	3.2	4.1	3.5	1.3	4.7	4.7
Exc. food and energy		12.2	10.2	5.2	4.2	4.7	4.3	3.9	4.7	5.2
Nonfarm business sector										
Output per hour		1.0	-.6	1.0	3.6	1.0	.2	.7	1.0	1.0
Compensation per hour		10.9	8.3	7.3	3.3	4.3	3.9	2.6	3.0	4.6
Unit labor costs		9.8	9.0	6.2	-.3	3.2	3.7	1.8	2.0	3.5

* Percent changes are from fourth quarter to fourth quarter.

July 1, 1987

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

	1986		1987 Projection				1988 Projection				1985 (fourth quarter to fourth quarter, net change)	1986	1987 Projection	1988 Projection
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Real GNP	25.0	9.7	43.3	20.6	24.4	23.5	22.4	21.9	21.8	23.2	101.9	73.8	111.7	89.4
Gross domestic product	23.2	13.4	41.2	21.4	24.9	24.5	23.4	22.4	22.8	23.6	107.6	82.0	112.1	92.2
Gross domestic purchases	34.4	-5.6	29.0	12.7	16.2	12.8	10.0	8.6	9.3	10.1	141.2	89.8	70.7	38.0
Final sales	40.4	37.8	-25.7	42.1	35.6	13.7	18.4	22.2	22.3	22.7	141.1	97.0	65.6	85.7
Private dom. final purchases	41.6	3.6	-20.8	19.8	24.0	5.3	6.1	7.8	8.6	8.7	122.5	93.1	28.2	31.2
Personal consumption expend.	39.6	-2.2	-7.0	15.0	21.7	3.7	5.0	6.4	6.4	6.1	80.0	94.1	33.4	23.9
Durables	34.5	-11.2	-20.4	9.5	10.8	-1.7	-1.3	.4	.6	.3	20.2	33.4	-1.8	-.1
Nondurables	-1.9	-.3	.1	-4.3	4.1	1.5	1.5	1.6	1.7	1.3	16.7	27.9	1.4	6.0
Services	7.0	9.2	13.4	9.8	6.8	3.9	4.9	4.4	4.2	4.5	43.1	32.7	33.9	18.0
Business fixed investment	-2.4	3.4	-11.5	8.4	5.3	2.8	2.4	2.0	2.5	2.2	29.3	-19.1	5.0	9.1
Producers' durable equipment	1.0	5.2	-7.9	7.9	5.3	3.2	3.1	2.8	3.1	2.8	24.4	5.6	8.5	11.9
Nonresidential structures	-3.4	-1.8	-3.5	.4	.0	-.4	-.7	-.7	-.7	-.7	4.9	-24.7	-3.5	-2.8
Residential structures	4.5	2.5	-2.4	-3.7	-3.0	-1.2	-1.4	-.7	-.2	.5	13.2	18.2	-10.2	-1.8
Change in business inventories	-15.4	-28.2	69.2	-21.6	-11.2	9.8	4.0	-.3	-.5	.5	-39.1	-23.3	46.2	3.7
Nonfarm	-19.6	-1.2	42.6	-12.9	-8.2	7.5	4.0	-.3	-.5	.5	-17.8	-25.9	29.0	3.7
Farm	4.2	-27.0	26.6	-8.7	-3.0	2.3	.0	.0	.0	.0	-21.3	2.6	17.2	.0
Net exports	-9.4	15.3	14.3	7.9	8.1	10.7	12.4	13.3	12.6	13.1	-39.3	-16.0	41.0	51.4
Exports	11.4	14.6	10.9	8.7	12.6	15.7	15.5	15.1	14.4	14.6	-12.1	22.9	47.9	59.5
Imports	20.9	-.7	-3.5	.9	4.4	5.0	3.1	1.8	1.8	1.4	27.1	39.0	6.9	8.2
Government purchases	8.2	18.9	-19.2	14.4	3.5	-2.3	.0	1.2	1.1	.9	57.9	19.9	-3.6	3.1
Federal	2.0	17.7	-23.3	12.3	1.1	-4.7	-2.8	-1.3	-1.4	-1.7	43.4	1.4	-14.6	-7.3
Defense	10.1	-6.9	3.3	3.8	-.7	-1.8	-3.5	-2.1	-1.9	-1.8	13.4	13.2	4.6	-9.3
Nondefense	-8.0	24.6	-26.6	8.5	1.8	-2.9	.7	.8	.5	.1	30.0	-11.8	-19.2	2.0
State and local	6.2	1.2	4.1	2.1	2.4	2.4	2.8	2.5	2.5	2.6	14.5	18.5	11.0	10.4

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*	1987 I*	FRB Staff Estimates 1987 II	1987 III	1987 IV	1988 I	1988 II	1988 III
								Not seasonally adjusted							
Budget receipts[2]	769	842	845	917	886	782	859	190	194	254	208	204	199	259	224
Budget outlays[2]	990	1016	1014	1024	1054	991	1034	253	252	250	258	273	249	262	270
Surplus/deficit(-) to be financed[2]	-221	-173	-169	-108	-168	-209	-175	-63	-59	3	-51	-69	-50	-3	-47
Means of financing:															
Borrowing from public	236	162	166	107	159	215	146	69	28	29	40	49	49	12	48
Cash balance decrease	-14	11	0	0	7	0	16	0	22	-31	9	17	0	-5	-5
Other[3]	-1	0	3	1	3	-6	13	-6	9	-2	2	4	1	-5	3
Cash operating balance, end of period	31	20	32	20	25	31	15	31	9	40	32	15	15	20	25
Memo: Sponsored agency borrowing[4]	14	n.a.	13	n.a.	18	13	13	4	-2	7	4	4	4	5	5
NIPA Federal Sector								Seasonally adjusted annual rates							
Receipts	815	875	880	968	926	827	891	855	873	911	884	897	921	940	947
Expenditures	1025	1061	1055	1089	1101	1030	1065	1043	1043	1065	1071	1082	1107	1105	1110
Purchases	368	385	378	395	388	366	381	372	365	385	390	384	388	389	390
Defense	275	291	288	301	295	278	291	279	287	292	294	294	295	295	295
Nondefense	94	94	90	94	93	89	89	93	78	93	96	90	93	94	95
All other expend.	657	676	678	694	714	664	684	671	679	680	681	699	720	716	721
Surplus/deficit(-)	-211	-186	-175	-121	-175	-203	-174	-189	-170	-154	-187	-185	-186	-165	-163
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-173	n.a.	-138	n.a.	-141	-165	-140	-146	-135	-118	-154	-152	-153	-131	-129

*--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. The bearish sentiment that had pervaded the U.S. securities markets in the period leading up to the last FOMC meeting dissipated to a degree in late May and June. Some abatement of inflation fears and a firmer dollar on exchange markets fostered a more constructive atmosphere in which such jolts as the announcement of Citibank's loss provisions and Chairman Volcker's departure could be quickly overcome. Taxable bond yields have declined roughly 1/4 to 1/2 percentage point from the highs reached in May. For most short-term money market instruments, rate declines have been somewhat smaller--about 1/8 to 3/8 of a point. The federal funds rate has been about unchanged at 6-3/4 percent.

Since last fall, market rates in the short- to intermediate-maturity range are up, on balance, by 1/2 to more than a full percentage point. This rise has been a significant factor retarding monetary expansion this year, as deposit rates have lagged behind. M2 is now estimated to have grown at a 4-1/4 percent annual rate from the fourth quarter of last year to June, placing it below the lower end of its annual growth cone. M3 is estimated to have grown by 5-1/2 percent, bringing it just to the bottom of its growth cone. Although M1 has expanded more rapidly than the broader aggregates, its growth also has slowed markedly from last year.

After a tax-related surge in April, M1 growth slowed to 4-1/2 percent in May and this aggregate appears to have declined substantially in June. M2 was virtually unchanged in May as tax payments also likely depressed MMDA growth in late April and early May and probably played a role in the runoff of money fund shares. In June, sizable growth in small time deposits was prompted by sharp increases in offering rates and a steepening of the retail deposit yield curve. Some of the growth in small time deposits probably came from more liquid components of M2; however, on balance, the nontransactions component of M2 was boosted more than enough to offset the decline in M1. M3 growth has remained moderate but appears to have strengthened a bit from the May pace of just under 5 percent. There were substantial increases in commercial bank large CDs; at thrifts, CDs increased despite the problems of institutions in the Southwest.

Credit growth at banks slackened somewhat over the past two months, after an April bulge. Bank lending to businesses (including bookings at foreign branches) has tapered off, after picking up in April, and consumer loans also have weakened. However, real estate lending has remained strong, likely bolstered to some degree by shifts from consumer loans to home equity lines. Asset growth at S&Ls also was strong in April, when borrowers rushed to close mortgage loans under previous commitments at lower interest rates.

For the nonfinancial business sector in the aggregate, debt growth appears to have picked up a little over the second quarter as a whole. Commercial paper issuance lifted the total in April and May, more than compensating for the diminished volume of gross bond issuance. As interest rates declined in June, there was some return to bond financing, particularly in the domestic market, but total net issuance for the quarter apparently was still well below the second-quarter pace. Gross equity issuance, on the other hand, has remained sizable, but so too have share retirements.

In the household sector, revolving credit picked up sharply in April, perhaps for tax-related reasons, boosting total consumer installment credit growth from the minimal first quarter pace. However, preliminary data point to little, if any, further growth in May. Home mortgage borrowing in the second quarter likely also was greater than in the first quarter. Issuance of FHLMC and FNMA pass-throughs was quite strong in April and, in May, their volume was well maintained; the volume of GNMA pass-throughs was reduced in May, however, probably because loan originators were released from prior rate commitments on FHA/VA loans by the increases in the VA ceiling rate.

The pace of tax-exempt bond issuance rebounded in June--but probably not enough to bring net borrowing by states and localities for the quarter as a whole up to the first-quarter rate. The pickup in bond offerings last month was concentrated in issues for new capital; refunding volume remained at only about one-third of the first-quarter pace, as interest rates remained well above their earlier levels.

Net borrowing by the Treasury increased in the second quarter, despite the April surge in tax collections that kept the total budget deficit about zero. As a result, federal debt growth on a seasonally adjusted basis surged in the second quarter while the Treasury raised its cash balance by more than $25 billion. Nevertheless, paydowns of Treasury bills continued to be substantial, resulting in a reduction of about 8-1/2 percent in the total outstanding stock of Treasury bills over the first half of this year.

Outlook. Although the staff projections point to only moderate economic growth in coming months, it is thought that, more likely than not, interest rates will be somewhat higher by year-end, owing to pressures stemming from occasional bouts of dollar weakness and from concerns about inflation trends. Under the circumstances, the nonfinancial credit aggregate is likely to remain well within the FOMC's monitoring range.

Federal debt expansion will slow from its elevated second-quarter pace, as the Treasury works down its large cash balance. A disruption of federal borrowing patterns could occur in mid-July if there is a delay in completing congressional action on the debt ceiling, but this would almost certainly be temporary and has no bearing on the staff's forecast. In the state and local sector, also, borrowing may be a little slower in the second half of the year, with the higher level of interest rates continuing to depress advance refunding.

In the business and household sectors, the pace of debt growth is likely to remain close to the second-quarter pace, and somewhat above the average for the first half of the year. In the nonfinancial business sector, the financing gap should remain small, but sizable net share retirements will continue to require external financing.

In the household sector, consumer credit probably will continue to register only meager growth. Net extensions of mortgage debt are likely to ebb very gradually. The possibility of shifting from fixed-rate to ARM financing will ease the effect of higher interest rates; such a shift is hinted in data for early May.

During 1988, the staff is expecting about the same debt growth as in 1987. It is likely that the federal deficit will be little changed as the current year's tax windfall will not be repeated. In the business sector, the financing gap will widen a bit but this boost to external financing may be offset by a reduced pace of equity retirements. Household debt growth, in particular mortgage borrowing, is likely to slacken in an environment of somewhat higher interest rates and moderate growth of spending for housing and consumer durables.

Recent developments. On balance the dollar strengthened during the intermeeting period, as downward pressure abated despite some reports of continuing negative sentiment for the long term. The dollar rose early in the period and following the announcement on May 29 of the Japanese economic stimulus package. The dollar subsequently declined with the announcement of Chairman Volcker's resignation and weakened further in the days prior to the Venice Summit. Late in the period, the dollar recovered in response to better-than-expected economic news for the United States and has since traded in a narrow range. On balance, the weighted-average foreign exchange value of the dollar against the other G-10 currencies has appreciated about 2-3/4 percent since the May FOMC meeting. The dollar rose nearly 5 percent against the yen and 2-3/4 percent against the mark.

Since the May meeting of the FOMC, U.S. long-term interest rates have declined about 50 basis points. This resulted in a narrowing of the differential between U.S. and foreign rates, as long-term bond rates rose almost 40 basis points in Germany and almost 70 basis points in Japan.

. The Desk intervened twice, following the announcement by Citibank of the addition to its loan-loss reserves and again after the announcement of Chairman Volcker's resignation, purchasing a total of $543 million against marks and $103 million against yen.

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Economic activity in the foreign industrial countries has generally remained sluggish so far this year. In Germany both real GNP and industrial production fell sharply during the first quarter while in France output growth was very weak. German industrial production in April showed some rebound in activity. In Japan and the United Kingdom real GNP did rise sharply during the initial quarter of the year. Japanese industrial production declined in April and May, however. Consumer price inflation has remained generally low abroad, although the rate has recently increased slightly in Japan, France, Canada, and Italy.

Brazil announced in mid-June a new package of stabilization measures, including a devaluation of the cruzado, a freeze in prices and wages, cuts in public expenditures, and tighter monetary controls. Officials hope that the plan will win approval of the IMF and break the deadlock with the commercial banks. Mexico's current account and international reserves have shown considerable strength in the first four months of the year. Phillipine authorities have announced that they will not seek to reopen the loan negotiations with commercial banks.

The U.S. merchandise trade deficit was about unchanged in the first quarter from its value in the final quarter of last year. Both exports and imports increased slightly on average during the three months. Much of the increase in the latter was accounted for by a rise in the value of oil imports, as the price of imported oil rose 23 percent during the quarter. The April trade data, measured on a not-seasonally adjusted basis, show a deficit smaller than that in March and well below the monthly average for the first quarter. The U.S. current account deficit was reduced slightly in the first quarter from its rate during the last quarter of 1986. Gains in transfer items more than offset reduction of net service receipts to account for most of the improvement in the first quarter.

Outlook. Consistent with higher U.S. interest rates contained in the current outlook, the rate of decline in the exchange value of the dollar will be more moderate over the forecast horizon than was projected in the last Greenbook. However, there remains significant risk that downward pressure on the dollar in exchange markets will be greater than expected. If such pressures should emerge, perhaps as a result of renewed impatience with the pace of external adjustment by the United States or a changed perception on the part of market participants of policy intentions both in the United States and in the major foreign industrial countries, a greater decline in the exchange value of the dollar could result. The staff has raised slightly its forecast of GNP growth in the foreign industrial countries to about 1-3/4 percent, annual rate, on average during 1987-88, in response to the changed outlook for the real value of their currencies during the forecast period and in the light of recent policy actions, particularly in Japan. The U.S. current account deficit is projected to be about $155 billion in 1987 and then to decline somewhat, reaching an annual rate of about $125 billion in the fourth quarter of next year. The change in the outlook from the previous forecast reflects the change in the projected value of the dollar over the forecast horizon and adjustment of the forecast for service transactions based on data for the first quarter.

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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	-106.6	-85.3	-108.9	-110.2	-107.9	-109.1	-106.3	-102.9	-97.7	-89.9	-81.3	-72.3
Exports of G+S	373.0	420.7	499.3	370.8	383.5	399.0	409.7	426.8	447.3	468.2	489.0	509.5	530.5
Imports of G+S	477.3	527.2	584.6	479.7	493.7	506.9	518.8	533.1	550.2	565.8	578.9	590.9	602.8
Constant 82 $, Net	-147.8	-121.0	-74.9	-163.3	-148.0	-133.7	-125.8	-117.6	-106.9	-94.5	-81.2	-68.6	-55.5
Exports of G+S	371.5	413.4	471.2	371.2	385.8	396.7	405.4	417.9	433.6	449.1	464.2	478.5	493.1
Imports of G+S	519.2	534.3	546.1	534.5	533.8	530.3	531.0	535.4	540.4	543.5	545.3	547.1	548.5
2. U.S. Merchandise Trade Balance 2/	-144.3	-152.6	-133.3	-148.5	-154.4	-153.3	-154.5	-152.7	-149.7	-144.8	-137.7	-129.4	-121.3
Exports	224.4	248.9	303.6	226.1	228.1	232.8	241.8	253.6	267.5	282.2	296.7	310.6	324.9
Agricultural	27.0	26.1	28.3	26.6	28.1	26.3	26.1	25.5	26.5	27.2	28.1	28.7	29.3
Non-Agricultural	197.3	222.9	275.3	199.6	200.0	206.6	215.8	228.1	241.0	255.0	268.7	281.8	295.6
Imports	368.7	401.5	436.9	374.6	382.5	386.2	396.3	406.3	417.2	427.0	434.5	439.9	446.2
Petroleum and Products	33.8	39.6	43.5	31.6	32.0	34.8	39.3	41.5	43.0	43.0	43.3	43.8	44.1
Non-Petroleum	334.9	361.9	393.3	343.0	350.4	351.4	357.0	364.8	374.3	384.0	391.2	396.2	402.1
3. U.S. Current Account Balance	-141.4	-154.0	-138.3	-146.3	-151.9	-148.5	-156.4	-156.5	-154.6	-148.7	-142.0	-134.6	-127.8
Of Which: Net Investment Income	20.8	10.0	3.1	21.4	18.0	15.3	9.6	8.4	6.8	5.5	4.2	2.1	0.6
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.4	2.0	1.8	2.1	1.7	1.3	2.2	1.8	1.9	1.7	1.7	1.8	1.8
Real GNP--NonOPEC LDC 5/	4.4	3.8	4.1	4.1	3.9	3.6	3.7	3.8	3.9	4.0	4.3	4.6	5.0
Consumer Prices--Ten Ind. 4/	2.0	2.2	2.8	0.1	2.1	2.4	3.5	2.1	2.4	2.8	3.3	2.7	3.5

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