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

June 22, 1988

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 data suggest that the economy has expanded somewhat less rapidly in the second quarter than in the first. The strength of the industrial sector apparently has been sustained, with a pickup in auto production, but labor market data point to some moderation in overall output growth. Few indications of more rapid price inflation have appeared to date at the consumer level, although the effects of drought may in coming months augment pressures associated with reduced slack in available capital and labor resources.

The index of industrial production rose 0.4 percent in May after a sizable April advance, bringing the May level 4-1/2 percent (annual rate) above the first-quarter average. The recent growth reflects, in part, continued gains in the production of capital goods, for which both foreign and domestic demand is especially strong. Auto and truck assemblies rose further in May in response to the sustained strength in sales. However, output of nonauto consumer goods edged down, perhaps owing in part to the persistent overhang in retailers' stocks--especially for apparel. The overall rise in production pushed up the rate of capacity utilization to 82.9 percent. Increases in utilization rates were widespread, with primary processing industries exhibiting the tightest conditions.

The strength in industrial activity has supported further hiring in manufacturing and kept overtime schedules at high levels in recent months. In contrast, employment growth in other sectors--notably construction, services, and retail trade--slowed somewhat in May, and, overall, held the rise in nonfarm payroll employment to 209,000. The civilian unemployment rate stood at 5.6 percent in May, returning to its March level. The level of initial claims for unemployment insurance has remained near 300,000 in recent weeks, suggesting continued expansion in labor demand through early June.

Autos and light trucks continued to sell at a fairly strong pace in April and May, and an extension of sales incentive plans into midyear may aid sales in June as well. However, excluding autos, real outlays for goods fell in April, and available data on retail sales suggest little change in May. Much of the recent weakness continues to be concentrated in spending for nondurable goods.

Total housing starts, which had run at about a 1-1/2 million unit annual rate over the preceding three months, fell to 1.38 million units in May. The sharp drop in starts appeared somewhat at odds with other information, especially for the single-family sector: single-family permits actually edged up last month, and sales had moved upward through April. A decline in multifamily starts, however, was not surprising, in light of the high April level and prevailing market conditions.

Business fixed investment slowed early in the second quarter, after rising rapidly in the first quarter. In large part, the slowing reflects a reduced level of shipments for office and computing equipment from the exceptional first-quarter pace. Among other components of equipment, the April-May level of shipments was about 2-1/2 percent (not at an annual rate) above the first-quarter average. In contrast, outlays for structures turned up in April after a sluggish first quarter, with much of that growth in the industrial sector. With regard to near-term indicators of investment, new orders for nondefense capital goods (excluding aircraft) were little changed in April and May; new commitments for nonresidential construction have trended down since the turn of the year. However, the latest surveys of capital spending plans for 1988 now show year-over-year increases of roughly 10-11 percent, implying further gains in outlays in the second half of the year.

Nonfarm inventory investment excluding autos slowed in March and April. Stock buildups continued in manufacturing and wholesale trade, but remained concentrated in industries experiencing strong domestic and foreign demand. In contrast, nonauto retail inventory investment slowed sharply in April, as production cutbacks apparently helped stem the accumulation of stocks at general merchandise stores and apparel outlets.

The consumer price index advanced 0.3 percent in May, after a 0.4 percent rise in April. Food prices have risen more than 1/2 percent, on average, in the past two months, and drought conditions in major growing regions have boosted the prices of a wide range of farm products on commodity markets. Retail energy prices also moved up in April and May, as earlier increases in crude oil prices reached the retail level; however, spot prices have moved down most recently, partly in response to OPEC's failure to agree on a tightening of production quotas. Excluding food and energy, the CPI was up an average 0.3 percent in April and May, bringing the rise so far this year to around 4-1/2 percent, similar to the pace for all of last year.

Outlook

The staff estimates that real GNP rose at around a 3-1/4 percent annual rate in the second quarter.[1] Higher automobile assemblies, which were reflected in a swing from a liquidation of dealers' stocks in the first quarter to a slight accumulation in the second quarter, contributed about 1-1/4 percentage points to GNP growth. Net exports probably improved substantially further, while growth of domestic spending appears to have been weak. Real consumer spending likely rose about 1-1/2 percent. Business fixed investment is expected to have flattened out at the high level of spending reached in the first quarter. And, housing activity probably was little changed.

The staff believes that the recent pace of expansion cannot be sustained without generating increasing inflation over the projection period. With the increased competitiveness of U.S. industry anticipated to bolster exports and damp imports, the staff continues to expect that the containment of wage and price pressures will require additional policy restraint on domestic demand.

Much of the burden of imposing that restraint likely will fall on the Federal Reserve. The path of interest rates in the forecast is essentially the same as that in the May projection, with the rise in market yields expected to induce a noticeable increase in monetary

---

1. The staff estimate of second-quarter GNP growth may not be directly comparable to the BEA estimate scheduled to be released in late July because our estimate is based on currently available data from the National Income and Product Accounts through the first quarter. When BEA publishes information on second-quarter GNP in late July, they will also release revisions to the NIPA accounts, including new seasonal factors, for the last three years that may alter the underlying pattern of activity.

velocity. Consequently, M2 growth is projected to move down toward the middle of its range for 1988, and to be appreciably slower in 1989; M3 is expected to grow somewhat faster than M2 in both years. The dollar is expected to depreciate moderately against other G-10 currencies.

Fiscal policy is assumed to be mildly restrictive, with the structural deficit tending to fall over the projection period. However, the staff expects the federal deficit (total budget) to rise from last year's $150 billion to a little under $160 billion in FY1988. Growth in receipts has slowed, owing in part to the effects of the Tax Reform Act, which bolstered revenues sharply last year and are reducing taxes, on balance, this year. Meanwhile, increased outlays for interest and most entitlements are more than offsetting spending restraint in domestic discretionary programs and reductions in agricultural supports. Similar factors are expected to keep the deficit virtually unchanged in FY1989, despite the assumed enactment of the remaining elements of the budget summit measures agreed to last fall. Although the staff's deficit projection for FY1989 is above the $146 billion level specified in the Gramm-Rudman-Hollings Act for triggering a sequester, it is assumed that OMB--whose estimate determines whether a sequester occurs--will generate a forecast below the trigger by using more favorable economic and technical assumptions.

The staff continues to expect real GNP growth to slow markedly after the current quarter--running around 2 percent at an annual rate over the next six quarters. The noticeable third-quarter slowing in activity reflects both a decline in automobile production and a likely dropoff in farm output--especially for grains and oilseeds--associated with the current drought. There is substantial uncertainty about both the size of the drought effects and how those effects will be allocated by the BEA. The staff outlook assumes that lower farm output will subtract about 3/4 percentage point from GNP growth in the third quarter. Looking ahead, agricultural production is expected to remain at a depressed level in the fourth quarter, but then is projected to move back up in 1989 as weather patterns are assumed to return to normal and as an easing of government restrictions opens up additional cropland for production.

Beginning later this year, moderation in inventory investment from the recent unsustainable pace, along with the damping effects of higher interest rates on domestic final purchases, are expected to restrain overall growth. Moreover, budgetary pressures at both the federal level and state and local level probably will constrain government purchases. By next year, slower growth in nominal income combined with relatively rapid increases in consumer prices should limit increases in consumer spending. In addition, impetus to business investment from strong export demand will likely be offset by expectations of lower domestic final sales. High vacancy rates for multifamily units and rising mortgage costs are expected to damp housing activity throughout the projection period.

As measured by the GNP fixed-weight price index, inflation is expected to be 4-3/4 percent over the remainder of the year, after rising at around a 3-3/4 percent annual rate over the past several quarters. The acceleration in the second quarter reflects a runup in food prices, a swing in energy prices, and price hikes for apparel goods. In coming months, food prices are expected to move up sharply in response to the drought. More broadly, continued price increases for non-oil imports and pressures associated with tight conditions in labor and product markets also are projected to add to inflation in the second half of 1988. With the civilian unemployment rate expected to edge up only slightly, the pickup in prices is projected to feed into labor costs, boosting hourly compensation growth to about 4-1/2 percent by the end of this year.

While overall pressures on productive resources are not projected to change greatly in 1989--and the trend of compensation increases remains in the 4-1/2 percent area--the staff forecast shows a deceleration of aggregate price inflation to about 4 percent in the second half of next year. The rise in nonpetroleum import prices is projected to moderate, and the effects of the current drought on food prices will be ebbing. Slower economic growth, coupled with additional expansion of capacity--especially in industries with high operating rates--could alleviate somewhat the tightness in product markets, although the magnitude of this effect is likely to be relatively small.

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

June 22, 1988

NFIDENTIAL - 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)	
	5/11/88	6/22/88	5/11/88	6/22/88	5/11/88	6/22/88	5/11/88	6/22/88	5/11/88	6/22/88
Annual changes:										
1986 <1>	5.6	5.6	2.9	2.9	2.7	2.7	2.6	2.6	7.0	7.0
1987 <1>	6.0	6.0	2.9	2.9	3.4	3.4	3.0	3.0	6.2	6.2
1988	6.5	6.8	3.2	3.6	3.9	4.0	3.1	3.1	5.6	5.6
1989	6.2	6.3	2.2	2.2	4.3	4.4	3.9	4.1	5.8	5.8
Quarterly changes:										
1987 Q1 <1>	8.6	8.6	4.4	4.4	4.5	4.5	4.2	4.2	6.6	6.6
Q2 <1>	6.3	6.3	2.5	2.5	4.1	4.1	3.5	3.5	6.3	6.3
Q3 <1>	7.3	7.3	4.3	4.3	3.4	3.4	2.8	2.8	6.0	6.0
Q4 <1>	7.6	7.6	4.8	4.8	3.6	3.6	2.7	2.7	5.9	5.9
1988 Q1 <1>	4.7	5.4	2.3	3.9	3.7	3.6	2.4	1.7	5.7	5.7
Q2	7.1	8.2	3.5	3.3	4.1	4.7	3.6	4.7	5.5	5.6
Q3	6.7	6.3	2.4	2.1	4.5	4.4	4.1	4.2	5.6	5.7
Q4	6.3	6.7	2.3	2.3	4.4	4.5	4.0	4.3	5.6	5.7
Q1	6.2	6.5	1.9	2.0	4.6	4.9	4.2	4.4	5.7	5.7
Q2	5.8	5.5	1.9	1.7	4.2	4.1	3.9	3.7	5.8	5.8
Q3	5.8	6.1	2.0	2.4	4.0	4.0	3.7	3.5	5.8	5.8
Q4	5.6	6.1	1.9	2.4	3.9	4.0	3.6	3.6	5.9	5.9
Two-quarter changes: <2>										
1987 Q2 <1>	7.5	7.5	3.4	3.4	4.4	4.4	3.9	3.9	-.5	-.5
Q4 <1>	7.4	7.4	4.6	4.6	3.6	3.6	2.8	2.8	-.4	-.4
1988 Q2	5.9	6.8	2.9	3.6	3.9	4.2	3.0	3.2	-.4	-.3
Q4	6.5	6.5	2.3	2.2	4.4	4.5	4.1	4.2	.1	.1
1989 Q2	6.0	6.0	1.9	1.9	4.4	4.5	4.0	4.0	.2	.1
Q4	5.7	6.1	2.0	2.4	3.9	4.0	3.6	3.6	.1	.1
Four-quarter changes: <3>										
1986 Q4 <1>	4.5	4.5	2.2	2.2	2.3	2.3	2.2	2.2	-.3	-.3
1987 Q4 <1>	7.4	7.4	4.0	4.0	4.0	4.0	3.3	3.3	-.9	-.9
1988 Q4	6.2	6.7	2.6	2.9	4.1	4.3	3.5	3.7	-.3	-.2
1989 Q4	5.8	6.0	1.9	2.1	4.1	4.2	3.8	3.8	.3	.2

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

CONFIDENTIAL - FR
CLASS II FOMC

June 22, 1988

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

	Units	1987		1988				1989			
						Projection					
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of $	4524.0	4607.4	4668.7	4762.0	4835.9	4914.4	4992.0	5059.5	5134.4	5210.7
Real GNP	Billions of 82$	3835.9	3880.8	3918.0	3949.8	3970.2	3992.8	4012.9	4030.3	4054.6	4078.6
Nominal GNP	Percent change	7.3	7.6	5.4	8.2	6.3	6.7	6.5	5.5	6.1	6.1
Real GNP		4.3	4.8	3.9	3.3	2.1	2.3	2.0	1.7	2.4	2.4
Gross domestic product		4.8	4.4	4.3	3.2	2.0	2.2	1.9	1.7	2.4	2.3
Gross domestic purchases		4.8	4.3	2.1	1.6	1.8	1.3	.4	.3	1.1	1.1
Final sales		6.0	.9	4.5	3.5	2.7	3.2	3.2	2.1	2.5	2.4
Private dom. final purchases		7.3	-1.4	5.7	1.1	3.6	2.3	1.4	.5	1.1	1.0
Personal consumption expend.		5.4	-2.5	4.3	1.5	3.0	2.2	1.6	.6	.9	1.0
Durables		24.3	-20.3	13.3	4.2	.7	1.2	.8	-.1	-.1	.6
Nondurables		-1.5	-.5	1.7	-3.2	2.9	1.7	1.0	.1	.2	.2
Services		5.0	2.4	3.3	4.0	3.7	2.9	2.3	1.2	1.7	1.7
Business fixed investment		25.8	1.6	20.8	.0	9.8	4.7	3.1	1.6	2.8	1.7
Producers' durable equipment		26.3	-.9	32.8	-1.5	13.0	6.0	4.4	2.4	4.0	2.4
Nonresidential structures		24.6	8.4	-6.6	4.3	1.1	1.1	-.5	-.7	-.7	-.4
Residential structures		-6.5	7.4	-9.4	-1.7	-2.5	-2.4	-5.4	-4.5	-.4	-.5
Exports		23.7	15.9	20.7	10.6	9.9	15.2	17.9	17.8	15.5	14.2
Imports		22.4	9.9	3.4	-2.6	6.7	5.8	4.1	5.2	4.9	4.2
Government purchases		2.6	9.2	-9.0	4.7	-2.6	1.5	2.1	1.0	1.2	.9
Federal		4.5	14.1	-21.2	8.2	-9.1	.0	1.5	-1.1	-.7	-1.3
Defense		7.5	-.9	-4.3	-8.5	-11.1	-.3	1.8	-1.1	-1.1	-1.1
State and local		1.2	5.5	1.5	2.1	2.5	2.5	2.5	2.5	2.6	2.5
Change in business inventories	Billions of 82$	24.6	60.5	55.4	53.7	48.2	39.8	28.7	25.6	25.2	25.6
Nonfarm	Billions of 82$	12.1	51.5	37.6	45.8	40.9	33.8	20.8	17.1	16.7	17.1
N[illegible]orts	Billions of 82$	-138.4	-135.8	-119.1	-102.9	-100.8	-91.3	-75.7	-60.9	-47.7	-34.5
E[illegible]NT AND PRODUCTION											
Nonfarm payroll employment	Millions	102.7	103.7	104.7	105.5	106.0	106.4	106.8	107.0	107.4	107.8
Unemployment rate	Percent*	6.0	5.9	5.7	5.6	5.7	5.7	5.7	5.8	5.8	5.9
Industrial production index	Percent change	8.8	7.0	3.9	4.6	3.7	2.6	2.0	2.7	3.0	3.0
Capacity utilization rate-mfg.	Percent*	81.4	82.3	82.7	83.1	83.2	83.0	82.8	82.7	82.6	82.5
Housing Starts	Millions	1.62	1.53	1.49	1.49	1.47	1.41	1.39	1.38	1.38	1.38
Auto sales	Millions	11.42	10.02	10.79	10.40	10.10	10.12	10.05	10.02	9.95	9.93
Domestic	Millions	7.84	6.63	7.64	7.27	7.07	7.10	7.05	7.05	7.00	7.00
Foreign	Millions	3.58	3.38	3.15	3.12	3.03	3.02	3.00	2.97	2.95	2.93
INCOME AND SAVING											
Nominal personal income	Percent change	5.8	10.3	5.1	7.0	5.8	8.4	7.8	5.4	5.4	6.5
Real disposable income	Percent change	4.5	6.0	3.9	.9	2.3	2.9	2.8	.0	.7	1.5
Personal saving rate	Percent*	2.8	4.8	4.7	4.5	4.4	4.5	4.8	4.6	4.5	4.6
Corp. profits with IVA & CCAdj	Percent change	26.7	-2.4	-3.9	21.6	1.5	-3.1	3.4	1.0	8.5	12.1
Profit share of GNP	Percent*	7.0	6.8	6.6	6.8	6.8	6.6	6.5	6.5	6.5	6.6
Federal govt. surplus/deficit	Billions of $	-135.8	-160.2	-151.8	-141.3	-136.9	-141.5	-150.9	-139.5	-128.9	-126.6
State and local govt. surplus		46.5	37.9	45.8	49.2	53.6	56.3	60.1	60.4	60.8	61.5
Exc. social insurance funds		-5.6	-15.5	-9.2	-6.5	-2.8	-.8	2.3	1.9	1.6	1.6
PRICES AND COSTS											
GNP implicit deflator	Percent change	2.8	2.7	1.7	4.7	4.2	4.3	4.4	3.7	3.5	3.6
GNP fixed-weight price index		3.4	3.6	3.6	4.7	4.4	4.5	4.9	4.1	4.0	4.0
Cons. & fixed invest. prices		3.9	3.3	2.7	5.1	4.7	4.7	4.7	4.6	4.4	4.4
CPI		3.6	3.9	3.2	4.8	4.8	5.0	4.6	4.8	4.6	4.7
Exc. food and energy		3.6	4.2	4.4	4.7	4.5	5.2	5.1	5.1	5.0	5.0
Nonfarm business sector											
Output per hour		4.2	-1.0	3.6	-.1	.2	.8	.4	.7	.9	.9
C[illegible]nsation per hour		3.6	3.5	3.4	3.8	4.1	4.4	4.9	4.6	4.6	4.6
[illegible]abor costs		-.6	4.5	-.2	3.9	3.9	3.6	4.5	3.9	3.7	3.7

* Not at an annual rate.

CONFIDENTIAL - FR
CLASS II FOMC

June 22, 1988

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

	Units	1981	1982	1983	1984	1985	1986	1987	Projection 1988	1989
EXPENDITURES										
Nominal GNP	Billions of $	3052.6	3166.0	3405.7	3772.2	4010.3	4235.0	4488.5	4795.2	5099.2
Real GNP	Billions of 82$	3248.8	3166.0	3279.1	3501.4	3607.5	3713.3	3821.0	3957.7	4044.1
Real GNP	Percent change*	.6	-1.9	6.5	5.1	3.3	2.2	4.0	2.9	2.1
Gross domestic product		.3	-1.6	6.6	5.3	3.5	2.6	4.1	2.9	2.1
Gross domestic purchases		.8	-.8	8.4	6.4	4.1	2.7	3.4	1.7	.7
Final sales		.1	.3	3.7	4.7	4.6	2.6	2.0	3.5	2.5
Private dom. final purchases		-.3	.8	7.7	5.6	4.6	3.2	1.3	3.2	1.0
Personal consumption expend.		.2	2.9	5.4	4.1	4.5	4.1	1.0	2.7	1.0
Durables		-3.3	9.0	14.7	10.8	6.6	12.4	-3.6	4.7	.3
Nondurables		.5	1.8	4.4	2.3	2.9	2.9	-.6	.8	.3
Services		.9	2.3	3.9	3.5	5.0	2.4	3.7	3.5	1.7
Business fixed investment		5.6	-11.3	10.8	13.8	4.7	-4.7	5.1	8.5	2.3
Producers' durable equipment		2.2	-12.5	20.9	14.9	7.0	.2	5.4	11.9	3.3
Nonresidential structures		11.7	-9.1	-4.8	11.8	.1	-15.4	4.2	-.1	-.6
Residential structures		-22.4	4.9	38.1	6.1	6.0	12.5	-2.6	-4.1	-2.7
Exports		2.4	-13.8	5.8	5.9	-2.7	5.9	16.8	14.0	16.4
Imports		4.9	-5.9	23.8	17.4	5.2	8.9	9.1	3.2	4.6
Government purchases		2.9	3.8	-2.7	7.9	8.7	2.4	2.2	-1.5	1.3
Federal		9.5	8.2	-8.1	13.0	14.9	-.2	.9	-6.2	-.4
Defense		7.6	8.8	5.1	6.5	7.0	4.8	5.9	-6.1	-.4
State and local		-1.3	.6	1.5	4.4	4.0	4.6	3.3	2.2	2.5
Change in business inventories	Billions of 82$	23.9	-24.5	-6.4	62.3	7.4	13.8	42.9	49.3	26.3
Nonfarm	Billions of 82$	19.0	-23.1	-.1	57.8	12.0	15.4	32.5	39.5	17.9
Net exports	Billions of 82$	49.4	26.3	-19.9	-84.0	-108.2	-145.8	-135.5	-103.5	-54.7
minal GNP	Percent change*	9.3	3.1	10.4	8.6	6.6	4.5	7.4	6.7	6.0
OYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	91.2	89.6	90.2	94.5	97.5	99.6	102.1	105.7	107.3
Unemployment rate	Percent	7.6	9.7	9.6	7.5	7.2	7.0	6.2	5.6	5.8
Industrial production index	Percent change*	-1.0	-7.7	14.3	6.6	1.7	1.0	5.8	3.7	2.7
Capacity utilization rate-mfg.	Percent	78.2	70.3	73.9	80.5	80.1	79.7	81.0	83.0	82.6
Housing Starts	Millions	1.10	1.06	1.71	1.77	1.74	1.81	1.63	1.46	1.38
Auto sales	Millions	8.56	8.00	9.18	10.43	11.09	11.52	10.34	10.35	9.99
Domestic	Millions	6.24	5.77	6.77	7.97	8.24	8.28	7.14	7.27	7.03
Foreign	Millions	2.32	2.23	2.41	2.46	2.84	3.25	3.21	3.08	2.96
INCOME AND SAVING										
Nominal personal income	Percent change*	9.2	5.3	7.8	8.4	6.8	5.5	7.3	6.6	6.3
Real disposable income	Percent change*	.7	1.0	5.1	4.3	2.8	3.6	2.1	2.5	1.2
Personal saving rate	Percent	7.5	6.8	5.4	6.1	4.5	4.3	3.7	4.5	4.6
Corp. profits with IVA & CCAdj	Percent change*	2.3	-19.1	70.1	7.4	4.1	1.2	11.3	3.5	6.2
Profit share of GNP	Percent	6.2	4.7	6.3	7.1	6.9	6.7	6.8	6.7	6.5
Federal govt. surplus/deficit	Billions of $	-63.8	-145.9	-176.0	-169.6	-196.0	-204.7	-151.4	-142.9	-136.5
State and local govt. surplus		34.1	35.1	47.5	64.6	63.1	56.8	44.0	51.2	60.7
Exc. social insurance funds		4.1	-1.7	4.4	19.8	16.0	7.4	-7.7	-4.8	1.8
PRICES AND COSTS										
GNP implicit deflator	Percent change*	8.7	5.2	3.6	3.4	3.1	2.2	3.3	3.7	3.8
GNP fixed-weight price index		8.5	5.0	3.9	3.7	3.6	2.3	4.0	4.3	4.2
Cons. & fixed invest. prices		8.2	4.4	3.3	3.3	3.5	2.0	4.3	4.3	4.5
CPI		9.6	4.4	3.2	4.1	3.5	1.3	4.4	4.5	4.7
Exc. food and energy		10.2	5.2	4.2	4.8	4.3	3.9	4.3	4.8	5.0
Nonfarm business sector										
tput per hour		-.6	1.0	3.6	1.5	1.0	1.5	1.3	1.1	.7
ensation per hour		8.3	7.3	3.3	4.2	4.8	3.4	2.8	3.9	4.7
it labor costs		9.0	6.2	-.3	2.6	3.7	1.9	1.5	2.8	3.9

* Percent changes are from fourth quarter to fourth quarter.

June 22, 1988

CONFIDENTIAL - FR
CLASS II FOMC

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

	1987		Projection 1988				1989				1986	1987	Projection 1988	1989
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	(fourth quarter to fourth quarter, net change)			
Real GNP	40.6	44.9	37.2	31.8	20.4	22.7	20.1	17.4	24.3	24.0	80.6	149.3	112.0	85.8
Gross domestic product	44.5	41.6	40.5	31.1	19.3	22.0	19.0	16.8	23.6	22.6	92.7	150.2	112.9	82.0
Gross domestic purchases	46.3	42.3	20.5	15.6	18.3	13.1	4.5	2.7	11.1	10.7	103.1	133.3	67.5	29.0
Final sales	55.1	8.9	42.3	33.5	25.9	31.0	31.2	20.5	24.7	23.6	93.3	74.5	132.7	100.0
Private dom. final purchases	55.8	-10.9	44.0	8.4	28.9	18.7	11.6	3.8	9.1	8.5	97.7	41.4	100.0	33.0
Personal consumption expend.	33.2	-16.1	26.3	9.3	18.6	14.1	10.3	3.9	5.8	6.6	97.3	24.1	68.2	26.6
Durables	21.5	-22.4	12.2	4.1	.7	1.2	.8	-.1	-.1	.6	43.9	-14.5	18.2	1.3
Nondurables	-3.3	-1.1	3.8	-7.1	6.2	3.7	2.1	.2	.4	.4	24.6	-5.7	6.6	3.1
Services	15.0	7.5	10.1	12.4	11.7	9.2	7.3	3.9	5.5	5.5	28.6	44.5	43.3	22.2
Business fixed investment	25.9	1.8	22.5	.0	11.5	5.8	3.9	2.0	3.5	2.2	-22.0	22.4	39.8	11.6
Producers' durable equipment	19.1	-.8	24.7	-1.3	11.1	5.4	4.1	2.3	3.8	2.3	.6	17.2	39.9	12.4
Nonresidential structures	6.8	2.6	-2.2	1.3	.4	.3	-.2	-.2	-.2	-.1	-22.6	5.2	-.2	-.8
Residential structures	-3.3	3.5	-4.8	-.8	-1.2	-1.2	-2.6	-2.2	-.2	-.2	22.5	-5.2	-8.0	-5.2
Change in business inventories	-14.4	35.9	-5.1	-1.7	-5.6	-8.4	-11.1	-3.1	-.4	.4	-12.8	74.9	-20.7	-14.2
Nonfarm	-10.6	39.4	-13.9	8.2	-5.0	-7.1	-13.0	-3.7	-.4	.4	-14.4	49.2	-17.7	-16.7
Farm	-3.8	-3.5	8.8	-9.9	-.6	-1.3	1.9	.6	.0	.0	1.6	25.6	-3.0	2.5
Net exports	-5.7	2.6	16.7	16.2	2.1	9.5	15.6	14.7	13.2	13.2	-22.5	16.0	44.5	56.8
Exports	22.6	16.4	21.8	12.1	11.7	18.0	21.8	22.5	20.6	19.7	21.8	65.2	63.6	84.6
Imports	28.4	13.7	5.0	-4.0	9.6	8.5	6.2	7.8	7.4	6.4	44.3	49.2	19.1	27.8
Government purchases	5.0	17.2	-18.4	8.8	-5.0	2.8	4.0	1.9	2.4	1.8	18.1	17.1	-11.8	10.2
Federal	3.7	11.3	-20.1	6.5	-7.8	.0	1.2	-.9	-.5	-1.1	-.7	3.0	-21.4	-1.2
Defense	4.8	-.6	-2.9	-5.8	-7.5	-.2	1.1	-.7	-.7	-.7	11.6	15.0	-16.4	-1.0
Nondefense	-1.2	12.1	-17.3	12.3	-.3	.2	.1	-.2	.2	-.4	-12.3	-11.9	-5.1	-.2
State and local	1.3	5.9	1.7	2.3	2.8	2.8	2.8	2.8	2.9	2.9	18.7	14.2	9.6	11.4

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1987*	FY1988e Admin[1]	FY1988e FRB Staff	FY1989e Admin[1]	FY1989e FRB Staff	CY 1987*	CY1988e FRB Staff	1987 IV*	1988 I*	FRB Staff Estimates 1988 II	1988 III	1988 IV	1989 I	1989 II	1989 III
								Not seasonally adjusted							
Budget receipts[2]	854	909	906	965	970	869	915	205	208	265	228	214	232	278	246
Budget outlays[2]	1005	1056	1064	1094	1127	1037	1056	287	245	266	266	278	28[illegible]	287	279
Surplus/deficit(-) to be financed[2]	-150	-147	-158	-130	-157	-168	-140	-82	-37	-1	-38	-64	-52	-8	-33
Means of financing:															
Borrowing from public	152	127	149	127	149	142	144	61	43	16	30	56	37	29	27
Cash balance decrease	-5	16	4	0	-2	8	3	14	0	-12	2	13	5	-15	-5
Other[3]	4	3	5	3	10	16	-6	7	-5	-3	6	-5	10	-6	11
Cash operating balance, end of period	36	20	33	20	35	23	20	23	23	35	33	20	15	30	35
Memo: Sponsored agency borrowing[4]	20	n.a.	51	n.a.	32	34	37	19	11	12	9	5	5	10	12
NIPA Federal Sector								Seasonally adjusted annual rates							
Receipts	894	974	963	1029	1029	916	978	938	952	980	981	998	1022	1040	1057
Expenditures	1053	1098	1110	1146	1169	1067	1121	1098	1103	1122	1118	1140	1173	1180	1186
Purchases	374	375	384	396	392	379	383	389	380	388	381	384	393	395	396
Defense	290	289	297	295	298	295	295	300	302	297	290	291	298	300	301
Nondefense	84	86	87	101	94	84	88	89	78	91	92	93	95	95	96
All other expend.	679	723	726	750	777	688	737	709	724	734	736	756	780	785	789
Surplus/deficit(-)	-159	-124	-148	-117	-140	-151	-143	-160	-152	-141	-137	-142	-151	-140	-129
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-141	n.a.	-155	n.a.	-149	-141	-153	-161	-159	-153	-148	-153	-161	-147	-136

*--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 1989 (February 1988). The Congressional Budget Office baseline estimates released March 1988 indicated receipts of $898 and $954 billion, outlays of $1059 and $1131 billion, and deficits of $161 and $177 billion in FY1988 and FY1989, respectively.
2. Includes social security receipts and outlays, which are 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, 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

The federal funds rate has moved up almost 1/2 percentage point since the May FOMC meeting, running about 7-1/2 percent in recent days. Other interest rates have been volatile, as investors have reacted nervously to the release of economic data that have provided mixed signals regarding the outlook for economic growth and inflation. Tightening by the System appeared to have a salutary effect on inflation expectations, which was reinforced by the release in mid-June of the trade data for April showing a substantial decline in imports. In the last week, however, long-term rates have firmed on news of strong economic growth and monetary tightening abroad and drought in the Farm Belt. On balance, most long-term interest rates have declined 10 to 20 basis points over the intermeeting period, while short-term rates have risen by 25 to 35 basis points.

Growth of the monetary aggregates slowed significantly during May. M2 and M3 both expanded at a 5 percent annual rate, while M1 was flat. This slowing largely reflected the unwinding of April's tax-related bulge in checkable deposits. Deposit growth probably also was depressed by increased opportunity costs that accompanied the rise in short-term market interest rates during April and May. Finally, M3 growth was held down by substantial inflows from nondeposit sources, particularly borrowings by banks from their foreign offices. Data for the first half of June point to some pickup in the growth of all three monetary aggregates, and M2 and M3 are likely to remain in the upper portion of their annual target ranges through midyear.

Total bank loans grew at a 15-1/4 percent clip in May, up from 11-1/2 percent in April and 8-1/2 percent in the first quarter. Strength was evident in all of the major loan categories, except for consumer loans, which were depressed by the securitization of credit card receivables and possibly by the surge in home equity loans. For the second consecutive month, business loan demand was especially strong.

Available data for the second quarter point to a sharp increase in total credit demands by nonfinancial businesses, spurred by a widening of the financing gap and heavy merger activity. The sum of business loans at commercial banks and commercial paper outstanding grew at an average annual rate of 19 percent in April and May. Bond offerings by nonfinancial corporations were well maintained over these months and then surged in early June, when corporate bond yields declined.

Several segments of the corporate securities markets that had seen little activity since the stock market crash last October began to show signs of recovery in early June. Junk bond volume in the first half of the month exceeded that in any full month since the crash. And with stock prices advancing nearly 6 percent between the May FOMC meeting and mid-month, equity offerings by nonfinancial firms also picked up substantially. Nonetheless, with gross equity issuance still below pre-crash levels and merger activity near a record high, net equity retirements in the second quarter appear likely to exceed those in any previous quarter.

Tax-exempt bond offerings also picked up in early June after several months of lackluster activity. The decline in tax-exempt yields in late May and early June, which was in line with the decline in corporate bond yields, brought forth several large issues. For the second quarter as a whole, however, borrowing by state and local governments appears about in line with the first-quarter pace.

Tax inflows have produced a steep reduction in the federal budget deficit; consequently, marketable borrowing by the Treasury is estimated to have fallen to $10 billion in the second quarter from $34 billion in the first quarter. By contrast, borrowing by the federally sponsored credit agencies is estimated to have edged up in the second quarter, with the increase more than accounted for by a seasonal jump in credit needs of the Federal Home Loan Banks. The Financing Corporation (FICO) also borrowed $1.1 billion during the quarter, which brought its total bonds outstanding to $2.9 billion. In the last week, the yield spread between FICO bonds and Treasury bonds has increased from around 100 to 110 basis points to nearly 120 basis points following news that FSLIC-insured institutions had recorded aggregate losses of $3-3/4 billion for the first quarter.

Total household borrowing appears to have increased a bit in the second quarter, although it remained moderate compared with the average pace of recent years. In the mortgage market, data from banks and thrifts point to some pickup in net lending early in the quarter, although recent data on loan applications and commitments suggest no further near-term increase. Issuance of pass-through securities has edged up, but a paucity of new fixed-rate home loans continues to restrain volume; just over half the conventional home mortgages originated in early May had adjustable-rate features. The shortage of fixed-rate loans in the secondary market has contributed to a narrowing of the spread between rates paid by homebuyers in the primary market and yields on Treasury securities with comparable durations. In the market for consumer loans, auto lending in April dipped significantly with the expiration of many auto sales incentives. Available data on other components suggest that total consumer credit growth in the second quarter will remain near its subdued first-quarter pace.

Outlook

Interest rates are projected to rise significantly over the remainder of 1988 and into 1989, as the System gradually tightens conditions in money markets in order to prevent inflationary pressures from intensifying. Of course, the problematic outlook for such pressures necessarily implies that considerable uncertainty attaches to this interest rate projection as well. Moreover, although the projected upward trend of rates has been arbitrarily assumed to be smooth, the market volatility that has been evident in recent weeks may well persist, as investors remain highly sensitive to inflation prospects and react strongly to new economic data.

Total domestic nonfinancial debt is forecast to continue to grow at around an 8-1/2 percent annual rate over the second half of 1988 and to slow a bit in 1989. Business borrowing is anticipated to moderate significantly over the projection period from its strong second-quarter pace, as a drop in net equity retirements is projected to more than offset the effects of a gradual widening of the gap between internal funds and investment outlays. Merger activity appears likely to peak in the second quarter; the dollar amount of proposed but unconsummated deals has decreased substantially in the last month or two, and as rates rise and economic growth slows, the environment may be less hospitable to mergers and buyouts. At the same time, equity issuance by nonfinancial firms appears likely to rise well above the crash-depressed levels recorded late last year and in the first quarter.

In the household sector, higher interest rates will hold down homebuilding and act to restrain demands for mortgage credit throughout the projection period. Consumer credit growth also may slow a bit, in light of the outlook for sluggish growth in consumer spending and the likely continued substitution of mortgage borrowing through home equity credit.

Borrowing by government units also appears likely to remain relatively restrained. Rising interest rates will add to the Treasury's borrowing requirement in 1989, but the modest increase in the dollar amount of financing implies a virtually flat growth rate. In the state and local government sector, higher interest rates will discourage refunding and housing issues, and overall credit demands likely will remain moderate.

Recent Developments

The trade-weighted, foreign exchange value of the dollar against the other G-10 currencies has risen 3-1/2 percent since the previous FOMC. The dollar increased 4-1/4 percent against the German mark, 5-1/4 percent against the pound sterling, and more than 2-1/4 percent against the yen. In contrast, the Canadian dollar strengthened 2-1/4 percent against the U.S. dollar. Greater-than-expected improvement in the U.S. merchandise trade deficit for April and further tightening of U.S. monetary policy contributed to the rise in the dollar.

Short-term interest rates have risen in the major foreign industrial countries since the previous FOMC. The German call money rate rose 65 basis points, as market participants anticipated the 25 basis point increase by the Bundesbank, late in the period, of its official rate for repurchase transactions; the Japanese call money rate rose nearly 20 basis points as new data indicated that the economy continued to grow vigorously during the first quarter and heightened expectations that the Bank of Japan would act to increase interest rates. Short-term interest rates in the United Kingdom first declined and then more than reversed that decline as the Bank of England adjusted its official lending rates in several steps in response to exchange market developments. Canadian short-term interest rates rose about 40 basis points during the period as well. In France and several smaller European countries, official interest rates were lowered during the intermeeting period.

The Desk did not intervene during this period.

Real economic activity expanded strongly during the first quarter in most of the major foreign industrial countries. Real GNP rose 11.3 percent (s.a.a.r.) in Japan and 6 percent in Germany during the first quarter. Real growth was strong in France, the United Kingdom, and Canada as well. Industrial production data through April for Germany and Japan suggest that growth is continuing, but at a slower pace. Inflation remains low in the foreign industrial countries. To date in 1988, the cumulative net trade surplus of the foreign members of the G-7 has been below that recorded for the same period last year.

In late May, Brazil reached substantive agreement on principal elements of a stand-by arrangement with the IMF; the Brazilian Constituent Assembly voted that President Sarney's term should be for five years, thus allowing him to turn his attention to macroeconomic policy issues. The Mexican government announced in May an extension through August of the freeze on the peso's exchange rate against the dollar, on public sector prices, and on the minimum wage. Argentina has paid no interest to creditor banks on its medium- and long-term public sector debt since late March. The IMF granted approval in principle to a new stand-by arrangement with Yugoslavia, and full approval should be granted shortly as creditor banks have achieved the critical mass of commitments by banks to $300 million of financing.

In April, the seasonally adjusted U.S. merchandise trade deficit was $9.9 billion, somewhat lower than the revised March deficit of $11.7 billion. The deficit fell as imports dropped sharply, and exports declined more moderately. The reduction in the value of imports in April was widespread across categories of goods. Automotive imports, consumer goods, and capital goods all declined on a seasonally adjusted basis. Exports fell only slightly in April from the very strong March level, with much of the decrease the result of fewer exports of automotive products.

Recent stability of the dollar, relatively high interest rates on short-term dollar assets, and perceptions that U.S. interest rates may rise further have encouraged private demands for dollar-denominated assets. Foreigners increased their net claims on banking offices in the United States an unusually large $15.4 billion in April. In addition, foreign private net purchases of U.S. corporate stocks and bonds rose in April to a level three times that of the first quarter; the $1.3 billion in net foreign purchases of corporate stock was the first significant monthly inflow on such transactions since October 1987. Net inflows from official transactions were down markedly in April to a rate less than one third of those in the fourth quarter of 1987 and first quarter of 1988. For the most part, this decline in official inflows reflected the lower volume of exchange market intervention; to a lesser extent, it reflected reduced shifting from the Euromarkets of dollar assets previou'ly purchased.

Outlook

The staff projection continues to incorporate a moderate decline in the foreign exchange value of the dollar in terms of other G-10 currencies from current levels. The exceptional pace of economic growth observed recently in foreign industrial countries is projected to moderate as in some countries policies are directed at restraining the expansion from becoming excessive. On average, economic expansion in developing countries is projected to slow during 1988 from the 1987 pace and then partially rebound in 1989 as a result of macroeconomic adjustment undertaken, particularly in the Western Hemisphere countries. As a result, the U.S. trade deficit is expected to narrow to about $100 billion at an annual rate by the end of the forecast period compared with the first-quarter rate of $144 billion. The current account balance is projected to show similar improvement. By the fourth quarter of 1989, the current account deficit is expected to decline to about $115 billion.

Real merchandise imports excluding petroleum are projected to increase only slightly over the forecast horizon while non-oil import prices on a fixed-weighted basis are projected to rise strongly this year, reflecting importantly the prices of basic commodities, and then to slow next year. Real merchandise exports excluding agricultural products are projected to increase steadily through 1989 at nearly a 20 percent annual rate. As a result, real net exports improve significantly over the forecast horizon.

Strictly Confidential (FR)
Class II FOMC

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

	ANNUAL			1987		1988				1989			
	1987-	1988-P	1989-P	Q3-	Q4-	Q1-	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
GNP Exports and Imports 1/													
Current $, Net	-119.6	-98.0	-63.9	-123.7	-124.3	-109.4	-95.6	-96.8	-90.2	-78.4	-68.5	-59.2	-49.5
Exports of G+S	427.8	512.7	611.2	439.2	458.1	482.7	501.3	521.1	545.8	574.1	600.3	624.0	646.5
Imports of G+S	547.4	610.7	675.1	562.9	582.4	592.1	596.9	617.9	636.0	652.4	668.8	683.2	696.0
Constant 82 $, Net	-135.5	-103.6	-54.8	-138.4	-135.8	-119.1	-103.0	-100.9	-91.4	-75.8	-61.0	-47.8	-34.6
Exports of G+S	425.7	494.7	571.0	437.1	453.5	475.3	487.4	499.1	517.1	538.9	561.4	582.1	601.7
Imports of G+S	561.3	598.2	625.7	575.6	589.3	594.3	590.3	599.9	608.4	614.6	622.4	629.8	636.2
2. **U.S. Merchandise Trade Balance 2/**	-160.3	-136.4	-112.4	-158.7	-164.8	-143.8	-132.6	-136.8	-132.2	-123.4	-115.7	-108.6	-102.0
Exports	249.6	320.4	382.8	259.6	272.1	298.7	315.4	325.6	341.7	359.6	375.6	390.5	405.4
Agricultural	29.5	36.7	41.9	33.1	30.5	36.1	39.0	34.7	37.0	40.9	42.4	42.4	42.0
Non-Agricultural	220.1	283.7	340.8	226.5	241.5	262.6	276.5	290.9	304.7	318.7	333.1	348.1	363.4
Imports	409.8	456.7	495.2	418.3	436.8	442.5	448.1	462.4	474.0	483.0	491.2	499.1	507.4
Petroleum and Products	42.9	42.6	48.8	51.0	45.2	39.9	40.8	43.7	46.0	46.9	48.2	49.4	50.7
Non-Petroleum	367.0	414.1	446.4	367.2	391.7	402.5	407.3	418.7	428.0	436.1	443.1	449.6	456.7
3. **U.S. Current Account Balance**	-154.0	-153.1	-125.8	-167.9	-134.1	-159.0	-152.0	-153.9	-147.5	-137.7	-129.6	-122.0	-114.0
Of Which: Net Investment Income	20.4	-3.7	-3.1	4.3	50.2	-2.4	-5.7	-4.7	-2.0	-2.3	-3.0	-3.7	-3.3
4. **Foreign Outlook 3/**													
Real GNP--Ten Industrial 4/	2.8	3.2	1.9	5.2	3.3	4.5	1.4	1.7	1.9	1.8	2.1	2.1	1.9
Real GNP--NonOPEC LDC 5/	4.1	3.3	3.6	3.6	3.3	3.1	3.2	3.4	3.6	3.8	3.7	3.5	3.4
Consumer Prices--Ten Ind. 4/	2.1	2.4	2.7	1.7	2.4	1.5	3.7	2.1	3.0	2.3	3.1	2.5	3.4

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