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Strictly Confidential (FR) Class II FOMC

March 21, 1990

SUMMARY AND OUTLOOK

Prepared for the Federal Open Market Committee
By the staff of the Board of Governors of the Federal Reserve System

Overview

The Commerce Department now estimates that real GNP increased at a 0.9 percent annual rate in the fourth quarter. Although this upward revision was modest on balance, it did alter the mix of outlays, indicating stronger final sales and less inventory accumulation. The Board staff projects that growth in the current quarter will be at about a 2 percent annual rate--more than twice the increase predicted in the January Greenbook--based largely on robust employment reports for January and February. On the spending side, this upward revision to the current quarter shows up as a smaller inventory correction, reflecting the relatively prompt adjustments made late last year. The projected pace of inflation for the current quarter also has been raised, to a 6-1/4 percent annual rate for the GNP fixed-weight price index and to a 7-3/4 percent pace for the consumer price index.

Over 1990 as a whole, the staff projection for growth of real GNP has been revised up, to 2 percent, resulting in a higher level of resource utilization during the year than was anticipated in the January Greenbook. Moreover, recent data suggest that price pressures may be more intense than the staff previously had estimated. In light of the apparently greater inflationary risks, the staff now assumes that monetary policy will impose somewhat greater restraint on aggregate demand over the forecast period. The extra restraint is expected to keep real GNP growth at 2 percent in 1991, leaving the level of output at the end of 1991 close to that in the previous projection. The forecast shows inflation rising a bit this year and then edging down, but the CPI is still expected to be increasing at a 4-1/2 percent rate at the end of 1991.

Reflecting the tighter assumed stance of monetary policy, both short-term and long-term interest rates are expected to rise somewhat from current levels by early next year. The value of the dollar is anticipated to decline slightly in real terms over the forecast period; the amount of depreciation is less than that built into the January Greenbook forecast. For the monetary aggregates, M2 is projected to expand in the upper portion of its tentative target range this year, with the effects of the rise in interest rates restraining M2 a little relative to the expansion in nominal GNP. Assuming that interest rates do move higher, M2 growth in 1991 is expected to slow from this year's pace. The growth of M3, reflecting further reductions in the funding needs of thrifts, is projected to be around the midpoint of its range for 1990, and to grow close to that rate in 1991.

Fiscal policy still is assumed to be moderately restrictive through the end of 1991, with real federal purchases projected to decline a bit on balance over the period. Although the basic stance of fiscal policy has not been altered from the January Greenbook, the staff's estimate of the (unified) federal budget deficit has been revised up $28 billion in fiscal year 1990 and $27 billion in fiscal year 1991 to account for advances of working capital to the Resolution Trust Corporation. The January Greenbook forecast and the Administration's budget had excluded RTC working capital from the projected deficit, owing to the uncertainty surrounding the source of funding and its treatment in the budget.[1] Accounting for RTC working capital--and continuing to assume a $30 billion package of spending cuts and revenue increases--the staff estimates the FY1991 deficit will be $148 billion, down from $168 billion in FY1990. Under current law, working capital outlays by the RTC are included in the Gramm-Rudman deficit calculations, which, in our view, effectively puts the 1991 target of $64 billion beyond reach, even on the more favorable OMB economic assumptions. Accordingly, we continue to forecast that the Gramm-Rudman law will be modified to avoid a sequester.

Assessment of the Current Quarter

Real activity in the current quarter appears to be expanding at a pace above that estimated for the fourth quarter. Nonfarm payroll employment jumped 372,000 in February, after a gain of 332,000 during the preceding month; aggregate hours of production or nonsupervisory workers advanced 0.5 percent and 0.7 percent, respectively, in January and February. At the same time, the civilian unemployment rate held at 5.3 percent. Historical patterns would suggest that these labor market data could be consistent with first-quarter real GNP growth of around 3 percent. However, the available spending data do not seem to corroborate such an increase in output, and consequently, the staff has partially discounted the labor market data, projecting current-quarter GNP growth at about 2 percent.

Compared with the estimate in the January Greenbook, the higher growth in the current quarter takes the form of a smaller correction to nonfarm

1. In February, the Administration decided that the RTC would borrow from the Federal Financing Bank, and thus working capital loans will be counted as outlays when disbursed by the RTC, with repayments scored as outlay-offsetting receipts.

inventories. As shown in the table below, BEA adjusted down by $13 billion its estimate of the fourth-quarter accumulation of nonfarm stocks excluding autos. Thus, in our view, a good part of the inventory correction previously expected to occur this quarter likely was accomplished by the end of last year. Accordingly, the contribution to current-quarter GNP growth from investment in nonfarm inventories excluding autos (the "swing" in the table) has been revised up from a negative $17-1/2 billion to a positive $6-1/4 billion. This swing is influenced heavily by movements in oil inventories in the fourth and first quarters; oil stocks are estimated to have been drawn down late last year with the weather-related surge in energy demand and to have been rebuilt this quarter. Removing oil (and autos held by dealers) from total nonfarm stocks, the negative inventory swing in the current quarter is now expected to be only half as large as that projected in the January Greenbook.

STAFF PROJECTION OF INVENTORY INVESTMENT IN THE CURRENT QUARTER
(Billions of 1982 dollars, seasonally adjusted annual rate)

	Inventory Investment		Swing from
	1989:Q4	1990:Q1	Q4 to Q1
		------Projection-----	
Total nonfarm, excl. retail autos	15.0	21.2	6.2
(Previous)	*28.1*	*10.5*	*-17.6*
Oil[1]	-9.0	12.6	21.6
(Previous)	*-6.0*	*6.2*	*12.2*
All other[1]	24.0	8.6	-15.4
(Previous)	*34.1*	*4.3*	*-29.8*

1. The staff estimates the breakdown between oil and other inventories based on data from the Department of Energy.

Although special factors have markedly affected growth in particular sectors this quarter, their combined influence on total activity appears to be relatively small, as best as we can judge (see table below). The resumption of full-capacity output at Boeing after the strike last fall is more than offset by the depressed rate of motor vehicle production, which shows up in the forecast mainly as a drawdown of inventories. Considerably more uncertainty surrounds our estimate of the effect on GNP of the unseasonably warm weather during much of the first quarter; our best guess is that the weather had little net effect on GNP growth, as the surge in construction activity is estimated to have been offset by reduced domestic production of energy. Excluding these special factors, the staff projects that real GNP will advance 2.4 percent in the current quarter, up from the 1.8 percent pace estimated for the fourth quarter.

SUMMARY OF NEAR-TERM GNP PROJECTION
(Contributions to growth, percentage points)

	1989:Q4	1990:Q1	1990:Q2
		-----Projection-----	
Real GNP	.9	2.0	2.6
Motor vehicles	-.4	-1.3	1.4
Boeing strike	-.6	.6	.0
Weather	.1	.3	-.2
GNP excl. these factors	1.8	2.4	1.4

As noted above, the inflation forecast for the current quarter has been revised upward. The change reflects, in part, an even larger surge in food and energy prices than had been anticipated at the time of the January Greenbook. But, in addition, the CPI reports for January and February indicated fairly large price hikes for various other goods and services, and our projection of the CPI excluding food and energy was adjusted up 1-1/2 percentage points to show a 5-3/4 percent rate of increase for the quarter.

Taken together, the recent CPI reports suggest that underlying cost pressures may be flowing through to prices to a greater degree than had been anticipated in the previous forecast--a pattern that certainly is consistent with the higher level of activity in the economy.

Longer-term Outlook

Despite the surprising strength in first-quarter activity, we have not carried forward an upward revision to growth in coming quarters. Several considerations limit the expected gains in output. In manufacturing, the domestic automakers recently completed a sizable inventory correction and have little scope to raise production from current levels given the softness in demand. Excluding motor vehicles, manufacturing output has been essentially flat since the autumn, and data on orders don't suggest much near-term pickup in production. Moreover, the recent weather-related boost to construction activity is likely to be largely reversed in coming quarters, and fiscal stringency is projected to restrain outlays for some time at all levels of government. On the whole, in an environment of financial restraint, final sales are projected to grow at a sluggish pace for the rest of 1990, with real GNP expected to advance about 2 percent for the year as a whole. As in the January Greenbook, the staff expects net exports to accelerate late in 1990 and to provide significant impetus to growth next year. However, even with this boost from the external sector, real GNP growth now is projected to remain around 2 percent in 1991, as the restraint on domestic demand is somewhat greater than previously assumed.

Consumer spending. The trend in consumer spending recently has been obscured by wide swings in purchases of motor vehicles and energy-related goods and services. Excluding energy items and motor vehicles, real consumer spending is projected to rise at an average rate of about 2-3/4 percent during the first half of the year and to decelerate to a 2 percent pace during the second half in line with more sluggish increases in disposable personal income.

Spending gains in 1991 are expected to remain subdued, especially in light of the projection that growth in real disposable income will be nearly 3/4 percentage point below that of GNP. This gap results, in roughly equal measure, from the loss of real income induced by the rise in consumer prices relative to GNP prices and from the projected increase in personal tax payments as a share of income.[2] Both factors damp the rise in disposable income. Many households are expected to view the slower growth of income as transitory, thus keeping their consumption path on a stronger trajectory than that of contemporaneous income, which causes the personal saving rate to edge down over the forecast period.

Business fixed investment. The environment for business investment is not expected to be particularly favorable through 1991. Profit margins shrank dramatically over 1989 and are projected to diminish still further. The slow growth projected for final sales opens up some slack in various industries, and real interest rates are anticipated to rise further from current levels. Moreover, the greater caution now being exercised by lenders--and perhaps some inclination on the part of business in this environment to husband liquidity--may foster less aggressive capital spending.

2. The rise in personal tax burdens reflects the staff's assumed package of deficit-reducing actions and "bracket creep" at the federal level, along with higher tax rates at the state and local level.

In all, the staff expects that business fixed investment will be essentially flat for the rest of 1990 and then edge up in 1991. In line with the pattern of recent years, purchases of equipment are expected to rise, while those for nonresidential structures decline. Among the various types of equipment, demand for computers and other office equipment is projected to be buoyed by declining relative prices, and spending for productivity-enhancing industrial equipment should hold up fairly well as firms seek to improve competitiveness. On the construction side, activity in all major sectors is expected to be weak, with commercial building the most severely squeezed by the more stringent lending standards.

Housing. After the weather-related surge in housing starts this quarter, the staff expects starts to drop back in the second quarter and then to edge down somewhat further over the forecast period, to 1.3 million units in 1991. The fundamentals in the housing market argue for such an anemic forecast. On the demand side, mortgage interest rates are expected to rise from current levels over the next year, and gains in disposable income are projected to be slow. Demand also may be subdued by a shift in demographics, with household formations projected to average 1.2 million annually over the first half of the 1990s, down from the 1.5 million pace during 1983-89. On the supply side, the incentives for building also are relatively weak, as vacancy rates have remained high for multifamily units, and an overhang of unsold single-family homes continues in the Northeast. Moreover, the availability of credit to builders has tightened, with thrifts cutting back ADC lending as a result of the FIRREA-mandated capital requirements and loan limits; middle-sized builders will require some time to re-establish credit sources, and even then, the absence of the overly aggressive lending of prior years will damp real estate development.

Government purchases. Continuing budgetary constraints at all levels of government are likely to hold the growth of total real purchases to less than a 1 percent annual rate over the forecast period. The staff expects purchases in the federal sector to trend lower over the next seven quarters, pulled down by declining defense outlays. However, part of the reduction in defense spending is projected to be offset by small increases in real nondefense outlays, primarily for space and law enforcement programs. In the state and local sector, the budget deficit (excluding social insurance funds) widened considerably in 1989. The staff expects these governmental units to respond by holding down growth of purchases and by raising taxes. Real purchases in this sector are projected to increase less than 2 percent in both 1990 and 1991, despite pressing needs to repair and expand the infrastructure and to meet growing school enrollments.

Net exports. The contribution of the external sector to GNP growth during 1989 diminished relative to that in 1988, largely reflecting the waning stimulus from the earlier depreciation of the dollar and the firming of its value over 1988 and the first half of 1989. The staff expects some further deceleration in net exports of goods and services this year, largely because of higher imports, with the foreign sector making only a small contribution to gains in real GNP for the year as a whole. However, real net exports are projected to provide renewed impetus to domestic output around the turn of the year, given the expectation that the dollar's downtrend since mid-1989 will continue, albeit at a slower rate, and that GNP growth abroad will be well maintained. The increase in real net exports expected over 1991--a bit more than $30 billion--is about the same as that in the January Greenbook, in large part because the effect of the slower projected depreciation of the dollar is offset by stronger export demand associated with recent developments in Europe. The acceleration projected for net exports, and the related "multiplier" effects, would lead to more robust GNP growth in 1991 if not for the tightening of monetary policy to check domestic demand.

Labor costs and prices. Recent news on wage developments has been quite favorable, with no indication of any acceleration despite the continuation of unemployment at only 5-1/4 percent. The spurt in consumer prices this winter clearly raises a risk of a pickup in wage inflation, but the forecast for labor costs has been revised up only slightly at this point. Nevertheless, the experience of the past year indicates that wage inflation probably will not abate unless there is some easing of pressures on resources. The projected rise in the unemployment rate to 6 percent by year-end 1991 is assumed to be sufficient to slow the rise in hourly compensation over the projection period. Compensation will be boosted in the first half of 1990 and the first half of 1991 by higher social security taxes and hikes in the federal minimum wage. Excluding these factors, the rise in ECI compensation is projected to slow to a 4-1/4 percent annual rate by the end of 1991, roughly 1/2 percentage point below the 1989 pace. With labor productivity gains expected to move back up to the trend rate of increase next year, the projected slowing of compensation growth yields a deceleration in unit labor costs.

Because the easing of underlying labor cost pressures occurs gradually over the forecast period, inflation is not expected to move back below the

1989 pace through year-end 1991. The GNP fixed-weight price index is projected to increase about 4-1/2 percent in 1990 and 1991, slightly above the reading last year. The CPI is expected to rise about 4-3/4 percent this year and 4-1/2 percent in 1991, similar to the 4.6 percent rise in 1989.

Compared with the outlook in the January Greenbook, the inflation picture has deteriorated a bit. The upward adjustment for 1990--about 0.3 percentage point for the GNP fixed-weight price index--is larger than that for 1991, and mainly reflects price reports for January and February that, as noted earlier, showed more rapid inflation in a number of areas than the staff had expected. This burst of inflation, combined with the lower projected path for the unemployment rate through year-end, added 0.1 percentage point to projected wage increases in 1990 and 1991. In addition, crude oil prices were revised up about $1 per barrel across the forecast period. These upward influences on inflation were only partly offset by some tempering of the rise in non-oil import prices associated with the depreciation of the dollar.

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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)	
	1/31/90	3/21/90	1/31/90	3/21/90	1/31/90	3/21/90	1/31/90	3/21/90	1/31/90	3/21/90
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 <2>	7.2	7.2	2.9	3.0	4.5	4.5	4.8	4.8	5.3	5.3
1990	5.6	6.2	1.6	2.0	4.1	4.4	4.3	4.8	5.7	5.5
1991	6.3	6.1	2.1	1.9	4.3	4.3	4.4	4.4	6.1	5.9
Quarterly changes:										
1988 Q1 <2>	6.5	6.5	4.0	4.0	3.8	3.8	3.9	3.5	5.7	5.7
Q2 <2>	8.6	8.6	3.7	3.7	4.8	4.8	4.5	4.2	5.5	5.5
Q3 <2>	7.5	7.5	3.2	3.2	5.2	5.2	4.5	5.2	5.5	5.5
Q4 <2>	7.5	7.5	2.7	2.7	4.3	4.3	4.4	4.1	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	6.0	5.3	5.3
Q3 <2>	6.2	6.2	3.0	3.0	2.9	2.9	2.6	2.9	5.3	5.3
Q4 <2>	4.3	4.4	.5	.9	3.8	3.6	3.9	3.9	5.3	5.3
1990 Q1	5.2	7.6	.7	2.0	5.0	6.3	5.6	7.7	5.5	5.3
Q2	6.3	6.1	2.6	2.6	3.7	3.7	3.7	3.0	5.6	5.4
Q3	5.8	5.9	1.6	1.7	4.1	3.9	4.2	4.2	5.8	5.6
Q4	5.6	5.9	1.7	1.7	4.1	4.2	4.3	4.5	5.9	5.7
1991 Q1	6.8	6.2	2.1	1.7	4.9	4.7	4.6	4.7	6.0	5.8
Q2	6.4	6.0	2.3	1.8	4.2	4.3	4.5	4.5	6.0	5.9
Q3	6.4	6.3	2.4	2.2	4.1	4.2	4.5	4.5	6.1	6.0
Q4	6.5	6.2	2.5	2.2	4.1	4.2	4.5	4.5	6.1	6.0
Two-quarter changes: <3>										
1988 Q2 <2>	7.5	7.5	3.9	3.9	4.2	4.2	4.1	3.9	-.3	-.3
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	5.7	.0	.0
Q4 <2>	5.3	5.3	1.7	1.9	3.3	3.3	3.2	3.4	.0	.0
1990 Q2	5.7	6.8	1.6	2.3	4.3	5.0	4.6	5.3	.3	.1
Q4	5.7	5.9	1.6	1.7	4.1	4.1	4.2	4.3	.3	.3
1991 Q2	6.6	6.1	2.2	1.8	4.6	4.5	4.6	4.6	.1	.2
Q4	6.4	6.3	2.5	2.2	4.1	4.2	4.5	4.5	.1	.1
Four-quarter changes: <4>										
1987 Q4 <2>	8.6	8.6	5.4	5.4	4.0	4.0	4.4	4.5	-1.0	-1.0
1988 Q4 <2>	7.5	7.5	3.4	3.4	4.5	4.5	4.3	4.3	-.5	-.5
1989 Q4 <2>	6.4	6.4	2.4	2.5	4.1	4.1	4.5	4.6	.0	.0
1990 Q4	5.7	6.4	1.6	2.0	4.2	4.5	4.4	4.8	.6	.4
1991 Q4	6.5	6.2	2.3	2.0	4.3	4.4	4.5	4.6	.2	.3

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

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

	Units	1983	1984	1985	1986	1987	1988	1989	Projection 1990	Projection 1991
EXPENDITURES										
Nominal GNP	Billions of $	3405.7	3772.2	4014.9	4231.6	4524.3	4880.6	5233.3	5557.1	5895.0
Real GNP	Billions of 82$	3279.1	3501.4	3618.7	3717.9	3853.7	4024.4	4143.7	4226.5	4305.1
Real GNP	Percent change*	6.5	5.1	3.6	1.9	5.4	3.4	2.5	2.0	2.0
Gross domestic purchases		8.4	6.4	4.3	2.1	4.6	2.4	1.9	1.7	1.2
Final sales		3.7	4.7	4.6	2.7	3.3	4.4	2.4	2.3	1.9
Private dom. final purchases		7.7	5.6	4.6	2.9	2.7	3.8	2.1	2.2	1.3
Personal consumption expend.		5.4	4.1	4.6	3.8	2.2	3.8	2.5	2.3	1.5
Durables		14.7	10.8	7.0	11.5	-2.0	8.0	-.1	3.9	1.3
Nondurables		4.4	2.3	3.3	2.9	1.1	2.1	1.1	.3	.7
Services		3.9	3.5	5.0	2.1	4.4	3.6	4.3	3.1	2.1
Business fixed investment		10.8	13.8	3.7	-5.5	8.5	4.2	3.4	2.4	1.5
Producers' durable equipment		20.9	14.9	4.6	.4	11.1	7.0	4.8	4.4	3.3
Nonresidential structures		-4.8	11.8	1.9	-17.7	1.9	-3.4	-.8	-4.0	-5.1
Residential structures		38.1	6.1	5.8	11.6	-4.2	3.2	-6.9	1.3	-1.6
Exports		5.8	5.9	-2.4	10.6	19.1	13.9	9.8	8.3	9.1
Imports		23.8	17.4	4.5	10.0	9.6	5.3	4.5	6.1	3.9
Government purchases		-2.7	7.9	8.6	3.1	2.1	1.8	.2	1.2	.5
Federal		-8.1	13.0	13.3	.5	.7	-.3	-3.5	.2	-1.3
Defense		5.1	6.5	7.1	6.0	4.3	-1.9	-2.3	-3.9	-3.3
State and local		1.5	4.4	4.9	5.2	3.1	3.4	2.9	1.9	1.8
Change in business inventories	Billions of 82$	-6.4	62.3	9.1	5.6	23.7	27.9	22.9	8.2	14.5
Nonfarm	Billions of 82$	-.1	57.8	13.4	8.0	25.8	30.7	18.7	9.8	14.2
Net exports	Billions of 82$	-19.9	-84.0	-104.3	-129.7	-115.7	-74.9	-52.9	-40.5	-19.2
Nominal GNP	Percent change*	10.4	8.6	6.6	4.6	8.6	7.5	6.4	6.4	6.2
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	90.2	94.5	97.5	99.5	102.2	105.6	108.6	110.8	111.8
Unemployment rate	Percent	9.6	7.5	7.2	7.0	6.2	5.5	5.3	5.5	5.9
Industrial production index	Percent change*	14.3	6.6	1.7	1.0	5.8	5.0	1.6	1.3	2.0
Capacity utilization rate-mfg.	Percent	73.9	80.5	80.1	79.7	81.1	83.5	83.9	82.0	81.2
Housing starts	Millions	1.70	1.75	1.74	1.81	1.62	1.49	1.37	1.36	1.30
Auto sales	Millions	9.19	10.35	11.03	11.45	10.23	10.65	9.89	9.51	9.41
Domestic	Millions	6.82	7.92	8.22	8.22	7.06	7.55	7.06	6.88	6.91
Foreign	Millions	2.37	2.43	2.82	3.23	3.18	3.10	2.83	2.63	2.50
INCOME AND SAVING										
Nominal personal income	Percent change*	7.8	8.4	6.6	5.8	8.6	7.1	8.4	6.9	6.3
Real disposable income	Percent change*	5.1	4.3	2.7	3.3	3.0	4.0	3.6	1.6	1.3
Personal saving rate	Percent	5.4	6.1	4.4	4.1	3.2	4.2	5.4	5.4	5.1
Corp. profits with IVA & CCAdj	Percent change*	70.1	7.4	9.2	-5.6	12.0	10.4	-18.4	1.1	.9
Profit share of GNP	Percent	6.3	7.1	7.0	6.7	6.6	6.7	5.7	5.0	4.7
Federal govt. surplus/deficit	Billions of $	-176.0	-169.6	-196.9	-206.9	-161.4	-145.8	-148.5	-131.2	-106.5
State and local govt. surplus		47.5	64.6	65.1	62.8	51.3	49.7	44.3	45.4	62.5
Exc. social insurance funds		4.4	19.8	13.8	5.6	-12.4	-21.4	-33.8	-38.9	-27.8
PRICES AND COSTS										
GNP implicit deflator	Percent change*	3.6	3.4	2.9	2.6	3.0	4.0	3.7	4.3	4.1
GNP fixed-weight price index		3.9	3.7	3.3	2.6	4.0	4.5	4.1	4.5	4.4
Cons. & fixed invest. prices		3.3	3.3	3.4	2.5	4.7	4.2	4.4	4.6	4.4
CPI		3.2	4.2	3.5	1.3	4.5	4.3	4.6	4.8	4.6
Exc. food and energy		4.2	5.0	4.3	3.9	4.3	4.5	4.3	4.8	4.7
ECI hourly compensation		5.7	4.9	3.9	3.2	3.3	4.9	4.8	5.1	4.6
Nonfarm business sector										
Output per hour		3.4	1.5	1.6	1.3	2.4	1.6	.6	.7	1.4
Compensation per hour		3.1	4.2	4.6	5.0	4.0	4.8	5.4	5.5	5.3
Unit labor costs		-.4	2.6	3.0	3.6	1.5	3.1	4.8	4.8	3.9

* Percent changes are from fourth quarter to fourth quarter.

March 21, 1990

CONFIDENTIAL - FR
CLASS II FOMC

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

	Units	1989 Q3	1989 Q4	Projection 1990 Q1	1990 Q2	1990 Q3	1990 Q4	1991 Q1	1991 Q2	1991 Q3	1991 Q4
EXPENDITURES											
Nominal GNP	Billions of $	5281.0	5337.6	5436.1	5517.3	5596.9	5677.9	5763.8	5848.1	5938.7	6029.3
Real GNP	Billions of 82$	4162.9	4172.4	4193.0	4219.9	4237.6	4255.4	4273.3	4292.6	4315.7	4339.0
Real GNP	Percent change	3.0	.9	2.0	2.6	1.7	1.7	1.7	1.8	2.2	2.2
Gross domestic purchases		3.5	.1	1.4	2.2	1.9	1.3	1.1	1.1	1.3	1.3
Final sales		2.7	.5	4.4	2.3	.9	1.6	1.8	1.7	2.1	2.2
Private dom. final purchases		4.7	-.7	3.7	2.2	1.6	1.4	1.1	1.1	1.4	1.5
Personal consumption expend.		5.6	.4	1.7	3.3	2.3	1.8	1.4	1.5	1.5	1.5
Durables		11.3	-14.2	14.9	-1.4	2.0	.9	.6	1.3	1.4	1.8
Nondurables		5.0	.3	-3.6	2.8	1.2	.9	.7	.6	.6	.8
Services		4.3	5.6	1.6	5.3	3.0	2.6	2.2	2.1	2.1	1.8
Business fixed investment		5.2	-6.4	9.7	-.4	.2	.3	.3	1.5	2.0	2.1
Producers' durable equipment		4.6	-8.4	10.8	2.5	2.2	2.2	2.0	3.4	3.9	4.0
Nonresidential structures		8.0	.0	6.4	-9.7	-6.1	-5.9	-5.5	-5.1	-4.9	-4.7
Residential structures		-9.2	-.6	17.5	-6.2	-4.0	-.5	-1.8	-4.5	-.8	.9
Exports		3.9	8.6	14.0	4.2	6.5	8.5	9.0	8.6	9.5	9.4
Imports		7.4	2.0	9.3	1.9	7.8	5.7	4.5	4.0	3.5	3.7
Government purchases		-2.4	1.3	4.3	.9	-.7	.3	1.4	.3	.2	.1
Federal		-8.4	-4.9	7.5	-.5	-4.0	-1.9	.7	-1.8	-2.0	-2.1
Defense		6.9	-6.7	-2.0	-5.8	-4.4	-3.2	-3.7	-3.1	-2.9	-3.3
State and local		2.2	5.9	2.0	1.9	1.7	1.8	1.8	1.8	1.8	1.6
Change in business inventories	Billions of 82$	21.9	26.2	1.6	4.5	12.6	13.9	12.9	14.5	15.2	15.5
Nonfarm	Billions of 82$	16.2	22.3	4.5	6.6	13.4	14.7	13.1	14.6	14.6	14.6
Net exports	Billions of 82$	-57.1	-48.2	-42.6	-39.2	-41.9	-38.2	-31.6	-24.5	-15.0	-5.6
Nominal GNP	Percent change	6.2	4.4	7.6	6.1	5.9	5.9	6.2	6.0	6.3	6.2
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	108.9	109.4	110.2	110.9	110.9	111.1	111.4	111.6	111.9	112.2
Unemployment rate	Percent*	5.3	5.3	5.3	5.4	5.6	5.7	5.8	5.9	6.0	6.0
Industrial production index	Percent change	1.3	-.1	-1.4	3.2	1.8	1.8	1.7	2.0	2.1	2.3
Capacity utilization rate-mfg.	Percent*	84.0	83.0	82.3	82.2	81.9	81.7	81.4	81.3	81.1	81.0
Housing starts	Millions	1.34	1.34	1.47	1.34	1.32	1.32	1.31	1.30	1.30	1.30
Auto sales	Millions	10.18	9.09	9.75	9.40	9.45	9.45	9.40	9.40	9.40	9.45
Domestic	Millions	7.36	6.56	7.01	6.75	6.85	6.90	6.90	6.90	6.90	6.95
Foreign	Millions	2.83	2.54	2.74	2.65	2.60	2.55	2.50	2.50	2.50	2.50
INCOME AND SAVING											
Nominal personal income	Percent change	5.2	7.5	9.4	6.7	5.6	6.0	7.2	6.0	5.5	6.5
Real disposable income	Percent change	4.4	2.7	2.1	2.5	.9	.9	2.3	.9	.4	1.4
Personal saving rate	Percent*	5.1	5.7	5.8	5.6	5.3	5.1	5.3	5.2	5.0	5.0
Corp. profits with IVA & CCAdj	Percent change	-15.4	-21.8	3.6	-8.0	6.5	3.0	-6.4	-4.6	12.8	2.9
Profit share of GNP	Percent*	5.6	5.2	5.2	5.0	5.0	4.9	4.8	4.7	4.7	4.7
Federal govt. surplus/deficit	Billions of $	-144.7	-156.5	-146.1	-138.7	-122.4	-117.6	-119.3	-112.2	-99.1	-95.4
State and local govt. surplus		44.9	35.8	41.1	43.8	46.2	50.4	53.9	61.0	65.0	69.9
Exc. social insurance funds		-34.3	-44.7	-40.9	-39.7	-38.8	-36.1	-34.1	-28.5	-26.0	-22.6
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.2	3.2	5.6	3.4	4.1	4.2	4.4	4.1	4.1	4.0
GNP fixed-weight price index		2.9	3.6	6.3	3.7	3.9	4.2	4.7	4.3	4.2	4.2
Cons. & fixed invest. prices		2.3	4.4	6.8	3.3	4.0	4.4	4.5	4.4	4.4	4.4
CPI		2.9	3.9	7.7	3.0	4.2	4.5	4.7	4.5	4.5	4.5
Exc. food and energy		3.8	4.4	5.8	4.1	4.7	4.7	4.9	4.7	4.6	4.6
ECI hourly compensation**		4.9	4.7	5.6	5.4	4.7	4.6	4.9	5.0	4.4	4.3
Nonfarm business sector											
Output per hour		2.4	.2	-.7	1.3	1.0	1.1	1.2	1.3	1.5	1.5
Compensation per hour		5.3	6.0	5.3	6.2	5.3	5.3	5.6	5.7	5.1	5.0
Unit labor costs		2.8	5.8	6.0	4.8	4.3	4.2	4.3	4.3	3.5	3.4

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

March 21, 1990

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	30.4	9.5	20.6	26.9	17.7	17.8	17.8	19.3	23.1	23.3	133.8	103.0	83.0	83.5
Gross domestic purchases	36.3	.6	15.1	23.5	20.3	14.2	11.2	12.2	13.6	13.9	97.8	77.4	73.1	51.0
Final sales	27.5	5.2	45.2	24.0	9.6	16.5	18.8	17.7	22.4	23.0	172.0	95.2	95.3	81.9
Private dom. final purchases	38.4	-6.3	31.2	18.7	13.7	12.3	9.5	9.9	12.4	13.4	121.7	68.1	75.8	45.1
Personal consumption expend.	36.4	2.5	11.7	22.3	15.3	12.1	9.9	10.1	10.2	10.2	95.4	64.9	61.4	40.4
Durables	11.5	-16.4	14.8	-1.5	2.2	1.0	.7	1.4	1.5	2.0	31.1	-.5	16.5	5.6
Nondurables	11.1	.8	-8.5	6.3	2.8	2.1	1.6	1.4	1.4	1.9	19.1	9.6	2.7	6.2
Services	13.9	18.2	5.2	17.5	10.3	9.1	7.6	7.3	7.3	6.4	45.2	55.9	42.1	28.6
Business fixed investment	6.5	-8.5	12.0	-.6	.3	.4	.4	1.9	2.5	2.8	20.0	16.7	12.1	7.6
Producers' durable equipment	4.4	-8.6	10.1	2.5	2.2	2.2	2.0	3.4	4.0	4.1	24.3	17.7	17.0	13.5
Nonresidential structures	2.3	.0	1.9	-3.1	-1.9	-1.8	-1.6	-1.5	-1.4	-1.3	-4.3	-1.0	-4.9	-5.8
Residential structures	-4.5	-.3	7.6	-3.1	-1.9	-.2	-.8	-2.1	-.4	.4	6.2	-13.6	2.3	-2.9
Change in business inventories	2.8	4.3	-24.6	2.9	8.1	1.3	-1.0	1.6	.7	.3	-38.3	7.9	-12.3	1.6
Nonfarm	-3.3	6.1	-17.8	2.1	6.8	1.3	-1.6	1.5	.0	.0	-23.7	-9.6	-7.6	-.1
Farm	6.1	-1.7	-6.8	.8	1.3	.0	.6	.1	.7	.3	-14.6	17.5	-4.7	1.7
Net exports	-5.9	8.9	5.6	3.4	-2.6	3.7	6.6	7.1	9.5	9.3	36.0	25.6	10.0	32.6
Exports	5.6	12.3	20.2	6.5	10.1	13.2	14.2	14.0	15.6	15.9	67.3	54.0	50.0	59.7
Imports	11.5	3.3	14.7	3.1	12.7	9.6	7.6	6.8	6.1	6.6	31.3	28.3	40.1	27.2
Government purchases	-5.0	2.6	8.5	1.9	-1.5	.6	2.8	.7	.5	.3	14.3	1.5	9.5	4.3
Federal	-7.5	-4.2	6.1	-.4	-3.5	-1.6	.6	-1.5	-1.7	-1.7	-1.0	-12.0	.6	-4.3
Defense	4.3	-4.5	-1.3	-3.8	-2.8	-2.0	-2.3	-1.9	-1.8	-2.0	-5.1	-6.0	-9.9	-8.0
Nondefense	-11.8	.3	7.4	3.4	-.7	.4	2.9	.4	.1	.3	4.1	-6.0	10.5	3.7
State and local	2.5	6.8	2.4	2.3	2.0	2.2	2.2	2.2	2.2	2.0	15.3	13.5	8.9	8.6

FEDERAL S. . ACCOUNTS[1]
(Billions of dollars)

	Fiscal years				1989				1990				1991			
	1988a	1989a	1990	1991	Ia	IIa	IIIa	IVa	I	II	III	IV	I	II	III	IV
BUDGET					Not seasonally adjusted											
Budget receipts[2]	908	991	1055	1133	219	308	242	229	238	324	265	252	257	341	283	267
Budget outlays[2]	1063	1143	1223	1281	280	285	288	298	306	308	311	326	316	322	318	332
Surplus/deficit(-)[2]	-155	-152	-168	-148	-61	23	-46	-70	-68	16	-46	-74	-59	19	-35	-65
(On-budget)	-194	-204	-231	-218	-77	0	-54	-76	-87	-7	-61	-84	-79	-5	-50	-74
(Off-budget)	39	52	63	70	16	23	7	6	19	23	14	10	21	24	16	10
Surplus excluding RTC working capital[3]	-155	-152	-140	-121	-61	23	-46	-70	-65	26	-31	-67	-52	26	-28	-62
Means of financing:																
Borrowing	162	140	169	146	38	10	39	63	61	15	30	74	32	13	26	62
Cash decrease	-8	3	6	0	19	-29	3	14	6	-24	10	10	10	-25	5	10
Other[4]	1	8	-7	2	4	-4	5	-8	1	-7	6	-10	16	-8	3	-7
Cash operating balance, end of period	44	41	35	35	15	44	41	27	21	45	35	25	15	40	35	25
NIPA FEDERAL SECTOR					Seasonally adjusted annual rates											
Receipts	958	1032	1102	1190	1036	1053	1043	1054	1098	1118	1138	1158	1183	1200	1220	1240
Expenditures	1103	1183	1243	1302	1184	1199	1188	1211	1244	1257	1260	1276	1302	1312	1319	1336
Purchases	377	404	412	423	399	406	403	404	413	416	415	415	424	425	426	426
Defense	297	302	303	303	299	301	308	301	305	303	302	301	304	304	303	303
Nondefense	80	101	109	120	100	105	95	103	108	113	113	114	120	121	123	123
Other expend.	726	780	831	880	785	793	785	807	831	840	846	860	878	887	893	909
Surplus/deficit	-145	-151	-141	-112	-148	-145	-145	-156	-146	-139	-122	-118	-119	-112	-99	-95
FISCAL INDICATORS[5]																
High-employment (HEB) surplus/deficit(-)	-150	-167	-148	-101	-165	-162	-162	-168	-155	-146	-124	-114	-110	-97	-81	-74
Change in HEB, percent of potential GNP	.3	.4	-.4	-.9	-.3	-.1	.0	.1	-.2	-.2	-.4	-.2	-.1	-.2	-.3	-.1
Fiscal impetus measure (FI), percent	.2 *	-3.4 *	-6.5 *	-3.2 *	-2.7	-.2	.5	-2.3	-3.8	-.3	-1.1	-1.9	-.7	-.4	-.4	-.5

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 FY1991 Budget (January 1990) are $124 billion and $63 billion, respectively. These estimates incorporate approximately $39 billion of cuts from the adjusted Gramm-Rudman-Hollings baseline in FY1991. CBO's FY90 and FY91 baseline deficits (March 1990) are $159 billion and $161 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. The Administration's deficit projections exclude RTC working capital. CBO's March deficit estimates, excluding RTC working capital, are $140 billion and $136 billion in 1990 and 1991, respectively.
4. Other means of financing are checks issued less checks paid, accrued items; and changes in other financial assets and liabilities.
5. 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

The federal funds rate has remained in a narrow band around 8-1/4 percent since the February FOMC meeting. Nonetheless, other short-term interest rates have moved up a little, as signs of sustained growth in the economy have dashed hopes for an easing in monetary policy. Long-term rates have recorded mixed net changes, with Treasury bond yields down somewhat from the levels that prevailed in the nervous atmosphere preceding the mid-quarter refunding. Share prices have risen 2 to 4 percent, despite a steep decline in the Japanese stock market.

A particularly dramatic development in the intermeeting period was the bankruptcy of Drexel Burnham Lambert. For the most part, financial markets took this event in stride. Even in the junk bond market, the immediate effect was small, in part because issuance had all but dried up in previous months and because Drexel already had largely withdrawn from the secondary market. Nevertheless, Drexel's failure has focused greater attention on the weaknesses of the junk bond market, including the lack of liquidity and the potential exposure of institutions holding large portfolios of these securities. Indeed, spreads widened after last week's announcement of plans by the largest thrift holder to liquidate its portfolio.

Drexel's demise also has highlighted the vulnerabilities of the securities industry and has caused parent corporations of some prominent broker-dealers to provide capital and other forms of assistance to their subsidiaries. Even so, creditors apparently are continuing to exercise greater caution in lending to the most troubled firms.

Growth of the monetary aggregates strengthened appreciably in February. M2 grew at a 9-1/4 percent rate last month, up from 3-3/4 percent in January. Growth was boosted by a rebound in demand deposits and by faster growth in interest-bearing retail accounts, which occurred despite a notable lag in the adjustment of deposit rates to rising market yields. Preliminary data for March suggest, however, that the higher opportunity costs have begun to slow M2 growth. M3 rose 5-3/4 percent in February--up from 2-1/4 percent in January. The uptick reflected a step-up in bank credit growth, offsetting a continued decline in thrift assets.

Net borrowing by nonfinancial corporations appears to have weakened further in February from January's sluggish pace. The slowdown in business borrowing thus far in 1990 owes partly to lenders' reluctance to extend credit to finance merger and restructuring activity. As a result, junk bond issuance has come to a virtual halt, and merger-related loans at banks--the source of business loan growth in 1989--are essentially unchanged for the year. Besides that for mergers, borrowing was weak in February, not only at banks but also in the commercial paper and bond markets. Higher stock prices helped push February's gross equity issuance by nonfinancial corporations to its highest level since July 1988.

In the household sector, mortgage credit flows in January appear to have been maintained at about their fourth-quarter pace. Banks and other lenders again picked up much of the slack left by the contracting thrift industry and thus prevented any disruptions in credit availability for residential mortgage loans, as evidenced by the relative stability of rate spreads between primary mortgages and Treasury securities. Consumer installment credit growth slowed a bit in January; at a 6 percent annual rate, it was in line with last year's expansion as a whole. After adjusting for loan securitizations, consumer credit growth at banks remained fairly brisk in February. Most measures of consumer loan delinquency rates showed a small improvement in the fourth quarter, after some worsening in the previous quarter; on balance, repayment performance appears to have deteriorated a little in 1989. Mortgage delinquency rates have fluctuated from quarter to quarter, but have remained low.

The federal budget deficit is expected to be about $68 billion (not seasonally adjusted) in the current quarter, a bit less than in the previous quarter. The decision to finance the Resolution Trust Corporation's needs for working capital through the Federal Financing Bank has resulted in the Treasury's raising additional funds through increased bill issuance.

New bond offerings by state and local governments have been sluggish in the current quarter, in part because the runup in yields earlier this year has contributed to a substantial slowing in refunding volume. At the same time, issuance to raise new capital has been below its 1989 pace. The volume of short-term issuance has been light, but it should pick up in coming weeks, as a sizable offering to cover a seasonal revenue shortfall is expected soon from New York State. Massachusetts and several other Northeastern states experiencing budgetary problems also are expected to issue short-term debt.

Outlook

As noted in the previous section, the staff anticipates that interest rates will rise somewhat over the next year. It is assumed as well that the overall monetary restraint implied by these interest rate movements will be somewhat reinforced by a more cautious provision of credit by lenders, reflecting regulatory pressure and investor concern about highly leveraged and other high-risk borrowers.

Debt of the domestic nonfinancial sectors is expected to grow 7 percent in 1990, down about 1 percentage point from last year's pace, but still in excess of projected growth in nominal GNP. The decline occurs despite an increase in the federal budget deficit of roughly $35 billion to finance the RTC's working capital requirements. Next year, RTC's working capital needs boost the deficit about $20 billion; nevertheless, debt growth is expected to decline to 6-1/2 percent. Without RTC-related borrowing, the rate of nonfinancial debt growth next year would be near that of nominal GNP.

The gap between capital outlays and internal funds of nonfinancial corporations is projected to widen in coming quarters. Nonetheless, business borrowing is expected to be restrained by a slowing in merger and restructuring activity, which should about halve net equity retirements from the 1989 level. Tightened lending standards will play a role in damping merger activity, as greater regulatory scrutiny, several prominent bankruptcies, and the collapse of the junk bond market have made many lenders reluctant to finance highly leveraged transactions. Moreover, the prospect that many borrowers may have difficulty making large interest payments due in the next several years on reset and deferred-payment bonds has added to lenders' conservatism.

In the household sector, a relatively soft housing market, characterized by sluggish home sales and a drop-off in construction, should produce some further slowing in the expansion of mortgage indebtedness over the projection period. Growth of consumer debt also should moderate, such moderation being consistent with the longer-term prospects for household income and spending. Apart from selected tightening of lending standards along the lines reported recently on home equity loans and longer-term automobile loans, the projection assumes no significant disruptions in the flow of credit to households.

Outstanding debt of the municipal sector is expected to expand at a slower pace over the next two years. Higher interest rates should damp refunding activity. At the same time, a growing volume of calls of high-coupon bonds, many of which have been refunded in advance, also should act to slow the sector's debt growth.

Recent developments

The weighted average foreign exchange value of the dollar in terms of the other G-10 currencies has risen 3 percent since the February FOMC meeting. The dollar benefited from continuing uncertainty about inflation prospects and the course of monetary policies abroad. In Germany, discussion of rapid monetary union between East and West Germany added to concerns that reunification would have an inflationary impact, and the mark declined 3-1/2 percent against the dollar during February and early March. The unexpectedly strong showing in the East German election of the conservative Alliance for Germany contributed to a partial recovery of the mark late in the intermeeting period. In Japan, despite an LDP election victory that was more favorable than expected, financial markets remained unsettled. Officials at the Bank of Japan and the Ministry of Finance disagreed openly about the need for a discount rate increase, contributing to a lack of public confidence in the near-term course of policy against the background of a substantial decline in the Japanese stock market. On March 20, the Bank of Japan finally raised the discount rate a full percentage point, but that action failed to support the yen or calm Japanese financial markets. On balance, the dollar rose 6 percent against the yen and 3 percent against the mark during the intermeeting period.

The appreciation of the dollar occurred at the same time that differentials between market rates of interest moved in favor of assets denominated in foreign currencies. Short-term German interbank rates have risen 30 basis points, and 3-month Japanese CD rates have risen 65 basis points since the February FOMC meeting. In contrast, U.S. CD rates have risen less than 20 basis points. Mark and yen bond yields have risen about 60 basis points while dollar bond yields have remained little changed, on balance. U.S. stock prices rose 2 to 4 percent during the intermeeting period, Japanese stock prices declined 17 percent, and German stock prices declined early in the period but then recovered to rise 1-1/2 percent, on balance, spurred in part by the outcome of the March 18 election.

. The Desk sold $1,480 million against yen, of which $650 million was sold before March 5 and was split evenly between the System account and the Treasury account. The remaining yen intervention and $200 million sold against marks occurred after March 5 and were all for the Treasury account.

Economic activity in the continental European countries has generally been strong, whereas economic indicators in the other major foreign industrial countries have been mixed. In the fourth quarter, real GNP growth in Germany strengthened to 3.7 percent (s.a.a.r.). Industrial production accelerated in December and January, in part the result of exceptionally strong construction activity during mild weather in January. Japanese real GNP increased 3 percent (s.a.a.r.) in the fourth quarter, a substantial slowing from the rapid 12.1 percent growth in the previous quarter. A sharp swing from a positive to a negative contribution from the external sector accounted for most of the slowdown. In the United Kingdom and Canada, measures of production suggest a slowing of activity, but consumption expenditure remains relatively strong in both countries.

Inflation rates remain generally stable in most foreign industrial countries. Appreciating currencies have helped to moderate inflation in Germany and France while the weakness of the yen may prove to be a source of inflationary pressure in Japan.

On March 16, Brazilian officials announced the new government's program intended to reduce inflation dramatically in the coming months. The program includes a substantial planned reduction in the size of the public sector, the imposition of new taxes and indexation of all tax payments, a partial freeze on a broad range of domestic financial assets, a 45-day price and wage freeze to be followed by a monthly adjustment of wages to past inflation, and a move to a flexible exchange rate regime with intervention. The bank debt package for Mexico is expected to be implemented on March 28. Until then, Mexico faces a cash flow problem because special factors related to the bank agreement combine to concentrate in the first quarter more than half of the expected 1990 current account deficit. On March 4, the Argentine government announced a new set of fiscal measures aimed at generating savings equivalent to 4 percent of GNP. The measures call for substantial increases in export taxes, the retirement of many public sector workers, the permanent closing of some official banks, and the postponement of payments to domestic suppliers. In mid-March, Venezuela and its commercial bank creditors reached agreement in principle on the terms of a package of alternatives for debt and debt-service reduction and a new money component.

Preliminary data for January indicate that the U.S. merchandise trade deficit widened to $9.3 billion (seasonally adjusted, Census basis, customs valuation) from an unusually low $7.7 billion revised December deficit.

There was a sharp increase in the value of imports that was only partly offset by a 4 percent rise in the value of exports. The trade deficit was slightly larger for the fourth quarter than it was for the other quarters of 1989. Imports rose somewhat more than exports, with consumer goods, selected capital goods, and gold particularly strong. Virtually all of the increase in imports was in quantity, as prices of non-oil imports rose only marginally. The value of oil imports was about unchanged in the fourth quarter, as the effect of higher prices was offset by a decline in the quantity of imports. Total exports were up only slightly in the fourth quarter in both value and quantity. In January, import prices as reported by the BLS rose 1.4 percent; sharply higher prices for imported petroleum accounted for almost all of this increase. Prices of exports increased 1.1 percent in January, largely for fuels (part of industrial supplies) and agricultural products.

The U.S. current account deficit excluding the influences of capital gains largely associated with the dollar's depreciation narrowed to $98 billion at an annual rate in the fourth quarter, from a revised $102 billion in the third quarter. The improvement in the fourth quarter was more than accounted for by an increase in net direct investment income.

In January, private foreign net purchases of U.S. corporate and government agency bonds slowed to $2-1/4 billion, from $4-1/4 billion in December, as differentials in long-term interest rates moved in favor of bonds denominated in foreign currencies. Net sales of U.S. stocks by private foreign investors continued in January, but at a somewhat reduced pace from that recorded in the fourth quarter. Private foreign transactions in U.S. Treasury securities were small on balance in December and January, following large net purchases in November; thus, the familiar pattern of large purchases during the month of the Treasury mid-quarter refunding and sales in subsequent months was evident. Foreign official reserve assets in the United States declined $3-1/4 billion in January, about half the size of the December drop. Most of the January fall was accounted for by lower holdings by the NIEs and Mexico.

Outlook

The staff forecast incorporates a more moderate decline in the foreign exchange value of the dollar in terms of other G-10 currencies over the next two years than that in the January Greenbook, reflecting the projected higher level of real dollar interest rates in this forecast for late 1990 and 1991.

Largely in response to developments in Eastern Europe and to the expanded opportunities for exports to and investment in those countries, real growth on average in the foreign industrial countries is projected to remain at about the 3-1/2 percent pace of the past two years through the forecast horizon, about 1/2 percent more rapid than the pace projected in the January Greenbook. Prospects for stronger activity are concentrated in the continental European economies. The faster pace of activity is expected to keep inflation, on average, from falling much below its 1989 rate of 4-1/4 percent.

Prices for U.S. oil imports are now estimated to average $20.19 per barrel during the current quarter and are assumed to decline to slightly through mid-1990. Over the remainder of the forecast period, oil import prices are projected to remain about unchanged in real terms. This price path is about $1 per barrel above the January Greenbook forecast from mid-1990 through the end of the forecast period. The outlook for higher oil prices reflects recent developments in spot markets which, in turn, have been affected by the prospects for stronger demand in the industrial countries and the shortfall of supplies from Eastern Europe.

The U.S. merchandise trade deficit is projected to narrow somewhat this quarter as the effects of the recent Boeing strike are reversed. The deficit is then projected to fluctuate between $105 and $110 billion (annual rate) through mid-1991. By the end of 1991, the projected decline in the dollar contributes to further narrowing of the merchandise trade balance to under $100 billion at an annual rate. The outlook for the trade balance is somewhat improved from the projection in the previous forecast as a result of the strengthened outlook for activity in several U.S. trading partners, a boost in exports to Eastern Europe, and a slightly weaker outlook for U.S. activity in 1991.

Net receipts from direct investment income are projected to improve further during this year and next. This projection reflects sharply higher figures received for the fourth quarter, lower expected direct investment income payments to foreigners, and improved growth (and profit) prospects in continental Europe. These projected earnings and other net service flows more than offset the expected increase in U.S. net portfolio payments associated with our rising international indebtedness. As a result, the current account balance (excluding capital gains and losses) is projected to improve by more than the trade balance over the forecast period. The deficit is projected to decline from $98 billion in the fourth quarter of 1989 to less than $70 billion by the end of 1991.

Strictly Con. .ential (FR)
Class II FOMC

March 20, 1990

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

	ANNUAL			1989		1990				1991			
	1989	1990-P	1991-P	-Q3	-Q4	Q1-P	-Q2-P	-Q3-P	-Q4-P	Q1-P	-Q2-P	-Q3-P	-Q4-P
1. GNP Exports and Imports 1/													
Current $, Net	-47.7	-36.8	-16.9	-45.1	-41.2	-37.9	-36.2	-38.0	-35.2	-29.6	-22.8	-12.7	-2.5
Exports of G+S	625.3	687.4	764.7	628.5	641.0	667.1	677.7	692.8	712.0	732.8	752.9	775.3	797.9
Imports of G+S	673.0	724.2	781.6	673.6	682.2	704.9	713.9	730.8	747.2	762.4	775.7	788.0	800.4
Constant 82 $, Net	-52.9	-40.6	-19.3	-57.1	-48.2	-42.7	-39.3	-42.0	-38.3	-31.7	-24.6	-15.1	-5.7
Exports of G+S	588.9	638.8	691.9	593.1	605.4	625.6	632.1	642.2	655.4	669.6	683.6	699.2	715.2
Imports of G+S	641.8	679.3	711.1	650.2	653.5	668.2	671.3	684.0	693.6	701.2	708.1	714.2	720.8
2. Merchandise Trade Balance 2/	-113.2	-109.0	-100.3	-114.2	-115.2	-107.8	-107.5	-110.8	-110.0	-107.8	-103.9	-98.0	-91.3
Exports	361.9	402.4	450.3	362.8	368.5	390.5	396.6	405.5	416.8	428.6	441.9	457.0	473.6
Agricultural	41.4	42.5	44.5	38.7	40.4	42.7	41.9	42.1	43.5	43.7	44.2	44.6	45.4
Non-Agricultural	320.4	359.8	405.8	324.0	328.1	347.9	354.7	363.4	373.3	384.8	397.8	412.5	428.2
Imports	475.1	511.4	550.5	477.0	483.7	498.4	504.1	516.3	526.9	536.3	545.8	555.0	565.0
Petroleum and Products	50.2	61.3	65.4	52.1	51.9	65.1	57.5	60.3	62.4	63.3	64.7	66.0	67.7
Non-Petroleum	424.9	450.1	485.1	424.9	431.8	433.3	446.6	456.0	464.5	473.0	481.1	489.1	497.3
3. Other Current Account Transactions													
Capital Gains and Losses 3/	-2.1	3.2	1.2	10.4	16.0	9.1	1.8	1.0	0.9	1.2	1.2	1.2	1.2
Other D.I. Income, Net	38.3	44.1	48.5	36.1	45.8	43.7	43.7	44.1	44.7	46.4	47.7	49.4	50.5
Portfolio Income, Net	-35.1	-38.9	-44.5	-35.1	-34.8	-37.1	-38.2	-39.4	-40.9	-42.3	-43.8	-45.3	-46.6
Other Current Account, Net	6.3	11.4	17.7	11.2	5.9	10.3	11.3	12.7	11.2	15.7	17.1	19.4	18.6
4. U.S. Current Account Balance													
Including Capital G/L	-105.9	-89.3	-77.4	-91.6	-82.3	-81.9	-88.9	-92.5	-94.0	-86.8	-81.7	-73.3	-67.7
Excluding Capital G/L	-103.7	-92.5	-78.6	-102.1	-98.3	-90.9	-90.7	-93.4	-94.9	-88.0	-82.9	-74.5	-68.9
5. Foreign Outlook 4/													
Real GNP--Ten Industrial 5/	3.5	3.1	3.4	2.7	3.7	3.0	3.2	3.4	3.9	3.4	3.3	3.2	3.5
Real GNP--LDC 6/	3.1	3.7	4.3	3.2	3.6	3.8	3.9	4.0	4.0	4.1	4.5	4.9	5.3
Consumer Prices--Ten Ind. 5/	4.0	4.0	3.9	2.3	4.4	4.0	4.7	3.5	3.7	3.7	4.9	3.3	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