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Strictly Confidential (FR) Class II FOMC

December 13, 1989

SUMMARY AND OUTLOOK

Prepared for the Federal Open Market Committee

By the staff of the Board of Governors of the Federal Reserve System

Recent Developments

Economic activity appears to have registered only a small increase in the current quarter. Fragmentary data suggest flagging demand for motor vehicles, declining business equipment spending, and decelerating exports--all of which have combined to weaken industrial production. The service sector, however, appears to have grown at a healthy pace. The rise in the consumer price index in October was larger than in the preceding several months, but the underlying trend in consumer price inflation still appears to be running at a little more than 4 percent.

Industrial production, abstracting from the disruptions caused by the Boeing strike, is estimated to have declined slightly on net between September and November. Automobile assemblies were cut to 6-1/4 million units (annual rate) in November and are now about 1 million units lower than in the spring. Production cuts and layoffs also have extended to related industries, such as metals, plastic, and machinery. In addition, production of business equipment, which provided considerable support to manufacturing output earlier in the year, has declined in recent months; output of non-auto consumer goods has flattened out, and production of materials is down slightly. All told, factory employment has declined 165,000 in the past eight months; almost 60,000 of the reduction has come in the motor vehicles industry.

Outside of the industrial sector, economic activity apparently has expanded moderately, on balance, in recent months. Private employment in the service-producing sector posted only a small increase in October, but then rose 200,000 in November. Increases were fairly widespread, with the notable exception of general merchandise stores, where hiring in November only matched seasonal norms.

Growth in consumer spending has been sustained in recent months by outlays for services, while spending on goods has declined. Sales of new cars and light trucks dropped to an average of 13 million units in October and November, 3 million units below the third-quarter pace. The steepest retrenchment was felt by the domestic big three. Retail sales of goods other than autos are estimated to have posted a strong gain in November in nominal terms, but the increase follows two months for which revised data now show a slight net decline. Non-auto retailers entered the autumn with their inventory-sales ratio, on average, at the high end of the range of recent years, but qualitative reports in November suggested that concerns about excessive stocks were not widespread.

Total housing starts turned up in October to 1.42 million units at an annual rate. Multifamily starts rebounded sharply from an exceptionally low September level, and single-family starts rose to 1.03 million units. Averaging over recent months, the response to lower mortgage interest rates still looks rather subdued; apparently, overhangs of unsold units in some areas, coupled with some tightening of credit availability, has deterred building.

Shipments of nondefense capital goods (excluding aircraft) fell in October for a second month, to a level 2-1/2 percent below the third-quarter average; the weakness has been widespread. New orders for these equipment items also dropped 3 percent below their third-quarter level. Declining prices and an uptrend in backlogs for computing machines offers some potential for near-term increases in their shipments in real terms. But the outlook for shipments of other types of non-aircraft equipment is for little growth; this weakness could show up either in domestic investment or exports.[1] Construction put in place has been rising moderately, on balance, in recent months. However, looking ahead, a contraction in this sector seems likely because vacancy rates are still high, lenders are smarting from losses on commercial real estate, and capacity utilization is declining; indeed, building permits have been weakening for a while.

The consumer price index rose 0.5 percent in October, after a series of four small monthly changes. Energy prices turned up in October, interrupting four months of decline, and food price inflation was boosted by sharp increases in dairy products, pork, and fresh produce. The CPI excluding food and energy also was up 0.5 percent, boosted by sharply higher prices for apparel and new cars. Nonetheless, the rise in this index so far this year has been 4-1/4 percent (annual rate), about 1/2 percentage point lower than the 1988 pace. The slowdown in inflation has been most noticeable in commodities and likely reflects in good part this year's moderation in price increases for imported goods. By contrast, the producer price index for finished goods excluding food and energy has accelerated to a 5 percent rate over the first ten months of 1989.

The most current measure of wage inflation, average hourly earnings, showed a small decline in November after a downward-revised increase of 0.4 percent in October. As a result, the year-over-year change in this

1. In addition, the Boeing strike is estimated to have reduced aircraft shipments $14 billion, which will appear in the national income and product accounts mainly as a reduction in exports. GNP is affected by less than this amount, owing to the buildup of inventories at Boeing.

measure dipped to 3.6 percent last month. The outcome of recent collective bargaining activity, however, has been consistent with the larger wage increases seen in new settlements over the first three quarters of the year. In addition, the negotiations at the regional telephone companies and AT&T, in which benefit costs and coverage were the key issue, highlight the current importance of benefit increases in overall compensation gains. As measured by the employment cost index, benefits have accelerated to a 6-1/2 percent annual rate since early 1988--well above the pace of wage increase.

Outlook

Signs of a substantial slackening in the pace of economic expansion have accumulated in recent weeks. Demand for motor vehicles clearly has softened beyond the "payback" for this summer's surge, and the contraction in output at the big three is having ripple effects in other manufacturing industries. Producers of capital goods also appear to be experiencing a significant falloff in demand, most likely attributable not only to a slackening in domestic business spending but also to an erosion of U.S. competitiveness in foreign markets associated with the rise in the foreign exchange value of the dollar earlier this year. In addition, the effects on construction of the decline in interest rates have been muted by a tightening in credit availability and sagging real estate returns, and defense spending is on a downtrend.

The staff forecast of real GNP is a little weaker through the first half of 1990 than that in the November Greenbook. Growth of real GNP now is projected to average 1-1/4 percent at an annual rate over that period.[2] The added slack is anticipated to have some salutary effects on wage and price pressures early next year. But, the dollar has fallen more than anticipated in the previous forecast and is projected to depreciate moderately further. Thus, by late 1990 the effects of a firming in economic activity and rising import prices still are expected to inhibit progress toward a reduction in overall inflation.

The staff forecast is conditioned on the FOMC's anti-inflation goal; achievement of that goal likely will require maintenance of a degree of monetary restraint. Short-term interest rates are expected to remain near current levels over coming months, and possibly to rise a bit by 1991 as the economy gathers some upward momentum. For the monetary aggregates, growth of M2, which is expected to end this year around the middle of its target range, is anticipated to move into the upper half of its tentative range during 1990. If interest rates do edge higher in 1991, velocity would be expected to firm a bit and growth of M2 to moderate somewhat. Growth of M3 is expected to come in just above the bottom of its 1989 target range, to remain in the lower portion of its tentative range next year, and to continue at about the same pace in 1991.

Fiscal policy remains somewhat restrictive throughout the forecast period. The current estimate of the fiscal year 1990 deficit, at $130

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2. The variation in quarterly growth rates of real GNP through the first half of 1990 largely reflects the influence of the Boeing strike and natural disasters. The strike is estimated to have lowered GNP growth 0.6 percentage point this quarter and to add a similar amount in the first quarter. The estimated positive contribution of rebuilding from the California earthquake now is assumed to be delayed until early next year, adding 0.3 percentage point in the first quarter and reducing the second quarter 0.2 percentage point.

billion, is down slightly from the previous Greenbook forecast. The reduction is primarily the result of somewhat larger deficit reductions in the fiscal year 1990 reconciliation bill than previously assumed. These reductions are anticipated to carry forward into fiscal year 1991. In addition, the staff's assumptions about deficit-reducing actions in fiscal year 1991 have been altered to include some additional cuts in defense outlays in light of reports that the Administration is contemplating sizable cuts in the defense budget in coming years. Thus, the total for new deficit-reduction measures has been raised to $28 billion in fiscal year 1991. That period's deficit is now projected at $114 billion, $8 billion below the previous projection, but still far in excess of the $64 billion Gramm-Rudman target.

In the near term, growth of real GNP is expected to be restrained by the sharp slowdown in goods production. Automobile manufacturers are assumed to use a combination of production cuts, which are already under way, and sales incentives to control inventories. Assemblies are projected to drop from an annual rate of 6-3/4 million units in the third quarter to 6-1/2 million units in the current quarter and to bottom out at just over 6 million units in the first quarter of next year. This decline reduces the annualized growth of real GNP 0.3 or 0.4 percentage point each quarter. In addition, business fixed investment, residential construction, and net exports of goods and services are expected to grow only a little between now and next spring, thus contributing to sluggish domestic production.

In the latter half of 1990, growth of real GNP is projected to pick up slightly. The inventory correction in the auto sector is assumed to be completed by the second quarter, removing one of the important drags on growth. But elsewhere, growth in final demand is projected to remain slow. Consumer spending is forecast to rise at a rate of only about 1-1/2 percent, as the trend in household income weakens noticeably in response to slower employment growth and consumer sentiment deteriorates. Business outlays for fixed investment are expected to continue to be constrained by weak cash flow and a cautious attitude toward expanding facilities. Net exports are forecast to contribute little to growth; economic growth abroad, on average, is expected to moderate somewhat, although it remains above U.S. growth, and the anticipated depreciation of the dollar is not projected to boost import prices significantly until late in 1990.

By 1991, the declining dollar is projected to stimulate export sales significantly and thus generate a pickup in U.S. production. The acceleration in output should boost spending on capital goods; however, outlays for nonresidential structures are likely to remain soft in response to the lingering overhang of vacant commercial space. In light of the anticipated firmness of interest rates, growth in personal consumption expenditures, particularly for credit-sensitive durable goods, remains sluggish and new homebuilding is about flat. Over the four quarters of the year, real GNP is projected to increase 2-1/4 percent.

The near-term weakness in economic activity apparently has begun to generate some uptick in unemployment, and, compared with the November Greenbook, the forecast now shows a somewhat faster rise in joblessness, to more than 5-3/4 percent by mid-1990. Subsequently, GNP growth remains below its potential rate, and the civilian unemployment rate continues to edge up, leveling out at 6-1/4 percent by late 1990.

In the very near term, the weakness in demand probably will force many businesses to trim prices to spur sales. In addition, the staff continues to assume that finished energy prices will resume their decline over the next several months, and that the slow rise in prices of imported goods will hold down domestic inflation. However, food prices are expected to increase more rapidly in coming months because of the sharp increases seen recently in dairy and livestock prices. On balance, the consumer price index is projected to rise at a 3-1/2 percent annual rate this quarter and next.

With slack in the labor market developing a little faster, growth in hourly compensation is projected to be fractionally lower than was shown in the previous forecast. In the near term, recent and prospective moderation in consumer prices should damp wage demands. Nonetheless, hourly compensation, as measured by the employment cost index, is projected to rise just under 5 percent over the four quarters of 1990 as compared with 4-3/4 percent this year. Higher social security taxes contribute about 3/4 percentage point to the annualized increase in the first quarter of 1990, and the hike in the minimum wage adds an equal amount to the second-quarter projection.[3] Subsequently, the rise in ECI compensation slows, reaching an annual rate of just over 4 percent by the second half of 1991.

Energy prices are anticipated to contribute to holding down the rise in the CPI in 1990, but to rise in line with overall prices in 1991.[4] Food prices are forecast to slow over the forecast horizon a bit more than the

3. The projection of hourly compensation in the first quarter of 1990 also includes a downward adjustment of 0.4 percentage point in the staff's estimate of the effect of a higher wage base for Social Security taxes.

4. The price of imported oil, which is expected to average $17.80 per barrel in the current quarter, is projected to decline to $17 per barrel by the second quarter of next year and in 1991 to rise in line with domestic inflation.

moderation in labor cost increases. The boost to non-oil import prices from the depreciation of the dollar is anticipated to begin to offset the influence of moderating labor cost increases. All told, increases in overall consumer prices are projected to run between 4 and 4-1/2 percent in the next two years.

December 13, 1989

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STAFF GNP PROJECTIONS

Percent changes, annual rate

	Nominal GNP		Real GNP		GNP fixed-weight price index		Consumer Price Index <1>		Unemployment rate (percent)	
	11/8/89	12/13/89	11/8/89	12/13/89	11/8/89	12/13/89	11/8/89	12/13/89	11/8/89	12/13/89
Annual changes:										
1987 <2>	6.9	6.9	3.7	3.7	3.6	3.6	3.7	3.7	6.2	6.2
1988 <2>	7.9	7.9	4.4	4.4	4.2	4.2	4.1	4.1	5.5	5.5
1989	7.2	7.2	3.0	2.9	4.5	4.5	4.8	4.8	5.2	5.3
1990	5.7	5.7	1.8	1.7	4.0	4.0	3.8	3.9	5.6	5.8
1991	5.7	6.1	1.8	1.9	4.2	4.3	4.4	4.4	6.1	6.2
Quarterly changes:										
1988 Q1 <2>	6.5	6.5	4.0	4.0	3.8	3.8	3.9	3.9	5.7	5.7
Q2 <2>	8.6	8.6	3.7	3.7	4.8	4.8	4.5	4.5	5.5	5.5
Q3 <2>	7.5	7.5	3.2	3.2	5.2	5.2	4.5	4.5	5.5	5.5
Q4 <2>	7.5	7.5	2.7	2.7	4.3	4.3	4.4	4.4	5.3	5.3
1989 Q1 <2>	7.9	7.9	3.7	3.7	4.8	4.8	5.4	5.4	5.2	5.2
Q2 <2>	7.1	7.1	2.5	2.5	5.0	5.0	6.4	6.4	5.3	5.3
Q3 <2>	5.6	6.1	2.5	2.7	2.9	2.9	2.6	2.6	5.2	5.2
Q4	4.9	4.5	1.7	.7	3.6	3.8	3.3	3.6	5.3	5.4
1990 Q1	6.4	6.1	2.2	2.1	4.4	4.2	3.7	3.6	5.4	5.6
Q2	5.4	5.5	1.3	1.2	4.1	4.2	4.1	4.2	5.5	5.8
Q3	5.4	5.7	1.5	1.6	4.1	4.1	4.2	4.3	5.7	5.9
Q4	5.2	5.6	1.5	1.6	4.1	4.1	4.3	4.3	5.9	6.0
1991 Q1	6.2	6.6	1.7	1.9	4.7	4.9	4.6	4.6	6.0	6.1
Q2	5.8	6.1	2.1	2.2	4.1	4.1	4.4	4.4	6.1	6.1
Q3	5.9	6.2	2.2	2.3	4.0	4.0	4.4	4.4	6.2	6.2
Q4	5.9	6.2	2.3	2.4	4.0	4.0	4.4	4.4	6.2	6.2
Two-quarter changes: <3>										
1988 Q2 <2>	7.5	7.5	3.9	3.9	4.2	4.2	4.1	4.1	-.4	-.4
Q4 <2>	7.5	7.5	2.9	2.9	4.8	4.8	4.6	4.6	-.2	-.2
1989 Q2 <2>	7.5	7.5	3.1	3.1	5.0	5.0	5.9	5.9	.0	.0
Q4	5.3	5.3	2.1	1.7	3.2	3.3	2.8	3.0	.0	.1
1990 Q2	5.9	5.8	1.7	1.7	4.3	4.2	3.9	3.9	.2	.4
Q4	5.3	5.7	1.5	1.6	4.1	4.1	4.3	4.3	.4	.2
1991 Q2	6.0	6.3	1.9	2.0	4.4	4.5	4.5	4.5	.2	.1
Q4	5.9	6.2	2.2	2.3	4.0	4.0	4.4	4.4	.1	.1
Four-quarter changes: <4>										
1987 Q4 <2>	8.6	8.6	5.4	5.4	4.0	4.0	4.4	4.4	-.9	-.9
1988 Q4 <2>	7.5	7.5	3.4	3.4	4.5	4.5	4.3	4.3	-.6	-.6
1989 Q4	6.4	6.4	2.6	2.4	4.1	4.1	4.4	4.4	.0	.1
1990 Q4	5.6	5.7	1.6	1.6	4.2	4.2	4.1	4.1	.6	.6
1991 Q4	6.0	6.3	2.0	2.2	4.2	4.2	4.4	4.4	.3	.2

<1> For all urban consumers.
<2> Actual.
<3> Percent change from two quarters earlier.
<4> Percent change from four quarters earlier.

December 13, 1989

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

	Units	1983	1984	1985	1986	1987	1988	Projection 1989	1990	1991
EXPENDITURES										
Nominal GNP	Billions of $	3405.7	3772.2	4014.9	4231.6	4524.3	4880.6	5232.8	5528.9	5864.3
Real GNP	Billions of 82$	3279.1	3501.4	3618.7	3717.9	3853.7	4024.4	4141.7	4211.0	4290.3
Real GNP	Percent change*	6.5	5.1	3.6	1.9	5.4	3.4	2.4	1.6	2.2
Gross domestic purchases		8.4	6.4	4.3	2.1	4.6	2.4	2.0	1.5	1.5
Final sales		3.7	4.7	4.6	2.7	3.3	4.4	2.3	1.9	2.1
Private dom. final purchases		7.7	5.6	4.6	2.9	2.7	3.8	2.2	2.1	1.6
Personal consumption expend.		5.4	4.1	4.6	3.8	2.2	3.8	2.4	2.3	1.6
Durables		14.7	10.8	7.0	11.5	-2.0	8.0	.4	3.9	1.3
Nondurables		4.4	2.3	3.3	2.9	1.1	2.1	.9	1.2	.9
Services		3.9	3.5	5.0	2.1	4.4	3.6	4.2	2.6	2.1
Business fixed investment		10.8	13.8	3.7	-5.5	8.5	4.2	4.1	1.2	2.6
Producers' durable equipment		20.9	14.9	4.6	.4	11.1	7.0	5.6	2.3	3.9
Nonresidential structures		-4.8	11.8	1.9	-17.7	1.9	-3.4	-.6	-2.4	-2.0
Residential structures		38.1	6.1	5.8	11.6	-4.2	3.2	-5.1	1.2	-1.2
Exports		5.8	5.9	-2.4	10.6	19.1	13.9	7.6	7.0	10.1
Imports		23.8	17.4	4.5	10.0	9.6	5.3	4.5	5.3	5.0
Government purchases		-2.7	7.9	8.6	3.1	2.1	1.8	.5	.3	.5
Federal		-8.1	13.0	13.3	.5	.7	-.3	-1.8	-1.9	-1.5
Defense		5.1	6.5	7.1	6.0	4.3	-1.9	-3.2	-4.7	-3.0
State and local		1.5	4.4	4.9	5.2	3.1	3.4	2.2	1.8	1.8
Change in business inventories	Billions of 82$	-6.4	62.3	9.1	5.6	23.7	27.9	22.1	4.5	14.9
Nonfarm	Billions of 82$	-.1	57.8	13.4	8.0	25.8	30.7	18.8	7.2	17.1
Net exports	Billions of 82$	-19.9	-84.0	-104.3	-129.7	-115.7	-74.9	-57.4	-54.1	-36.7
Nominal GNP	Percent change*	10.4	8.6	6.6	4.6	8.6	7.5	6.4	5.7	6.3
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	90.2	94.5	97.5	99.5	102.2	105.6	108.6	110.2	111.4
Unemployment rate	Percent	9.6	7.5	7.2	7.0	6.2	5.5	5.3	5.8	6.2
Industrial production index	Percent change*	14.3	6.6	1.7	1.0	5.8	5.0	1.2	1.5	2.7
Capacity utilization rate-mfg.	Percent	73.9	80.5	80.1	79.7	81.1	83.5	83.8	81.5	80.8
Housing starts	Millions	1.70	1.75	1.74	1.81	1.62	1.49	1.40	1.36	1.36
Auto sales	Millions	9.23	10.38	11.06	11.47	10.26	10.69	9.86	9.61	9.50
Domestic	Millions	6.82	7.92	8.22	8.22	7.06	7.55	7.01	6.90	6.90
Foreign	Millions	2.41	2.46	2.84	3.25	3.21	3.14	2.85	2.71	2.60
INCOME AND SAVING										
Nominal personal income	Percent change*	7.8	8.4	6.6	5.8	8.6	7.1	8.1	6.1	6.1
Real disposable income	Percent change*	5.1	4.3	2.7	3.3	3.0	4.0	3.3	1.7	1.4
Personal saving rate	Percent	5.4	6.1	4.4	4.1	3.2	4.2	5.3	5.1	4.9
Corp. profits with IVA & CCAdj	Percent change*	70.1	7.4	9.2	-5.6	12.0	10.4	-18.1	1.8	.7
Profit share of GNP	Percent	6.3	7.1	7.0	6.7	6.6	6.7	5.7	5.1	4.8
Federal govt. surplus/deficit	Billions of $	-176.0	-169.6	-196.9	-206.9	-161.4	-145.8	-150.1	-130.0	-102.4
State and local govt. surplus		47.5	64.6	65.1	62.8	51.3	49.7	46.0	51.8	64.5
Exc. social insurance funds		4.4	19.8	13.8	5.6	-12.4	-21.4	-32.0	-32.6	-25.8
PRICES AND COSTS										
GNP implicit deflator	Percent change*	3.6	3.4	2.9	2.6	3.0	4.0	3.9	4.0	4.0
GNP fixed-weight price index		3.9	3.7	3.3	2.6	4.0	4.5	4.1	4.2	4.2
Cons. & fixed invest. prices		3.3	3.3	3.4	2.5	4.7	4.2	4.3	4.0	4.3
CPI		3.2	4.2	3.5	1.3	4.4	4.3	4.4	4.1	4.4
Exc. food and energy		4.2	5.0	4.3	3.9	4.2	4.6	4.3	4.4	4.6
ECI hourly compensation		5.7	4.9	3.9	3.2	3.3	4.9	4.7	4.9	4.4
Nonfarm business sector										
Output per hour		3.4	1.5	1.6	1.3	2.4	1.6	.4	.8	1.3
Compensation per hour		3.1	4.2	4.6	5.0	4.0	4.8	5.3	5.6	5.1
Unit labor costs		-.4	2.6	3.0	3.6	1.5	3.1	4.9	4.7	3.8

* Percent changes are from fourth quarter to fourth quarter.

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CLASS II FOMC

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

December 13, 1989

	Units	1987 Q1	1987 Q2	1987 Q3	1987 Q4	1988 Q1	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2
EXPENDITURES											
Nominal GNP	Billions of $	4388.8	4475.9	4566.6	4665.8	4739.8	4838.5	4926.9	5017.3	5113.1	5201.7
Real GNP	Billions of 82$	3783.0	3823.5	3872.8	3935.6	3974.8	4010.7	4042.7	4069.4	4106.8	4132.5
Real GNP		5.4	4.4	5.3	6.6	4.0	3.7	3.2	2.7	3.7	2.5
Gross domestic purchases		3.4	4.0	5.4	5.5	.7	3.0	3.4	2.5	1.8	2.1
Final sales		1.1	4.9	6.0	1.4	6.5	5.0	1.6	4.7	3.1	3.1
Private dom. final purchases		-.9	5.9	6.5	-.6	6.0	4.4	3.1	1.7	2.3	2.0
Personal consumption expend.		.1	4.8	4.7	-.7	6.2	2.5	3.3	3.0	2.0	1.9
Durables		-19.9	14.8	15.8	-13.5	21.0	6.4	-3.9	9.9	-1.1	5.5
Nondurables		1.9	.6	1.3	.5	1.7	1.2	5.0	.7	1.3	-2.3
Services		6.0	5.0	3.8	3.0	5.2	2.2	4.5	2.6	3.6	3.8
Business fixed investment		-4.3	14.4	26.7	-.1	9.5	12.3	2.6	-6.5	6.9	8.6
Producers' durable equipment		-2.0	24.1	25.9	-.3	18.2	15.8	2.9	-6.9	9.6	14.8
Nonresidential structures		-10.3	-7.8	29.3	.6	-11.8	2.3	1.6	-5.1	-1.0	-9.5
Residential structures		-5.9	1.0	-11.0	-.4	-5.7	11.2	1.9	6.3	-5.0	-12.3
Exports		12.6	21.4	21.4	21.3	30.5	1.8	9.7	15.5	14.0	13.1
Imports		-3.6	14.5	19.1	9.8	1.2	-2.2	10.2	12.6	-.4	9.3
Government purchases		.3	-.9	4.5	4.5	-8.3	4.1	-3.6	16.7	-3.3	5.4
Federal		-4.9	-4.0	7.4	5.0	-22.3	5.2	-9.5	33.7	-9.4	10.0
Defense		5.1	8.9	9.4	-5.6	-5.4	-.8	-5.5	4.4	-10.6	2.2
State and local		4.6	1.5	2.5	4.0	3.7	3.4	.9	5.7	1.5	2.2
Change in business inventories	Billions of 82$	18.1	13.3	6.8	56.6	34.3	21.5	37.5	18.3	24.5	19.1
Nonfarm	Billions of 82$	20.3	14.5	12.9	55.6	28.3	25.4	37.2	31.9	16.9	19.5
Net exports	Billions of 82$	-118.2	-115.9	-118.9	-109.8	-78.2	-72.6	-74.9	-73.8	-55.0	-51.2
Nominal GNP	Percent change	8.8	8.2	8.4	9.0	6.5	8.6	7.5	7.5	7.9	7.1
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	101.0	101.8	102.5	103.5	104.4	105.2	106.0	106.8	107.7	108.3
Unemployment rate	Percent*	6.6	6.3	6.0	5.9	5.7	5.5	5.5	5.3	5.2	5.3
Industrial production index	Percent change	3.2	4.2	8.8	7.0	3.9	4.6	7.1	4.6	2.1	3.3
Capacity utilization rate-mfg.	Percent*	80.0	80.5	81.4	82.3	82.7	83.2	84.0	84.4	84.4	84.4
Housing starts	Millions	1.78	1.60	1.62	1.53	1.48	1.48	1.47	1.56	1.52	1.35
Auto sales	Millions	9.57	10.19	10.98	10.32	10.76	10.69	10.32	11.00	9.72	10.31
Domestic	Millions	6.77	7.12	7.40	6.93	7.60	7.50	7.20	7.89	6.89	7.30
Foreign	Millions	2.80	3.06	3.58	3.38	3.15	3.19	3.12	3.11	2.82	3.01
INCOME AND SAVING											
Nominal personal income	Percent change	8.7	6.6	6.9	12.5	4.1	8.1	7.2	8.8	13.3	7.9
Real disposable income	Percent change	4.0	-5.8	6.7	7.8	4.6	2.4	4.9	4.3	6.6	.8
Personal saving rate	Percent*	4.3	1.8	2.3	4.3	3.9	3.9	4.3	4.6	5.6	5.4
Corp. profits with IVA & CCAdj	Percent change	7.0	21.2	29.0	-6.0	13.5	9.4	7.1	11.7	-25.3	-10.3
Profit share of GNP	Percent*	6.4	6.6	6.9	6.6	6.7	6.7	6.7	6.8	6.2	5.9
Federal govt. surplus/deficit	Billions of $	-199.4	-137.7	-143.9	-164.4	-151.8	-141.5	-122.5	-167.6	-147.5	-145.4
State and local govt. surplus		46.3	60.4	50.5	48.0	50.8	52.4	49.8	45.7	48.8	47.5
Exc. social insurance funds		-14.6	-2.5	-14.0	-18.4	-17.5	-17.9	-22.3	-28.1	-26.6	-29.6
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.2	3.8	2.8	2.4	2.0	4.8	4.4	4.7	4.0	4.6
GNP fixed-weight price index		4.3	4.1	3.8	3.8	3.8	4.8	5.2	4.3	4.8	5.0
Cons. & fixed invest. prices		5.5	5.1	3.9	4.3	3.1	4.7	4.4	4.7	4.8	5.9
CPI		5.2	5.1	3.6	3.5	3.9	4.5	4.5	4.4	5.4	6.4
Exc. food and energy		4.2	4.2	3.8	4.4	4.7	4.7	4.0	4.9	5.2	4.1
ECI hourly compensation**		3.3	3.0	3.6	3.5	5.7	5.1	3.7	4.9	4.5	4.8
Nonfarm business sector											
Output per hour		.4	3.2	3.5	2.5	2.8	-1.6	3.3	1.9	-1.3	1.1
Compensation per hour		1.5	2.6	4.7	7.1	2.5	5.4	5.4	5.9	4.9	5.6
Unit labor costs		1.1	-.6	1.2	4.5	-.3	7.1	2.0	3.8	6.2	4.5

* Not at an annual rate.
** Private industry workers; seasonally adjusted by Board staff.

CONFIDENTIAL - FR
CLASS II FOMC

December 13, 1989

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

		Projection									
		1989		1990				1991			
	Units	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of $	5278.9	5337.6	5416.8	5489.6	5566.3	5643.0	5733.7	5819.4	5907.1	5997.1
Real GNP	Billions of 82$	4160.2	4167.1	4188.7	4201.6	4218.6	4234.9	4254.6	4277.7	4301.6	4327.5
Real GNP		2.7	.7	2.1	1.2	1.6	1.6	1.9	2.2	2.3	2.4
Gross domestic purchases		3.9	.3	1.0	2.1	1.5	1.2	1.4	1.5	1.5	1.5
Final sales		2.5	.5	4.9	.5	1.0	1.4	1.7	2.0	2.2	2.4
Private dom. final purchases		5.1	-.4	4.5	1.5	1.3	1.1	1.3	1.6	1.7	1.8
Personal consumption expend.		6.2	-.3	4.5	2.0	1.5	1.4	1.5	1.6	1.6	1.7
Durables		13.2	-13.8	14.9	1.4	-.5	.6	1.3	1.0	1.3	1.5
Nondurables		5.7	-1.1	1.7	1.3	.9	.9	.8	.9	.9	1.0
Services		4.4	5.0	3.3	2.6	2.6	2.0	2.0	2.2	2.2	2.2
Business fixed investment		4.6	-3.3	4.7	-.3	.0	.4	1.7	2.6	2.9	3.1
Producers' durable equipment		4.4	-5.2	6.2	.5	1.0	1.5	3.0	4.0	4.2	4.4
Nonresidential structures		5.5	3.4	.0	-3.0	-3.2	-3.2	-2.6	-2.2	-1.7	-1.3
Residential structures		-8.4	6.4	4.4	.8	.9	-1.2	-1.8	-1.5	-1.1	-.4
Exports		1.6	2.3	13.2	-.1	6.9	8.2	8.7	10.3	10.8	10.5
Imports		9.5	-.2	4.8	5.3	5.7	5.5	5.1	5.1	5.1	4.5
Government purchases		-2.1	2.3	.8	.2	-.6	.7	.7	.3	.4	.4
Federal		-7.9	1.4	-.8	-2.2	-3.9	-.9	-.9	-1.8	-1.8	-1.4
Defense		7.4	-10.6	-6.8	-5.0	-4.0	-3.1	-3.1	-3.1	-3.0	-2.7
State and local		2.3	2.8	1.9	2.0	1.7	1.8	1.8	1.8	1.8	1.6
Change in business inventories	Billions of 82$	21.2	23.4	-5.2	2.7	9.3	11.3	13.4	15.0	15.5	15.6
Nonfarm	Billions of 82$	15.3	23.4	-2.4	5.2	11.9	14.1	15.8	17.5	17.5	17.5
Net exports	Billions of 82$	-63.6	-59.8	-48.8	-57.6	-56.6	-53.4	-48.7	-41.3	-33.0	-23.7
Nominal GNP	Percent change	6.1	4.5	6.1	5.5	5.7	5.6	6.6	6.1	6.2	6.2
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	108.9	109.4	109.8	110.2	110.2	110.5	110.9	111.2	111.5	111.9
Unemployment rate	Percent*	5.2	5.4	5.6	5.8	5.9	6.0	6.1	6.1	6.2	6.2
Industrial production index	Percent change	1.3	-1.9	.8	1.2	2.0	2.0	2.0	2.8	3.0	3.2
Capacity utilization rate-mfg.	Percent*	83.9	82.7	82.0	81.6	81.3	81.0	80.8	80.7	80.7	80.8
Housing starts	Millions	1.34	1.39	1.37	1.37	1.36	1.36	1.36	1.36	1.35	1.35
Auto sales	Millions	10.51	8.90	9.80	9.70	9.50	9.45	9.50	9.50	9.50	9.50
Domestic	Millions	7.62	6.23	7.00	6.90	6.85	6.85	6.90	6.90	6.90	6.90
Foreign	Millions	2.88	2.68	2.80	2.80	2.65	2.60	2.60	2.60	2.60	2.60
INCOME AND SAVING											
Nominal personal income	Percent change	5.3	6.0	7.8	5.8	4.9	6.0	7.0	6.2	5.5	5.9
Real disposable income	Percent change	4.7	1.2	4.5	1.3	-.2	1.3	2.6	.9	.8	1.1
Personal saving rate	Percent*	5.0	5.4	5.4	5.2	4.9	4.8	5.1	5.0	4.8	4.7
Corp. profits with IVA & CCAdj	Percent change	-18.7	-17.5	4.5	-4.4	9.2	-1.4	-6.2	-4.3	6.4	7.6
Profit share of GNP	Percent*	5.5	5.2	5.2	5.1	5.1	5.0	4.9	4.7	4.7	4.8
Federal govt. surplus/deficit	Billions of $	-147.4	-160.1	-145.0	-136.9	-120.2	-117.6	-116.7	-107.8	-95.6	-89.4
State and local govt. surplus		44.3	43.5	49.1	48.6	54.4	55.1	58.0	64.5	66.9	68.8
Exc. social insurance funds		-34.8	-37.1	-33.0	-35.0	-30.7	-31.5	-30.1	-25.1	-24.2	-23.8
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.2	3.8	3.9	4.2	4.0	4.0	4.6	3.8	3.8	3.7
GNP fixed-weight price index		2.9	3.8	4.2	4.2	4.1	4.1	4.9	4.1	4.0	4.0
Cons. & fixed invest. prices		2.4	3.9	3.7	4.1	4.2	4.3	4.4	4.3	4.3	4.3
CPI		2.6	3.6	3.6	4.2	4.3	4.3	4.6	4.4	4.4	4.4
Exc. food and energy		3.5	4.2	4.0	4.4	4.5	4.5	4.8	4.5	4.5	4.5
ECI hourly compensation**		4.7	4.7	5.5	5.3	4.5	4.4	4.7	4.8	4.2	4.1
Nonfarm business sector											
Output per hour		2.5	-.7	.7	.8	.9	.9	1.1	1.4	1.4	1.4
Compensation per hour		5.3	5.3	6.1	5.9	5.2	5.1	5.4	5.5	4.9	4.8
Unit labor costs		2.8	6.0	5.4	5.1	4.3	4.2	4.3	4.0	3.5	3.4

* Not at an annual rate.
** Private industry workers; seasonally adjusted by Board staff.

December 13, 1989

CONFIDENTIAL - FR
CLASS II FOMC

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

	1987				1988				1989		1986	1987	1988	Projection 1989
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	(fourth quarter to fourth quarter, net change)			
Real GNP	49.4	40.5	49.3	62.8	39.2	35.9	32.0	26.7	37.4	25.7	71.2	202.0	133.8	97.7
Gross domestic purchases	32.2	38.2	52.3	53.7	7.6	30.3	34.3	25.6	18.6	21.9	81.3	176.4	97.8	83.7
Final sales	10.5	45.2	55.9	13.0	61.5	48.7	16.0	45.8	31.3	31.2	99.7	124.6	172.0	92.7
Private dom. final purchases	-7.3	44.6	50.3	-4.7	46.9	35.2	25.4	14.2	19.2	16.8	86.5	82.9	121.7	74.6
Personal consumption expend.	.5	29.4	28.8	-4.2	38.5	16.0	21.3	19.6	13.3	12.7	90.9	54.5	95.4	64.3
Durables	-21.4	13.2	14.5	-14.4	19.0	6.4	-4.1	9.8	-1.2	5.6	41.1	-8.1	31.1	1.9
Nondurables	4.2	1.3	2.8	1.1	3.7	2.6	11.1	1.7	3.0	-5.3	25.2	9.4	19.1	8.0
Services	17.7	15.0	11.4	9.1	15.9	6.9	14.2	8.2	11.5	12.3	24.6	53.2	45.2	54.5
Business fixed investment	-4.8	14.7	27.2	-.1	10.9	14.2	3.2	-8.3	8.3	10.4	-25.2	37.0	20.0	20.2
Producers' durable equipment	-1.6	17.2	19.4	-.3	14.8	13.5	2.7	-6.7	8.6	13.3	1.2	34.7	24.3	20.9
Nonresidential structures	-3.3	-2.4	7.8	.2	-3.9	.7	.5	-1.6	-.3	-3.0	-26.5	2.3	-4.3	-.7
Residential structures	-3.0	.5	-5.7	-.2	-2.8	5.1	.9	3.0	-2.5	-6.3	20.9	-8.4	6.2	-10.0
Change in business inventories	38.9	-4.8	-6.5	49.8	-22.3	-12.8	16.0	-19.2	6.2	-5.4	-28.5	77.4	-38.3	5.1
Nonfarm	31.2	-5.8	-1.6	42.7	-27.3	-2.9	11.8	-5.3	-15.0	2.6	-34.1	66.5	-23.7	-8.5
Farm	7.7	1.0	-4.9	7.1	4.9	-9.9	4.3	-13.9	21.2	-8.1	5.6	10.9	-14.6	13.6
Net exports	17.2	2.3	-3.0	9.1	31.6	5.6	-2.3	1.1	18.8	3.8	-10.1	25.6	36.0	14.0
Exports	12.2	20.8	21.8	22.8	33.3	2.3	12.2	19.5	18.3	17.8	39.1	77.6	67.3	41.8
Imports	-5.0	18.5	24.8	13.7	1.7	-3.3	14.6	18.3	-.6	14.1	49.3	52.0	31.3	27.8
Government purchases	.6	-1.7	8.6	8.6	-17.0	7.9	-7.1	30.5	-6.7	10.6	23.3	16.1	14.3	4.1
Federal	-4.3	-3.4	6.0	4.2	-21.1	4.1	-8.1	24.1	-8.4	8.1	1.8	2.5	-1.0	-6.1
Defense	3.2	5.6	6.0	-3.9	-3.7	-.5	-3.7	2.8	-7.2	1.4	14.4	10.9	-5.1	-8.4
Nondefense	-7.5	-9.0	.0	8.1	-17.4	4.6	-4.4	21.3	-1.2	6.7	-12.6	-8.4	4.1	2.3
State and local	4.9	1.6	2.7	4.4	4.1	3.8	1.0	6.4	1.7	2.5	21.5	13.6	15.3	10.2

CONFIDENTIAL - FR
CLASS II FOMC

December 13, 1989

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

	Projection											Projection		
	1989		1990				1991				1988	1989	1990	1991
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	(fourth quarter to fourth quarter, net change)			
Real GNP	27.7	6.9	21.6	12.8	17.1	16.3	19.7	23.1	23.9	25.9	133.8	97.7	67.8	92.5
Gross domestic purchases	40.1	3.1	10.7	21.6	16.1	13.0	15.0	15.7	15.6	16.5	97.8	83.7	61.4	62.8
Final sales	25.5	4.7	50.2	4.9	10.5	14.3	17.6	21.5	23.4	25.8	172.0	92.7	79.9	88.2
Private dom. final purchases	42.2	-3.6	37.7	13.2	10.8	9.5	11.4	13.4	14.4	15.5	121.7	74.6	71.3	54.8
Personal consumption expend.	40.4	-2.1	29.8	13.2	10.4	9.6	10.1	10.8	11.2	11.6	95.4	64.3	63.0	43.8
Durables	13.4	-15.9	14.9	1.5	-.5	.7	1.4	1.1	1.5	1.6	31.1	1.9	16.6	5.6
Nondurables	12.8	-2.5	3.9	3.0	2.1	2.1	1.9	2.1	2.1	2.3	19.1	8.0	11.0	8.4
Services	14.3	16.4	11.0	8.8	8.8	6.8	6.9	7.6	7.6	7.7	45.2	54.5	35.4	29.8
Business fixed investment	5.8	-4.3	5.9	-.4	.0	.5	2.2	3.3	3.7	4.1	20.0	20.2	6.0	13.3
Producers' durable equipment	4.3	-5.3	5.9	.5	1.0	1.5	3.0	4.0	4.2	4.5	24.3	20.9	8.9	15.6
Nonresidential structures	1.6	1.0	.0	-.9	-1.0	-1.0	-.8	-.7	-.5	-.4	-4.3	-.7	-2.9	-2.3
Residential structures	-4.1	2.9	2.0	.4	.4	-.6	-.9	-.7	-.5	-.2	6.2	-10.0	2.3	-2.3
Change in business inventories	2.1	2.2	-28.6	7.9	6.6	2.0	2.1	1.6	.5	.1	-38.3	5.1	-12.1	4.3
Nonfarm	-4.2	8.1	-25.8	7.6	6.7	2.2	1.7	1.7	.0	.0	-23.7	-8.5	-9.3	3.4
Farm	6.5	-6.0	-2.8	.3	-.1	-.2	.4	-.1	.5	.1	-14.6	13.6	-2.8	.9
Net exports	-12.4	3.8	11.0	-8.8	.9	3.3	4.7	7.4	8.3	9.4	36.0	14.0	6.4	29.7
Exports	2.3	3.4	18.7	-.1	10.3	12.4	13.3	16.1	17.2	17.2	67.3	41.8	41.3	63.8
Imports	14.7	-.4	7.8	8.6	9.4	9.1	8.6	8.7	8.9	7.9	31.3	27.8	34.9	34.1
Government purchases	-4.3	4.5	1.6	.5	-1.3	1.5	1.5	.7	.7	.9	14.3	4.1	2.2	3.7
Federal	-7.0	1.2	-.6	-1.8	-3.3	-.7	-.7	-1.5	-1.5	-1.1	-1.0	-6.1	-6.5	-4.9
Defense	4.6	-7.2	-4.4	-3.2	-2.5	-1.9	-1.9	-1.9	-1.8	-1.6	-5.1	-8.4	-12.0	-7.2
Nondefense	-11.7	8.5	3.8	1.4	-.8	1.2	1.2	.4	.3	.5	4.1	2.3	5.5	2.3
State and local	2.7	3.3	2.2	2.3	2.0	2.2	2.2	2.2	2.2	2.0	15.3	10.2	8.7	8.6

December 13, 1989

FEDERAL SECTOR ACCOUNTS[1]
(Billions of dollars)

	Fiscal years				1989				1990				1991			
	1988a	1989a	1990	1991	Ia	IIa	IIIa	IV	I	II	III	IV	I	II	III	IV
BUDGET					Not seasonally adjusted											
Budget receipts[2]	908	991	1056	1129	219	308	242	228	241	324	263	249	260	339	281	266
Budget outlays[2]	1063	1143	1186	1243	280	285	288	303	298	297	289	316	306	312	308	321
Surplus/deficit(-) to be financed[2]	-155	-152	-130	-114	-61	23	-46	-75	-56	27	-26	-68	-46	27	-27	-55
(On-budget)	-194	-204	-193	-183	-77	0	-54	-82	-75	4	-40	-77	-66	3	-43	-65
(Off-budget)	39	52	63	69	16	23	7	7	19	23	14	10	20	24	15	9
Means of financing:																
Borrowing	162	140	125	111	38	10	39	64	37	9	15	64	23	6	19	49
Cash decrease	-8	3	6	0	19	-29	3	22	8	-29	5	10	10	-25	5	10
Other[3]	1	8	-1	3	4	-4	5	-11	11	-8	6	-6	13	-8	3	-3
Cash operating balance, end of period	44	41	35	35	15	44	41	19	11	40	35	25	15	40	35	25
NIPA FEDERAL SECTOR					Seasonally adjusted annual rates											
Receipts	958	1032	1100	1185	1036	1053	1043	1056	1096	1114	1134	1152	1178	1197	1215	1235
Expenditures	1103	1184	1240	1295	1184	1199	1191	1216	1241	1251	1254	1270	1295	1305	1311	1325
Purchases	377	404	413	423	399	406	403	408	415	416	414	415	425	426	427	427
Defense	297	302	301	302	299	301	308	302	303	301	299	299	304	303	303	302
Nondefense	80	102	112	121	100	105	95	107	112	115	114	116	122	123	124	125
Other expend.	726	780	827	872	785	793	787	808	826	835	840	855	870	878	884	898
Surplus/deficit	-145	-152	-141	-109	-148	-145	-148	-160	-145	-137	-120	-118	-117	-108	-96	-89
FISCAL INDICATORS[4]																
High-employment (HEB) surplus/deficit(-)	-150	-168	-141	-88	-165	-162	-165	-169	-150	-134	-112	-103	-97	-84	-69	-61
Change in HEB, percent of potential GNP	.3	.4	-.5	-1.0	-.3	-.1	.0	.1	-.4	-.3	-.4	-.2	-.1	-.2	-.3	-.1
Fiscal impetus measure (FI), percent	.2 *	-3.5 *	-7.7 *	-3.7 *	-2.7	-.2	.6	-3.0	-4.3	-.6	-1.2	-1.8	-1.2	-.3	-.4	-.3

a--actual *--calendar year

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

1. Staff projections. The FY90 and FY91 deficits in OMB's Mid-Session Review of the Budget (July) are $99 billion and $85 billion, respectively. These estimates incorporate approximately $29 billion and $37 billion of cuts from the Gramm-Rudman-Hollings baseline in FY1990 and FY1991, respectively. The FY90 and FY91 baseline deficits in CBO's Economic and Budget Outlook: An Update (August) are $141 billion and $144 billion, respectively.
2. Budget receipts, outlays, and surplus/deficit include social security (OASDI) receipts, outlays and surplus, respectively. The OASDI surplus is excluded from the "on-budget" deficit and shown separately as "off-budget", as classified under current law.
3. Other means of financing are checks issued less checks paid, accrued items; and changes in other financial assets and liabilities, including Post Office surplus/deficit in FY90 and FY91.
4. HEB is the NIPA measure in current dollars with cyclically-sensitive receipts and outlays adjusted to a 6 percent unemployment rate and 2.7% potential output growth. Quarterly figures for change in HEB and FI are not at annual rates. Change in HEB, as a percent of nominal potential GNP, is reversed in sign. FI is the weighted difference of discretionary federal spending and tax changes (in 1982 dollars), scaled by real federal purchases. For change in HEB and FI, (-) indicates restraint.

Recent Developments

Most market interest rates are little changed on balance since the November FOMC meeting, with federal funds trading in a range around 8-1/2 percent. Although there were sharp rate declines in the short- and intermediate-term maturities just before Thanksgiving, when market participants misread seasonal reserve injections as signaling a System easing, these declines reversed quickly when subsequent operations clarified the Desk's intentions.

M2 growth continued to grow briskly in November, bolstered by large inflows to money market mutual funds and liquid household deposits, whose opportunity costs have declined most substantially with the drop in market rates. M3 growth also increased, as banks stepped up their use of term-RPs, in part to fund acquisitions of mortgaged-backed securities, and as the contraction in managed liabilities at thrifts slowed. The November growth placed M2 near the midpoint of its annual target range, and M3 just above the lower bound of its range.

Aggregate credit flows appear to have eased during November, following October's robust pace. Corporate borrowing has slackened somewhat as the reduced level of merger activity this quarter has offset increased needs associated with deteriorating cash flows. The slowdown in corporate restructuring in part reflects higher costs and reduced availability of merger financing. Yields on poorer-quality junk bonds have risen further relative to those on Treasuries, and there have been increasing reports of delays and restructurings of scheduled offerings. Banks also appear to be scrutinizing leveraged deals more closely in light of supervisory cautions and concerns about business prospects. In November, gross corporate bond offerings and net bank business lending fell below October's pace. Some nonfinancial firms may have shifted financing from banks to the commercial paper market, where issuance picked up; little of the increase in outstanding paper was in merger-related programs.

Despite the continuing news of deteriorating profits, broad stock price indexes rose about 3 to 4 percent in November and early December. New equity issues by nonfinancial corporations have trended up moderately this year, with total offerings in the U.S. and abroad averaging about $1.4 billion in October and November, but the total volume for 1989 will remain well below that for several years before the October 1987 market break.

In the household sector, consumer installment credit rose at a 5-3/4 percent rate in October, the high end of its growth range of recent months. The pickup in growth may be somewhat overstated because of the difficulties in seasonally adjusting auto credit owing to the timing of auto-incentive programs of recent years. A second consecutive month of slower expansion in revolving credit in October and sluggish new-car sales in November suggest that the underlying trend in consumer credit remains weak.

Total mortgage debt in the third quarter expanded near the pace of the first half and early indicators imply similar growth in the fourth quarter. Available information suggests that SAIF-insured institutions continued to contract operations by selling off mortgage assets in November, but at a slower pace; real estate lending at banks, meanwhile, has remained strong and mortgage bankers reportedly continue to expand their lending operations. Borrowers have been more attracted to fixed-rate mortgages, responding to relatively low current rates and the narrow spread between fixed and adjustable rates. Monthly survey data indicate that, since August, three-fourths of new conventional mortgage originations at major institutional lenders have carried fixed rates, a surge in this type of financing that has facilitated an increase in issuance of mortgage pass-through securities since midsummer.

The Treasury is expected to borrow about $64 billion from the public and to draw down cash balances a sizable amount to finance the projected $75 billion budget deficit in the fourth quarter. Marketable borrowings are likely to be about evenly distributed between bills and coupon issues, in contrast to earlier quarters, when coupons were the primary vehicle. In the agency market, diminishing demand for advances from member thrift institutions allowed the Federal Home Loan Banks to pay down outstanding debt in the third quarter and in October and November. Recently, the Home Loan Banks have stepped up their acquisitions of mortgage-backed securities, which have been attractively priced relative to Treasuries.

In municipal markets, the volume of new bond issues declined slightly in October and November owing to reduced offerings of refunding bonds. Municipal yields have declined less than those on Treasury bonds, perhaps in part because of reduced demand for tax-exempts by banks whose need for tax-sheltered income has diminished as prospective credit losses have mounted. The relatively attractive rates on tax-exempts appear to have bolstered individual investor demand; sales of tax-exempt mutual bond funds have increased in recent months.

Outlook

As noted in the nonfinancial section, the staff anticipates no major changes in interest rates over the next year, but perhaps some upward pressure in 1991 as activity begins to respond noticeably to the weaker dollar and resulting rise in net exports.

The growth of debt of domestic nonfinancial sectors is expected to continue to trend down, from nearly 8 percent this year to about 6-3/4 percent in 1991. Public sector borrowing is projected to lead the deceleration of debt, with growth of Treasury debt in the next two years the lowest since the early seventies. The growth of municipal debt also is expected to slow further as state and local governments use assets acquired with proceeds from earlier advance refundings to retire outstanding high-cost debt.

Business credit needs will be subject to conflicting pressures in the projection period. The staff anticipates that the pace of mergers and acquisitions will remain well below that of recent years, as banks and other lenders tighten their credit standards for such transactions. Fewer deals and increased use of stock-for-stock financing are expected to reduce net equity retirements to two-thirds their volume of recent quarters. Credit needs for other purposes may rise, however, if, as projected, sluggish sales eat into corporate profits. The gap between capital outlays and internal funds is expected to increase markedly through 1990. Taking into account both merger and earnings effects, the volume of business borrowing is projected to remain near current levels, which implies a slower growth rate of outstanding business debt.

With home sales and construction expected to continue at about current levels, mortgage debt growth should slow a bit next year. Consumer credit expansion is expected to maintain its current, relatively slow, pace, next year and decelerate a bit in 1991 given the weak outlook projected for personal income growth and consumer durable purchases.

Recent Developments

The weighted-average foreign exchange value of the dollar in terms of other G-10 currencies has declined 3-1/2 percent since the FOMC meeting on November 14. The decline in the dollar primarily reflected strength in the mark, which rose 5-1/2 percent against the dollar and even more against the yen. The mark rose on the market's favorable assessment of the implications for the German economy of political developments in Eastern Europe. The strength of the German currency generated pressures within the EMS, as the franc fell to near the bottom of its 2-1/4 percent band against the mark.

Short-term interest rate differentials moved slightly in favor of the dollar over the period, after having moved substantially against the dollar in the preceding period. Rates in Germany and Japan eased 15 to 25 basis points, while U.S. rates were little changed on balance. Stock markets abroad rose somewhat more than the U.S. market. A 9 percent surge in the German market reversed the sharp decline in that market during October.

the Desk sold a total of $150 million against yen

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The growth of economic activity in other major industrial countries, on average, continued fairly strong in the third quarter, about in line with the first half of the year. Performance across countries was mixed, however. In Japan, rapid growth of domestic demand, particularly business fixed investment, pushed GNP growth to 12 percent at an annual rate in the third quarter. Growth appears to have continued firm in Germany in the third quarter (when adjusted for the smaller number of working days in the quarter), but has slowed or remained generally weak elsewhere. Net exports continue to be the main source of strength in German output. An inflow of more than 100,000 immigrants from Eastern Europe in recent months helped to raise the German unemployment rate slightly in November. Inflation in major foreign countries appears to have moderated somewhat in recent months.

Germany's external surplus rose significantly in the third quarter, returning to near previous highs, while the U.K. deficit widened somewhat. Japan's surplus remained little changed from its second-quarter rate, and well below peak rates reached earlier.

Among the major developing countries, Mexico's anti-inflation pact has been extended four months beyond the original expiration date at the end of next March. By mid-December, the Mexican debt restructuring operation had covered banks holding about 95 percent of the $48 billion debt to be restructured, and $1.4 billion in new loans had been pledged by banks holding 12 percent of the debt. Brazil's inflation rate surpassed 40 percent at a monthly rate in November, and the volatility of financial markets in Brazil has increased in advance of the presidential run-off election later this month. Argentina recently announced new reforms to bolster its faltering adjustment program. Peru made a substantial debt service payment to the IMF for the first time since 1986.

The U.S. merchandise trade deficit narrowed to $7.9 billion in September (on a seasonally adjusted customs basis), more than reversing the increase in the deficit in August. (October trade data will be released on Friday, December 15.) After having narrowed since 1987, the deficit leveled off in the third quarter (on a seasonally adjusted balance-of-payments basis), suggesting tha' the rise in the dollar over the preceding year may have begun to have an adverse effect. Both imports and exports rose moderately in terms of value and somewhat faster in terms of quantity during the third quarter, as prices fell. Aircraft and computers accounted for the strength in exports, while computers, consumer goods, and especially oil registered the strongest increases on the import side. The higher quantity of oil imports went largely into domestic stocks.

The fixed-weight index of import prices fell by more than 2 percent in the third quarter, reflecting both a substantial drop in oil prices and declines in prices of most other imports as the dollar was rising. Import prices rebounded in October, with oil returning to about $17.50 per barrel and the prices of non-oil imports rising moderately as well. Export prices also moved up in October, after having declined in the third quarter; prices of capital goods and automotive products led the way.

Large net inflows of capital were recorded across most categories of assets in the third quarter. Net foreign purchases of Treasury securities and bonds issued by U.S. government agencies showed unusual strength.

Outlook

Over the past three months the rate of decline in the dollar has exceeded the moderate rate of depreciation that had been incorporated into the staff forecast. Part of the unanticipated weakness of the dollar can be attributed to the tightening of monetary policy abroad that came sooner and was stronger than had been expected. The staff continues to project a moderate rate of decline in the dollar over the forecast period, though at less than the rates assumed in the September and November Greenbooks. While there is a risk of a faster rate of decline in the dollar, continued firmness of U.S. monetary policy is seen as mitigating this risk.

Economic growth in the major foreign industrial countries is expected to average 2-3/4 percent at an annual rate, down somewhat from the annual rate of about 3-1/2 percent recorded over the past two years. The monetary restraint that is expected to hold growth to this more subdued pace should also hold down consumer price inflation abroad to an average rate somewhat below that in the United States.

Recent developments in Eastern Europe are expected to influence the outlook for Western Europe, and Germany in particular, in two ways. First, the recent flood of immigrants from East Germany will raise West Germany's fiscal expenditures, consumption, and housing demand, and in the slightly longer term, its potential output as well. The near-term stimulus to aggregate demand will raise growth and inflationary pressures somewhat in the year ahead.

Second, recent political events in Eastern Europe may lead to a significant economic restructuring and an opening of Eastern Europe to increased trade and foreign investment from the West. While such developments could have a profound effect on Europe for decades, this aspect of recent events is not expected to have a significant effect on the economies of Western Europe during the relatively short time horizon of the staff forecast.

Oil import prices are expected to average about $17.80 per barrel in the current quarter and then to fall to $17 by the second quarter next year in response to continued strong OPEC production and rising inventories. These prices are assumed to rise in line with domestic inflation in 1991.

The U.S. merchandise trade deficit is projected to remain little changed, on average, over the next six quarters. A transitory improvement in the first quarter next year can be expected as the effects of the recent Boeing strike and a backlog of aircraft exports are unwound. The projected slowing of U.S. growth and associated lower growth in demand for imports over the year ahead will about offset the negative effects on the trade balance of the rise in the dollar over the past year. The more recent and projected further decline in the dollar is expected to begin to show through in a decline in the deficit after mid-1991.

Net portfolio investment income payments will continue to rise as U.S. net indebtedness to the rest of the world mounts. However, these higher net payments are projected to be more than offset by increases in net direct investment income receipts and other net services. As a result, the current account deficit (excluding capital gains and losses) is expected to improve slightly more than the trade deficit, edging below $100 billion by the end of 1991.

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

	ANNUAL			1989		1990				1991			
	1989-P	1990-P	1991-P	Q3	Q4-P	Q1	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current $, Net	-52.8	-43.9	-33.5	-53.5	-53.1	-38.7	-46.4	-46.3	-44.1	-41.6	-37.0	-31.3	-24.2
Exports of G+S	620.4	662.2	739.0	623.3	626.5	647.9	650.9	665.9	683.9	703.7	726.5	750.7	775.0
Imports of G+S	673.1	706.0	772.5	676.8	679.5	686.6	697.3	712.2	728.0	745.3	763.5	782.0	799.2
Constant 82 $, Net	-57.4	-54.1	-36.7	-63.6	-59.8	-48.8	-57.6	-56.6	-53.4	-48.7	-41.3	-33.0	-23.7
Exports of G+S	585.1	620.1	672.8	589.8	593.2	611.9	611.8	622.1	634.5	647.8	663.9	681.1	698.3
Imports of G+S	642.4	674.2	709.5	653.4	653.0	660.8	669.4	678.8	687.9	696.5	705.2	714.1	722.0
2. Merchandise Trade Balance 2/	-111.4	-106.2	-105.5	-111.0	-110.7	-98.1	-107.8	-109.6	-109.5	-109.9	-108.1	-104.4	-99.5
Exports	363.7	391.7	436.1	366.3	371.0	386.1	384.1	393.0	403.7	414.6	428.1	443.0	458.6
Agricultural	41.6	42.3	45.8	39.1	40.6	41.2	41.9	42.6	43.5	44.3	45.3	46.3	47.3
Non-Agricultural	322.1	349.4	390.3	327.2	330.4	344.9	342.3	350.4	360.2	370.4	382.8	396.7	411.4
Imports	475.0	498.0	541.6	477.3	481.8	484.2	492.0	502.6	513.1	524.5	536.2	547.4	558.1
Petroleum and Products	50.6	52.0	55.6	53.2	52.1	51.8	51.4	52.0	52.6	53.8	55.0	56.2	57.4
Non-Petroleum	424.4	446.0	486.0	424.1	429.6	432.3	440.6	450.5	460.5	470.7	481.2	491.2	500.7
3. Other Current Account Transactions													
Capital Gains and Losses 3/	-7.8	1.5	1.0	-0.2	1.6	2.5	1.1	1.1	1.1	1.1	1.0	1.0	1.0
Other D.I. Income, Net	36.3	37.9	42.6	36.3	36.8	36.8	37.2	38.2	39.4	41.0	42.3	43.1	43.9
Portfolio Income, Net	-37.2	-45.4	-51.0	-38.2	-41.5	-43.4	-44.7	-46.1	-47.4	-48.7	-50.1	-51.8	-53.6
Other Current Account, Net	4.9	10.0	14.1	6.3	4.9	9.1	10.5	11.3	9.1	13.0	14.2	15.4	13.8
4. U.S. Current Account Balance													
Including Capital G/L	-115.1	-102.2	-98.8	-106.7	-109.0	-93.1	-103.7	-104.9	-107.3	-103.4	-100.6	-96.7	-94.4
Excluding Capital G/L	-107.3	-103.7	-99.8	-106.6	-110.6	-95.6	-104.8	-106.1	-108.4	-104.5	-101.6	-97.7	-95.4
5. Foreign Outlook 4/													
Real GNP--Ten Industrial 5/	3.5	3.0	2.8	3.4	3.6	3.1	2.9	2.7	2.9	2.6	2.8	2.9	2.9
Real GNP--LDC 6/	2.9	3.9	4.0	3.2	3.8	4.3	4.3	4.0	3.8	3.7	4.0	4.4	4.8
Consumer Prices--Ten Ind. 5/	4.1	3.7	3.7	2.4	4.6	2.9	4.7	3.1	3.3	3.6	4.4	3.6	3.7

1/ National Income and Product Account data.
2/ International accounts basis.
3/ The net of gains (+) or losses (-) on foreign-currency denominated assets due to their revaluation at current exchange rates and other valuation adjustments.
4/ Percent change, annual rates.
5/ Weighted by multilateral trade-weights of G-10 countries plus Switzerland; prices are not seasonally adjusted.
6/ Weighted by share in LDC GNP.
P/ Projected