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CONFIDENTIAL (FR)

July 12, 1978

SUMMARY AND OUTLOOK

By the Staff
Board of Governors
of the Federal Reserve System

SUMMARY AND OUTLOOK

DOMESTIC NONFINANCIAL DEVELOPMENTS

Summary. Economic activity has continued to expand, although--as expected--at a more moderate pace than during early spring. Demand for workers remained strong in June, but mainly in the service groups and in construction. Autos have been selling at a brisk pace, reflecting in part buying in anticipation of future price increases. Food price increases have been a major factor in the rapid acceleration of over-all inflation this year, but prices for nonfood items also have been moving up more rapidly.

Total employment rose substantially further in June, and the unemployment rate moved down 0.4 percentage point to 5.7 per cent. About half of the over-all decline in joblessness reflected a sharp reduction in the volatile teenage category, but there was a further significant drop for more experienced groups of workers as well. Since last December, nonfarm payroll employment has risen sharply--by 2.3 million--and the over-all unemployment rate has fallen 0.7 percentage point.

Following sizable gains earlier in the year, manufacturing employment increased little in May and was about unchanged in June. As a result of these and other developments, industrial production is tentatively estimated to have increased between 1/4 and 1/2 percentage point in June, with gains evenly spread among products and materials. Auto assemblies were lower than in April and May but there was an offsetting rise in truck output.

The large gains in employment this year have boosted income growth and provided support for consumer spending. Sales of new autos in June continued close to a 12 million unit annual rate for the fourth month in a row. Retail sales other than autos leveled out in June after substantial increases during the preceding four months.

While business inventories have risen rapidly in recent months, these increases generally have not outstripped the rapid pace of sales. In manufacturing, the book value of stocks grew at more than a \$20 billion annual rate in April and May, well above the first-quarter average rise, with rising prices contributing to these nominal increases. While ratios of inventories to sales generally remain low, some inventory buildup may be indicated in retail at furniture and appliance stores, where such ratios have now moved above their 1974 peaks.

Outlays for producer durable goods and nonresidential construction increased considerably during the spring, following the weather depressed first quarter. While new orders for nondefense capital goods and nonresidential construction contracts rose sharply in May, the increase since the first of the year has been below the 1977 pace. This suggests a more moderate expansion of business fixed investment for the remainder of the year. Residential construction remained at a high level in May. Total private housing starts were at a 2.08 million unit annual rate--only slightly below the advanced pace of late 1977.

A substantial pick-up in construction outlays has boosted recent State and local government spending. In addition, hiring in this sector has remained brisk, despite the fact that the Federally-funded public service jobs program reached its employment goal by late spring. The Administration's estimate of fiscal year 1978 Federal outlays has been reduced by \$2 billion to \$452 billion; mainly as a result of smaller than expected spending for the Commodity Credit Corporation and defense programs. Revenues are still estimated at \$401 billion for FY 1978, and the Administration is now projecting a \$51 billion deficit.

Retail prices increased sharply again in May. Along with a sharp rise in food prices for the fifth consecutive month, there were sizable increases in housing and energy costs. Since the first of the year, over-all consumer prices have climbed at a 10-1/4 per cent annual rate; excluding food and energy, prices have climbed at an 8-1/2 per cent rate. Furthermore, the June report on producer prices suggests little relief in the near term. Prices for processed consumer foods at the producer level rose more than 1 per cent in June, and the index for crude food and feed prices was up almost 2 per cent. The rise in producer prices for nonfood consumer finished goods did slow in June, primarily due to smaller increases for passenger cars. But with truck prices again higher, capital equipment prices registered another large increase.

Outlook. Recent data on economic activity have generally been consistent with earlier expectations, and the staff estimate of a real GNP increase at about an 8-3/4 per cent annual rate in the second quarter remains unchanged. Inflation has continued at a high rate, and the fixed-weighted price index for gross business product now appears to have risen at a 9-3/4 per cent annual rate, up a bit from last month's estimate.

The fiscal and monetary policy assumptions underlying the projection have been altered somewhat this month. The staff continues to assume that a \$19 billion tax cut will take effect at the beginning of calendar year 1979 with about two-thirds of the reductions accruing to individuals. However, anticipating further spending shortfalls, the staff has reduced its estimates of Federal outlays by about \$3 billion in FY 1978 and \$4 billion in FY 1979. With respect to monetary policy, M-1 now is assumed to grow near the upper end of the 4 to 6-1/2 per cent range shown for alternative B in the Bluebook-- specifically at about a 6-1/4 per cent annual rate through mid-1979. Further substantial increases in short-term interest rates continue to be anticipated in the months ahead.^{1/}

This month, the projection period has been extended to the end of 1979. The projected growth of economic activity in the second half of 1978 is still projected to average about 3-1/2 per cent,

^{1/} We have assumed increases in interest rates consistent with the low end of the Federal funds rate ranges shown in Appendix I of the Bluebook.

roughly 1 percentage point less than the annual growth rate expected for the first half of this year. Some acceleration of economic growth is expected in the first half of 1979 in response to the tax cut, but then expansion is projected to diminish to about a 3 per cent annual rate in the latter half of 1979.

Growth is expected to decelerate in the next two quarters mainly because of the anticipated decline in real outlays for residential structures as tighter mortgage market conditions begin to curtail activity. In 1979, business spending is projected to grow more slowly than in 1978, due to a conservative pace of inventory accumulation and to some slowing in plant and equipment outlays. With such sources of income growth losing momentum, growth of real consumption outlays is projected to be rather moderate, averaging about 3-1/2 per cent over the six-quarter projection period; the strongest advances are anticipated early next year as a result of the initial stimulus of the assumed tax cut.

Given the slower rate of expansion of aggregate activity, growth in employment over the projection horizon is projected to ease back toward a more typical rate of around 2-1/4 per cent annually from the unusually high 4 per cent increase over the past year. As a result, the unemployment rate is likely to hold about level over the year ahead and then to turn up slightly toward the end of 1979.

The rate of inflation, as measured by the gross business product fixed-weighted price index, is projected to average slightly more than 7 per cent over the next six quarters. The rate of increase in food prices is still expected to slow later this year, but there is little prospect that the pressure of rising costs on nonfood prices will ease in the near term. Unit labor costs are likely to continue rising at a rapid pace as recent large price increases are expected to influence settlements in the heavy round of wage contract negotiations that are scheduled for next year. In addition, as was the case this year, inflation is projected to accelerate somewhat in the first part of 1979 as a consequence of further boosts in social security taxes and the minimum wage.

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

STAFF GNP PROJECTIONS

| | Per cent changes, annual rate | | | | | | | |
|-----------------------------------|-------------------------------|---------|----------|---------|---|---------|------------------------------|---------|
| | Nominal GNP | | Real GNP | | Gross business product fixed-weighted price index | | Unemployment rate (per cent) | |
| | 6/14/78 | 7/11/78 | 6/14/78 | 7/11/78 | 6/14/78 | 7/11/78 | 6/14/78 | 7/11/78 |
| 1975 ^{1/} | 8.2 | 8.2 | -1.3 | -1.3 | 9.5 | 9.5 | 8.5 | 8.5 |
| 1976 ^{1/} | 11.6 | 11.6 | 6.0 | 6.0 | 5.4 | 5.4 | 7.7 | 7.7 |
| 1977 ^{1/} | 10.7 | 10.7 | 4.9 | 4.9 | 6.0 | 6.0 | 7.0 | 7.0 |
| 1978 | 11.0 | 11.2 | 3.9 | 4.0 | 6.7 | 6.6 | 6.1 | 5.9 |
| 1979 | | 11.4 | | 3.9 | | 7.4 | | 5.8 |
| 1978-I ^{1/} | 6.6 | 7.0 | -.4 | .0 | 6.5 | 6.2 | 6.2 | 6.2 |
| 1978-II | 18.1 | 18.8 | 8.8 | 8.8 | 9.3 | 9.7 | 6.1 | 5.9 |
| 1978-III | 10.8 | 10.5 | 3.7 | 3.5 | 7.0 | 7.1 | 6.0 | 5.8 |
| 1978-IV | 10.7 | 10.8 | 3.2 | 3.4 | 7.0 | 6.7 | 6.0 | 5.8 |
| 1979-I | 12.0 | 11.7 | 4.5 | 4.2 | 7.7 | 7.9 | 5.9 | 5.7 |
| 1979-II | 10.8 | 10.9 | 3.9 | 3.7 | 7.3 | 7.5 | 5.9 | 5.7 |
| 1979-III | | 10.2 | | 3.2 | | 6.8 | | 5.8 |
| 1979-IV | | 10.1 | | 2.7 | | 6.9 | | 5.9 |
| Change: | | | | | | | | |
| 77-II to 78-II | 11.1 | 11.4 | 4.3 | 4.4 | 6.5 | 6.4 | -1.0 | -1.2 |
| 77-IV to 78-IV | 11.5 | 11.7 | 3.8 | 3.9 | 7.4 | 7.3 | -.6 | -.8 |
| 78-II to 79-II | 11.1 | 11.0 | 3.8 | 3.7 | 7.3 | 7.3 | -.2 | -.2 |
| 78-IV to 79-IV | | 10.7 | | 3.5 | | 7.2 | | .1 |
| Memo: | | | | | | | | |
| Growth Over Annual Policy Period: | | | | | | | | |
| 78-II to 79-II | 11.1 | 11.0 | 3.8 | 3.7 | 7.3 | 7.3 | -.2 | -.2 |

^{1/} Actual.

July 12, 1978

DENTIAL - FR
II FOMCGROSS NATIONAL PRODUCT AND RELATED ITEMS
(Quarterly figures are seasonally adjusted. Expenditures and income
figures are billions of current dollars at annual rates.)

| | 1978 | | | | 1979 | | | |
|---|--------|--------|--------|--------|----------------|--------|--------|--------|
| | I | II | III | IV | Projected I | II | III | IV |
| Gross national product | 1995.3 | 2082.9 | 2135.7 | 2191.4 | 2253.0 | 2311.9 | 2368.6 | 2426.3 |
| Final purchases | 1974.3 | 2059.5 | 2110.6 | 2165.3 | 2225.1 | 2283.2 | 2339.4 | 2396.6 |
| Private | 1557.7 | 1632.9 | 1672.0 | 1712.5 | 1762.1 | 1809.6 | 1854.7 | 1899.5 |
| Excluding net exports | 1581.4 | 1645.3 | 1683.3 | 1721.6 | 1772.5 | 1818.9 | 1861.1 | 1903.5 |
| Personal consumption expenditures | 1282.4 | 1330.6 | 1361.8 | 1393.9 | 1438.1 | 1477.5 | 1512.3 | 1547.0 |
| Goods | 687.8 | 719.5 | 734.4 | 751.5 | 776.5 | 797.1 | 813.7 | 830.4 |
| Services | 594.6 | 611.1 | 627.4 | 642.4 | 661.6 | 680.4 | 698.6 | 716.6 |
| Gross private domestic investment | 320.0 | 338.1 | 346.6 | 353.8 | 362.3 | 370.1 | 378.0 | 386.2 |
| Residential construction | 100.1 | 105.1 | 105.6 | 105.6 | 105.6 | 105.6 | 106.1 | 107.1 |
| Business fixed investment | 198.8 | 209.6 | 215.9 | 222.1 | 228.8 | 235.8 | 242.7 | 249.4 |
| Change in business inventories | 21.1 | 23.4 | 25.1 | 26.1 | 27.9 | 28.7 | 29.2 | 29.7 |
| Nonfarm | 20.3 | 23.4 | 25.1 | 26.1 | 27.9 | 28.7 | 29.2 | 29.7 |
| Net exports of goods and services ^{1/} | -23.7 | -12.4 | -11.3 | -9.1 | -10.4 | -9.3 | -6.4 | -4.0 |
| Exports | 180.5 | 198.7 | 203.6 | 214.3 | 224.2 | 233.2 | 241.5 | 249.9 |
| Imports | 204.2 | 211.1 | 214.9 | 223.4 | 234.6 | 242.5 | 247.9 | 253.9 |
| Gov't. purchases of goods and services | 416.6 | 426.6 | 438.6 | 452.8 | 463.0 | 473.6 | 484.7 | 497.1 |
| Federal ^{2/} | 152.7 | 150.0 | 155.2 | 162.7 | 166.0 | 169.7 | 173.7 | 178.8 |
| State and local | 263.8 | 276.6 | 283.4 | 290.1 | 297.0 | 303.9 | 311.0 | 318.3 |
| Gross national product in constant (1972) dollars | 1360.3 | 1389.3 | 1401.4 | 1413.4 | 1428.0 | 1441.2 | 1452.6 | 1462.2 |
| Personal income | 1638.8 | 1693.3 | 1738.2 | 1782.0 | 1827.7 | 1873.6 | 1923.9 | 1970.9 |
| Wage and salary disbursements | 1058.7 | 1099.7 | 1122.0 | 1149.3 | 1183.0 | 1211.4 | 1239.3 | 1270.6 |
| Disposable personal income | 1402.1 | 1445.2 | 1478.2 | 1513.4 | 1565.0 | 1602.7 | 1644.9 | 1638.1 |
| Saving rate (per cent) | 6.1 | 5.5 | 5.4 | 5.4 | 5.7 | 5.4 | 5.6 | 5.6 |
| Corporate profits with I.V.A. and C.C. Adj. | 126.5 | 147.3 | 154.9 | 160.8 | 156.6 | 162.3 | 165.7 | 168.6 |
| Corporate profits before tax | 171.9 | 193.4 | 197.6 | 203.2 | 199.5 | 205.7 | 209.6 | 213.0 |
| Federal government surplus or deficit (-) (N.I.A. basis) | -55.8 | -35.4 | -36.3 | -35.7 | -38.0 | -34.2 | -35.8 | -34.4 |
| High employment surplus or deficit (-) | -9.9 | 1.7 | 1.7 | 5.9 | 3.0 | 7.4 | 8.1 | 14.4 |
| State and local government surplus or deficit (-) (N.I.A. basis) | 34.1 | 29.8 | 28.2 | 25.5 | 23.7 | 22.2 | 19.9 | 18.6 |
| Excluding social insurance funds | 18.1 | 13.3 | 11.2 | 8.0 | 5.7 | 3.7 | .9 | -9 |
| Civilian labor force (millions) | 99.2 | 100.2 | 101.0 | 101.5 | 102.0 | 102.6 | 103.2 | 103.7 |
| Unemployment rate (per cent) | 6.2 | 5.9 | 5.8 | 5.8 | 5.7 | 5.7 | 5.8 | 5.9 |
| Nonfarm payroll employment (millions) | 84.1 | 85.5 | 85.9 | 86.2 | 86.8 | 87.3 | 87.8 | 88.3 |
| Manufacturing | 20.1 | 20.2 | 20.3 | 20.4 | 20.6 | 20.8 | 20.9 | 21.0 |
| Industrial production (1967=100) | 139.6 | 143.6 | 145.2 | 147.4 | 150.0 | 152.0 | 153.6 | 154.9 |
| Capacity utilization: all mfg. (per cent) | 82.1 | 83.5 | 83.7 | 84.2 | 84.9 | 85.2 | 85.3 | 85.2 |
| Materials (per cent) | 81.7 | 83.8 | 84.1 | 84.8 | 85.7 | 86.3 | 86.5 | 86.7 |
| Housing starts, private (million units, A.R.) | 1.72 | 2.05 | 1.85 | 1.80 | 1.75 | 1.70 | 1.70 | 1.70 |
| New autos sales, (millions, A.R.) | 10.73 | 2.10 | 11.25 | 10.80 | 10.95 | 10.75 | 10.65 | 10.55 |
| Domestic models | 8.77 | 10.00 | 9.25 | 8.90 | 9.00 | 8.90 | 8.85 | 8.80 |
| Foreign models | 1.96 | 2.10 | 2.00 | 1.90 | 1.95 | 1.85 | 1.80 | 1.75 |

^{1/} Balance of payments data and details underlying these estimates are shown in the International Developments section of this part of the Greenbook.

^{2/} Components of purchases and total receipts and total expenditures are shown in the Federal Sector Accounts table which follows.

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IDENTIAL - FR
S II FOMCPER CENT CHANGES IN GROSS NATIONAL PRODUCT
AND RELATED ITEMS
(Annual rates compounded quarterly)

| | 1978 | | | | 1979 | | | |
|---|-------|-------|------|------|----------------|------|------|------|
| | I | II | III | IV | Projected I | II | III | IV |
| <u>Constant (1972) dollars</u> | | | | | | | | |
| Gross national product | .0 | 8.8 | 3.5 | 3.4 | 4.2 | 3.7 | 3.2 | 2.7 |
| Final purchases | -1.7 | 8.3 | 3.2 | 3.3 | 3.9 | 3.5 | 3.2 | 2.6 |
| Private | -1.2 | 9.6 | 2.5 | 3.1 | 4.3 | 3.6 | 3.2 | 2.8 |
| Excluding net exports | -.5 | 7.5 | 2.3 | 2.6 | 4.2 | 3.3 | 2.7 | 2.5 |
| Personal consumption expenditures | -.9 | 6.2 | 2.6 | 3.0 | 4.9 | 3.8 | 3.0 | 2.7 |
| Goods | -7.2 | 9.1 | 2.2 | 3.4 | 5.6 | 3.7 | 2.4 | 2.1 |
| Services | 7.3 | 2.8 | 3.2 | 2.5 | 4.2 | 4.0 | 3.7 | 3.3 |
| Gross private domestic investment | 14.3 | 16.6 | 3.7 | 1.5 | 3.4 | 2.7 | 1.7 | 2.0 |
| Residential structures | -3.9 | 12.0 | -6.1 | -7.8 | -7.8 | -7.8 | -6.1 | -4.3 |
| Business fixed investment | 4.1 | 14.5 | 4.4 | 4.6 | 5.1 | 5.0 | 4.5 | 3.9 |
| Gov't. purchases of goods and services | -3.8 | 3.4 | 5.6 | 4.2 | 2.4 | 3.2 | 3.2 | 1.8 |
| Federal | -9.1 | -10.6 | 10.5 | 6.8 | 2.2 | 4.4 | 4.0 | .1 |
| State and local | -.4 | 12.5 | 2.9 | 2.8 | 2.6 | 2.4 | 2.8 | 2.7 |
| Disposable personal income | 1.7 | 3.4 | 2.4 | 3.1 | 5.9 | 2.5 | 4.1 | 2.8 |
| <u>Current dollars</u> | | | | | | | | |
| Gross national product | 7.0 | 18.8 | 10.5 | 10.8 | 11.7 | 10.9 | 10.2 | 10.1 |
| Final purchases | 5.5 | 18.4 | 10.3 | 10.8 | 11.5 | 10.9 | 10.2 | 10.1 |
| Private | 6.2 | 20.8 | 9.9 | 10.0 | 12.1 | 11.2 | 10.3 | 10.0 |
| Excluding net exports | 7.6 | 17.2 | 9.6 | 9.4 | 12.4 | 10.9 | 9.6 | 9.4 |
| Personal consumption expenditures | 7.5 | 15.9 | 9.7 | 9.8 | 13.3 | 11.4 | 9.8 | 9.5 |
| Goods | 1.1 | 19.7 | 8.5 | 9.6 | 14.0 | 11.0 | 8.6 | 8.5 |
| Services | 15.4 | 11.6 | 11.1 | 9.9 | 12.5 | 11.9 | 11.1 | 10.7 |
| Gross private domestic investment | 18.6 | 24.6 | 10.4 | 8.6 | 10.0 | 8.9 | 8.8 | 9.0 |
| Residential structures | 1.8 | 21.5 | 1.9 | .0 | .0 | .0 | 1.9 | 3.8 |
| Business fixed investment | 11.5 | 23.5 | 12.6 | 12.0 | 12.6 | 12.8 | 12.2 | 11.5 |
| Gov't. purchases of goods and services | 2.8 | 10.0 | 11.7 | 13.6 | 9.3 | 9.5 | 9.7 | 10.6 |
| Federal | -2.6 | -7.0 | 14.6 | 20.8 | 8.4 | 9.2 | 9.8 | 12.3 |
| State and local | 6.1 | 20.8 | 10.2 | 9.8 | 9.9 | 9.6 | 9.7 | 9.7 |
| Disposable personal income | 10.3 | 12.9 | 9.5 | 9.9 | 14.4 | 10.0 | 11.0 | 9.6 |
| Personal income | 9.2 | 14.0 | 11.0 | 10.5 | 10.7 | 10.4 | 11.2 | 10.1 |
| Wage and salary disbursements | 12.0 | 16.4 | 8.4 | 10.1 | 12.3 | 10.0 | 9.5 | 10.5 |
| Corporate profits with IVA & C.C. Adj. | -41.8 | 83.8 | 22.3 | 16.1 | -10.0 | 15.4 | 8.6 | 7.2 |
| Corporate profits before tax | -13.6 | 60.1 | 9.1 | 11.8 | -7.1 | 13.1 | 7.9 | 6.6 |
| Nonfarm payroll employment | 4.5 | 6.6 | 1.9 | 1.7 | 2.6 | 2.3 | 2.4 | 2.3 |
| Manufacturing | 6.6 | 3.5 | 1.2 | 2.5 | 4.7 | 3.4 | 1.8 | 1.5 |
| Nonfarm business sector | | | | | | | | |
| Output per hour | -2.7 | 1.7 | 3.3 | 2.2 | 2.0 | 1.9 | 1.7 | 1.5 |
| Compensation per hour | 13.6 | 8.7 | 7.9 | 8.0 | 12.4 | 8.7 | 8.8 | 8.8 |
| Unit labor costs | 16.8 | 7.1 | 4.4 | 5.7 | 10.2 | 6.7 | 7.0 | 7.2 |
| GNP implicit deflator ^{1/} | 7.0 | 9.2 | 6.8 | 7.2 | 7.2 | 6.9 | 6.7 | 7.3 |
| Gross business product fixed-weighted price index ^{2/} | 6.2 | 9.7 | 7.1 | 6.7 | 7.9 | 7.5 | 6.8 | 6.9 |
| Industrial production | .9 | 12.0 | 4.6 | 6.2 | 7.2 | 5.6 | 4.2 | 3.6 |

Excluding Federal pay increases rates of change are: 1978 Q1, 6.9 per cent; 1978 QIV, 6.6 per cent; 1979 Q1, 7.2 per cent; 1979 QIV, 6.7 per cent.
Using expenditures in 1972 as weights.

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LASS II FOMCGROSS NATIONAL PRODUCT AND RELATED ITEMS
(Expenditures and income figures are billions of current dollars.)

| | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | Projected | |
|---|--------|--------|--------|--------|--------|--------|-----------|--------|
| | | | | | | | 1978 | 1979 |
| Gross national product | 1171.1 | 1306.6 | 1412.9 | 1528.8 | 1706.5 | 1889.6 | 2101.3 | 2339.9 |
| Final purchases | 1161.7 | 1288.6 | 1404.0 | 1540.3 | 1693.1 | 1871.4 | 2077.4 | 2311.1 |
| Private | 908.6 | 1019.1 | 1101.3 | 1201.4 | 1331.7 | 1476.4 | 1643.8 | 1831.5 |
| Excluding net exports | 911.9 | 1012.0 | 1095.3 | 1181.0 | 1323.9 | 1487.3 | 1657.9 | 1839.0 |
| Personal consumption expenditures | 733.0 | 809.9 | 889.6 | 980.4 | 1094.0 | 1211.2 | 1342.2 | 1493.7 |
| Goods | 410.5 | 457.5 | 498.3 | 542.2 | 601.6 | 660.5 | 723.3 | 804.4 |
| Services | 322.4 | 352.3 | 391.3 | 438.2 | 492.3 | 550.7 | 618.9 | 689.3 |
| Gross private domestic investment | 188.3 | 220.0 | 214.6 | 189.1 | 243.3 | 294.2 | 339.6 | 374.1 |
| Residential construction | 62.0 | 66.1 | 55.1 | 51.5 | 68.0 | 91.0 | 104.1 | 106.1 |
| Business fixed investment | 116.8 | 136.0 | 150.6 | 149.1 | 161.9 | 185.1 | 211.6 | 239.2 |
| Change in business inventories | 9.4 | 17.9 | 8.9 | -11.5 | 13.3 | 18.2 | 23.9 | 28.9 |
| Nonfarm | 8.8 | 14.7 | 10.8 | -15.1 | 14.9 | 17.1 | 23.7 | 28.9 |
| Net exports of goods and services ^{1/} | -3.3 | 7.1 | 6.0 | 20.4 | 7.8 | -10.9 | -14.1 | -7.5 |
| Exports | 72.7 | 101.6 | 137.9 | 147.3 | 162.9 | 174.7 | 199.3 | 237.2 |
| Imports | 75.9 | 94.4 | 131.9 | 126.9 | 155.1 | 185.6 | 213.4 | 244.7 |
| Gov't. purchases of goods and services | 253.1 | 269.5 | 302.7 | 338.9 | 361.4 | 395.0 | 433.6 | 479.6 |
| Federal ^{2/} | 102.1 | 102.2 | 111.1 | 123.3 | 130.1 | 145.4 | 155.2 | 172.0 |
| State and local | 151.0 | 167.3 | 191.5 | 215.6 | 231.2 | 249.6 | 278.5 | 307.5 |
| Gross national product in constant (1972) dollars | 1171.1 | 1235.0 | 1217.8 | 1202.1 | 1274.7 | 1337.3 | 1391.1 | 1446.0 |
| Personal income | 942.5 | 1052.4 | 1154.9 | 1253.4 | 1382.7 | 1536.7 | 1713.1 | 1899.0 |
| Wage and salary disbursements | 633.8 | 701.3 | 764.6 | 805.7 | 891.8 | 990.0 | 1107.4 | 1226.1 |
| Disposable personal income | 801.3 | 901.7 | 984.6 | 1084.4 | 1185.8 | 1309.2 | 1459.7 | 1623.9 |
| Saving rate (per cent) | 6.2 | 7.8 | 7.3 | 7.4 | 5.6 | 5.1 | 5.6 | 5.6 |
| Corporate profits with I.V.A. and C.C. Adj. | 92.1 | 99.1 | 83.6 | 99.3 | 128.1 | 139.9 | 147.4 | 163.3 |
| Corporate profits before tax | 96.2 | 115.8 | 126.9 | 123.5 | 156.9 | 171.7 | 191.5 | 207.0 |
| Federal government surplus or deficit (N.I.A. basis) | -17.3 | -6.7 | -10.7 | -70.2 | -54.0 | -49.5 | -40.8 | -35.6 |
| High employment surplus or deficit (-) | -5.9 | -7 | 17.1 | -20.3 | -10.4 | -8.7 | -2 | 8.2 |
| State and local government surplus or deficit (-) (N.I.A. basis) | 13.7 | 13.0 | 7.5 | 5.9 | 18.4 | 29.2 | 29.4 | 21.1 |
| Excluding social insurance funds | 5.6 | 4.1 | -2.9 | -6.2 | 3.9 | 13.7 | 12.7 | 2.3 |
| Civilian labor force (millions) | 86.5 | 88.7 | 91.0 | 92.6 | 94.8 | 97.4 | 100.5 | 102.9 |
| Unemployment rate (per cent) | 5.6 | 4.9 | 5.6 | 8.5 | 7.7 | 7.0 | 5.9 | 5.8 |
| Nonfarm payroll employment (millions) | 73.7 | 76.9 | 78.4 | 77.1 | 79.4 | 82.1 | 85.4 | 87.6 |
| Manufacturing | 19.1 | 20.1 | 20.0 | 18.3 | 19.0 | 19.6 | 20.3 | 20.9 |
| Industrial production (1967=100) | 119.7 | 129.8 | 129.3 | 117.8 | 129.8 | 137.1 | 144.0 | 152.6 |
| Capacity utilization: all manufacturing (per cent) | 83.1 | 87.5 | 84.2 | 73.6 | 80.2 | 82.4 | 83.4 | 85.2 |
| Materials (per cent) | 88.0 | 92.4 | 87.7 | 73.6 | 80.4 | 81.9 | 83.6 | 86.3 |
| Housing starts, private (million units, A.R.) | 2.36 | 2.05 | 1.34 | 1.16 | 1.54 | 1.99 | 1.85 | 1.71 |
| New auto sales, (millions, A.R.) | 10.93 | 11.42 | 8.91 | 8.66 | 10.12 | 11.13 | 11.22 | 10.72 |
| Domestic models | 9.32 | 9.65 | 7.49 | 7.08 | 8.63 | 9.07 | 9.23 | 8.89 |
| Foreign models | 1.61 | 1.77 | 1.42 | 1.58 | 1.50 | 2.06 | 1.99 | 1.84 |

^{1/} Balance of payments data and details underlying these estimates are shown in the International Developments section of this part of the Greenbook.

^{2/} Components of purchases and total receipts and total expenditures are shown in the Federal Sector Accounts table which follows.

CONFIDENTIAL - FR
LASS II FOMCPER CENT CHANGES IN GROSS NATIONAL PRODUCT
AND RELATED ITEMS

July 12, 1978

| | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | Projected | |
|---|------|------|-------|-------|------|------|-----------|------|
| | | | | | | | 1978 | 1979 |
| <u>Constant (1972) dollars</u> | | | | | | | | |
| Gross national product | 5.7 | 5.5 | -1.4 | -1.3 | 6.0 | 4.9 | 4.0 | 3.9 |
| Final purchases | 5.5 | 4.9 | -.7 | .2 | 4.5 | 4.7 | 3.7 | 3.7 |
| Private | 6.7 | 6.3 | -1.4 | -.3 | 5.6 | 5.3 | 3.9 | 3.8 |
| Excluding net exports | 7.0 | 5.1 | -2.3 | -1.0 | 6.4 | 6.0 | 4.0 | 3.4 |
| Personal consumption expenditures | 5.9 | 4.7 | -.9 | 1.9 | 6.0 | 4.9 | 3.6 | 3.8 |
| Goods | 6.5 | 5.0 | -3.4 | .9 | 6.9 | 5.1 | 2.9 | 4.0 |
| Services | 5.3 | 4.4 | 2.3 | 3.0 | 4.9 | 4.6 | 4.5 | 3.5 |
| Gross private domestic investment | 12.9 | 10.0 | -11.4 | -22.9 | 22.2 | 13.0 | 8.1 | 3.4 |
| Residential structures | 18.8 | -3.7 | -24.6 | -13.8 | 22.9 | 19.3 | 5.1 | -6.0 |
| Business fixed investment | 8.1 | 12.2 | -.3 | -13.7 | 3.6 | 8.6 | 6.2 | 5.3 |
| Gov't. purchases of goods and services | 1.5 | -.2 | 2.1 | 2.1 | .5 | 2.5 | 2.8 | 3.4 |
| Federal | -1.7 | -5.4 | -.8 | .9 | -.2 | 5.1 | -.1 | 3.7 |
| State and local | 3.8 | 3.2 | 3.8 | 2.8 | 1.0 | 1.1 | 4.5 | 3.3 |
| Disposable personal income | 4.2 | 6.7 | -1.5 | 1.8 | 3.8 | 4.6 | 4.3 | 3.7 |
| <u>Current dollars</u> | | | | | | | | |
| Gross national product | 10.1 | 11.6 | 8.1 | 8.2 | 11.6 | 10.7 | 11.2 | 11.4 |
| Final purchases | 9.9 | 10.9 | 8.9 | 9.7 | 9.9 | 10.5 | 11.0 | 11.2 |
| Private | 10.3 | 12.2 | 8.0 | 9.1 | 10.8 | 10.9 | 11.3 | 11.4 |
| Excluding net exports | 11.0 | 11.0 | 8.2 | 7.8 | 12.1 | 12.3 | 11.5 | 10.9 |
| Personal consumption expenditures | 9.7 | 10.5 | 9.8 | 10.2 | 11.6 | 10.7 | 10.8 | 11.3 |
| Goods | 9.5 | 11.4 | 8.9 | 8.8 | 11.0 | 9.8 | 9.5 | 11.2 |
| Services | 9.9 | 9.3 | 11.1 | 12.0 | 12.3 | 11.9 | 12.4 | 11.4 |
| Gross private domestic investment | 17.7 | 16.8 | -2.5 | -11.9 | 28.7 | 20.9 | 15.4 | 10.2 |
| Residential structures | 25.0 | 6.6 | -16.6 | -6.5 | 32.0 | 33.8 | 14.4 | 1.9 |
| Business fixed investment | 12.2 | 16.4 | 10.7 | -1.0 | 8.6 | 14.3 | 14.3 | 13.0 |
| Gov't. purchases of goods and services | 8.3 | 6.5 | 12.3 | 12.0 | 6.6 | 9.3 | 9.8 | 10.6 |
| Federal | 6.1 | .1 | 8.7 | 11.0 | 5.5 | 11.8 | 6.7 | 10.9 |
| State and local | 9.8 | 10.8 | 14.5 | 12.6 | 7.2 | 8.0 | 11.6 | 10.4 |
| Disposable personal income | 7.9 | 12.5 | 9.2 | 10.1 | 9.4 | 10.4 | 11.5 | 11.3 |
| Personal income | 9.7 | 11.7 | 9.7 | 8.5 | 10.3 | 11.1 | 11.5 | 10.9 |
| Wage and salary disbursements | 9.4 | 10.6 | 9.0 | 5.4 | 10.7 | 11.0 | 11.9 | 10.7 |
| Corporate profits with IVA & C.C. Adj. | 19.3 | 7.6 | -15.6 | 18.8 | 29.0 | 9.1 | 5.4 | 10.8 |
| Corporate profits before tax | 17.3 | 20.4 | 9.6 | -2.7 | 27.0 | 9.4 | 11.5 | 8.1 |
| Nonfarm payroll employment | 3.5 | 4.3 | 2.0 | -1.7 | 3.1 | 3.4 | 4.0 | 2.5 |
| Manufacturing | 2.8 | 5.1 | -.1 | -8.5 | 3.3 | 3.2 | 3.6 | 2.9 |
| Nonfarm business sector | | | | | | | | |
| Output per hour | 3.0 | 1.7 | -2.9 | 1.6 | 4.1 | 2.2 | 1.1 | 2.1 |
| Compensation per hour | 5.8 | 7.8 | 9.4 | 9.6 | 8.7 | 8.8 | 9.4 | 9.4 |
| Unit labor costs | 2.7 | 6.0 | 12.7 | 7.9 | 4.5 | 6.4 | 8.2 | 7.2 |
| GNP implicit deflator | 4.1 | 5.9 | 9.7 | 9.6 | 5.3 | 5.5 | 6.9 | 7.1 |
| Gross business product fixed-weighted price index ^{1/} | 3.3 | 5.7 | 10.3 | 9.5 | 5.5 | 5.9 | 6.6 | 7.4 |
| Industrial production | 9.2 | 8.4 | -.4 | -8.9 | 10.2 | 5.6 | 5.0 | 6.0 |

^{1/} Using expenditures in 1972 as weights.

FEDERAL SECTOR ACCOUNTS
(billions of dollars)

July 12, 1978

| | Fiscal Year 1977* | F.R. staff estimates | | | | | | | | | | | | | | | |
|---|-------------------------|----------------------|---------------------|-------------|---------------|-------------|---------------------|-------------------------|---|-------|-------|-------|-------|----------------|-------|-------|--|
| | | FY78e/ | | FY79e/ | | | CY 1977* | CY78e/ F.R. Board | Calendar quarters; unadjusted data | | | | | | | | |
| | | Admn. 1/ | F.R. Board | Admn. 1/ | F.R. Board | Cong. 2/ | | | 1977 | | | 1978 | | | 1979 | | |
| | | | | | | | IV* | I* | II | III | IV | I | II | III | | | |
| Unified budget receipts 3/ | 357.8 | 401.2 | 400.0 | 448.2 | 448.4 | 447.9 | 366.1 | 412.8 | 84.5 | 85.4 | 124.2 | 105.9 | 97.3 | 98.3 | 136.3 | 116.5 | |
| Unified budget outlays 3/ | 402.8 | 452.3 | 449.7 | 496.6 | 495.0 | 498.8 | 417.0 | 458.4 | 113.3 | 111.2 | 110.6 | 114.6 | 122.0 | 120.5 | 123.7 | 128.8 | |
| Surplus(+)/Deficit(-), unified budget | -45.0 | -51.1 | -49.7 | -48.5 | -46.6 | -50.9 | -50.9 | -45.6 | -28.8 | -25.8 | 13.6 | -8.7 | -24.7 | -22.2 | 12.6 | -12.3 | |
| Surplus(+)/Deficit(-), off-budget agencies 4/ | -8.7 | -11.0 | -10.9 | -12.9 | -12.7 | n.a. | -10.4 | -10.6 | -1.3 | -3.6 | -2.4 | -3.6 | -1.0 | -3.9 | -3.2 | -4.6 | |
| Means of financing combined deficits: | | | | | | | | | | | | | | | | | |
| Net borrowing from public | 53.5 | 54.9 | 53.3 | 62.0 | 59.3 | n.a. | 56.8 | 54.7 | 20.7 ^{8/} | 20.8 | 2.5 | 9.3 | 22.1 | 25.1 | -7.5 | 19.6 | |
| Decrease in cash operating balance | -1.7 | 4.0 | 5.1 | 0 | 2.0 | n.a. | -0.6 | 0.3 | 6.8 ^{8/} | 5.9 | -11.1 | 3.5 | 2.0 | 0 | 0 | 0 | |
| Other 5/ | 1.9 | 3.2 | 2.2 | -0.6 | -2.0 | n.a. | 5.3 | 1.2 | 2.6 | 2.8 | -2.7 | -0.5 | 1.6 | 1.0 | -1.9 | -2.7 | |
| Cash operating balance, end of period | 19.1 | 15.1 | 14.0 | 15.1 | 12.0 | n.a. | 12.3 | 12.0 | 12.3 | 6.4 | 17.5 | 14.0 | 12.0 | 12.0 | 12.0 | 12.0 | |
| Memo: Sponsored agency borrowing 6/ | 5.2 | n.a. | 18.9 | n.a. | 12.3 | n.a. | 6.8 | 20.2 | 2.0 | 4.5 | 6.2 | 6.2 | 3.0 | 1.0 | 3.5 | 4.5 | |
| NIA Budget | | | | | | | | | Seasonally adjusted annual rates | | | | | | | | |
| Receipts | 361.9 ^{9/} | n.a. | 406.3 ^{9/} | n.a. | 460.3 | n.a. | 373.9 | 423.2 | 386.3 | 395.3 | 417.4 | 433.4 | 446.6 | 453.8 | 467.7 | 480.6 | |
| Expenditures | 411.9 | n.a. | 455.0 | n.a. | 498.1 | n.a. | 423.4 | 464.0 | 446.3 | 451.1 | 452.8 | 469.7 | 482.3 | 491.8 | 501.9 | 516.4 | |
| Purchases (total) | 140.6 | n.a. | 152.9 | n.a. | 168.0 | n.a. | 145.5 | 155.2 | 153.8 | 152.7 | 150.0 | 155.2 | 162.7 | 166.0 | 169.7 | 173.7 | |
| Defense | 91.8 | n.a. | 100.0 | n.a. | 107.2 | n.a. | 94.3 | 101.6 | 98.5 | 99.5 | 100.6 | 101.6 | 104.6 | 105.6 | 108.1 | 110.5 | |
| Non-defense | 48.8 | n.a. | 52.9 | n.a. | 60.8 | n.a. | 51.2 | 53.6 | 55.3 | 53.2 | 49.4 | 53.6 | 58.1 | 60.4 | 61.6 | 63.2 | |
| All other expenditures | 271.4 ^{9/} | n.a. | 302.1 | n.a. | 330.1 | n.a. | 278.0 | 308.8 | 292.5 | 298.4 | 302.8 | 314.5 | 319.6 | 325.8 | 332.2 | 342.7 | |
| Surplus(+)/Deficit(-) | -50.0 ^{9/} | n.a. | -48.7 ^{9/} | n.a. | -37.8 | n.a. | -49.5 | -40.8 | -60.0 | -55.8 | -35.4 | -36.3 | -35.7 | -38.0 | -34.2 | -35.8 | |
| High Employment Surplus(+)/Deficit(-) (NIA basis) 7/ | -5.0 | n.a. | -7.2 | n.a. | 6.1 | n.a. | -8.7 | -0.2 | -22.1 | -9.9 | 1.7 | 1.7 | 5.9 | 3.0 | 7.4 | 8.1 | |
| | | *actual | e--estimated | r--revised | | | n.a.--not available | | | | | | | p--preliminary | | | |

1/ OMB Mid-Session Review of the 1979 Budget, (July 6, 1978).

2/ Congress' First Concurrent Resolution on the Budget, (May 17, 1978).

3/ Adjusted for accounting change in earned income credit payments--formerly treated as income tax refunds and now classified as outlays.

4/ Includes Federal Financing Bank, Postal Service, U.S. Railway Association, Rural Electrification and Telephone Revolving fund, Housing for the Elderly or Handicapped Fund (until October 1977), and Pension Benefit Guaranty Corporation.

5/ Checks issued less checks paid, accrued items and other transactions.

6/ Includes Federal Home Loan Banks, FNMA, Federal Land Banks, Federal Intermediate Credit Banks, and Banks for Cooperatives.

7/ Estimated by F. R. B. staff.

8/ Includes \$2.5 billion of borrowing from the Federal Reserve on September 30 which was repaid October 4.

9/ Quarterly average exceeds fiscal year total by \$1.7 billion for FY 1977, by \$1.8 billion for FY 1978 and by \$1.9 billion for FY 1979 due to spreading of wage base effect over calendar year.

Comments on the Fiscal Policy Outlook

This month's fiscal policy assumptions include a lower level of Federal spending during the current quarter and the year ahead. For fiscal year 1978, the staff now projects outlays at \$450 billion, about \$2-3 billion below last month's forecast and the Administration's most recent estimate. Higher farm prices, which encourage farmers to repay Commodity Credit Corporation loans, are responsible for most of this month's reduction.^{1/} Incoming data also suggest that spending will be lower than expected for highway, waste treatment and Medicaid grants. The receipts forecast remains unchanged at around \$400 billion, and the resulting deficit is now projected at \$50 billion, about \$11 billion below the President's January budget estimate.

Some additional spending shortfalls--perhaps \$5 to \$6 billion from the Administration's current forecast (\$496.6 billion)--are likely to occur once again in fiscal year 1979. These anticipated reductions are partially offset--in the staff's forecast--by adjustments for higher projected interest rates and for new Congressional spending initiatives.^{2/} As a result, spending in fiscal year 1979, is now expected to total around \$495 billion. The receipts forecast continues

^{1/} These loan repayments are treated as negative outlays in the budget.

^{2/} The Mid-Session Budget Review assumed a constant 6.5 per cent bill rate for fiscal years 1978 and 1979.

to assume passage of a \$19 billion tax reduction (annual rate), and is essentially unchanged from last month at \$448 billion.^{1/} The resulting deficit for fiscal year 1979 is now expected to be \$47 billion, while the total deficit to be financed (unified plus off-budget) is projected at \$59 billion.

Even though the expected outlay shortfalls have reduced the deficits for fiscal years 1978 and 1979, Treasury financing requirements are likely to be heavy during the next six months. The staff projects that borrowing from the public will total around \$9-1/2 billion in the third quarter (\$7 billion marketable and \$2-1/2 billion nonmarketable) and \$22 billion in the fourth quarter (\$19 billion marketable and \$3 billion nonmarketable). This forecast assumes that the Treasury will meet \$5-1/2 billion of its borrowing requirements by drawing down its large \$17-1/2 billion cash balance over the remainder of calendar year 1978.

The full employment budget now shows a \$13 billion shift toward surplus between fiscal years 1978 and 1979.

^{1/} The staff has moved the starting date of the crude oil equalization tax forward from October 1, 1978 to January 1, 1979 in order to be consistent with the date assumed by the Administration in its Mid-Session Budget Review.

DOMESTIC FINANCIAL DEVELOPMENTS

Summary. Market rates of interest have risen further since mid-June. The Federal funds rate advanced 1/4 point to 7-3/4 per cent immediately after the last FOMC meeting; increases for most other short- and long-term security yields have ranged between 1/8 and 1/4 percentage point, the major exception being the 3-month bill rate which has risen almost 1/2 point.

M-1 expansion slowed to an annual rate of 5-1/2 per cent in June, probably in part because of the transitory effect of a sharp rise in Treasury cash balances at the mid-month tax date. Growth in M-2 equaled and that in M-3 slightly exceeded May's moderate rates, however, as inflows to interest-bearing deposits included in these broader aggregates picked up. At commercial banks, savings deposits declined absolutely in June, but growth of time deposits other than large negotiable CDs increased markedly. On balance, deposits subject to Regulation Q are estimated to have grown at about the same pace as in May, suggesting that the new 6-month certificates enabled banks to retain funds in the face of rising market yields, but not to increase inflows. In contrast, deposit growth at savings and loan associations and mutual savings banks increased noticeably in June, indicating that thrift institutions were able to use the new certificates to greater effect.

Managed liabilities of commercial banks grew moderately in June as bank credit demand slackened; most notably, business loans posted only a small advance following the outsized gain in May. Over

the second quarter as a whole, however, total loans and investments registered the largest gain since 1974, led by a 19 per cent (SAAR) increase in business loans.

Over-all business financing demands appear to have remained strong in June. Commercial paper issued by nonfinancial companies grew sharply, and a record increase in finance company paper during June, as well as continued sizable bond issuance by these firms, suggests that growth of short- and intermediate-term business credit at finance companies also remained substantial. Public bond offerings of non-financial corporations in June roughly matched the moderate pace of earlier months of 1978, while stock issuance rose more than seasonally. Over the course of the second quarter, the ratio of short- to long-term business debt appears to have risen a bit further, and the ratio of liquid assets to current liabilities is estimated to have moved still lower.

Available information indicates little, if any, abatement recently in total household borrowing. Consumer instalment credit expanded in May at an annual rate on the order of 20 per cent for the third consecutive month, and data for large banks suggest continued strength in June. Mortgage debt formation probably also was well maintained as FNMA again acquired a large volume of loans and S&Ls tapped the Home Loan Banks for lendable funds. S&Ls have brought their commitment positions into somewhat more comfortable alignment with their cash flows, and the FHLBB continues to pursue a liberal advance policy.

Against this backdrop, there have been signs of some stabilization in mortgage credit conditions in recent weeks; interest rates on new S&L loan commitments have leveled off, as has the percentage of associations reporting lendable funds in short supply. The ceiling rate on FHA/VA home mortgages was raised 1/2 point to 9-1/2 per cent, effective June 28, thereby cutting loan discounts to more manageable levels.

The Treasury has redeemed \$5.5 billion, net, of bills since the last FOMC meeting; however, sales of notes and bonds have offset about half of this debt reduction and held the Treasury's cash balance at a high level. Long-term debt offerings by State and local governments declined in June from the exceptionally high May volume, owing to a sharp drop in advance refundings.

Outlook. Credit demands during the next few months are not likely to be significantly stronger than during the first half of this year. Nonetheless, declining liquidity of key lenders suggests further upward pressures on interest rates. Such pressures may become increasingly evident by the fall, when a further significant tightening of System policy may be needed to restrain monetary expansion.

In the business sector, internal cash flows are projected to rise during the second half of 1978 in step with the moderate growth of inventory and fixed investment, leaving the corporate financing gap little changed. Nonfinancial firms may fund in the bond markets some of their short-term debt, but business loan demand probably will remain

strong enough to place continued liquidity pressures on commercial banks. Further firming of bank lending policies therefore may occur.

Consumer instalment credit expansion may slow a bit as purchases of autos and other durable goods slacken from the accelerated second quarter pace. In the mortgage market, field reports suggest that interest rates of 10 per cent and higher are causing some potential home buyers to hesitate, but loan demand by and large is still strong. Thus, although the staff has raised its estimate of the effect of the new 6-month accounts on deposit flows and this implies a little less deterioration of S&L liquidity, mortgage rates and nonprice terms still are likely to tighten gradually.

Federally sponsored credit agencies will remain heavy borrowers as they provide sizable support to the residential mortgage market. The agencies will encounter increased competition from the Treasury, reflecting the seasonal swing of the Federal budget into deficit in the second half of the year. Because it will be able to run down its high mid-year cash balance, the Treasury is projected to raise only about \$9 billion of new cash in the third quarter; however, fourth quarter cash needs may exceed \$22 billion. State and local governments are expected to run a smaller surplus in the second half, and their reduced acquisition of financial assets will contribute marginally to increased credit market pressures.

INTERNATIONAL DEVELOPMENTS

Summary. The weighted-average exchange rate of the dollar has fallen further by over 2 per cent in the past four weeks, continuing the decline that began at the end of May. The average exchange value of the dollar has fallen below its previous year low of the end of March, and about 9 per cent below its level of last September. The renewed exchange market pressures over the past month were most intense against the yen, which has appreciated by 6-1/2 per cent over this period, the Swiss franc, and the French franc; however, except for the Canadian dollar, all other major currencies have appreciated against the dollar.

The main underlying factors depressing dollar exchange rates over the past month were heightened concern over (a) the prospect of a high U.S. inflation rate relative to those abroad and (b) the persistence of extremely large Japanese and German current-account surpluses at a time when the U.S. deficit remains high. In addition, selling pressure on the dollar, particularly against some EC currencies, intensified in reaction to the focus on developing closer monetary cooperation in the EC at the July 6-7 Bremen Summit, as well as expectations that no agreement will be reached on measures that would help to strengthen the dollar at the July 16-17 Bonn Summit.

. The Desk occasionally entered the market to sell small amounts of German marks and Swiss francs during

the past month to moderate exchange-rate movements. Over the period as a whole, the System made net purchases of over \$370 million equivalent of marks, most of which were acquired directly from the Bundesbank, enabling the System to reduce its outstanding swap obligations to about \$910 million.

The U.S. trade deficit declined in May to an annual rate of less than \$32 billion. The April-May average of less than \$35 billion was down substantially from the very high first-quarter rate of \$45 billion. The decline in the deficit in April-May reflected a relatively strong advance in exports, particularly of agricultural goods, and a smaller increase in imports.

Foreign official assets in the United States (excluding OPEC holdings) increased by only \$200 million in May, and preliminary estimates indicate little further change in June. For the second quarter as a whole, foreign official assets declined by about \$2.5 billion, a significant reversal of the large increases over the past year.

• However, in the first ten days of July, foreign holdings at the Federal Reserve Bank of New York increased by \$700 million

•
OPEC banking and security holdings in the United States fell by \$1.5 billion in May. Preliminary data for June indicate a further \$500 million reduction. The decline in OPEC holdings is related to a tightening

of liquidity positions of several OPEC members. The OPEC current-account surplus has been declining rapidly since mid-1977 as OPEC imports have continued to rise while oil revenues initially stabilized and subsequently declined. The OPEC current-account surplus in the first half of this year is estimated to have been almost halved from a high level of \$20 billion in the first half of 1977.

The shift to a net outflow of officially-held funds by both OPEC and non-OPEC countries in the second quarter of 1978 was offset by sizable net private capital inflows of private bank-reported and securities transactions. In April-May U.S. banking offices raised about \$4.5 billion for their domestic operations from the private sector, primarily through inflows from their foreign affiliates.

Economic expansion abroad shows little evidence of sustained strength. Industrial production in Japan has advanced for seven consecutive months, but only at a sluggish pace in April and May. German industrial output figures have moved erratically, with substantial monthly advances followed by declines. German industrial production in May remained at the level recorded in October 1977.

Outlook. The U.S. trade deficit is expected to continue in the range of \$33-36 billion at an annual rate through the end of next year. The staff is projecting a trade deficit of \$37 billion for 1978 and \$35 billion for next year. The corresponding deficits for the current account (including net reinvested earnings) are \$22 and \$18 billion. (See Appendix A in Part II for description of revision of current-account series.) We expect the following factors to continue

influencing U.S. trade flows over the projection period: a U.S. real GNP growth rate slightly lower than the average real GNP growth being projected for major foreign countries; the increasing effects of the depreciation of about 9 per cent in the average value of the dollar since the end of last September; and effects of various U.S. and foreign government commercial policy measures designed to influence U.S. imports and exports, such as the "trigger price mechanism" for imported steel and Japanese efforts to curtail the volume of selected Japanese exports to the United States.

The staff's projection for the U.S. trade deficit over the next six quarters envisions less of a turnaround in the U.S. trade position than what appears to be expected by most market participants. Moreover, we expect the trade surpluses of Germany and Japan to persist at least for the immediate future. In addition, it appears that the U.S. inflation rate will continue to be higher than the average rate for major foreign countries. The staff, therefore, expects some further decline in the value of the dollar in the months ahead.

July 12, 1978

| | 1977 ^r | 1978 ^p | 1979 ^p | 1978 | | | | 1979 ^p | | | |
|---|-------------------|-------------------|-------------------|---------|-----------------|------------------|-----------------|-------------------|--------|--------|--------|
| | | | | I | II ^p | III ^p | IV ^p | I | II | III | IV |
| 1. GNP NET EXPORTS - Intl Acct. data | -11.1 | -14.5 | -7.7 | -24.0 | -12.7 | -11.6 | -9.4 | -10.7 | -9.6 | -6.7 | -4.3 |
| 2. (GNP net exports - GNP Acct. data) <u>1/</u> | (-10.9) | (-14.1) | (-7.5) | (-23.7) | (-12.4) | (-11.3) | (-9.1) | (-10.4) | (-9.3) | (-6.4) | (-4.0) |
| 3. a) Merchandise Trade Balance | -31.1 | -37.3 | -34.9 | -44.8 | -35.1 | -35.2 | -33.8 | -36.7 | -36.5 | -34.3 | -32.5 |
| 4. Exports (excl. military) | 120.6 | 136.9 | 164.3 | 122.7 | 137.6 | 139.8 | 147.5 | 153.8 | 160.9 | 167.6 | 174.7 |
| 5. Agricultural | 24.4 | 28.2 | 29.3 | 26.1 | 31.6 | 27.0 | 28.3 | 28.5 | 29.0 | 29.5 | 30.0 |
| 6. Nonagricultural | 96.2 | 108.7 | 135.0 | 96.6 | 106.0 | 112.8 | 119.2 | 125.3 | 131.9 | 138.1 | 144.7 |
| 7. Imports | 151.6 | 174.2 | 199.2 | 167.5 | 172.7 | 175.0 | 181.3 | 190.5 | 197.4 | 201.9 | 207.2 |
| 8. Petroleum and petrol. products | 45.0 | 43.7 | 50.2 | 39.8 | 42.7 | 44.4 | 47.8 | 49.2 | 50.7 | 50.2 | 50.9 |
| 9. Nonpetroleum | 106.7 | 130.5 | 149.0 | 127.7 | 130.0 | 130.6 | 133.5 | 141.3 | 146.7 | 151.7 | 156.3 |
| 10. b) Military transactions, net <u>2/</u> | .9 | 1.5 | 3.1 | .8 | 1.4 | 1.8 | 2.1 | 2.5 | 2.9 | 3.3 | 3.7 |
| 11. c) Investment income, net <u>3/</u> | 17.3 | 19.5 | 21.7 | 18.2 | 19.2 | 20.1 | 20.4 | 21.4 | 21.6 | 21.8 | 21.9 |
| 12. d) Other services, net <u>4/</u> | 1.7 | 1.8 | 2.4 | 1.7 | 1.7 | 1.8 | 1.9 | 2.1 | 2.4 | 2.5 | 2.6 |
| 13. U.S. CURRENT ACCOUNT BALANCE | -15.2 | -21.5 | -18.3 | -27.8 | -20.2 | -19.4 | -18.6 | -21.1 | -20.2 | -17.3 | -14.8 |
| 14. a) GNP net exports (line 1.) | -11.1 | -14.5 | -7.7 | -24.0 | -12.7 | -11.6 | -9.4 | -10.7 | -9.6 | -6.7 | -4.3 |
| 15. b) U.S. Govt & private transfers <u>5/</u> | -4.1 | -7.0 | -10.6 | -3.8 | -7.5 | -7.8 | -9.2 | -10.4 | -10.6 | -10.6 | -10.5 |
| Constant (1972) dollars | | | | | | | | | | | |
| 16. Merchandise exports (excl. military) | 67.0 | 69.5 | 76.7 | 65.7 | 69.9 | 70.0 | 72.4 | 74.2 | 76.0 | 77.5 | 79.1 |
| 17. (% change, annual rates) | (0.3) | (3.7) | (10.3) | (4.1) | (28.2) | (0.4) | (14.8) | (10.0) | (10.4) | (8.2) | (8.2) |
| 18. Merchandise imports | 71.0 | 75.5 | 79.9 | 74.5 | 75.7 | 75.2 | 76.5 | 78.3 | 79.7 | 80.3 | 81.3 |
| 19. (% change, annual rates) | (13.0) | (6.3) | (5.8) | (7.4) | (6.1) | (-2.4) | (7.0) | (10.0) | (7.0) | (3.3) | (5.3) |
| Foreign Outlook - Major Industrial Countries <u>6/</u> | | | | | | | | | | | |
| 20. Real GNP, % change, annual rates | 3.0 | 3.7 | 4.5 | 4.9 | 4.4 | 4.0 | 4.1 | 5.0 | 4.7 | 4.6 | 4.9 |
| 21. Wholesale Prices, % change, A.R. <u>7/</u> | 8.7 | 5.2 | 6.3 | 5.3 | 6.9 | 6.1 | 6.1 | 6.0 | 6.0 | 7.0 | 7.3 |

1/ Differs from Intl. Acct. data (line 1) in the inclusion of revisions and new data.

2/ Excludes grants to Israel under military assistance acts and exports financed by those grants.

3/ Excludes U.S. Govt. interest payments to foreigners, and reinvested earnings of incorporated affiliates which are included in line 15.

4/ Includes travel, transportation, fees and royalties, and miscellaneous other service transactions.

5/ Includes U.S. Govt. grants, U.S. Govt. interest payments to foreigners, remittances and pensions, and exports to Israel financed by U.S. military assistance grants, and reinvested earnings of incorporated affiliates.

6/ Weighted by the shares of Canada, France, Germany, Italy, Japan and the United Kingdom in the sum of the real GNP of the six countries in dollar terms.

7/ Data are largely manufactured goods prices.

p/ Projected.

e/ Estimated.

r/ Published data.

NOTE: The current account now includes reinvested earnings of incorporated affiliates.