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March 23, 1988

SUMMARY AND OUTLOOK

Prepared for the Federal Open Market Committee

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

DOMESTIC NONFINANCIAL DEVELOPMENTS

Recent Developments

Economic activity has continued to expand in the first quarter-- apparently less rapidly, but with better balance, than at the end of last year. Final sales are up sharply, boosted by a rebound in consumer spending and by strong demand for business equipment. Inventory investment appears to have slowed considerably, reflecting the correction in the auto industry. Wage trends have remained stable, while price increases have been moderate of late.

Labor demand has remained strong since the turn of the year. Nonfarm payroll employment jumped 531,000 in February after an upward-revised gain of 175,000 in January. The largest increases in February were in services and in retail trade. In the manufacturing sector, employment gains were widespread but were smaller than during the second half of 1987. With the strength in employment, aggregate hours of nonfarm production workers in February were 1-1/4 percent above the fourth-quarter average. The unemployment rate edged down to 5.7 percent in February, its lowest level since mid-1979.

Growth in industrial production moderated early in the first quarter from the very rapid late-1987 pace, but in February was still 4 percent (annual rate) above its fourth-quarter average. The output of materials, which had surged in the second half of last year, edged down, and auto assemblies and the production of consumer home goods dropped below their late-1987 levels. In contrast, the production of business equipment remained quite strong, with gains in nearly all categories.

Capacity utilization in manufacturing held steady at 82.5 percent in February; a number of primary-processing industries still have very high utilization rates.

Consumer spending rebounded early in the year as a result of an increase in the demand for motor vehicles. Bolstered by generous incentive programs, strong income growth, and improving consumer confidence, sales of cars and light trucks averaged 15.3 million units at an annual rate in January and February, a bit above their selling pace for 1987 as a whole. This strength in sales, combined with cutbacks in auto production, reduced dealers' inventories to more comfortable levels. Outside of motor vehicles, consumer spending has been lackluster recently, with nominal retail sales at general merchandise, apparel, and furniture stores essentially flat since November. The personal saving rate appears to have remained well above the level prevailing in the year preceding the stock market break.

Housing activity picked up in February but still was below its fourth-quarter pace. Although sales of new and existing homes continued to decline in January, housing starts rose to a 1.49 million unit annual rate in February. In the single-family sector, starts rose to a 1.1 million unit annual rate, reflecting the sizable drop in mortgage rates posted since October. Multifamily starts also were up last month, but activity in this market segment still is being restrained by high vacancy rates.

Business fixed investment appears to have increased rapidly in the first quarter, led by large gains in equipment spending. Business

purchases of motor vehicles picked up from their low fourth-quarter pace, while shipments data indicate that spending on information processing equipment surged. Advances in shipments were smaller in other equipment categories but were widespread nonetheless. In contrast, drilling rig counts and data through January on construction put in place suggest that spending on nonresidential structures has been soft in the first quarter.

Nonauto inventory investment slowed in January in current-cost terms. At the retail level, inventories at apparel stores fell while stocks rose at general merchandise outlets. Inventories had risen considerably at both types of stores in the second half of last year and in January were still high relative to sales. Inventory investment picked up at the wholesale level in January, particularly for durable goods such as machinery. Manufacturers' inventories also continued to grow appreciably.

Increases in consumer prices remained relatively moderate in the first quarter, with the CPI rising 0.2 percent in February. Energy prices continued to be a moderating influence on inflation, as the passthrough of lower crude oil costs reduced retail energy prices by 2 percent over the last three months. Excluding food and energy, the CPI rose 0.2 percent in February, a bit slower than its average monthly pace in 1987, as apparel prices turned down.

At the producer level, prices of finished goods fell 0.2 percent in February after a 0.4 percent rise in January. Much of this recent volatility stems from swings in food prices. Excluding food and energy,

the PPI rose 0.3 percent last month, following a 0.5 percent rise in January. Prices of intermediate materials excluding food and energy rose only 0.2 percent in February, after large increases over the preceding nine months. Particularly sharp declines occurred in the prices of nonferrous metals, although a moderating tendency also was evident in other categories.

Wage gains have remained moderate. The hourly earnings index was unchanged in February after a 0.4 percent increase in January. Large movements in contract construction wages accounted for most of this January-February pattern. In February, hourly earnings were 2.7 percent above their year-earlier level, the same pace as in the second half of 1987.

Outlook

The staff's forecast of economic growth in 1988 has been raised noticeably, from just over 2 percent in the February Greenbook to 2-3/4 percent in this edition. Output, employment, and income have grown more than previously expected in the first quarter; this favorable performance in the aftermath of the stock market plunge--along with increased optimism about longer-run U.S. competitiveness--undoubtedly has raised business sales expectations and bolstered investment plans. Activity is expected to slow a bit in 1989, with real GNP rising 2-1/2 percent. Inflation, as measured by the GNP fixed-weight price index, is projected to rise from around 4 percent in 1988 to about 4-1/2 percent in 1989.

Interest rate pressures surface significantly at an earlier point in this forecast than in the last Greenbook, owing to the greater near-term growth of the economy and the associated inflation risks. Under these conditions, M2 and M3 are expected to grow somewhat above the midpoint of the target ranges for 1988 but considerably less in 1989 (as the lagged effects of rising rates boost velocity). The foreign exchange value of the dollar is expected to decline at a moderate pace over the projection horizon.

The staff has retained the assumption that the Congress will enact the package of deficit-reduction actions agreed to last December. It is expected that the budget deficit (on a unified basis) in fiscal year 1988 will be around \$155 billion--little changed from the previous forecast, as the favorable influence of more rapid economic growth has been offset by technical adjustments to outlay and revenue flows based on new information from the administration and CBO budget documents. Only a small improvement in the deficit now is anticipated between fiscal year 1988 and fiscal year 1989, owing in an important part to the effects of higher interest payments.

Real GNP is projected to grow at around a 2-3/4 percent annual rate in the first quarter of this year, and economic growth is expected to remain in that range over the remainder of 1988. Leading indicators of business fixed investment, such as new orders and surveys of spending intentions, point to substantial increases in capital spending, especially in the manufacturing sector. With moderate growth abroad and the improved competitive position of U.S. goods in world markets,

merchandise exports should continue to expand at a rapid pace. Homebuilding should be supported in the near term by the earlier declines in mortgage interest rates. However, after the rebound in the current quarter, growth in consumer spending is expected to grow relatively slowly, as employment growth tails off from its recent pace and nominal wage increases fail to keep pace with inflation.

As noted above, real GNP growth is expected to slow in 1989. Rising interest rates are projected to damp housing activity and to restrain somewhat the growth of business fixed investment. Consumer spending also is expected to be weak, reflecting the small gains in real income. However, the external sector remains a supportive element in output growth next year, aided by the depreciation of the dollar.

Prices, as noted above, are projected to accelerate somewhat over the coming year. Increases in nonpetroleum import prices, reflecting the effects of the past and prospective depreciation of the dollar, continue to be a source of inflationary pressure. Higher rates of resource utilization are projected to give added impetus to price increases for final goods later this year. Some weakness in energy prices is expected to hold down inflation in the near term; however, with crude oil prices rising over the remainder of the forecast horizon, energy prices contribute to the step-up in inflation next year.

Nominal increases in hourly compensation are expected to pick up over the projection horizon. Higher social security taxes contribute about 1/2 percentage point to the rise in wage inflation this year. In addition, underlying pressures on wages are somewhat stronger in this

forecast, owing to the lower level of unemployment now projected to prevail through next year. However, hourly compensation still is projected to decline in real terms in both 1988 and 1989. The staff is assuming that management emphasis on labor cost restraint and employee concern about job security will continue to damp compensation increases. And, although legislation has made some progress in Congress since the last Greenbook, an increase in the federal minimum wage has not been introduced into the forecast.

March 23, 1988

CONFIDENTIAL - FR
CLASS II FOMC

STAFF GNP PROJECTIONS

Percent changes, annual rate

| | Nominal GNP | | Real GNP | | GNP fixed-weighted price index | | GNP deflator | | Unemployment rate (percent) | | | |
|--|-------------|---------|----------|---------|-----------------------------------|---------|-----------------|---------|-----------------------------------|---------|------|------|
| | 2/3/88 | 3/23/88 | 2/3/88 | 3/23/88 | 2/3/88 | 3/23/88 | 2/3/88 | 3/23/88 | 2/3/88 | 3/23/88 | | |
| Annual changes: | | | | | | | | | | | | |
| 1986 | <1> | 5.6 | 5.6 | 2.9 | 2.9 | 2.7 | 2.7 | 2.6 | 2.6 | 7.0 | 7.0 | |
| 1987 | <1> | 5.9 | 6.0 | 2.9 | 2.9 | 3.4 | 3.4 | 3.0 | 3.0 | 6.2 | 6.2 | |
| 1988 | | 5.9 | 6.5 | 2.6 | 3.2 | 3.9 | 3.9 | 3.2 | 3.2 | 6.0 | 5.7 | |
| 1989 | | 6.6 | 6.5 | 2.8 | 2.5 | 4.2 | 4.3 | 3.8 | 3.9 | 5.8 | 5.7 | |
| Quarterly changes: | | | | | | | | | | | | |
| 1987 | Q1 | <1> | 8.6 | 8.6 | 4.4 | 4.4 | 4.5 | 4.5 | 4.2 | 4.2 | 6.6 | 6.6 |
| | Q2 | <1> | 6.3 | 6.3 | 2.5 | 2.5 | 4.1 | 4.1 | 3.5 | 3.5 | 6.3 | 6.3 |
| | Q3 | <1> | 7.3 | 7.3 | 4.3 | 4.3 | 3.4 | 3.4 | 2.8 | 2.8 | 6.0 | 6.0 |
| | Q4 | <1> | 6.7 | 7.3 | 4.2 | 4.5 | 3.7 | 3.7 | 2.7 | 2.7 | 5.9 | 5.9 |
| 1988 | Q1 | | 4.9 | 6.1 | 1.3 | 2.7 | 4.1 | 4.2 | 3.4 | 3.4 | 5.9 | 5.7 |
| | Q2 | | 5.2 | 5.7 | 1.7 | 2.5 | 3.8 | 3.6 | 3.5 | 3.1 | 6.0 | 5.7 |
| | Q3 | | 6.1 | 6.5 | 2.6 | 2.6 | 3.9 | 4.2 | 3.5 | 3.8 | 6.0 | 5.7 |
| | Q4 | | 6.7 | 6.7 | 2.9 | 2.8 | 4.2 | 4.3 | 3.8 | 3.8 | 6.0 | 5.7 |
| 1989 | Q1 | | 7.0 | 6.7 | 3.0 | 2.6 | 4.3 | 4.6 | 3.9 | 4.0 | 5.9 | 5.6 |
| | Q2 | | 6.7 | 6.6 | 2.8 | 2.5 | 4.2 | 4.5 | 3.9 | 4.1 | 5.9 | 5.6 |
| | Q3 | | 6.7 | 6.2 | 2.8 | 2.3 | 4.2 | 4.3 | 3.8 | 3.9 | 5.8 | 5.7 |
| | Q4 | | 6.7 | 6.3 | 2.8 | 2.3 | 4.2 | 4.4 | 3.8 | 3.9 | 5.8 | 5.7 |
| Two-quarter changes: <2> | | | | | | | | | | | | |
| 1987 | Q2 | <1> | 7.5 | 7.5 | 3.4 | 3.4 | 4.4 | 4.4 | 3.9 | 3.9 | - .6 | - .5 |
| | Q4 | <1> | 7.0 | 7.3 | 4.2 | 4.4 | 3.6 | 3.6 | 2.8 | 2.8 | - .4 | - .4 |
| 1988 | Q2 | | 5.1 | 5.9 | 1.5 | 2.6 | 4.0 | 3.9 | 3.4 | 3.3 | .1 | - .2 |
| | Q4 | | 6.4 | 6.6 | 2.7 | 2.7 | 4.0 | 4.2 | 3.6 | 3.8 | .0 | .0 |
| 1989 | Q2 | | 6.9 | 6.7 | 2.9 | 2.5 | 4.3 | 4.5 | 3.9 | 4.0 | - .1 | - .1 |
| | Q4 | | 6.7 | 6.2 | 2.8 | 2.3 | 4.2 | 4.3 | 3.8 | 3.9 | - .1 | .1 |
| Four-quarter changes: <3> | | | | | | | | | | | | |
| 1986 | Q4 | <1> | 4.5 | 4.5 | 2.2 | 2.2 | 2.3 | 2.3 | 2.2 | 2.2 | - .2 | - .3 |
| 1987 | Q4 | <1> | 7.2 | 7.4 | 3.8 | 3.9 | 4.0 | 4.0 | 3.3 | 3.3 | -1.0 | - .9 |
| 1988 | Q4 | | 5.7 | 6.2 | 2.1 | 2.7 | 4.0 | 4.1 | 3.5 | 3.5 | .1 | - .2 |
| 1989 | Q4 | | 6.8 | 6.4 | 2.8 | 2.4 | 4.2 | 4.4 | 3.8 | 4.0 | - .2 | .0 |

<1> Actual.

<2> Percent change from two quarters earlier.

<3> Percent change from four quarters earlier.

March 23, 1988

CONFIDENTIAL - FR
CLASS II FOMCGROSS NATIONAL PRODUCT AND RELATED ITEMS
(Seasonally adjusted; annual rate)

| | Units | Projection | | | | | | | | | |
|---------------------------------|------------------|------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| | | 1987 | | 1988 | | | | 1989 | | | |
| | | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| EXPENDITURES | | | | | | | | | | | |
| Nominal GNP | Billions of \$ | 4524.0 | 4604.0 | 4672.6 | 4737.5 | 4812.6 | 4891.6 | 4971.2 | 5051.8 | 5128.5 | 5207.0 |
| Real GNP | Billions of 82\$ | 3835.9 | 3877.9 | 3903.4 | 3927.3 | 3952.9 | 3980.7 | 4005.9 | 4030.5 | 4053.2 | 4076.1 |
| Nominal GNP | Percent change | 7.3 | 7.3 | 6.1 | 5.7 | 6.5 | 6.7 | 6.7 | 6.6 | 6.2 | 6.3 |
| Real GNP | | 4.3 | 4.5 | 2.7 | 2.5 | 2.6 | 2.8 | 2.6 | 2.5 | 2.3 | 2.3 |
| Gross domestic product | | 4.8 | 4.8 | 2.4 | 2.6 | 2.7 | 2.8 | 2.4 | 2.5 | 2.3 | 2.3 |
| Gross domestic purchases | | 4.8 | 4.1 | -1.1 | 1.6 | 1.8 | 1.7 | 1.1 | 1.2 | .9 | .9 |
| Final sales | | 6.0 | 1.0 | 4.1 | 1.8 | 2.7 | 3.3 | 3.1 | 2.7 | 2.6 | 2.7 |
| Private dom. final purchases | | 7.3 | -2.1 | 3.2 | 1.7 | 2.6 | 2.1 | 1.5 | 1.5 | 1.2 | 1.3 |
| Personal consumption expend. | | 5.4 | -3.1 | 2.8 | 1.7 | 2.0 | 1.7 | 1.3 | 1.4 | 1.2 | 1.2 |
| Durables | | 24.3 | -20.4 | 13.9 | -2.8 | 1.4 | 2.6 | 1.4 | 1.8 | 1.1 | 1.2 |
| Nondurables | | -1.5 | -2.6 | -2.3 | 2.8 | 2.6 | 1.5 | 1.2 | 1.2 | .7 | .7 |
| Services | | 5.0 | 2.8 | 3.2 | 2.3 | 1.8 | 1.5 | 1.3 | 1.5 | 1.5 | 1.5 |
| Business fixed investment | | 25.8 | -.5 | 11.7 | 1.7 | 4.6 | 4.1 | 3.8 | 3.5 | 3.1 | 2.8 |
| Producers' durable equipment | | 26.3 | -2.6 | 18.4 | 1.6 | 5.5 | 4.4 | 3.8 | 3.5 | 3.2 | 3.0 |
| Nonresidential structures | | 24.6 | 5.5 | -4.9 | 1.9 | 2.3 | 3.2 | 3.7 | 3.3 | 2.9 | 2.2 |
| Residential structures | | -6.5 | 8.1 | -9.9 | 1.8 | 5.4 | 2.4 | -1.8 | -2.6 | -2.9 | -4.4 |
| Exports | | 23.7 | 15.1 | 16.7 | 14.3 | 13.2 | 16.0 | 16.8 | 15.3 | 14.9 | 14.9 |
| Imports | | 22.4 | 9.7 | -5.6 | 5.4 | 5.5 | 5.7 | 4.8 | 5.1 | 4.4 | 4.4 |
| Government purchases | | 2.6 | 13.4 | -6.5 | -2.0 | -1.3 | 2.5 | 2.3 | 1.2 | 1.2 | 1.0 |
| Federal | | 4.5 | 24.4 | -15.6 | -7.0 | -5.5 | 3.1 | 2.2 | -.5 | -.8 | -1.4 |
| Defense | | 7.5 | -1.5 | -7.8 | -10.4 | -8.2 | 3.7 | 2.6 | -.8 | -.9 | -1.6 |
| State and local | | 1.2 | 5.3 | 1.4 | 2.0 | 2.0 | 2.1 | 2.4 | 2.5 | 2.7 | 2.7 |
| Change in business inventories | Billions of 82\$ | 24.6 | 56.7 | 43.7 | 50.1 | 50.2 | 45.9 | 41.2 | 39.4 | 36.7 | 33.3 |
| Nonfarm | Billions of 82\$ | 12.1 | 53.5 | 34.4 | 41.6 | 41.4 | 37.8 | 33.7 | 32.4 | 30.4 | 27.8 |
| Exports | Billions of 82\$ | -138.4 | -136.4 | -110.2 | -101.9 | -94.6 | -83.8 | -70.3 | -58.2 | -45.0 | -31.3 |
| INCOME AND PRODUCTION | | | | | | | | | | | |
| Nonfarm payroll employment | Millions | 102.3 | 103.3 | 104.2 | 104.6 | 105.0 | 105.5 | 105.9 | 106.3 | 106.7 | 107.0 |
| Unemployment rate | Percent* | 6.0 | 5.9 | 5.7 | 5.7 | 5.7 | 5.7 | 5.6 | 5.6 | 5.7 | 5.7 |
| Industrial production index | Percent change | 8.8 | 7.0 | 4.0 | 3.8 | 4.5 | 4.2 | 3.1 | 3.3 | 3.3 | 3.4 |
| Capacity utilization rate-mfg. | Percent* | 81.4 | 82.3 | 82.5 | 82.8 | 83.0 | 83.2 | 83.2 | 83.2 | 83.3 | 83.3 |
| Housing Starts | Millions | 1.62 | 1.53 | 1.46 | 1.53 | 1.53 | 1.51 | 1.50 | 1.48 | 1.44 | 1.44 |
| Auto sales | Millions | 11.42 | 10.02 | 10.53 | 9.84 | 9.84 | 10.02 | 10.05 | 10.10 | 10.10 | 10.10 |
| Domestic | Millions | 7.84 | 6.63 | 7.44 | 6.81 | 6.84 | 7.00 | 7.05 | 7.10 | 7.10 | 7.10 |
| Foreign | Millions | 3.58 | 3.38 | 3.09 | 3.03 | 3.00 | 3.02 | 3.00 | 3.00 | 3.00 | 3.00 |
| INCOME AND SAVING | | | | | | | | | | | |
| Nominal personal income | Percent change | 5.8 | 10.2 | 6.8 | 5.0 | 5.1 | 7.9 | 7.7 | 5.5 | 5.8 | 7.2 |
| Real disposable income | Percent change | 4.5 | 5.7 | 4.6 | -.6 | 2.0 | 2.4 | 2.3 | -.2 | .8 | 1.7 |
| Personal saving rate | Percent* | 2.8 | 4.8 | 5.2 | 4.7 | 4.7 | 4.8 | 5.0 | 4.6 | 4.5 | 4.6 |
| Corp. profits with IVA & CCAAdj | Percent change | 26.7 | 7.4 | -13.1 | 8.8 | 7.8 | 6.0 | 5.2 | 10.3 | 3.3 | 5.5 |
| Profit share of GNP | Percent* | 7.0 | 7.0 | 6.6 | 6.7 | 6.7 | 6.7 | 6.7 | 6.7 | 6.7 | 6.7 |
| Federal govt. surplus/deficit | Billions of \$ | -135.8 | -160.1 | -167.1 | -145.4 | -143.1 | -150.3 | -155.3 | -135.9 | -124.0 | -120.5 |
| State and local govt. surplus | | 46.5 | 39.1 | 46.8 | 50.4 | 54.1 | 58.5 | 62.6 | 62.9 | 61.8 | 61.3 |
| Exc. social insurance funds | | -5.6 | -14.1 | -7.3 | -4.4 | -1.4 | 2.3 | 5.7 | 5.3 | 3.5 | 2.3 |
| PRICES AND COSTS | | | | | | | | | | | |
| GNP implicit deflator | Percent change | 2.8 | 2.7 | 3.4 | 3.1 | 3.8 | 3.8 | 4.0 | 4.1 | 3.9 | 3.9 |
| GNP fixed-weight price index | | 3.4 | 3.7 | 4.2 | 3.6 | 4.2 | 4.3 | 4.6 | 4.5 | 4.3 | 4.4 |
| Cons. & fixed invest. prices | | 3.9 | 3.5 | 3.7 | 4.2 | 4.9 | 4.7 | 5.0 | 4.9 | 4.7 | 4.7 |
| CPI | | 3.6 | 3.9 | 3.5 | 4.3 | 5.2 | 5.0 | 4.9 | 5.2 | 5.0 | 5.1 |
| Exc. food and energy | | 3.6 | 4.2 | 4.5 | 4.9 | 5.2 | 5.2 | 5.3 | 5.3 | 5.2 | 5.2 |
| Nonfarm business sector | | | | | | | | | | | |
| Output per hour | | 4.2 | .3 | -1.0 | .9 | 1.0 | 1.2 | .9 | 1.1 | 1.0 | 1.2 |
| Compensation per hour | | 3.6 | 3.4 | 4.9 | 3.7 | 3.9 | 4.2 | 4.8 | 4.6 | 4.7 | 4.8 |
| t labor costs | | -.6 | 3.1 | 6.0 | 2.8 | 2.9 | 3.0 | 3.9 | 3.5 | 3.7 | 3.6 |

at an annual rate.

March 23, 1988

CONFIDENTIAL - FR
CLASS II FOMCGROSS NATIONAL PRODUCT AND RELATED ITEMS
(Seasonally adjusted; annual rate)

| | Units | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | Projection | |
|---|------------------|--------|--------|--------|--------|--------|--------|--------|------------|--------|
| | | | | | | | | | 1988 | 1989 |
| EXPENDITURES | | | | | | | | | | |
| ----- | | | | | | | | | | |
| Nominal GNP | Billions of \$ | 3052.6 | 3166.0 | 3405.7 | 3772.2 | 4010.3 | 4235.0 | 4487.7 | 4778.6 | 5089.6 |
| Real GNP | Billions of 82\$ | 3248.8 | 3166.0 | 3279.1 | 3501.4 | 3607.5 | 3713.3 | 3820.3 | 3941.1 | 4041.4 |
| Real GNP | Percent change* | .6 | -1.9 | 6.5 | 5.1 | 3.3 | 2.2 | 3.9 | 2.7 | 2.4 |
| Gross domestic product | | .3 | -1.6 | 6.6 | 5.3 | 3.5 | 2.6 | 4.1 | 2.6 | 2.4 |
| Gross domestic purchases | | .8 | -.8 | 8.4 | 6.4 | 4.1 | 2.7 | 3.4 | 1.3 | 1.1 |
| Final sales | | .1 | .3 | 3.7 | 4.7 | 4.6 | 2.6 | 2.0 | 3.0 | 2.7 |
| Private dom. final purchases | | -.3 | .8 | 7.7 | 5.6 | 4.6 | 3.2 | 1.1 | 2.4 | 1.4 |
| Personal consumption expend. | | .2 | 2.9 | 5.4 | 4.1 | 4.5 | 4.1 | .8 | 2.0 | 1.3 |
| Durables | | -3.3 | 9.0 | 14.7 | 10.8 | 6.6 | 12.4 | -3.7 | 3.6 | 1.3 |
| Nondurables | | .5 | 1.8 | 4.4 | 2.3 | 2.9 | 2.9 | -1.2 | 1.1 | .9 |
| Services | | .9 | 2.3 | 3.9 | 3.5 | 5.0 | 2.4 | 3.8 | 2.2 | 1.4 |
| Business fixed investment | | 5.6 | -11.3 | 10.8 | 13.8 | 4.7 | -4.7 | 4.5 | 5.4 | 3.3 |
| Producers' durable equipment | | 2.2 | -12.5 | 20.9 | 14.9 | 7.0 | .2 | 5.0 | 7.3 | 3.4 |
| Nonresidential structures | | 11.7 | -9.1 | -4.8 | 11.8 | .1 | -15.4 | 3.5 | .6 | 3.0 |
| Residential structures | | -22.4 | 4.9 | 38.1 | 6.1 | 6.0 | 12.5 | -2.4 | -.2 | -1.9 |
| Exports | | 2.4 | -13.8 | 5.8 | 5.9 | -2.7 | 5.9 | 16.6 | 15.1 | 15.5 |
| Imports | | 4.9 | -5.9 | 23.8 | 17.4 | 5.2 | 8.9 | 9.1 | 2.6 | 4.7 |
| Government purchases | | 2.9 | 3.8 | -2.7 | 7.9 | 8.7 | 2.4 | 3.2 | -1.9 | 1.4 |
| Federal | | 9.5 | 8.2 | -8.1 | 13.0 | 14.9 | -.2 | 3.1 | -6.5 | -.2 |
| Defense | | 7.6 | 8.8 | 5.1 | 6.5 | 7.0 | 4.8 | 5.8 | -5.8 | -.2 |
| State and local | | -1.3 | .6 | 1.5 | 4.4 | 4.0 | 4.6 | 3.3 | 1.9 | 2.6 |
| Change in business inventories | Billions of 82\$ | 23.9 | -24.5 | -6.4 | 62.3 | 7.4 | 13.8 | 42.0 | 47.5 | 37.7 |
| Nonfarm | Billions of 82\$ | 19.0 | -23.1 | -.1 | 57.8 | 12.0 | 15.4 | 33.1 | 38.8 | 31.1 |
| Net exports | Billions of 82\$ | 49.4 | 26.3 | -19.9 | -84.0 | -108.2 | -145.8 | -135.7 | -97.6 | -51.2 |
| Nominal GNP | Percent change* | 9.3 | 3.1 | 10.4 | 8.6 | 6.6 | 4.5 | 7.4 | 6.2 | 6.4 |
| EMPLOYMENT AND PRODUCTION | | | | | | | | | | |
| ----- | | | | | | | | | | |
| Nonfarm payroll employment | Millions | 91.2 | 89.6 | 90.2 | 94.5 | 97.5 | 99.6 | 102.1 | 104.8 | 106.5 |
| Unemployment rate | Percent | 7.6 | 9.7 | 9.6 | 7.5 | 7.2 | 7.0 | 6.2 | 5.7 | 5.7 |
| Industrial production index | Percent change* | -1.0 | -7.7 | 14.3 | 6.6 | 1.7 | 1.0 | 5.8 | 4.1 | 3.3 |
| Capacity utilization rate-mfg. | Percent | 78.2 | 70.3 | 73.9 | 80.5 | 80.1 | 79.7 | 81.0 | 82.9 | 83.3 |
| Housing Starts | Millions | 1.10 | 1.06 | 1.71 | 1.77 | 1.74 | 1.81 | 1.63 | 1.51 | 1.46 |
| Auto sales | Millions | 8.56 | 8.00 | 9.18 | 10.43 | 11.09 | 11.52 | 10.34 | 10.06 | 10.09 |
| Domestic | Millions | 6.24 | 5.77 | 6.77 | 7.97 | 8.24 | 8.28 | 7.14 | 7.02 | 7.09 |
| Foreign | Millions | 2.32 | 2.23 | 2.41 | 2.46 | 2.84 | 3.25 | 3.21 | 3.03 | 3.00 |
| INCOME AND SAVING | | | | | | | | | | |
| ----- | | | | | | | | | | |
| Nominal personal income | Percent change* | 9.2 | 5.3 | 7.8 | 8.4 | 6.8 | 5.5 | 7.2 | 6.2 | 6.6 |
| Real disposable income | Percent change* | .7 | 1.0 | 5.1 | 4.3 | 2.8 | 3.6 | 2.1 | 2.1 | 1.2 |
| Personal saving rate | Percent | 7.5 | 6.8 | 5.4 | 6.1 | 4.5 | 4.3 | 3.8 | 4.8 | 4.7 |
| Corp. profits with IVA & CCA _{adj} | Percent change* | 2.3 | -19.1 | 70.1 | 7.4 | 4.1 | 1.2 | 14.1 | 1.9 | 6.0 |
| Profit share of GNP | Percent | 6.2 | 4.7 | 6.3 | 7.1 | 6.9 | 6.7 | 6.8 | 6.7 | 6.7 |
| Federal govt. surplus/deficit | Billions of \$ | -63.8 | -145.9 | -176.0 | -169.6 | -196.0 | -204.7 | -151.4 | -151.5 | -133.9 |
| State and local govt. surplus | | 34.1 | 35.1 | 47.5 | 64.6 | 63.1 | 56.8 | 44.3 | 52.4 | 62.2 |
| Exc. social insurance funds | | 4.1 | -1.7 | 4.4 | 19.8 | 16.0 | 7.4 | -7.3 | -2.7 | 4.2 |
| PRICES AND COSTS | | | | | | | | | | |
| ----- | | | | | | | | | | |
| GNP implicit deflator | Percent change* | 8.7 | 5.2 | 3.6 | 3.4 | 3.1 | 2.2 | 3.3 | 3.5 | 4.0 |
| GNP fixed-weight price index | | 8.5 | 5.0 | 3.9 | 3.7 | 3.6 | 2.3 | 4.0 | 4.1 | 4.4 |
| Cons. & fixed invest. prices | | 8.2 | 4.4 | 3.3 | 3.3 | 3.5 | 2.0 | 4.3 | 4.4 | 4.8 |
| CPI | | 9.6 | 4.4 | 3.2 | 4.1 | 3.5 | 1.3 | 4.4 | 4.5 | 5.0 |
| Exc. food and energy | | 10.2 | 5.2 | 4.2 | 4.8 | 4.3 | 3.9 | 4.3 | 4.9 | 5.2 |
| Nonfarm business sector | | | | | | | | | | |
| Output per hour | | -.6 | 1.0 | 3.6 | 1.5 | 1.0 | 1.5 | 1.6 | .5 | 1.1 |
| Compensation per hour | | 8.3 | 7.3 | 3.3 | 4.2 | 4.8 | 3.4 | 2.8 | 4.2 | 4.7 |
| Unit labor costs | | 9.0 | 6.2 | -.3 | 2.6 | 3.7 | 1.9 | 1.2 | 3.7 | 3.6 |

* Percent changes are from fourth quarter to fourth quarter.

March 23, 1988

CONFIDENTIAL - FR
CLASS II FOMC

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

| | Projection | | | | | | | | | | Projection | | | |
|--------------------------------|------------|-------|-------|------|------|------|------|------|------|------|---|-------|-------|-------|
| | 1987 | | 1988 | | | | 1989 | | | | 1986 | 1987 | 1988 | 1989 |
| | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | (fourth quarter to fourth quarter, net change) | | | |
| | | | | | | | | | | | | | | |
| Real GNP | 40.6 | 42.0 | 25.5 | 24.0 | 25.6 | 27.8 | 25.2 | 24.6 | 22.7 | 22.9 | 80.6 | 146.4 | 102.8 | 95.4 |
| Gross domestic product | 44.5 | 44.9 | 23.4 | 24.7 | 25.8 | 27.4 | 24.0 | 24.7 | 22.5 | 23.2 | 92.7 | 153.5 | 101.3 | 94.4 |
| Gross domestic purchases | 46.3 | 40.0 | -8 | 15.6 | 18.3 | 17.1 | 11.6 | 12.6 | 9.4 | 9.2 | 103.1 | 131.0 | 50.3 | 42.9 |
| Final sales | 55.1 | 9.9 | 38.3 | 17.6 | 25.5 | 32.1 | 29.9 | 26.4 | 25.4 | 26.4 | 93.3 | 75.5 | 113.5 | 108.1 |
| Private dom. final purchases | 55.8 | -16.7 | 25.3 | 13.2 | 20.7 | 16.5 | 11.8 | 12.1 | 9.8 | 10.8 | 97.7 | 35.6 | 75.7 | 44.5 |
| Personal consumption expend. | 33.2 | -19.8 | 17.4 | 10.3 | 12.7 | 10.5 | 8.1 | 9.2 | 7.4 | 7.5 | 97.3 | 20.4 | 51.0 | 32.2 |
| Durables | 21.5 | -22.6 | 12.7 | -2.8 | 1.4 | 2.5 | 1.4 | 1.8 | 1.1 | 1.2 | 49.9 | -14.7 | 13.8 | 5.4 |
| Nondurables | -3.3 | -5.8 | -5.0 | 6.0 | 5.6 | 3.3 | 2.6 | 2.6 | 1.5 | 1.5 | 24.6 | -10.4 | 9.8 | 8.4 |
| Services | 15.0 | 8.5 | 9.9 | 7.2 | 5.7 | 4.7 | 4.1 | 4.8 | 4.8 | 4.8 | 28.6 | 45.5 | 27.5 | 18.5 |
| Business fixed investment | 25.9 | -6 | 12.9 | 2.0 | 5.4 | 4.9 | 4.6 | 4.2 | 3.9 | 3.4 | -22.0 | 20.0 | 25.2 | 16.1 |
| Producers' durable equipment | 19.1 | -2.2 | 14.5 | 1.4 | 4.7 | 3.8 | 3.4 | 3.1 | 2.9 | 2.7 | .6 | 15.8 | 24.4 | 12.2 |
| Nonresidential structures | 6.8 | 1.7 | -1.6 | .6 | .7 | 1.0 | 1.2 | 1.1 | .9 | .7 | -22.6 | 4.3 | .7 | 3.9 |
| Residential structures | -3.3 | 3.8 | -5.1 | .9 | 2.6 | 1.2 | -.9 | -1.3 | -1.4 | -.2 | 22.5 | -4.9 | -.5 | -3.8 |
| Change in business inventories | -14.4 | 32.1 | -13.0 | 6.4 | .1 | -4.3 | -4.7 | -1.8 | -2.7 | -3.4 | -12.8 | 71.1 | -10.8 | -12.7 |
| Nonfarm | -10.6 | 41.4 | -19.1 | 7.2 | -.2 | -3.6 | -4.1 | -1.3 | -2.0 | -2.6 | -14.4 | 51.2 | -15.7 | -10.1 |
| Farm | -3.8 | -9.4 | 6.2 | -.8 | .3 | -.7 | -.6 | -.5 | -.7 | -.8 | 1.6 | 19.7 | 5.0 | -2.6 |
| Net exports | -5.7 | 2.0 | 26.2 | 8.3 | 7.3 | 10.7 | 13.6 | 12.0 | 13.2 | 13.7 | -22.5 | 15.4 | 52.6 | 52.5 |
| Exports | 22.6 | 15.6 | 17.8 | 16.0 | 15.3 | 19.0 | 20.7 | 19.7 | 19.9 | 20.6 | 21.8 | 64.4 | 68.1 | 80.8 |
| Imports | 28.4 | 13.5 | -8.4 | 7.7 | 8.0 | 8.3 | 7.1 | 7.6 | 6.6 | 6.9 | 44.3 | 49.0 | 15.6 | 28.2 |
| Government purchases | 5.0 | 24.6 | -13.2 | -3.9 | -2.5 | 4.8 | 4.5 | 2.3 | 2.3 | 1.9 | 18.1 | 24.5 | -14.8 | 11.1 |
| Federal | 3.7 | 18.9 | -14.7 | -6.1 | -4.7 | 2.5 | 1.8 | -.5 | -.7 | -1.2 | -.7 | 10.6 | -23.0 | -.5 |
| Defense | 4.8 | -1.0 | -5.4 | -7.1 | -5.4 | 2.3 | 1.6 | -.5 | -.6 | -1.0 | 11.6 | 14.6 | -15.6 | -.5 |
| Nondefense | -1.2 | 20.0 | -9.3 | 1.0 | .7 | .2 | .2 | .0 | -.1 | -.2 | -12.3 | -4.0 | -7.4 | .0 |
| State and local | 1.3 | 5.7 | 1.5 | 2.2 | 2.2 | 2.3 | 2.7 | 2.8 | 3.0 | 3.1 | 18.7 | 14.0 | 8.2 | 11.6 |

I-11

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

| | Fiscal Year 1987* | FY1988e | | FY1989e | | CY1988e | | 1987 IV* | FRB Staff Estimates | | | | | | |
|---|-------------------------|--------------------|--------------|--------------------|--------------|-------------|--------------|-------------|----------------------------------|------|------|------|------|------|------|
| | | Admin ¹ | FRB Staff | Admin ¹ | FRB Staff | CY 1987* | FRB Staff | | 1988 | | | | 1989 | | |
| | | | | | | | | | I | II | III | IV | I | II | III |
| | | | | | | | | | Not seasonally adjusted | | | | | | |
| Budget receipts ² | 854 | 909 | 908 | 965 | 973 | 869 | 919 | 205 | 205 | 267 | 230 | 216 | 226 | 284 | 247 |
| Budget outlays ² | 1005 | 1056 | 1062 | 1094 | 1123 | 1038 | 1055 | 287 | 240 | 267 | 269 | 280 | 281 | 283 | 279 |
| Surplus/deficit(-) to be financed ¹ | -150 | -147 | -155 | -130 | -150 | -169 | -136 | -82 | -34 | 1 | -39 | -63 | -55 | 1 | -32 |
| Means of financing: | | | | | | | | | | | | | | | |
| Borrowing from public | 152 | 127 | 142 | 127 | 147 | 142 | 141 | 61 | 41 | 12 | 28 | 60 | 43 | 19 | 26 |
| Cash balance decrease | -5 | 16 | 9 | 0 | -7 | 9 | 2 | 14 | -2 | -8 | 5 | 8 | 5 | -15 | -5 |
| Other ³ | 4 | 3 | 2 | 3 | 10 | 15 | -8 | 6 | -5 | -5 | 6 | -4 | 8 | -4 | 11 |
| Cash operating balance, end of period | 36 | 20 | 28 | 20 | 35 | 22 | 20 | 22 | 25 | 32 | 28 | 20 | 15 | 30 | 35 |
| Memo: Sponsored agency borrowing ⁴ | 20 | n.a. | 42 | n.a. | 32 | 35 | 27 | 20 | 4 | 9 | 9 | 5 | 5 | 10 | 12 |
| | | | | | | | | | Seasonally adjusted annual rates | | | | | | |
| NIPA Federal Sector | | | | | | | | | | | | | | | |
| Receipts | 894 | 974 | 961 | 1029 | 1027 | 917 | 974 | 943 | 953 | 976 | 973 | 993 | 1019 | 1041 | 1056 |
| Expenditures | 1053 | 1098 | 1115 | 1146 | 1169 | 1068 | 1125 | 1103 | 1120 | 1122 | 1117 | 1144 | 1174 | 1177 | 1180 |
| Purchases | 374 | 375 | 389 | 396 | 395 | 381 | 387 | 395 | 390 | 386 | 383 | 389 | 396 | 398 | 399 |
| Defense | 290 | 289 | 294 | 295 | 297 | 295 | 292 | 300 | 298 | 292 | 288 | 292 | 298 | 299 | 300 |
| Nondefense | 84 | 86 | 94 | 101 | 98 | 86 | 95 | 95 | 93 | 94 | 96 | 97 | 98 | 99 | 99 |
| All other expend. | 679 | 723 | 727 | 750 | 773 | 688 | 738 | 708 | 730 | 736 | 733 | 755 | 778 | 779 | 781 |
| Surplus/deficit(-) | -159 | -124 | -154 | -117 | -141 | -151 | -151 | -160 | -167 | -145 | -143 | -150 | -155 | -136 | -124 |
| High-employment surplus/ deficit(-) evaluated at 6 percent unemp. | -141 | n.a. | -156 | n.a. | -149 | -140 | -156 | -160 | -169 | -149 | -148 | -157 | -163 | -144 | -132 |
| | | | | | | | | | | | | | | | |

*--actual

e--estimated

n.a.--not available

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

1. Budget of the United States Government, Fiscal Year 1989 (February 1988). The Congressional Budget Office baseline estimates released March 1988 indicated receipts of \$898 and \$954 billion, outlays of \$1059 and \$1131 billion, and deficits of \$161 and \$177 billion in FY1988 and FY1989, respectively.
2. Includes social security receipts and outlays, which are classified as off-budget under current law.
3. Checks issued less checks paid, accrued items, and other transactions.
4. Sponsored agency borrowing includes net debt issuance by Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation (excluding participation certificates), the Federal National Mortgage Association (excluding mortgage-backed securities), Farm Credit Banks, the Student Loan Marketing Association, and the Financing Corporation. The Administration's definition of borrowing by these agencies is somewhat broader.

Recent Developments

Indications that the economy has maintained its upward thrust in the face of the fall stock market break and inventory build-up have left their imprint recently on financial markets. Though federal funds have continued to trade in the vicinity of 6-1/2 percent, other rates have firmed--especially in the bond markets, where yields in the corporate and Treasury sectors now are about 3/8 percentage point above their February FOMC levels. The unanticipated buoyancy of the economy has, however, helped to ease some of the fears that were expressed earlier in widened risk premia, and the enhanced investor confidence has been reflected as well in the ability of the stock market to rally further despite the rise in interest rates. In this environment, investors seem to have been selective in their response to news about the problems of financial intermediaries: the ripple effects of the Texas banking adversities have been minimal, while share prices of thrift institutions have fallen noticeably in light of negative industry and FSLIC developments.

M2 and M3 maintained January's faster pace of expansion in February, putting both above the midpoints of their annual ranges. Early March data indicate continued strength. The reduced opportunity costs of holding monetary assets, as market yields have fallen more than deposit rates since the crash, likely have been largely responsible. M1 growth fell off in February but appears to be strengthening in March.

Business borrowing appears fairly strong so far this year. New equity offerings of nonfinancial firms remain minuscule despite the market rally. But, taking advantage of the lower yields since last October, companies have stepped up bond offerings, with increasing proportions of long maturity and lower-rated issues--instruments that had virtually disappeared late last year. Borrowing in shorter-term markets has been relatively well-maintained, although somewhat below the vigorous fourth-quarter pace. Business loan growth at banks (including foreign branches) averaged almost 8 percent in January and February. Early data indicate it may have fallen off in March, but commercial paper issuance has taken up the slack. The strength in borrowing reflects a repetition of last quarter's sizable financing gap, with elevated expenditures for fixed capital offsetting a moderation in spending on inventories, and a resurgence of equity retirements associated with mergers and share repurchases.

Tax-exempt bond offerings also have been stronger lately, with the volume of new issues in February and March approaching the 1987 average. The comparatively low yields recently have spurred a large volume of refunding issues; evidently, some governments that failed to refinance in 1986 or early 1987, when rates were lower, have finally decided to go ahead. The higher-than-expected new supply has lifted the ratios of municipal yields to Treasury and corporate yields, returning them to late October levels.

Net borrowing by the federal government has dropped off about seasonally in the current quarter. The amount of debt to be absorbed

by domestic investors has been further diminished, however, by the strong demand from foreign official institutions. Noncompetitive add-on awards to these buyers began to swell last fall and have maintained a brisk volume since, amounting to about \$14 billion so far this year compared with \$30 billion for all of last year and less for earlier years. These have enabled the Treasury to cut back on auction allotments available for competitive bidding. Auction sizes also have been held down by the municipal issues for advance refundings, whose proceeds are often reinvested in nonmarketable SLGS bonds.

Mortgage borrowing has eased since the crash. New loan originations at FSLIC-insured thrifts in January were the lowest in over two years; both purchase money and refinancing loans were down. At banks, real estate lending in January and February was down from the fourth-quarter pace. The share of loans closed with adjustable rates (ARMs) declined a little between early December and early February but remained historically high despite the decline in fixed rates and the flattening of the yield curve. Reflecting the low volumes of new fixed-rate loans, issuance of pass-throughs also has fallen, totaling only \$8 billion in January and \$9 billion in February--less than half the \$20 billion average over the past two years.

Consumer installment credit, on the other hand, accelerated to a 10-1/2 percent annual rate in January. Revolving credit again expanded rapidly, as it has since last June, consistent with the slowdown in home equity loans over the same period. Consumer lending at banks in February was also rapid.

Outlook

The Federal Reserve's resistance to inflationary pressures accompanying the greater strength in the economy now projected is likely to be associated with an upward drift in interest rates over the next year. Assuming that equity retirements in connection with corporate restructurings fall off only gradually, the staff expects growth of the debt aggregate of about 9 percent again this year and about 8-1/4 percent next year.

Business borrowing looks likely to remain sizable. The financing gap is likely to widen gradually, reaching quite substantial proportions relative to capital spending by 1989. Borrowing needs associated with net equity retirements will add greatly to the total demand for funds in the near term. New merger announcements involving a high proportion of debt financing have been very heavy in the past few weeks. Net retirements will be further boosted because, despite the current market rally, new equity issuance is expected to continue light while firms continue to repurchase their shares in large volume. By 1989, however, some moderation of merger and LBO financing is expected, in a less hospitable financial environment, and thus net equity issuance becomes less deeply negative in the forecast.

In the household sector, consumer installment credit growth is likely to remain above its 1987 average for at least a while longer, but probably will ease by year-end as consumer spending slows. Home mortgage borrowing should pick up fairly soon in connection with the

expected rebound in housing activity, but as interest rates rise further, loan volume will level off.

Growth in government deb' is likely to ease slightly over the forecast horizon. Federal budget deficits are not expected to change appreciably, and state and local government advance refundings should fall off as yields move upward.

Recent Developments

Since the last meeting of the FOMC, the dollar has fluctuated in a relatively narrow range, ending the period down about 3/4 percent against other G-10 currencies on a weighted-average basis. The net decline was largely accounted for by a 4 percent depreciation against the pound and lesser declines against the Canadian dollar and the yen, while the mark and other EMS currencies remained little changed. Market participants focused on the outlook for U.S. external adjustment; data indicating stronger than anticipated domestic demand tended to depress the dollar, while favorable trade figures tended to boost it. Demand for sterling, the Canadian dollar, and the yen apparently was stimulated by the continued strong performance of those economies, and, in the case of sterling and the Canadian dollar, by indications that steps would be taken by authorities in both countries to counter inflationary pressures. As the pound came under strong upward pressure toward the end of the intermeeting period, surpassing a rate of DM 3.10 per pound, the Bank of England reversed a 1/2 percentage point increase in its money market intervention rates that had been implemented in early February.

. The Desk did not intervene.

The average pace of economic growth in major foreign industrial countries slowed somewhat in the fourth quarter and early this year from its robust pace in the third quarter, although activity has remained very strong in Canada and Japan. In Japan, domestic demand advanced at a 10 percent annual rate in the fourth quarter, while a sharp drop in net exports reduced GNP growth to about a 7 percent rate. Canada's GNP growth rose to more than 6 percent, while U.K. growth slowed substantially from a rapid third-quarter pace, although consumption and fixed investment remained very strong. Labor market conditions are tightening somewhat in these three countries, and strains on output capacity are showing up in some sectors. Growth in Germany and France slowed substantially in the fourth quarter from fairly high rates in the third quarter.

Recent data on industrial production suggest that German growth continued at a moderate pace early this year, while Japan showed a further strong expansion. Inflation has remained quite low in most of the major industrial countries through early 1988. Wage pressures have picked up further in the United Kingdom, although to date they appear to have been partly offset by rapid gains in productivity. The external imbalances of major foreign economies have showed relatively little change on average in early 1988; the German surplus and the U.K. deficit widened slightly, while the Japanese surplus narrowed somewhat in the latest months for which data are available.

Brazil reached a preliminary agreement with its bank advisory committee at the end of February on key elements of a financing and

rescheduling package that will include nearly \$6 billion in new term loans. The auction of Mexican bonds backed by U.S. Treasury zero-coupon bonds, in late February, will enable Mexico to reduce its net outstanding debt by more than \$1 billion, and achieve a savings in external interest payments of roughly \$65 million annually. Argentina received the first drawing on a \$550 million U.S. Treasury bridge loan, also in late February, and the next drawing on that country's stand-by arrangement with the IMF was approved by the Executive Board on March 18.

The U.S. merchandise trade deficit in January was significantly below the fourth-quarter average (on both a seasonally adjusted balance of payments basis and an unadjusted Census basis). While the January deficit was roughly the same as in December, total non-oil imports and nonagricultural exports both fell noticeably from their December levels. The current account deficit narrowed substantially in the fourth quarter, to \$156 billion at an annual rate. However, the \$18 billion improvement over the third-quarter rate was more than accounted for by investment income receipts associated with capital gains on the book value of U.S. direct investment holdings abroad, as a result of the further depreciation of the dollar.

Foreign official reserve assets in the United States increased substantially in January, at about the same monthly rate as in the fourth quarter. Evidence of further large increases in February and early March, when official intervention was much reduced, suggests the shifting of official holdings from investments outside the United

States. The post-October 19 rapid selloff of private foreign holdings of U.S. corporate stocks ceased in January, while U.S. residents made sizable net purchases of foreign securities, and U.S. banking offices reported substantial net outflows of funds. Data for the fourth quarter showed a large net outflow on direct investment, partly due to the surge in (unrepatriated) capital gains on U.S. holdings abroad that resulted from the decline in the dollar. For the year as a whole, a record increase in foreign direct investment holdings in the United States was nearly offset by the increase in the dollar value of U.S. holdings abroad. U.S. chartered banks further reduced their claims on foreigners in the fourth quarter, bringing the total decline for the year 1987 to \$30 billion (after adjusting for the effect of the decline in the dollar on nondollar claims).

Outlook

The staff continues to project a moderate decline in the value of the dollar over the forecast horizon. With the recent evidence of near-term strengthening in U.S. domestic demand partially offset by an improvement in the near-term pace of economic activity abroad, we still expect to see a \$20 billion decline in the trade deficit over the four quarters of 1988, with most of the improvement taking place in the first quarter. The projected rate of decline slows later in the year, largely because of an expected rebound in oil import prices from recently depressed levels, but picks up again during 1989. We now expect a much smaller decline in the current account deficit than in the trade deficit this year, primarily because the unusually high level of net investment

income receipts in the fourth quarter of 1987 (due to capital gains) is not expected to persist. The current account deficit is projected to narrow by less than \$5 billion over the four quarters of 1988, but by another \$20 billion during 1989, falling to less than \$130 billion at an annual rate by the fourth quarter of 1989. The moderate improvement in nominal terms over the forecast horizon masks a substantial further rise in real net exports, since import prices are expected to rise considerably faster than export prices.

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

| | ANNUAL | | | 1987 | | 1988 | | | | 1989 | | | |
|---|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| | 1987- | 1988-P | 1989-P | Q3- | Q4- | Q1- | Q2-P | Q3-P | Q4-P | Q1-P | Q2-P | Q3-P | Q4-P |
| 1. GNP Exports and Imports 1/ | | | | | | | | | | | | | |
| Current \$, Net | -120.3 | -102.3 | -81.2 | -123.7 | -126.9 | -103.5 | -103.0 | -103.5 | -99.0 | -93.4 | -85.9 | -77.6 | -68.1 |
| Exports of G+S | 427.4 | 507.1 | 601.3 | 439.2 | 456.8 | 477.1 | 496.1 | 515.6 | 539.7 | 565.5 | 589.7 | 612.9 | 637.2 |
| Imports of G+S | 547.7 | 609.4 | 682.6 | 562.9 | 583.7 | 580.6 | 599.1 | 619.1 | 638.7 | 658.9 | 675.6 | 690.5 | 705.3 |
| Constant 82 \$, Net | -135.7 | -97.6 | -51.2 | -138.4 | -136.4 | -110.2 | -101.9 | -94.6 | -83.8 | -70.3 | -58.2 | -45.0 | -31.3 |
| Exports of G+S | 425.5 | 494.9 | 571.3 | 437.1 | 452.7 | 470.5 | 486.5 | 501.8 | 520.8 | 541.5 | 561.2 | 581.0 | 601.6 |
| Imports of G+S | 561.2 | 592.5 | 622.5 | 575.6 | 589.1 | 580.7 | 588.4 | 596.4 | 604.7 | 611.8 | 619.4 | 626.0 | 632.9 |
| 2. U.S. Merchandise Trade Balance 2/ | -159.2 | -141.7 | -127.6 | -161.4 | -160.7 | -141.8 | -141.5 | -142.9 | -140.4 | -137.8 | -131.6 | -124.8 | -116.1 |
| Exports | 250.8 | 314.5 | 376.8 | 260.4 | 276.2 | 292.8 | 307.3 | 321.1 | 336.8 | 352.5 | 368.0 | 384.1 | 402.6 |
| Agricultural | 29.5 | 35.1 | 39.3 | 33.3 | 30.9 | 33.7 | 35.1 | 34.7 | 36.8 | 38.0 | 38.9 | 39.4 | 41.0 |
| Non-Agricultural | 221.3 | 279.4 | 337.5 | 227.2 | 245.3 | 259.1 | 272.2 | 286.4 | 300.0 | 314.5 | 329.1 | 344.7 | 361.6 |
| Imports | 410.0 | 456.2 | 504.4 | 421.9 | 436.9 | 434.6 | 448.9 | 464.0 | 477.2 | 490.3 | 499.6 | 508.9 | 518.7 |
| Petroleum and Products | 42.3 | 44.0 | 53.3 | 50.4 | 44.4 | 37.6 | 43.6 | 46.9 | 48.0 | 51.7 | 52.7 | 53.8 | 55.1 |
| Non-Petroleum | 367.7 | 412.2 | 451.1 | 371.4 | 392.6 | 397.0 | 405.3 | 417.1 | 429.3 | 438.6 | 446.9 | 455.2 | 463.6 |
| 3. U.S. Current Account Balance | -160.7 | -153.0 | -139.0 | -173.8 | -156.0 | -152.8 | -152.6 | -153.9 | -152.7 | -149.2 | -143.0 | -136.1 | -127.8 |
| Of Which: Net Investment Income | 14.5 | 6.9 | 3.6 | 1.2 | 28.4 | 8.2 | 7.2 | 6.3 | 5.7 | 5.4 | 4.1 | 3.2 | 1.8 |
| 4. Foreign Outlook 3/ | | | | | | | | | | | | | |
| Real GNP--Ten Industrial 4/ | 2.7 | 2.7 | 1.9 | 5.0 | 3.2 | 2.2 | 2.1 | 2.0 | 1.9 | 2.0 | 1.9 | 2.0 | 2.0 |
| Real GNP--NonOPEC LDC 5/ | 3.9 | 3.6 | 4.3 | 3.5 | 3.4 | 3.3 | 3.6 | 4.0 | 4.4 | 4.6 | 4.5 | 4.3 | 4.1 |
| Consumer Prices--Ten Ind. 4/ | 2.1 | 2.4 | 2.8 | 1.7 | 2.4 | 1.7 | 3.1 | 2.2 | 3.5 | 2.4 | 3.1 | 2.5 | 3.4 |

1/ National Income and Product Account data.

2/ International accounts basis.

3/ Percent change, annual rates.

4/ Weighted by multilateral trade-weights of G-10 countries plus Switzerland; prices are not seasonally adjusted.

5/ Weighted by share in NonOPEC LDC GNP.

P/ Projected