Prefatory Note

The attached document represents the most complete and accurate version available based on original copies culled from the files of the FOMC Secretariat at the Board of Governors of the Federal Reserve System. This electronic document was created through a comprehensive digitization process which included identifying the best-preserved paper copies, scanning those copies,[1] and then making the scanned versions text-searchable.[2] Though a stringent quality assurance process was employed, some imperfections may remain.

Please note that this document may contain occasional gaps in the text. These gaps are the result of a redaction process that removed information obtained on a confidential basis. All redacted passages are exempt from disclosure under applicable provisions of the Freedom of Information Act.

---

[1] In some cases, original copies needed to be photocopied before being scanned into electronic format. All scanned images were deskewed (to remove the effects of printer- and scanner-introduced tilting) and lightly cleaned (to remove dark spots caused by staple holes, hole punches, and other blemishes caused after initial printing).

[2] A two-step process was used. An advanced optimal character recognition computer program (OCR) first created electronic text from the document image. Where the OCR results were inconclusive, staff checked and corrected the text as necessary. Please note that the numbers and text in charts and tables were not reliably recognized by the OCR process and were not checked or corrected by staff.

Strictly Confidential (FR) Class II FOMC

October 28, 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. The economic fallout from the recent turmoil in financial markets--the runup in interest rates followed by the plunge in share prices--is not yet clear. It is clear, however, that the economy entered the autumn on a solid uptrend. Real GNP was up substantially in the third quarter, with growth in the industrial sector especially robust, spurred by a pickup in business investment and a further expansion in real net exports, apart from oil. Even as unemployment declined further, there was only a hint of acceleration in wages, and underlying price trends remained stable.

Industrial production rose another 0.2 percent in September, after a big jump earlier in the summer. For the third quarter as a whole, output was up nearly 9 percent at an annual rate, with large gains in most major market groupings. Production of business equipment was especially vigorous, apparently reflecting improved foreign as well as domestic demand for U.S. products. Materials output also continued to strengthen; operating rates rose markedly for steel and remained high in the paper and chemicals industries. In contrast, automobile assemblies were reduced sharply in August and September, to about 6 million units at an annual rate. Current schedules indicate production of around 7-1/4 million units in the fourth quarter, despite prospects for relatively weak sales and growing inventories; recent reports, however, have hinted at possible adjustments to be announced in coming weeks.

Labor demand, on balance, has remained strong, with nonfarm payroll employment (on a strike-adjusted basis) up almost 200,000 in September. Manufacturing employment posted a sizable rise in the third quarter, with widespread gains across both durable and nondurable industries. Job growth elsewhere, however, has slowed; construction employment dropped in September, and hiring in the finance, insurance, and real estate grouping was damped by the dropoff in mortgage lending and by some shakeout among financial service firms. The civilian unemployment rate edged down another one-tenth of a percentage point in September to 5.9 percent.

Consumer spending generally has been on a sluggish growth path since late 1986, with real outlays up at only a 2 percent annual rate during the first three quarters, after rising more than 4 percent per year in 1985 and 1986. In the third quarter, consumption rose nearly 5 percent in real terms, but much of the gain was attributable to an incentive-induced increase in outlays on motor vehicles. With the expiration of the incentives at the end of September, sales of domestic autos dropped sharply. Purchases of other goods were essentially flat last quarter, reflecting continued softness in demand for big-ticket items as well as for most types of nondurables, while service outlays rose appreciably.

Housing activity through September continued to be damped by the effects of higher mortgage interest costs and elevated rental vacancy rates. Building permits were flat last month and, though starts ticked up--to a 1.67 million unit annual rate--they remained well below the pace of early this year.

Business fixed investment soared in the third quarter, according to BEA's preliminary estimates. Real outlays for equipment rose more than 25 percent at an annual rate, paced by a surge in purchases of computers, an incentive-induced bulge in motor vehicle spending, and a less dramatic but still substantial increase in spending on other types of equipment. Outlays on structures also recorded a large rise, as petroleum drilling activity expanded sharply, outlays by public utilities jumped, and office construction firmed. The advance spending indicators available through September also were strong; excluding aircraft, new orders for nondefense capital goods were up another 4 percent (not annualized) in the third quarter, after rising sharply over the first half, and recent information on commitments suggests that construction also will be relatively well-maintained. Recent events in financial markets undoubtedly will lead to some reassessment of capital spending plans, but investment outlays should be supported in the near term by projects that already are under way.

Inventory investment was held down in the third quarter by a sharp liquidation of stocks at automobile dealers. Judging from data available through August, the level of stocks elsewhere in the trade sector generally appeared to be in line with sales. In the manufacturing sector, the stronger orders received since last spring contributed to a step-up in the pace of inventory accumulation that was fairly widespread by industry and by stage of fabrication; even so, inventory-sales ratios in most industries remained low at the end of August.

Increases in consumer prices have been relatively moderate in recent months, with the CPI up 0.2 percent in September, after rising 0.5 percent in August. Retail energy prices fell last month, while food prices rose. Excluding food and energy items, consumer prices increased 0.3 percent per month, on average, in August and September, a bit below the average pace over the first seven months of the year. Price increases for finished goods at the producer level also have remained moderate. However, prices for intermediate and crude materials (apart from food and energy) have continued to rise substantially, owing to the higher levels of industrial activity, the lower exchange value of the dollar, and the effects on petroleum-based products of earlier increases in crude oil prices. Since mid-September, movements in spot commodity prices have been mixed, with prices of steel scrap and primary aluminum higher over the period and those of lumber and cotton lower. As yet, the stock market has had only a limited spillover on the commodity markets, although prices have turned down somewhat.

Wage trends have remained moderate, although increases in the past few months have been slightly larger than earlier in the year. In particular, the employment cost index measure of private compensation, which we feel is the best indicator of underlying compensation patterns, rose 3.3 percent over the 12 months ending in September, compared with a 3.0 percent increase for the year ending in June.

Outlook. The staff expects real GNP to increase at about a 2-1/4 percent annual rate in the fourth quarter, more than a percentage point below the average pace of the first three quarters. Consumer spending is anticipated to be held down by a sharp drop in purchases of motor vehicles, reflecting both a payback from the late summer incentives and a response to the stock market collapse. Residential construction also is likely to decline, and business fixed investment is expected to rise more moderately. However, inventory investment is anticipated to be higher than in the third quarter; this pickup mainly reflects a rebuilding of stocks at auto dealers after the late summer liquidation. Indeed, with auto production projected to be up in the current quarter, the swing in inventories more than offsets the effect on GNP of the drop in auto sales noted above. In addition, there is likely to be a sizable improvement in the external sector, as real exports of goods and services continue to rise rapidly and the volume of petroleum imports falls to a more normal level, after the third-quarter bulge. Prices, as measured by the fixed-weight index for GNP, are expected to rise about 3-1/4 percent at an annual rate, a bit less than the average pace during the first three quarters of the year.

The effects of recent financial events become an even greater forecasting issue as one looks beyond the current quarter. History offers no reliable way of assessing with any precision the magnitude and timing of the effects of the stock market plunge on the real economy. Assuming that the market will not recover its lost ground rapidly and that the psychological damage will last for awhile, the staff has interpreted the stock market drop as a significant negative impulse to aggregate demand.

In assembling the projection, however, the staff has assumed that monetary policy will be adjusted to offset some of the contractionary effect of the drop in stock prices. As a result, interest rates are projected to fall appreciably over the next several months and then to trend up gradually over the latter half of 1988. Growth of M2 and M3 is anticipated to be greater than in the last forecast, but still within the tentative target ranges for 1988. The foreign exchange value of the dollar against other G-10 currencies is expected to decline at a somewhat faster rate than was projected in the last Greenbook.

The federal budget deficit now is expected to be about $165 billion in fiscal 1988, compared with the final figure of $148 billion for FY1987. The projected deficit for FY1988 is slightly larger than in the last Greenbook; the weaker economic outlook more than offsets the favorable effects of lower interest rates and a somewhat bigger deficit reduction package. We have assumed revenue increases and spending cuts of $23 billion, consistent with the requirements of the Gramm-Rudman Balanced Budget Act; we also anticipate several billion dollars of additional deficit reduction through asset sales.

The staff now projects overall activity to be quite sluggish in the first half of next year, with real GNP rising only about 1 percent at an annual rate. After midyear, however, growth is expected to gather speed, as the beneficial effects of lower interest rates and some recovery in stock prices begin to take hold. Nonetheless, the projected rise in real GNP for 1988 as a whole now is a tad under 2 percent, compared with 2-1/2 percent in the September Greenbook.

The projections for consumer spending and business investment have been lowered substantially. Assuming stock prices fluctuate around recent levels in the near-term, consumption is expected to be subdued in the first half of 1988, before picking up somewhat in the ensuing period. Demand for motor vehicles and other discretionary, big-ticket items is expected to be especially soft for a time. And real business fixed investment now is projected to grow less than 2 percent next year, given the reduced need for additional capacity in some sectors and the greater initial uncertainty about future sales prospects. Housing construction is likely to drop somewhat in the near term, but that decline is forecast to be stemmed by lower mortgage rates. The outlook for real net exports of goods and services remains strong.

Given the less favorable prospects for real activity in 1988, the projected increases in prices and wages have been lowered a bit. The civilian unemployment rate now is projected to move above 6 percent early next year, and the pressures on wages of labor market tightness thus are expected to be less intense than expected a month ago. Nonetheless, increases in nonpetroleum import prices associated with the anticipated depreciation of the dollar still are likely to be substantial and to provide considerable impetus to inflation. The fixed-weight price index for GNP now is projected to increase about 4-1/4 percent next year, 1/4 percentage point less than shown in the September Greenbook but about 1/2 percentage point above the expected 1987 pace.

October 28, 1987

CONFIDENTIAL - FR
CLASS II FOMC

STAFF GNP PROJECTIONS

Percent changes, annual rate

	Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
	9/16/87	10/28/87	9/16/87	10/28/87	9/16/87	10/28/87	9/16/87	10/28/87	9/16/87	10/28/87
Annual changes:										
1985 <1>	6.3	6.3	3.0	3.0	3.6	3.6	3.2	3.2	7.2	7.2
1986 <1>	5.6	5.6	2.9	2.9	2.7	2.7	2.6	2.6	7.0	7.0
1987	5.8	5.7	2.7	2.7	3.5	3.3	3.1	2.9	6.2	6.2
1988	6.6	5.6	2.8	2.0	4.2	3.9	3.7	3.5	5.9	6.2
Quarterly changes:										
1986 Q1 <1>	7.0	7.0	5.4	5.4	2.2	2.2	1.8	1.8	7.1	7.1
Q2 <1>	3.6	3.6	.6	.6	2.2	2.2	2.9	2.9	7.1	7.1
Q3 <1>	5.3	5.3	1.4	1.4	2.6	2.6	3.6	3.6	6.9	6.9
Q4 <1>	2.1	2.1	1.5	1.5	2.3	2.3	.7	.7	6.9	6.9
1987 Q1 <1>	8.6	8.6	4.4	4.4	4.5	4.5	4.2	4.2	6.7	6.7
Q2 <1>	6.6	6.3	2.3	2.5	4.3	4.1	3.8	3.5	6.2	6.2
Q3 <1>	6.8	6.2	3.5	3.8	3.2	2.7	3.3	2.4	6.0	6.0
Q4	5.7	5.0	3.0	2.2	3.5	3.3	2.6	2.6	6.0	6.1
1988 Q1	6.9	4.8	2.9	.8	4.6	4.3	4.0	4.0	5.9	6.2
Q2	7.0	5.3	2.6	1.4	4.4	4.1	4.2	3.8	5.9	6.3
Q3	6.7	6.9	2.4	2.6	4.5	4.2	4.2	4.1	5.9	6.3
Q4	6.8	7.2	2.3	2.9	4.6	4.4	4.4	4.2	5.9	6.2
Two-quarter changes: <2>										
1986 Q2 <1>	5.3	5.3	3.0	3.0	2.1	2.1	2.3	2.3	.0	.0
Q4 <1>	3.7	3.7	1.5	1.5	2.5	2.5	2.1	2.1	-.2	-.2
1987 Q2 <1>	7.6	7.5	3.4	3.4	4.5	4.4	4.0	3.9	-.7	-.7
Q4	6.2	5.6	3.3	3.0	3.3	3.0	3.0	2.5	-.2	-.1
1988 Q2	7.0	5.0	2.7	1.1	4.5	4.2	4.1	3.9	-.1	.2
Q4	6.7	7.0	2.3	2.8	4.6	4.3	4.3	4.1	.0	-.1
Four-quarter changes: <3>										
1985 Q4 <1>	6.6	6.6	3.3	3.3	3.6	3.6	3.1	3.1	-.2	-.2
1986 Q4 <1>	4.5	4.5	2.2	2.2	2.3	2.3	2.2	2.2	-.2	-.2
1987 Q4	6.9	6.5	3.3	3.2	3.9	3.7	3.5	3.2	-.9	-.8
1988 Q4	6.8	6.0	2.5	1.9	4.5	4.3	4.2	4.0	-.1	.1

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

CONFIDENTIAL - FR
CLASS II FOMC

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

October 28, 1987

	Units	1986 Q3	1986 Q4	1987 Q1	1987 Q2	1987 Q3	1987 Q4 (Projection)	1988 Q1 (Projection)	1988 Q2 (Projection)	1988 Q3 (Projection)	1988 Q4 (Projection)
EXPENDITURES											
Nominal GNP	Billions of $	4265.9	4288.1	4377.7	4445.1	4512.0	4567.4	4620.9	4680.5	475[illegible].9	4841.8
Real GNP	Billions of 82$	3718.0	3731.5	3772.2	3795.3	3831.2	3852.3	3859.7	3873.3	389[illegible].7	3926.5
Nominal GNP	Percent change	5.3	2.1	8.6	6.3	6.2	5.0	4.8	5.3	6.9	7.2
Real GNP		1.4	1.5	4.4	2.5	3.8	2.2	.8	1.4	2.6	2.9
Gross domestic product		1.2	2.2	4.2	2.8	3.9	2.2	.9	1.5	2.7	2.8
Gross domestic purchases		3.0	.4	2.5	2.1	4.3	.1	-.9	-.1	1.4	1.5
Final sales		3.9	3.7	-2.3	3.5	6.2	.6	1.8	2.1	2.6	2.8
Private dom. final purchases		5.9	1.2	-3.2	2.9	7.0	-2.0	.2	.8	1.7	1.8
Personal consumption expend.		7.3	.5	-.7	1.9	4.8	-2.6	.4	.9	1.6	1.7
Durables		44.9	-6.3	-21.2	10.5	19.9	-22.9	-1.0	1.4	3.7	3.2
Nondurables		-.1	.2	1.3	-1.9	-.3	-.5	-.5	.0	.7	.9
Services		2.6	3.0	5.4	2.1	4.1	3.2	1.4	1.4	1.7	1.8
Business fixed investment		-3.0	5.1	-14.6	11.7	23.7	3.7	1.9	1.7	1.6	1.6
Producers' durable equipment		3.1	4.7	-15.3	16.5	26.6	3.4	2.5	2.5	2.5	2.5
Nonresidential structures		-16.6	6.3	-12.8	.0	15.8	4.9	.2	-.5	-.8	-1.0
Residential structures		9.7	2.2	-7.7	-2.8	-.2	-6.6	-5.9	-3.1	2.9	4.5
Exports		10.6	9.5	10.2	17.9	16.5	11.9	10.3	10.3	11.4	12.9
Imports		20.1	-.8	-5.2	11.1	16.5	-5.1	-3.6	-2.3	1.1	1.2
Government purchases		3.0	7.9	-6.2	3.8	4.7	1.1	-.4	-.5	.1	-.1
Federal		2.4	15.2	-18.6	6.6	7.0	.4	-2.5	-3.0	-1.9	-2.5
Defense		16.4	-10.5	7.6	9.8	2.1	-6.0	-5.6	-4.7	-3.1	-3.3
State and local		3.5	2.4	5.0	1.7	3.0	1.7	1.3	1.6	1.7	1.8
Change in business inventories	Billions of 82$	6.1	-14.4	47.6	39.0	18.1	33.0	23.6	17.5	17.9	18.5
Nonfarm	Billions of 82$	.1	2.3	43.9	22.7	9.2	30.0	24.1	18.5	18.9	19.5
Net exports	Billions of 82$	-161.6	-151.8	-135.2	-132.7	-137.9	-118.2	-102.1	-87.6	-76.4	-63.4
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	99.8	100.4	101.1	101.7	102.3	102.6	102.9	103.2	103.7	104.2
Unemployment rate	Percent*	6.9	6.9	6.7	6.2	6.0	6.1	6.2	.3	6.3	6.2
Industrial production index	Percent change	1.3	3.8	3.2	4.2	8.8	3.6	.9	2.2	4.5	4.2
Capacity utilization rate-mfg.	Percent*	79.5	79.8	80.0	80.5	81.5	81.7	81.4	81.3	81.6	81.9
Housing Starts	Millions	1.76	1.70	1.79	1.61	1.62	1.55	1.57	1.60	1.60	1.60
Auto sales	Millions	12.91	11.32	9.66	10.26	11.42	9.33	9.43	9.40	9.75	9.95
Domestic	Millions	9.43	7.66	6.86	7.20	7.84	6.44	6.57	6.50	6.80	7.00
Foreign	Millions	3.47	3.66	2.80	3.06	3.58	2.89	2.87	2.90	2.95	2.95
INCOME AND SAVING											
Nominal personal income	Percent change	3.1	4.6	7.8	5.2	5.6	6.7	5.2	4.1	4.8	7.4
Real disposable income	Percent change	-1.0	.5	2.7	-4.3	4.7	4.2	1.7	-1.0	.8	1.4
Personal saving rate	Percent*	3.6	3.6	4.4	3.0	3.0	4.6	4.9	4.4	4.2	4.2
Corp. profits with IVA & CCAdj	Percent change	5.9	-7.2	19.7	3.9	-2.5	8.9	-17.6	2.7	17.2	7.8
Profit share of GNP	Percent*	6.7	6.6	6.7	6.7	6.5	6.6	6.2	6.2	6.3	6.3
Federal govt. surplus/deficit	Billions of $	-203.7	-188.7	-170.5	-139.2	-149.4	-172.1	-182.3	-167.4	-157.6	-150.1
State and local govt. surplus		59.6	50.6	41.0	50.6	42.2	40.3	42.8	44.7	47.6	51.7
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.6	.7	4.2	3.5	2.4	2.6	4.0	3.8	4.1	4.2
GNP fixed-weight price index		2.6	2.3	4.5	4.1	2.7	3.3	4.3	4.1	4.2	4.4
Cons. & fixed invest. prices		3.1	3.0	5.1	4.7	2.9	3.2	4.4	4.4	4.7	4.9
CPI		2.5	2.6	5.3	4.9	4.0	3.2	4.1	4.5	4.7	5.2
Exc. food and energy		3.7	3.8	4.4	4.7	3.6	4.1	4.5	5.1	5.4	5.6
Nonfarm business sector											
Output per hour		-.6	.0	.4	1.3	2.5	.3	-.3	.4	1.0	1.3
Compensation per hour		2.8	4.0	1.1	3.0	4.5	2.8	4.9	4.0	4.2	4.5
Unit labor costs		3.5	4.0	.8	1.7	2.0	2.5	5.2	3.6	3.2	3.2

* Not at an annual rate.

CONFIDENTIAL - FR
CLASS II FOMC

October 28, 1987

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	3772.2	4010.3	4235.0	4475.6	4725.5
Real GNP	Billions of 82$	3187.1	3248.8	3166.0	3279.1	3501.4	3607.5	3713.3	3812.7	3889.5
Real GNP	Percent change*	-.1	.6	-1.9	6.5	5.1	3.3	2.2	3.2	1.9
Gross domestic product		.3	.3	-1.6	6.6	5.3	3.5	2.6	3.3	1.9
Gross domestic purchases		-1.1	.8	-.8	8.4	6.4	4.1	2.7	2.2	.5
Final sales		-.2	.1	.3	3.7	4.7	4.6	2.6	2.0	2.3
Private dom. final purchases		-1.7	-.3	.8	7.7	5.6	4.6	3.2	1.1	1.1
Personal consumption expend.		-.1	.2	2.9	5.4	4.1	4.5	4.1	.8	1.1
Durables		-5.6	-3.3	9.0	14.7	10.8	6.6	12.4	-5.3	1.8
Nondurables		-1.4	.5	1.8	4.4	2.3	2.9	2.9	-.3	.3
Services		2.4	.9	2.3	3.9	3.5	5.0	2.4	3.7	1.6
Business fixed investment		-4.8	5.6	-11.3	10.8	13.8	4.7	-4.7	5.1	1.7
Producers' durable equipment		-6.5	2.2	-12.5	20.9	14.9	7.0	.2	6.6	2.5
Nonresidential structures		-1.8	11.7	-9.1	-4.8	11.8	.1	-15.4	1.4	-.5
Residential structures		-14.2	-22.4	4.9	38.1	6.1	6.0	12.5	-4.4	-.5
Exports		.5	2.4	-13.8	5.8	5.9	-2.7	5.9	14.0	11.2
Imports		-8.8	4.9	-5.9	23.8	17.4	5.2	8.9	3.9	-.9
Government purchases		1.0	2.9	3.8	-2.7	7.9	8.7	2.4	.8	-.2
Federal		3.1	9.5	8.2	-8.1	13.0	14.9	-.2	-1.7	-2.5
Defense		3.1	7.6	8.8	5.1	6.5	7.0	4.8	3.2	-4.2
State and local		-.3	-1.3	.6	1.5	4.4	4.0	4.6	2.8	1.6
Change in business inventories	Billions of 82$	-6.9	23.9	-24.5	-6.4	62.3	7.4	13.8	34.4	19.4
Nonfarm	Billions of 82$	-2.3	19.0	-23.1	-.1	57.8	12.0	15.4	26.5	20.3
Net exports	Billions of 82$	57.0	49.4	26.3	-19.9	-84.0	-108.2	-145.8	-131.0	-82.4
Nominal GNP	Percent change*	9.9	9.3	3.1	10.4	8.6	6.6	4.5	6.5	[illegible]
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	6.2	6.2
Industrial production index	Percent change*	-.8	-1.0	-7.7	14.3	6.6	1.7	1.0	4.9	2.9
Capacity utilization rate-mfg.	Percent	79.3	78.2	70.3	73.9	80.5	80.1	79.7	80.9	81.5
Housing Starts	Millions	1.30	1.10	1.06	1.71	1.77	1.74	1.82	1.64	1.59
Auto sales	Millions	9.04	8.56	8.00	9.18	10.43	11.09	11.52	10.17	9.63
Domestic	Millions	6.62	6.24	5.77	6.77	7.97	8.24	8.28	7.09	6.72
Foreign	Millions	2.42	2.32	2.23	2.41	2.46	2.84	3.25	3.08	2.92
INCOME AND SAVING										
Nominal personal income	Percent change*	12.0	9.2	5.3	7.8	8.4	6.8	5.5	6.3	5.4
Real disposable income	Percent change*	1.1	.7	1.0	5.1	4.3	2.8	3.6	1.8	.7
Personal saving rate	Percent	7.1	7.5	6.8	5.4	6.1	4.5	4.3	3.7	4.4
Corp. profits with IVA & CCAdj	Percent change*	-6.8	2.3	-19.1	70.1	7.4	4.1	1.2	7.2	1.7
Profit share of GNP	Percent	6.5	6.2	4.7	6.3	7.1	6.9	6.7	6.6	6.3
Federal govt. surplus/deficit	Billions of $	-61.3	-63.8	-145.9	-176.0	-169.6	-196.0	-204.7	-157.8	-164.4
State and local govt. surplus		26.8	34.1	35.1	47.5	64.6	63.1	56.8	43.5	46.7
PRICES AND COSTS										
GNP implicit deflator	Percent change*	9.9	8.7	5.2	3.6	3.4	3.1	2.2	3.2	4.0
GNP fixed-weight price index		9.8	8.5	5.0	3.9	3.7	3.6	2.3	3.7	4.3
Cons. & fixed invest. prices		10.1	8.2	4.4	3.3	3.3	3.5	2.0	4.0	4.6
CPI		12.5	9.6	4.5	3.2	4.1	3.5	1.3	4.3	4.6
Exc. food and energy		12.2	10.2	5.2	4.2	4.7	4.3	3.9	4.2	5.2
Nonfarm business sector										
Output per hour		1.0	-.6	1.0	3.6	1.5	1.0	1.5	1.1	.6
Compensation per hour		10.9	8.3	7.3	3.3	4.2	4.8	3.4	2.8	4.4
Unit labor costs		9.8	9.0	6.2	-.3	2.6	3.7	1.9	1.7	3.8

* Percent changes are from fourth quarter to fourth quarter.

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

	1986		1987				Projection 1988				1985	1986	Projection 1987	Projection 1988
	Q3	Q4	Q1	Q2	Q3	Q4 (Projection)	Q1	Q2	Q3	Q4	(fourth quarter to fourth quarter, net change)			
Real GNP	13.3	13.5	40.7	23.1	35.9	21.1	7.4	13.6	25.4	27.8	115.7	80.6	120.8	74.2
Gross domestic product	10.6	20.4	38.3	25.8	36.1	20.8	8.5	13.9	25.4	26.7	121.5	92.7	121.0	74.5
Gross domestic purchases	28.1	3.7	24.1	20.6	41.1	1.4	-8.7	-.9	14.2	14.8	150.2	103.1	87.2	19.4
Final sales	35.2	33.9	-21.3	31.8	56.8	6.1	16.8	19.7	25.0	27.3	159.0	93.3	73.4	88.8
Private dom. final purchases	44.4	9.5	-25.7	22.2	53.2	-15.8	1.5	6.1	13.5	14.4	133.0	97.7	33.9	35.5
Personal consumption expend.	43.2	3.0	-4.6	11.6	29.5	-16.6	2.2	5.6	10.3	10.5	102.1	97.3	19.9	28.6
Durables	35.9	-6.5	-23.1	9.5	17.9	-25.4	-.9	1.3	3.5	3.0	22.0	43.9	-21.1	6.9
Nondurables	-.2	.5	2.9	-4.2	-.6	-1.0	-1.0	.0	1.5	2.0	24.5	24.6	-2.9	2.4
Services	7.5	8.9	15.8	6.2	12.3	9.7	4.2	4.3	5.3	5.5	55.7	28.6	44.0	19.3
Business fixed investment	-3.3	5.5	-17.2	11.9	23.9	4.2	2.2	2.0	1.9	1.8	20.8	-22.0	22.8	7.8
Producers' durable equipment	2.4	3.6	-13.0	11.9	19.3	2.8	2.1	2.1	2.1	2.1	20.7	.6	21.0	8.5
Nonresidential structures	-5.7	1.9	-4.2	.0	4.5	1.5	.1	-.1	-.3	-.3	.1	-22.6	1.8	-.7
Residential structures	4.6	1.1	-4.0	-1.4	-.1	-3.4	-2.9	-1.5	1.4	2.1	10.1	22.5	-8.9	-.9
Change in business inventories	-22.0	-20.5	62.0	-8.6	-20.9	14.9	-9.4	-6.1	.4	.5	-43.3	-12.8	47.4	-14.6
Nonfarm	-23.8	2.2	41.6	-21.2	-13.5	20.8	-5.9	-5.6	.4	.5	-22.0	-14.4	27.7	-10.6
Farm	1.8	-22.6	20.3	12.6	-7.4	-5.9	-3.5	-.5	.0	.0	-21.2	1.6	19.6	-4.0
Net exports	-14.8	9.8	16.6	2.5	-5.2	19.7	16.1	14.5	11.2	13.0	-34.5	-22.5	33.6	54.8
Exports	9.4	8.7	9.5	16.7	16.1	12.2	11.0	11.3	12.7	14.7	-10.1	21.8	54.5	49.7
Imports	24.2	-1.1	-7.1	14.2	21.3	-7.5	-5.1	-3.2	1.5	1.7	24.4	44.3	20.9	-5.2
Government purchases	5.6	14.6	-12.2	7.1	8.8	2.2	-.8	-.9	.3	-.1	60.5	18.1	5.9	-1.5
Federal	2.0	12.0	-17.3	5.3	5.7	.3	-2.2	-2.6	-1.6	-2.1	44.8	-.7	-6.0	-8.5
Defense	9.7	-7.1	4.7	6.1	1.4	-4.1	-3.7	-3.1	-2.0	-2.1	15.8	11.6	8.1	-10.9
Nondefense	-7.6	19.1	-22.0	-.8	4.3	4.4	1.5	.5	.4	.0	29.0	-12.3	-14.1	2.4
State and local	3.6	2.5	5.2	1.8	3.2	1.8	1.4	1.7	1.9	2.0	15.7	18.7	12.0	7.0

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1986*	Fiscal Year 1987[1]	FY1988e Admin[2]	FY1988e FRB Staff	CY 1986*	CY1987e FRB Staff	1986 IV*	1987 I*	1987 II*	1987 III[1]	FRB Staff Estimates IV	1988 I	1988 II	1988 III
							Not seasonally adjusted							
Budget receipts[3]	769	854	909	895	782	870	190	194	254	217	206	204	261	225
Budget outlays[3]	990	1002	1032	1059	991	1033	253	252	251	245	284	244	261	270
Surplus/deficit(-) to be financed[3]	-221	-148	-123	-164	-209	-163	-63	-59	2	-29	-78	-40	-1	-45
Means of financing:														
Borrowing from public	236	151	107	153	215	142	69	28	32	22	60	38	15	39
Cash balance decrease	-14	-5	0	11	0	12	0	22	-31	4	18	1	-10	3
Other[4]	-1	3	1	0	-6	9	-6	9	-3	3	0	1	-4	3
Cash operating balance, end of period	31	36	20	25	31	19	31	9	40	36	19	18	28	25
Memo: Sponsored agency borrowing[5]	14	16	n.a.	27	14	17	5r	-4	7	8	6	4	9	8
NIPA Federal Sector							Seasonally adjusted annual rates							
Receipts	816	892	968	936	827	909	853	879	923	914	919	931	944	950
Expenditures	1027	1054	1089	1106	1032	1067	1041	1050	1062	1064	1091	1114	1111	1108
Purchases	369	375	395	389	366	379	369	367	380	385	385	390	390	391
Defense	275	289	301	295	278	293	279	288	295	296	294	296	295	295
Nondefense	93	86	94	94	88	86	90	79	85	89	91	94	95	96
All other expend.	658	679	694	717	666	688	673	683	683	679	706	724	721	717
Surplus/deficit(-)	-211	-162	-121	-170	-205	-158	-189	-171	-139	-149	-172	-182	-167	-158
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-190	-144	n.a.	-154	-183	-144	-163	-151	-123	-140	-162	-166	-147	-139

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

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

1. Partially estimated.
2. Mid-session Review of the 1988 Budget (August 1987). The Congressional Budget Office baseline estimates released August 19 indicated receipts of $897 billion, outlays of $1080 billion, and the deficit of $183 billion in FY1988. The CBO estimate of the FY1988 deficit with the policies of the Congressional Budget Resolution is $146 billion.
3. Includes social security receipts and outlays, which are classified as off-budget under current law.
4. Checks issued less checks paid, accrued items, and other transactions.
5. Sponsored agency borrowing includes net debt issuance by Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation (excluding participation certificates), the Federal National Mortgage Association (excluding mortgage-backed securities), Farm Credit Banks, the Student Loan Marketing Association, and the Financing Corporation. The Administration's definition of borrowing by these agencies is somewhat broader.

Recent Developments

Financial markets have been shaken by the crash in stock prices on October 19 and its aftershocks. Share prices in the United States have dropped about 25 percent since mid-October and more than 30 percent from their August 25 peak, erasing more than a trillion dollars of wealth over the past two months. Investors seeking refuge from stocks bid up prices of Treasury securities throughout the maturity spectrum, more than reversing the sharp run-up in yields that had developed earlier in the intermeeting period amid concerns about the dollar, inflation, and more restrictive monetary policies abroad. On balance over the intermeeting period, Treasury bill rates are down about 75 to 125 basis points and coupon yields are off about 50 basis points. The 30-year Treasury bond in recent days has carried a yield of around 9 percent after touching 10-1/4 percent just prior to the plunge in stock prices.

Elsewhere in the credit markets, rates on investment-grade corporate bonds and secondary mortgage instruments have broadly tracked movements in Treasury rates, while primary mortgage rates have lagged. In the "junk" bond sector, which had been performing fairly well, even in the face of heavy supply, tiering has developed since the stock market collapse; yields on lower-quality issues--those more akin to equity--have firmed while rates on the upper tier have moved a little lower. In tax-exempt markets, sharp rate advances in late September and the first half of October, aggravated a bit by efforts of mutual funds to build liquidity for a potential new wave of withdrawals, were only partly retraced after midmonth. Meanwhile, the flight from stocks has aided private money market instruments. Rates on CDs and prime commercial paper have moved down about a percentage point or more from their peaks in mid-October--encouraged by some reduction in the federal funds rate--prompting banks to roll back half of their early October 1/2 percentage point hike in the prime rate. Throughout the credit markets, intra-day and day-to-day movements in rates have been substantial as market makers have pulled back considerably, attempting more to match trades than to take on price-smoothing positions.

Evidence on the initial response of financing patterns and asset management to these developments is fragmentary. In the nonfinancial corporate sector, merger and buyout activity has been curtailed. However, because many firms have announced intentions to buy back their own shares, the net restraint on borrowing could be relatively minor. A number of firms having investment-grade status have rushed to the bond market in response to the recent drop in interest rates. In September, both bond issuance and bank loans had strengthened in association with heavy merger and restructuring activity. Gross stock issuance also had picked up a little in September and early October before drying up.

State and local governments appear to have responded less than businesses to the recent easing of bond rates. Reflecting the previous rise in rates, state and local governments in recent months had curbed their bond offerings, especially advance refundings, to a pace well below that of 1985 and 1986.

Very little is known about the reaction of households to recent financial developments. Consumer credit growth had been a little stronger in recent months, in part associated with automobile concessionary financing programs and rebates, but was still well below that of the past few years. Borrowing in the mortgage markets had slowed a little in recent months, reflecting weaker housing and refinancing activity associated with the previous rise in mortgage rates. The weakening in mortgage demand likely would have been more pronounced in the absence of ARMs. The rise in rates on ARMs fell short of the rise on fixed-rate mortgages, and the spread favoring ARMs widened to a record 3 percentage points. Reflecting these developments, the ARM share of conventional mortgages had been running above 50 percent. The relatively undeveloped secondary market for ARMs has been aided by new programs at FNMA and FHLMC and new Treasury regulations facilitating REMICs backed by ARMs.

Treasury borrowing in the current quarter has been boosted by September delays in raising the debt ceiling and a much reduced pace of asset sales. Heavy bill issuance in early October largely replaced the substantial September paydown. Otherwise, the Treasury continues to concentrate its net borrowing in the coupon area.

On the asset side, the public evidently has reacted to recent developments by shifting substantial amounts from equities to more liquid assets, as suggested by the record inflow to money market mutual funds in the week of October 21. Prior to this development, M2 had been expanding at a moderate pace but was continuing to run well below its annual range; meanwhile, M3 had been rising along the lower boundary of its annual range. Money funds in M2 had been growing fairly rapidly as had small time deposits as rates on both kinds of accounts had been rising.

Outlook

The outlook for financial markets and financing is extremely uncertain at this point, owing to questions about the reaction of domestic spending and policy measures abroad to the recent plunge in equity markets. The staff forecast anticipates some decline in the overall structure of interest rates in the United States. The effects of the weakening in domestic activity, in the aftermath of the stock market plunge, is seen as overriding the effects of potentially substantial downward pressures on the dollar and some unwinding of the flight to fixed-income assets and liquidity. Nevertheless, rate volatility could remain substantial; market liquidity is likely to return only gradually, and market participants probably will be extremely sensitive to new evidence on the direction of the economy and prices, external imbalances, and reactions abroad.

In the business sector, borrowing through the end of 1988 is expected to remain around the pace of recent quarters. Borrowing will tend to be lowered by reduced share retirements resulting from a cutback in merger and buyout activity. But this will be offset by some widening of the financing gap as profits soften while capital expenditures, including inventories, expand sluggishly. Business credit demands will tend in the direction of bond offerings in light of reduced bond rates, although ample supplies of short-term credit through the commercial paper market and banks and more restricted access to the low-rated bond market may limit moves toward long-term debt.

Household borrowing is expected to be concentrated in mortgage debt. Lower interest rates will tend to keep mortgage borrowing near recent levels, while weak consumption, especially spending on autos, and a perhaps more cautious approach to borrowing are likely to be associated with very little expansion in consumer debt.

State and local governments are expected to remain light borrowers despite lower financing costs. Issuance of refunding bonds could strengthen from recent levels, but borrowing to finance capital expenditure programs is expected to remain low. In the federal sector, the Treasury is expected over the balance of the current quarter to borrow more heavily than earlier in the year, in the absence of special one-time boosts in receipts and as asset sales remain lower. For calendar year 1988, growth in federal debt is expected to be around the reduced pace of this year.

Recent Developments. Relative to the extreme fluctuations that emerged in other financial markets during the intermeeting period, foreign exchange markets were generally calm until late in the period. The dollar rose somewhat against other G-10 currencies in the latter part of September, following the announcement by G-7 authorities of their continued commitment to the Louvre accord "to foster stability of exchange rates around current levels." Since early October, however, the dollar has generally declined, to a level about 3-1/4 percent below its level at the time of the September FOMC meeting. Indications of tighter monetary conditions in Germany and Japan early in October again raised doubts about the status of the Louvre accord, and the announcement in mid-October of a disappointing figure for the U.S. trade balance in August contributed to further downward pressure on the dollar. Remarks by Treasury Secretary Baker criticizing German monetary policy and suggesting that the dollar would be allowed to fall, which were reported prior to the sharp decline in stock prices on Monday, October 19, had only a small negative impact on the dollar. The dollar strengthened temporarily after the stock market plunge, when it was announced that Secretary Baker had met with German officials and reaffirmed a commitment to cooperate under the Louvre accord. But it came under significant downward pressure again toward the end of the intermeeting period, on renewed rumors that the dollar would be allowed to adjust downwards.

. The

desk purchased $300 million on October 27 and 28.

The plunge in the U.S. stock market was accompanied by sharp declines in stock markets abroad. By October 27, the London index had fallen nearly 28 percent below its level on September 22 -- compared with a 27 percent drop in the NYSE composite index. The Frankfurt and Tokyo indexes declined by 19 percent and 9 percent, respectively, over the same period. Stock markets in other industrial countries and in a number of developing countries also registered sharp declines.

Indicators of economic activity in major foreign industrial countries suggest that activity in the third quarter expanded somewhat faster than the weak average rate of the first half of the year, while inflation abroad remained low. In Japan, third-quarter industrial production was nearly 3-1/2 percent above the average level for the first half of the year. Japan's trade surplus was down slightly in nominal terms, and more substantially in real terms in the third quarter. Japanese consumer prices in the third quarter were slightly above their year-earlier level, while wholesale prices showed a smaller decline than in previous quarters. German industrial production rebounded strongly in August, following declines in June and July, but the average level for July-August was still below its year-ago level. German consumer prices in the third quarter were slightly above their level in the third quarter of 1986. Output in the United Kingdom continued to grow at a healthy pace, while that in France and Italy slowed somewhat.

Brazil has been in arrears on its interest payments on medium and long term loans since February 20, 1987, and the Paris Club decided in mid-September not to reschedule amortization payments due for the first half of the year. Argentina devalued the austral and announced new economic reform measures in mid-October. The U.S. Treasury recently agreed to participate in a $500 million multilateral bridge loan for Argentina.

The U.S. merchandise trade deficit in July-August was marginally larger than in the second quarter on a seasonally adjusted basis; both imports and exports rose substantially over that period. A surge in oil imports in July-August, most of which went into domestic stocks, accounted for more than half of the rise in total imports. Non-agricultural exports continued to grow at a rapid pace, with shipments of commercial aircraft showing particular strength in July. Agricultural exports also picked up strongly, with a bulge in shipments of wheat to the Soviet Union.

Foreign private net purchases of U.S. securities, particularly corporate stocks, dropped off sharply in August. Banks reported large net capital inflows in August, though these were down substantially from the very large inflows reported for July. The decline in private capital inflows was matched by an increase in official inflows. Foreign official reserve assets in the United States increased by $5-1/2 billion in August, after having declined in July.

Data now available on the foreign claims of U.S. chartered banks in the second quarter show an $8 billion decline from the level in the first quarter. Most of the decline reflected reductions in claims on G-10 countries and off-shore banking centers. Claims on non-OPEC developing countries rose by about $1/2 billion, with increased lending to Mexico partly offset by reduced lending to Brazil.

Outlook. We anticipate that monetary policy in the major foreign industrial countries will be adjusted less than U.S. monetary policy to offset the contractionary effects of the drop in stock prices, and that interest rates abroad will fall less than U.S. rates. As a result, we have built into our outlook a somewhat faster rate of decline in the dollar than in the September Greenbook, with that decline spread evenly over the forecast horizon. However, the overall magnitude of the decline in the dollar, of course, could be more than we anticipate, and in light of the contour of the U.S. outlook, more of it could take place by mid-1988 than we have assumed.

Economic activity in other industrial countries is generally viewed as being less sensitive to stock market fluctuations than the U.S. economy, and we judge that the negative impacts of recent stock market declines on growth abroad will be smaller than the underlying impact on U.S. growth. Other, more favorable, developments, including recent strength in foreign industrial production and orders data, offset the expected negative effects of the shocks from stock markets, leaving our projection of average growth of foreign G-10 real GNP essentially unchanged at nearly a 2 percent annual rate over the forecast period.

The lower projected levels of U.S. growth, interest rates, and the dollar, along with a downward revision in the outlook for import prices (based on a significant downward revision of preliminary estimates for the third quarter), all contribute to an improvement in the outlook for the U.S. current account. The current account deficit is now expected to decline to about $135 billion in the fourth quarter of 1988, roughly $15 billion less than in the September projection. The improvement in real net exports of goods and services on the forecast period has been revised up somewhat less because a lower projected level of prices of non-oil imports -- even with the lower dollar -- tends to push up the volumes of those inputs and offset some of the effects of the other factors.

Strictly Confidential (FR)
Class II FOMC

October 28, 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-	Q3-	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current $, Net	-105.5	-115.6	-91.7	-110.5	-116.9	-112.2	-118.4	-121.7	-110.3	-102.4	-94.2	-88.2	-81.9
Exports of G+S	376.2	424.6	495.1	376.6	383.3	397.3	416.5	433.4	451.1	467.4	484.3	503.4	525.2
Imports of G+S	481.7	540.2	586.8	487.1	500.2	509.5	534.8	555.1	561.4	569.8	578.5	591.7	607.1
Constant 82 $, Net	-145.8	-131.0	-82.4	-161.6	-151.8	-135.2	-132.7	-137.9	-118.2	-102.1	-87.6	-76.4	-63.4
Exports of G+S	377.4	421.4	472.3	379.6	388.3	397.8	414.5	430.6	442.8	453.9	465.1	477.8	492.5
Imports of G+S	523.2	552.4	554.7	541.2	540.1	533.0	547.2	568.5	561.0	556.0	552.7	554.2	555.9
2. U.S. Merchandise Trade Balance 2/	-144.3	-158.5	-140.8	-148.5	-154.4	-155.0	-158.1	-165.5	-155.6	-149.0	-142.3	-137.7	-134.2
Exports	224.4	248.6	305.0	226.1	228.1	228.0	239.9	257.0	269.4	284.3	298.4	312.1	325.4
Agricultural	27.0	28.6	32.3	26.6	28.1	26.1	28.6	30.5	29.2	30.5	31.9	33.0	33.9
Non-Agricultural	197.3	220.0	272.7	199.6	200.0	201.9	211.3	226.5	240.2	253.7	266.5	279.1	291.5
Imports	368.7	407.1	445.8	374.6	382.5	383.0	398.0	422.5	425.0	433.3	440.6	449.9	459.6
Petroleum and Products	33.8	42.3	44.0	31.6	32.0	34.8	40.0	51.0	43.4	42.4	43.2	45.2	45.3
Non-Petroleum	334.9	364.8	401.8	343.0	350.4	348.2	358.0	371.5	381.5	390.9	397.4	404.7	414.2
3. U.S. Current Account Balance	-141.4	-161.8	-140.7	-146.3	-151.9	-147.1	-164.4	-175.4	-160.4	-150.6	-142.4	-136.8	-133.1
Of Which: Net Investment Income	20.8	10.9	9.9	21.4	18.0	22.0	6.4	4.1	11.0	9.8	9.7	9.6	10.6
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.5	2.1	1.8	2.2	1.6	1.5	2.9	2.0	1.7	1.5	1.9	1.9	1.9
Real GNP--NonOPEC LDC 5/	4.6	4.4	4.3	4.6	4.4	4.3	4.2	4.3	4.3	4.3	4.3	4.3	4.3
Consumer Prices--Ten Ind. 4/	2.0	2.2	2.6	0.1	2.1	2.4	3.4	2.1	2.4	2.7	2.[illegible]	2.5	3.2

1/ National Income 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