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Strictly Confidential (FR) Class II FOMC

August 12, 1987

SUMMARY AND OUTLOOK

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

Recent developments. Economic activity continued to expand at a moderate pace around midyear, with manufacturing showing increased vigor. The unemployment rate fell further. Price increases in recent months, while still appreciable, have been somewhat smaller than in the early part of the year, and wage inflation has held at about the same pace as in 1986.

Industrial production rose 0.2 percent in June, and preliminary indications point to a large increase in July. The June increase reflected a third month of healthy gains in materials output. Production also rose for home goods and several categories of business equipment, but declined for motor vehicles. Labor market data for July suggest that output increased that month in a broad range of durable and nondurable goods industries, and other indicators show sharp advances in steel production and oil and gas drilling. However, auto assemblies were down for a fifth month.

Payroll employment rose 300,000 in July, after two months of slower growth. Hiring remained strong in services, and manufacturing employment recorded its largest monthly gain in three years. Construction employment, which had declined on net in the second quarter, was little changed in July. Household employment surged in July, and the civilian unemployment rate edged down 0.1 percentage point to 6.0 percent, bringing the cumulative decline so far this year to 0.7 of a percentage point.

Consumer spending has been sluggish this year. After declining slightly in the first quarter, real outlays rose only 2 percent at an annual rate in the second quarter, compared with gains of more than 4 percent in both 1985 and 1986. Sales of motor vehicles rebounded some in the second quarter and spending for consumer services rose appreciably, but outlays for nondurables are estimated to have slumped. In July, sales of domestically produced cars remained at the second-quarter average, and sales of foreign cars moved up slightly; expanded incentive programs announced by automakers in early August appear likely to boost sales of domestic makes over the balance of the quarter. Personal disposable income, in nominal terms, rose at an annual rate of about 6-1/2 percent from December to June; but with consumer prices accelerating, the gain in real income over the period was small.

Housing activity weakened in the second quarter in response to the spring runup in mortgage interest rates and the continued depressing effect of high vacancy rates on multifamily construction. However, by June, the decline appeared to be abating. Sales of new homes and building permits were essentially unchanged in that month, and total housing starts were down only slightly from the May level.

Capital spending appears to be strengthening, especially for equipment. After a steep tax-related decline in the first quarter of 1987, real outlays for producers' durables rose at an annual rate of about 11-1/2 percent in the second quarter; and the recent data on new orders, while probably reflecting in part increased demand from abroad, also seem to indicate further gains in domestic equipment spending in the period ahead. Outlays for nonresidential construction were little changed in the second quarter after sharp declines over most of the preceding two years; although office building continued to fall, spending was firm in most other sectors, especially petroleum drilling, which rose for a third consecutive quarter.

The second-quarter data on nonfarm inventories, which still are incomplete, currently point to a slower rate of stockpiling than in the first quarter, as auto dealers' inventories leveled off after a rapid first-quarter accumulation. Stockbuilding at nonauto trade establishments picked up fairly sharply in April and May; nevertheless, there was no evidence of serious inventory imbalances. In manufacturing, inventories increased a bit in the second quarter, but at the end of June, the sector's ratio of inventories to sales (measured at current cost) fell to the lowest level of the current expansion.

Increases in consumer prices have slowed a little in recent months but continue to run well above the 1986 pace. The recent slowdown has been concentrated among items other than food and energy; after surging at about a 5-1/4 percent annual rate in the first four months of the year, the index for these items rose 0.3 percent in May and only 0.2 percent in June. Consumer food prices rose sharply in May and June; but in view of recent declines in farm commodity prices, the increases in retail food prices in coming months should be smaller. Upward pressures on energy prices persisted around midyear. The rise in consumer energy prices, which had slowed in the spring, picked up again in June; in July, heightened tensions in the Persian Gulf--and the associated cautionary stockpiling of oil--pushed crude oil prices up further, even with OPEC production running above quota. Prices of imports other than oil also are providing some impetus to inflation; they rose sharply again in the second quarter for a fairly wide range of intermediate materials and products. Domestic producers also have boosted materials prices, but so far these increases have not left a broad imprint on the prices of finished goods.

Wage inflation remained comparatively moderate in the first half of 1987. Hourly compensation, as measured by the employment cost index, rose 3.0 percent for workers in private industry over the 12 months ended in June, not much different from the year-to-year rates of increase reported since the third quarter of last year. Compensation in service-producing industries appears to have accelerated somewhat this year, but gains have remained small in the goods-producing sectors, especially in manufacturing. Unionized workers' compensation rose roughly 2 percent at an annual rate over the first half of the year.

Outlook. The staff is expecting real GNP to rise at an annual rate of about 2-1/2 percent in the third quarter, similar to the second-quarter pace. Real exports are projected to continue growing rapidly in the current quarter, and business equipment spending probably will rise substantially. In addition, consumer spending is expected to be boosted this quarter by an incentive-induced rise in auto sales; however, excluding autos, consumption growth probably will remain well below the pace of recent years. The increase in auto sales, coupled with a further contraction in assemblies this quarter, is projected to result in a sharp decline in auto inventories. By contrast, oil inventories--and oil imports--probably will rise substantially. Inflation, as measured by the fixed-weighted price index for gross national product, is projected at an annual rate of about 3-1/2 percent this quarter, somewhat less than in the first half.

The policy assumptions that underlie the longer-run forecast are little changed this month. Growth of M3 is expected to be within the FOMC target ranges established for 1987 and, tentatively, for 1988, while M2 growth is anticipated to be slow, perhaps somewhat below the lower end of its range for 1987 and in the lower part of the tentative range for 1988. Interest rates are projected to drift up from current levels. The foreign exchange value of the dollar against other G-10 currencies still is expected to decline moderately, at about the same rate that was projected in the last Greenbook.

The federal budget deficit is projected to narrow from $221 billion in FY1986 to about $163 billion in FY1987 and $161 billion in FY1988. As in previous Greenbooks, the 1988 estimate incorporates the assumption of $25 billion in deficit-reduction measures. The projections for both 1987 and 1988 are somewhat lower than in the last Greenbook, owing primarily to indications that personal tax liabilities this year and next may run higher than previously expected.

Growth of real GNP over the balance of the forecast horizon is expected to average close to 2-1/2 percent at an annual rate, and the broad contours of the forecast remain much the same as before. Improvement in the external sector is expected to provide substantial impetus for real growth, as past and projected changes in the foreign exchange value of the dollar boost U.S. exports and damp import growth.

In contrast, growth in domestic spending is expected to be relatively subdued. Rising import prices associated with the fall in the value of the dollar are likely to limit increases in real income and consumer spending; budgetary pressures probably will constrain government purchases at the federal and state and local levels; and high vacancy rates and rising mortgage interest rates are expected to curtail construction activity. All told, real gross domestic purchases are projected to grow at a 2 percent rate in the second half of this year and only 1 percent over the four quarters of 1988.

After slowing a little in the second half of 1987, inflation is projected to move back up in 1988. The fixed-weighted price index for GNP is expected to rise nearly 4-1/2 percent in 1988, up from 2-1/4 percent in 1986 and a projected 4 percent rise this year. Energy prices are expected to settle down after the current quarter--assuming that tensions in the Mideast subside--but, more broadly, pressures from rising import prices are likely to persist through the end of the forecast horizon. In addition, with the civilian unemployment rate projected to remain around 6 percent, labor market slack no longer will be a damping influence on wages. As a result, the import-led pickup in prices is expected to feed through fairly directly into labor costs, and compensation gains are expected to increase noticeably next year. If, contrary to staff expectations, the unemployment rate were to remain on the downward course seen in recent months, or there were more adverse developments in the international oil market, the upward pressures on wages and prices could be greater than projected.

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

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STAFF GNP PROJECTIONS

Percent changes, annual rate

	Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
	7/1/87	8/12/87	7/1/87	8/12/87	7/1/87	8/12/87	7/1/87	8/12/87	7/1/87	8/12/87
Annual changes:										
1985 <1>	6.2	6.3	2.7	3.0	3.7	3.5	3.3	3.2	7.2	7.2
1986 <1>	5.2	5.6	2.5	2.9	2.8	2.7	2.7	2.6	7.0	7.0
1987	5.7	5.8	2.7	2.6	3.2	3.5	3.0	3.1	6.4	6.3
1988	6.0	6.4	2.4	2.5	3.9	4.1	3.5	3.8	6.3	6.0
Quarterly changes:										
1986 Q1 <1>	6.2	7.0	3.8	5.4	2.5	2.2	2.5	1.8	7.1	7.1
Q2 <1>	2.6	3.6	.6	.6	1.7	2.2	1.8	2.9	7.1	7.1
Q3 <1>	6.4	5.3	2.8	1.4	2.6	2.6	3.6	3.6	6.9	6.9
Q4 <1>	1.7	2.1	1.1	1.5	2.7	2.3	.7	.7	6.9	6.9
1987 Q1 <1>	9.1	8.6	4.8	4.4	3.9	4.5	4.2	4.2	6.7	6.7
Q2 <1>	6.1	6.7	2.2	2.6	3.7	4.3	3.8	3.8	6.3	6.2
Q3	5.9	6.4	2.6	2.6	3.6	3.6	3.2	3.7	6.3	6.1
Q4	5.3	5.7	2.5	2.7	3.3	3.5	2.8	2.9	6.3	6.1
988 Q1	6.3	6.6	2.4	2.5	4.2	4.5	3.8	4.0	6.3	6.0
Q2	6.0	6.6	2.3	2.4	4.0	4.2	3.6	4.1	6.3	6.0
Q3	6.3	6.6	2.3	2.4	4.2	4.4	3.9	4.1	6.3	6.0
Q4	6.5	6.7	2.4	2.3	4.3	4.5	4.0	4.3	6.3	6.0
Two-quarter changes: <2>										
1986 Q2 <1>	4.3	5.3	2.2	3.0	2.1	2.1	2.1	2.3	.0	.0
Q4 <1>	4.0	3.7	1.9	1.5	2.6	2.5	2.1	2.1	-.2	-.2
1987 Q2 <1>	7.6	7.6	3.5	3.5	3.8	4.5	4.0	4.0	-.6	-.7
Q4	5.6	6.1	2.6	2.6	3.5	3.6	3.0	3.3	.0	-.1
1988 Q2	6.1	6.6	2.3	2.4	4.1	4.3	3.7	4.1	.0	-.1
Q4	6.4	6.6	2.4	2.4	4.3	4.4	3.9	4.2	.0	.0
Four-quarter changes: <3>										
1985 Q4 <1>	6.3	6.6	2.9	3.3	3.6	3.6	3.3	3.1	-.2	-.2
1986 Q4 <1>	4.2	4.5	2.0	2.2	2.4	2.3	2.1	2.2	-.2	-.2
1987 Q4	6.6	6.8	3.0	3.1	3.6	4.0	3.5	3.7	-.6	-.8
1988 Q4	6.3	6.6	2.3	2.4	4.2	4.4	3.8	4.1	.0	-.1

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

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

		1986		1987				1988			
						Projection					
	Units	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of $	4265.9	4288.1	4377.7	4448.8	4518.8	4581.7	4655.1	4729.9	4805.9	4884.1
Real GNP	Billions of 82$	3718.0	3731.5	3772.2	3796.4	3820.5	3845.8	3869.4	3892.0	3915.3	3937.8
Nominal GNP	Percent change	5.3	2.1	8.6	6.7	6.4	5.7	6.6	6.6	6.6	6.7
Real GNP		1.4	1.5	4.4	2.6	2.6	2.7	2.5	2.4	2.4	2.3
Gross domestic product		1.2	2.2	4.2	2.9	2.6	2.9	2.5	2.4	2.5	2.3
Gross domestic purchases		3.0	.4	2.5	1.7	3.0	.9	.9	1.2	1.2	1.1
Final sales		3.9	3.7	-2.3	3.3	4.2	1.9	3.3	2.3	2.5	2.5
Private dom. final purchases		5.9	1.2	-3.2	2.7	4.8	-.1	1.7	1.4	1.5	1.5
Personal consumption expend.		7.3	.5	-.7	2.1	4.9	-.3	1.8	1.5	1.5	1.3
Durables		44.9	-6.3	-21.2	11.4	20.5	-15.1	3.5	1.9	1.7	.4
Nondurables		-.1	.2	1.3	-4.3	-.3	1.9	.9	.6	.6	.6
Services		2.6	3.0	5.4	4.0	3.9	3.3	2.0	2.0	2.0	2.1
Business fixed investment		-3.0	5.1	-14.6	7.9	8.6	2.9	2.9	2.4	2.7	2.4
Producers' durable equipment		3.1	4.7	-15.3	11.6	11.5	4.0	4.2	3.8	4.2	3.8
Nonresidential structures		-16.6	6.3	-12.8	-.7	1.2	.0	-.7	-1.2	-1.4	-1.4
Residential structures		9.7	2.2	-7.7	-.4	-3.6	-3.4	-3.3	-2.7	-1.5	1.9
Exports		10.6	9.5	10.2	13.6	13.2	15.1	14.9	14.0	12.5	12.6
Imports		20.1	-.8	-5.2	4.2	14.1	-1.2	.8	2.9	1.9	1.9
Government purchases		3.0	7.9	-6.2	1.4	3.6	1.0	1.7	.1	.6	.4
Federal		2.4	15.2	-18.6	-1.2	5.5	-.7	.9	-2.7	-1.4	-1.7
Defense		16.4	-10.5	7.6	8.0	-2.6	-4.4	-5.8	-4.9	-2.8	-2.5
State and local		3.5	2.4	5.0	3.4	2.2	2.2	2.4	2.3	2.1	2.0
Change in business inventories	Billions of 82$	6.1	-14.4	47.6	41.2	26.5	33.7	26.4	27.0	26.1	24.0
Nonfarm	Billions of 82$	.1	2.3	43.9	22.5	15.5	28.4	24.6	25.8	24.9	22.8
Net exports	Billions of 82$	-161.6	-151.8	-135.2	-127.8	-132.9	-116.2	-101.7	-90.6	-79.3	-67.3
OYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	99.8	100.4	101.1	101.7	102.3	102.8	103.3	103.8	104.2	104.6
Unemployment rate	Percent*	6.9	6.9	6.7	6.2	6.1	6.1	6.0	6.0	6.0	6.0
Industrial production index	Percent change	1.9	3.2	3.4	2.6	5.6	3.9	3.6	3.5	3.5	3.4
Capacity utilization rate-mfg.	Percent*	79.7	79.8	80.2	80.1	80.8	81.1	81.3	81.5	81.6	81.6
Housing Starts	Millions	1.76	1.70	1.79	1.61	1.61	1.60	1.58	1.57	1.56	1.56
Auto sales	Millions	12.91	11.32	9.66	10.26	11.74	10.10	10.30	10.45	10.65	10.65
Domestic	Millions	9.43	7.66	6.86	7.20	8.35	7.03	7.20	7.35	7.50	7.50
Foreign	Millions	3.47	3.66	2.80	3.06	3.39	3.07	3.10	3.10	3.15	3.15
INCOME AND SAVING											
Nominal personal income	Percent change	3.1	4.6	7.8	6.1	4.4	7.2	7.0	5.9	5.1	7.5
Real disposable income	Percent change	-1.0	.5	2.7	-3.2	6.2	2.7	1.9	-.1	.8	1.7
Personal saving rate	Percent*	3.6	3.6	4.4	3.2	3.5	4.2	4.2	3.8	3.7	3.8
Corp. profits with IVA & CCAdj	Percent change	5.9	-7.2	19.7	-.8	18.8	8.5	-12.2	3.3	12.6	2.6
Profit share of GNP	Percent*	6.7	6.6	6.7	6.6	6.8	6.8	6.5	6.5	6.5	6.5
Federal govt. surplus/deficit	Billions of $	-203.7	-188.7	-170.5	-132.7	-164.7	-174.4	-175.7	-157.6	-150.6	-146.1
State and local govt. surplus		59.6	50.6	41.0	44.6	42.8	44.3	48.0	50.9	54.0	56.4
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.6	.7	4.2	3.8	3.7	2.9	4.0	4.1	4.1	4.3
GNP fixed-weight price index		2.6	2.3	4.5	4.3	3.6	3.5	4.5	4.2	4.4	4.5
Cons. & fixed invest. prices		3.1	3.0	5.1	4.7	3.9	3.7	4.5	4.5	4.7	4.8
CPI		2.5	2.6	5.3	4.9	4.1	4.1	4.4	4.7	4.9	5.1
Exc. food and energy		3.7	3.8	4.4	4.7	3.7	4.8	4.9	5.2	5.4	5.6
Nonfarm business sector											
Output per hour		-.6	.0	.4	1.4	2.1	.6	.8	.6	1.0	1.1
Compensation per hour		2.8	4.0	1.1	2.9	3.4	3.6	5.0	4.1	4.5	4.8
it labor costs		3.5	4.0	.8	1.5	1.3	3.0	4.2	3.5	3.5	3.7

* Not at an annual rate.

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

	Units	1980	1981	1982	1983	1984	1985	1986	Projection 1987	Projection 1988
EXPENDITURES										
Nominal GNP	Billions of $	2732.0	3052.6	3166.0	3405.7	3772.2	4010.3	4235.0	4481.7	4768.8
Real GNP	Billions of 82$	3187.1	3248.8	3166.0	3279.1	3501.4	3607.5	3713.3	3808.7	3903.6
Real GNP	Percent change*	-.1	.6	-1.9	6.5	5.1	3.3	2.2	3.1	2.4
Gross domestic product		.3	.3	-1.6	6.6	5.3	3.5	2.6	3.1	2.4
Gross domestic purchases		-1.1	.8	-.8	8.4	6.4	4.1	2.7	2.0	1.1
Final sales		-.2	.1	.3	3.7	4.7	4.6	2.6	1.8	2.7
Private dom. final purchases		-1.7	-.3	.8	7.7	5.6	4.6	3.2	1.0	1.5
Personal consumption expend.		-.1	.2	2.9	5.4	4.1	4.5	4.1	1.5	1.5
Durables		-5.6	-3.3	9.0	14.7	10.8	6.6	12.4	-2.6	1.9
Nondurables		-1.4	.5	1.8	4.4	2.3	2.9	2.9	-.4	.7
Services		2.4	.9	2.3	3.9	3.5	5.0	2.4	4.2	2.0
Business fixed investment		-4.8	5.6	-11.3	10.8	13.8	4.7	-4.7	.7	2.6
Producers' durable equipment		-6.5	2.2	-12.5	20.9	14.9	7.0	.2	2.3	4.0
Nonresidential structures		-1.8	11.7	-9.1	-4.8	11.8	.1	-15.4	-3.2	-1.2
Residential structures		-14.2	-22.4	4.9	38.1	6.1	6.0	12.5	-3.8	-1.6
Exports		.5	2.4	-13.8	5.8	5.9	-2.7	5.9	13.0	13.5
Imports		-8.8	4.9	-5.9	23.8	17.4	5.2	8.9	2.7	1.9
Government purchases		1.0	2.9	3.8	-2.7	7.9	8.7	2.4	-.1	
Federal		3.1	9.5	8.2	-8.1	13.0	14.9	-.2	-4.2	-1.2
Defense		3.1	7.6	8.8	5.1	6.5	7.0	4.8	2.0	-4.0
State and local		-.3	-1.3	.6	1.5	4.4	4.0	4.6	3.2	2.2
Change in business inventories	Billions of 82$	-6.9	23.9	-24.5	-6.4	62.3	7.4	13.8	37.3	25.9
Nonfarm	Billions of 82$	-2.3	19.0	-23.1	-.1	57.8	12.0	15.4	27.6	24.5
Net exports	Billions of 82$	57.0	49.4	26.3	-19.9	-84.0	-108.2	-145.8	-128.0	-84.7
Nominal GNP	Percent change*	9.9	9.3	3.1	10.4	8.6	6.6	4.5	6.8	6.6
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	90.4	91.2	89.6	90.2	94.5	97.5	99.6	102.0	103.9
Unemployment rate	Percent	7.1	7.6	9.7	9.6	7.5	7.2	7.0	6.3	6.0
Industrial production index	Percent change*	-.8	-1.0	-7.7	14.3	6.6	1.7	1.1	3.9	3.5
Capacity utilization rate-mfg.	Percent	79.3	78.3	70.3	74.0	80.5	80.1	79.7	80.5	81.5
Housing Starts	Millions	1.30	1.10	1.06	1.71	1.77	1.74	1.82	1.65	1.57
Auto sales	Millions	9.04	8.56	8.00	9.18	10.43	11.09	11.52	10.44	10.51
Domestic	Millions	6.62	6.24	5.77	6.77	7.97	8.24	8.28	7.36	7.39
Foreign	Millions	2.42	2.32	2.23	2.41	2.46	2.84	3.25	3.08	3.[illegible]3
INCOME AND SAVING										
Nominal personal income	Percent change*	12.0	9.2	5.3	7.8	8.4	6.8	5.5	6.4	6.4
Real disposable income	Percent change*	1.1	.7	1.0	5.1	4.3	2.8	3.6	2.1	1.2
Personal saving rate	Percent	7.1	7.5	6.8	5.4	6.1	4.5	4.3	3.8	3.9
Corp. profits with IVA & CCAdj	Percent change*	-6.8	2.3	-19.1	70.1	7.4	4.1	1.2	11.2	1.2
Profit share of GNP	Percent	6.5	6.2	4.7	6.3	7.1	6.9	6.7	6.7	6.5
Federal govt. surplus/deficit	Billions of $	-61.3	-63.8	-145.9	-176.0	-169.6	-196.0	-204.7	-160.6	-157.5
State and local govt. surplus		26.8	34.1	35.1	47.5	64.6	63.1	56.8	43.2	52.3
PRICES AND COSTS										
GNP implicit deflator	Percent change*	9.9	8.7	5.2	3.6	3.4	3.1	2.2	3.7	4.1
GNP fixed-weight price index		9.8	8.5	5.0	3.9	3.7	3.6	2.3	4.0	4.4
Cons. & fixed invest. prices		10.1	8.2	4.4	3.3	3.3	3.5	2.0	4.4	4.6
CPI		12.5	9.6	4.5	3.2	4.1	3.5	1.3	4.6	4.8
Exc. food and energy		12.2	10.2	5.2	4.2	4.7	4.3	3.9	4.4	5.3
Nonfarm business sector										
Output per hour		1.0	-.6	1.0	3.6	1.5	1.0	1.5	1.1	.9
Compensation per hour		10.9	8.3	7.3	3.3	4.2	4.8	3.4	2.8	4.6
Unit labor costs		9.8	9.0	6.2	-.3	2.6	3.7	1.9	1.6	3.7

* Percent changes are from fourth quarter to fourth quarter.

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August 12, 1987

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

	1986		1987		Projection								Projection	
							1988				1985	1986	1987	1988
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	(fourth quarter to fourth quarter, net change)			
Real GNP	13.3	13.5	40.7	24.2	24.1	25.3	23.5	22.7	23.3	22.4	115.7	80.6	114.3	91.9
Gross domestic product	10.6	20.4	38.3	26.6	24.6	27.0	24.0	22.5	23.8	22.5	121.5	92.7	116.5	92.8
Gross domestic purchases	28.1	3.7	24.1	16.8	29.2	8.6	9.1	11.6	11.9	10.5	150.2	103.1	78.7	43.1
Final sales	35.2	33.9	-21.3	30.8	38.7	18.1	30.8	22.1	24.2	24.5	159.0	93.3	66.3	101.6
Private dom. final purchases	44.4	9.5	-25.7	20.8	37.0	-.4	13.1	10.7	11.7	11.8	133.0	97.7	31.7	47.2
Personal consumption expend.	43.2	3.0	-4.6	12.8	29.7	-1.9	11.5	9.3	9.4	8.2	102.1	97.3	36.0	38.4
Durables	35.9	-6.5	-23.1	10.3	18.4	-16.2	3.4	1.8	1.7	.4	22.0	43.9	-10.6	7.3
Nondurables	-.2	.5	2.9	-9.6	-.6	4.1	2.0	1.3	1.4	1.3	24.5	24.6	-3.2	5.9
Services	7.5	8.9	15.8	12.0	11.9	10.2	6.2	6.2	6.3	6.5	55.7	28.6	49.9	25.2
Business fixed investment	-3.3	5.5	-17.2	8.2	9.1	3.2	3.2	2.7	3.0	2.7	20.8	-22.0	3.3	11.6
Producers' durable equipment	2.4	3.6	-13.0	8.5	8.7	3.2	3.4	3.1	3.4	3.1	20.7	.6	7.3	13.0
Nonresidential structures	-5.7	1.9	-4.2	-.2	.3	.0	-.2	-.4	-.4	-.4	.1	-22.6	-4.0	-1.4
Residential structures	4.6	1.1	-4.0	-.2	-1.8	-1.7	-1.6	-1.3	-.7	.9	10.1	22.5	-7.7	-2.8
Change in business inventories	-22.0	-20.5	62.0	-6.4	-14.7	7.2	-7.3	.6	-.9	-2.1	-43.3	-12.8	48.1	-9.7
Nonfarm	-23.8	2.2	41.6	-21.4	-7.0	12.9	-3.8	1.2	-.9	-2.1	-22.0	-14.4	26.1	-5.6
Farm	1.8	-22.6	20.3	14.9	-7.6	-5.[illegible]	-3.5	-.6	.0	.0	-21.2	1.6	21.9	-4.1
Net exports	-14.8	9.8	16.6	7.4	-5.1	16.8	14.4	11.1	11.4	11.9	-34.5	-22.5	35.6	48.8
Exports	9.4	8.7	9.5	12.9	12.9	15.1	15.5	15.1	14.1	14.6	-10.1	21.8	50.4	59.3
Imports	24.2	-1.1	-7.1	5.5	18.0	-1.6	1.0	4.0	2.7	2.7	24.4	44.3	14.6	10.4
Government purchases	5.6	14.6	-12.2	2.6	6.8	1.8	3.3	.3	1.2	.8	60.5	18.1	-1.0	5.6
Federal	2.0	12.0	-17.3	-1.0	4.4	-.6	.7	-2.2	-1.1	-1.4	44.8	-.7	-14.5	-4.0
Defense	9.7	-7.1	4.7	5.0	-1.7	-2.9	-3.8	-3.2	-1.8	-1.6	15.8	11.6	5.1	-10.4
Nondefense	-7.6	19.1	-22.0	-6.0	6.1	2.3	4.5	1.0	.7	.2	29.0	-12.3	-19.6	6.4
State and local	3.6	2.5	5.2	3.6	2.4	2.4	2.6	2.5	2.3	2.2	15.7	18.7	13.6	9.6

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1986*	FY1987e Admin[1]	FY1987e FRB Staff	FY1988e Admin[1]	FY1988e FRB Staff	CY 1986*	CY1987e FRB Staff	1986 IV*	1987 I*	1987 II*	1987 III	1987 IV	1988 I	1988 II	1988 III
								FRB Staff Estimates (1987 III – 1988 III)							
								Not seasonally adjusted							
Budget receipts[2]	769	842	850	917	898	782	862	190	194	254	213	202	205	267	225
Budget outlays[2]	990	1016	1013	1024	1059	991	1033	253	252	251	256	274	250	263	272
Surplus/deficit(-) to be financed[2]	-221	-173	-163	-108	-161	-209	-171	-63	-59	2	-44	-72	-45	3	-47
Means of financing:															
Borrowing from public	236	162	164	107	145	215	145	69	28	32	36	50	40	6	49
Cash balance decrease	-14	11	-7	0	13	0	11	0	22	-31	2	19	5	-5	-5
Other[3]	-1	0	5	1	3	-6	16	-6	9	-3	6	4	1	-4	3
Cash operating balance, end of period	31	20	38	20	25	31	20	31	9	40	38	20	15	20	25
Memo: Sponsored agency borrowing[4]	14	n.a.	14	n.a.	18	13	14	4	-2	7	5	4	4	5	5
NIPA Federal Sector								Seasonally adjusted annual rates							
Receipts	816	875	886	968	937	827	899	853	879	919	892	906	931	951	960
Expenditures	1027	1061	1050	1089	1102	1032	1060	1041	1050	1052	1057	1081	1107	1108	1111
Purchases	369	385	371	395	384	366	373	369	367	372	376	378	385	386	387
Defense	275	291	288	301	294	278	292	279	288	293	294	293	295	294	294
Nondefense	93	94	83	94	90	88	81	90	79	79	82	85	91	92	94
All other expend.	658	676	679	694	717	666	686	673	683	680	680	702	722	723	723
Surplus/deficit(-)	-211	-186	-164	-121	-165	-205	-161	-189	-171	-133	-165	-174	-176	-158	-151
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-190	n.a.	-145	n.a.	-153	-183	-145	-163	-151	-116	-151	-162	-164	-146	-139

*--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 1988 (January 1987). More up-to-date figures are scheduled to be published around August 15. The Congressional Budget Office preliminary summer baseline estimates released July 14 indicated receipts of $852 and $897 billion, outlays of $1013 and $1078 billion, and deficits of $161 and $181 billion in FY1987 and FY1988, respectively. Revised CBO budget estimates are scheduled to be released August 19.
2. Includes outlays formerly classified as off-budget (e.g. Federal Financing Bank and Strategic Petroleum Reserve) and social security receipts and outlays 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, Federal Home Loan Mortgage Corporation (excluding participation certificates), Federal National Mortgage Association (excluding mortgage-backed securities), Farm Credit Banks, and Student Loan Marketing Association marketable debt. The Administration's definition of borrowing by these agencies is somewhat broader.

Recent developments. Intermediate- and long-term interest rates have risen since the last FOMC meeting, most notably on corporate and Treasury securities, where yields are up 1/4 to 1/2 percentage point. Inflation concerns mounted with the heightening tension in the Persian Gulf, and key foreign bond markets also slumped. At the short end, bill rates, which had been unusually low relative to other money market yields, increased as legislative action permitted a resumption of auctions and as bill paydowns were seen as abating. Fed funds, by contrast, traded generally at 6-1/2 to 6-3/4 percent throughout the period; discount window borrowing has averaged somewhat less than $500 million. Most other private short-term rates have changed little on balance.

Money growth was weak again in July, as attractive yields on alternative assets continued to restrain demand, especially for the more liquid components. Demand deposits contracted, albeit less than in June. With only moderate growth in other checkable deposits, M1 was essentially unchanged. M2 rose at only a 3 percent annual rate, as its nontransactions component weakened. M3 growth slowed to 2 percent last month; managed liabilities were off at commercial banks, which faced soft commercial loan demand, but large time deposits at thrifts grew moderately despite runoffs at some troubled institutions. The weakness in the aggregates in July caused M2 to drift further below its annual target range, while M3 moved noticeably below the bottom of its growth cone.

Overall commercial bank credit was flat in July, the third month of deceleration. Loans in total were about unchanged; the business loan category registered about a 7 percent annual rate of decline. Real estate loans grew at their slowest pace in several months, but the advance still was considerable, buoyed by home equity credit. Security holdings at banks rose slightly in July; large additions of medium- and long-term governments--likely federally backed mortgage securities--offset runoffs of other securities.

Business borrowing has been concentrated in long-term markets thus far in the third quarter while borrowings from banks and in the commercial paper market have contracted. Corporate needs for funds in the aggregate continue to be ballooned by heavy merger and buyout activity. Many deals in the second quarter were financed initially with bridge loans from commercial or investment banks or with commercial paper; large volumes of these borrowings subsequently have been refinanced in the bond market, often via issues rated below investment grade. Meanwhile, issuance and prices in the Eurobond market have largely recovered following the Treasury's reversal of its late June announcement cancelling its tax treaty with the Netherlands Antilles. In equity markets, new stock offerings dipped a bit in July but remained historically high as issuers took advantage of the recent lofty prices.

In the household sector, home mortgage rates are about unchanged since the last FOMC meeting. Nonetheless, fixed-rate mortgages are about 1-1/4 percentage point above the nine-year low recorded in March, and borrowing volume has moderated in response. The earlier jump in fixed-rate mortgage yields has contributed to a rise in ARM originations, which in early June accounted for half of all conventional home purchase loans. The spring runup in rates also has slowed the pace of refinancings. Home equity loans continue to divert household borrowing into mortgage credit from traditional consumer credit channels. In the second quarter, consumer installment credit grew at only a 5 percent annual rate, even with some bounceback in June after the contraction in credit a month earlier.

In the federal sector, seasonal declines in tax receipts and some increase in outlays are estimated to raise the deficit in the third quarter to about $44 billion. The debt ceiling disrupted the Treasury's financing schedule in late July and early August, leading to some bunching of auctions. But with completion of the mid-quarter refunding auctions this week, the financing pattern will be back on track--at least until expiration of the current debt ceiling authorization on September 23. The Treasury continues to rely on longer-term debt, raising funds through coupon issues while paying down bills. Among the federally sponsored agencies, yield spreads on the debt of the Federal Home Loan Bank System and the Farm Credit System relative to Treasuries have narrowed a bit, perhaps reflecting passage of the FSLIC recapitalization and congressional attention to the farm situation.

State and local borrowing was down in July, after a surge in June. Long-term borrowing to raise new capital has been volatile in recent months, but refunding issues have tailed off because of the higher interest rates. Refundings were further damped in July when the Treasury, in response to the debt ceiling, temporarily suspended sales of its nonmarketable SLG securities, where proceeds of advance refundings are typically parked. The tax-exempt bond market has benefitted in the past couple of months from a return of open-end mutual funds as net purchasers and by the launching of new, sizable closed-end funds. Meanwhile, federal investigation of the tax-exempt status of selected municipal securities marketed in 1985-86 has had no discernible impact on the rest of the muni market.

Outlook. Domestic nonfinancial sector debt appears to have settled into a slower growth path this year. Debt growth through July is estimated at about 9-1/2 percent at an annual rate, and is expected to average a bit over 8 percent during the balance of the year. Moreover, debt growth is expected to remain well below 10 percent in 1988, as domestic spending and private credit use is damped by rising interest rates.

Federal borrowing is likely to pick up in the fourth quarter. Tax receipts should drop off after a catchup in corporate tax payments in September. The outlook for federal borrowing in 1988 is clouded a bit by remaining uncertainty about deficit actions, including possible modifications to Gramm-Rudman. Consistent with our fiscal assumptions, borrowing next year is not expected to diverge much from the total for 1987. State and local government borrowing is projected to tail off some in coming quarters. Proceeds from the unusually large volume of earlier debt issues will be used to finance some activities, and overall spending by state and local governments is expected to grow only modestly. Restrictions on private-purpose tax-exempt issuance will continue to constrain expansion of this debt component.

In the business sector, the financing gap--though remaining moderate--will be rising through next year as higher interest payments and labor costs hold down profit growth relative to increases in capital spending. Borrowing to finance share retirements is expected to remain strong despite some assumed diminution in restructuring activity. Short-term borrowing is expected to turn up following its recent contraction, but businesses probably will continue to focus demands in longer-term markets.

The growth of household borrowing is not expected to change much from its recent pace. Double-digit mortgage interest rates should keep home sales and refinancings somewhat below the average levels of recent quarters, although rising home prices will add to financing requirements. Home equity loans are likely to continue their rapid growth, but most of this will be diverted from other forms of household borrowing. Installment credit growth will get a near-term boost from the recently announced auto finance incentives, but otherwise home equity loans together with modest growth in consumer spending should keep consumer credit expansion at or below a 5 percent rate.

Recent developments. The foreign exchange value of the dollar in terms of a trade-weighted average of other G-10 currencies has experienced fairly strong upward pressure over most of the intermeeting period. Immediately following the July FOMC meeting, market participants seemed to be acting on optimism about improvement in the U.S. current account, but trade data released in mid-July dampened those expectations somewhat, and the rise in the dollar's value late in the period seems mainly attributable to threatening developments in the Middle East as well as a general perception of relative strength in the U.S. economy. The net rise in the dollar's value since the July FOMC meeting was 2-1/2 percent on average, about 3 percent in terms of marks, but only 1 percent in terms of yen.

Part of the reason for the relative strength in the yen's value over this period was a strong rise in Japanese bond yields that was large even in the context of rising long-term interest rates worldwide. On balance, the yield on the bellwether government bond rose 90 basis points in association with some signs of stronger economic activity in Japan and perceptions early in the period that the Bank of Japan had become concerned about rapid money growth. Three-month interest rates in foreign G-10 countries rose 20 basis points on a weighted-average basis and about 30 basis points in Germany, where the Bundesbank apparently took advantage of the dollar's strength late in the period to tighten monetary conditions slightly. Sizeable increases in short-term interest rates took place in Canada (60 basis points) and the United Kingdom (95 basis points). The Bank of England's increase in its dealing rates in early August caught most market participants by surprise and apparently was motivated by concern about possible overheating of the economy given recent rapid growth in broad money and credit measures.

Gold and silver prices rose sharply at times during the period in response to news from the Persian Gulf, reaching highs of $477.50 and $8.77 respectively on August 4, but have eased back somewhat recently.

the Desk, sold $631 million for marks, split evenly between the Federal Reserve and the Treasury.

Some improvement in economic activity in foreign industrial countries was discernible in the second quarter, compared with the generally very weak first-quarter results. U.K. indicators suggested broad-based strength, and German construction activity rebounded from its first-quarter drop, although other indicators of German economic activity showed less strength. In Japan, signs were mixed, but growth in the consumer and housing sectors seemed more robust in the latter part of the quarter. Although surpluses in Japanese and German external accounts remain very large, volumes of exports and imports in both countries continue to give indications of adjustment. Consumer price inflation remains low abroad, but a reversal of the 1986 price declines has begun in most foreign industrial countries.

Brazil has made preliminary contacts with its commercial bank creditors about the country's adjustment plans and financing needs. Disbursements under Argentina's IMF stand-by arrangement began in July, and the financing package arranged with commercial banks is expected to be signed on August 21. The new rescheduling agreement between commercial banks and the Philippines was signed in July, and Mexico reached a new agreement to reschedule private sector debts to foreign commercial banks. Recent substantial increases in international reserves and a current account surplus helped persuade Mexican authorities to ease import barriers further ahead of their original schedule. In Venezuela, the government may delay signing a revised restructuring agreement until reaching an understanding with its bank creditors that would provide an assurance of funding from the banks. Peru's president revealed his intention to seek nationalization of the country's domestic banking system, but this initiative has become embroiled in judicial and legislative debate. Under the current formulation, branches of foreign banks would be exempted from the nationalization. In July, Taiwan moved to reduce its large accumulation of reserve assets by easing restrictions on private foreign investments.

The U.S. merchandise trade deficit in the April-May period was marginally smaller than the first-quarter rate. The value of exports rose about 6 percent, with increases spread among agricultural products, machinery, chemicals, and consumer goods. A 2 percent increase in the value of imports was concentrated in imports of oil and of passenger cars from Japan and South Korea. Prices of imported manufactured goods continued to rise at a fairly strong rate during the second quarter, and prices of oil and other imported industrial supplies rose significantly faster than in previous quarters. On the export side, prices of materials also rose faster than prices of manufactured goods. (June trade figures, to be released Friday, August 14, will be reported in the Greenbook Supplement.)

Outlook. The staff has not changed its forecast that GNP in foreign industrial countries will expand on average at an annual rate of about 1-3/4 percent during the rest of 1987 and during 1988. Consistent with the staff's view that over the medium term a further decline in the foreign exchange value of the dollar on average is likely to be part of a process of restoring better balance to our external accounts, we have incorporated of a moderate rate of decline in the dollar through the end of 1988, in line with the outlook presented in the last Greenbook. Moreover, despite the dollar's recent strength, a significant risk remains that downward pressure on the dollar in exchange markets will be greater than the staff is projecting. The underlying outlook for the U.S. current account deficit in 1987 and through the fourth quarter of 1988 has changed little since the last Greenbook. The deficit is expected to average nearly $155 billion during 1987 and to decline during 1988 to rate of about $130 billion by the fourth quarter. However, tensions in the Persian Gulf are now expected to produce a temporary rise in the volume and price of petroleum imports and therefore a bulge in the deficit during the third quarter of this year. Uncertainties about the oil market in light of the unstable Persian Gulf situation should be regarded as a significant downside risk in our current account outlook as well as presenting a significant risk that domestic inflation will be higher than projected.

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

	ANNUAL			1986		1987				1988			
	1986-	1987-P	1988-P	Q3-	Q4-	Q1-	Q2-	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current $, Net	-105.5	-110.6	-91.4	-110.5	-116.9	-112.2	-108.6	-114.5	-107.0	-101.6	-94.6	-88.6	-80.6
Exports of G+S	376.2	422.3	500.7	376.6	383.3	397.3	413.3	429.6	449.1	469.3	490.6	510.5	532.3
Imports of G+S	481.7	532.9	592.0	487.1	500.2	509.5	521.9	544.1	556.1	570.9	585.2	599.1	612.9
Constant 82 $, Net	-145.8	-128.0	-84.7	-161.6	-151.8	-135.2	-127.8	-132.9	-116.2	-101.7	-90.6	-79.3	-67.3
Exports of G+S	377.4	417.7	476.2	379.6	388.3	397.8	410.7	423.6	438.7	454.2	469.3	483.4	498.0
Imports of G+S	523.2	545.7	561.0	541.2	540.1	533.0	538.5	556.5	554.9	555.9	560.0	562.7	565.3
2. U.S. Merchandise Trade Balance 2/	-144.3	-151.4	-134.6	-148.5	-154.4	-152.4	-149.3	-155.9	-148.0	-143.3	-137.6	-132.1	-125.3
Exports	224.4	249.9	303.3	226.1	228.1	230.7	244.0	255.5	269.6	282.8	296.9	309.5	323.9
Agricultural	27.0	27.9	30.2	26.6	28.1	26.2	29.0	27.8	28.5	28.9	29.9	30.6	31.4
Non-Agricultural	197.3	222.0	273.1	199.6	200.0	204.5	215.0	227.6	241.0	253.9	267.0	278.9	292.4
Imports	368.7	401.3	437.9	374.6	382.5	383.1	393.3	411.3	417.5	426.1	434.5	441.7	449.1
Petroleum and Products	33.8	41.6	43.6	31.6	32.0	34.8	39.3	48.1	44.2	42.6	43.6	43.8	44.4
Non-Petroleum	334.9	359.7	394.3	343.0	350.4	348.3	354.0	363.2	373.3	383.5	390.9	397.9	404.8
3. U.S. Current Account Balance	-141.4	-154.0	-139.0	-146.3	-151.9	-147.6	-150.2	-165.7	-152.6	-147.3	-141.3	-136.6	-130.9
Of Which: Net Investment Income	20.8	9.4	4.8	21.4	18.0	15.3	11.2	3.1	7.8	6.3	5.8	4.1	2.9
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.4	2.0	1.8	2.0	1.9	1.4	2.3	1.7	1.8	1.6	1.8	1.8	1.7
Real GNP--NonOPEC LDC 5/	4.4	4.1	4.2	4.3	4.2	4.0	4.0	4.0	3.9	4.0	4.3	4.6	5.0
Consumer Prices--Ten Ind. 4/	2.0	2.2	2.8	0.1	2.1	2.4	3.4	1.9	2.6	2.6	3.3	2.5	3.6

1/ Economic activity 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