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September 16, 1987

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. Output and employment appear to have registered solid gains in the third quarter, with particular strength in the industrial sector of the economy. Current indicators of investment and consumption show continued expansion. Price inflation has been lower in recent months owing in part to more favorable food and energy price developments.

Industrial production rose 0.3 percent in August after a 0.8 percent increase in July. The August level is more than 7 percent (annual rate) above the second-quarter average. Business equipment and materials have been the strongest components of industrial output in recent months, although gains have been widespread among major market groupings.

Nonfarm payroll employment rose only 150,000 in August—half the gain reported in July—but the workweek rose further. As a result, production hours increased 0.5 percent last month, bringing hours to a level 4.3 percent (annual rate) above the second-quarter average. Hiring remained strong in services, but manufacturing employment leveled off after a large gain in July. The unemployment rate was unchanged at 6.0 percent in August, having fallen 0.7 percentage point over the first seven months of the year. Other information indicative of strength in labor demand includes initial claims for unemployment insurance, which dropped noticeably lower during the last three weeks of August.

Auto sales are being boosted this quarter by end-of-model-year discounts and financing incentives. At the same time, August was a particularly weak month for domestic car production which, at a 5.9 million unit annual rate, was down 0.8 million units from July and was the lowest since the first half of 1983. The quickened selling pace, in

combination with the cutbacks in production, is reducing dealers' bloated stocks to more comfortable levels. However, domestic car sales in the first ten days of September fell to less than an 8 million unit rate suggesting that the effectiveness of the incentive programs may be waning.

Retail spending on consumer goods excluding autos and gasoline rose 0.3 percent in August after advancing at about the same rate in June and July. With these data, it appears that real consumption spending excluding motor vehicles is growing at approximately a 3 percent annual rate in the third quarter.

Housing activity in July was little changed from the reduced rate of the spring. Starts remained around a 1.6 million unit annual rate in July. Real construction outlays likely will decline in the current quarter, however, reflecting the drop in starts earlier in the year.

Business fixed investment appears to be strengthening. Shipments of nondefense capital goods in July were 2-1/2 percent above the second-quarter average, and orders for nondefense capital goods have risen substantially in recent months. Spending for nonresidential structures still appears to be trending lower, but not nearly so fast as over the past couple of years--owing partly to renewed strength in petroleum drilling. Read literally, the results from the Commerce Department's summer survey point to a sharp rise in plant and equipment purchases in the second half. The Conference Board reports a second-quarter upturn in the unspent backlog of capital appropriations at large manufacturers, a fairly reliable indicator of the near-term direction of spending by such companies.

Price increases have eased in recent months; the CPI and PPI for finished goods both rose 0.2 percent in July and the August PPI was unchanged. The deceleration in these price measures from the first-half pace largely reflects a downturn in food prices and smaller energy price increases. The producer prices of finished foods fell sharply in August as red meat prices receded and prices of fresh produce dropped sharply. Although the effect of rising oil prices continued to be evident in the August PPI, declines in both spot and contract prices should become the dominant influence in retail prices by early autumn. Excluding food and energy, the CPI rose 0.3 percent in July—about the same pace as in the second quarter but slower than during the first quarter when apparel prices were up sharply. The PPI for finished goods excluding food and energy also was up 0.3 percent in August.

Since the August Greenbook, there have been few new data on labor costs. The hourly earnings index for production and nonsupervisory workers shows that wages in August were up at a 2-1/2 percent annual rate from the second-quarter average—a pace in line with that observed over the past year.

Outlook. The staff is expecting real GNP to rise at an annual rate of 3-1/2 percent in the third quarter, better than a percentage point higher than the published second-quarter pace. Much of the step-up in growth occurs in private domestic purchases. Real consumer spending is expected to increase at more than a 6 percent annual pace in the current quarter, reflecting the pickup in car-buying. Despite the increase in sales, the automobile sector is expected to reduce third-quarter real GNP growth by about 3/4 percentage point as the higher sales are more than offset by

the drawdown of stocks. Business equipment spending is projected to contribute appreciably to total GNP growth. In foreign transactions, exports are projected to grow rapidly, while non-oil imports are expected to show little change. Imports of oil are up substantially, however; we are assuming that the bulk of this increase will show up in measured GNP either in inventory accumulation or energy consumption, although these flows have proven difficult for the Commerce Department to measure.

Growth of real GNP in the fourth quarter is expected to be maintained at around a 3 percent annual rate, supported by further gains in exports, nonauto consumption, and business investment spending. Auto assemblies are projected to rise in the fourth quarter from the low summer pace, but the extent of the increase is difficult to predict because the success of the current incentive program is uncertain and because of the possibility of strikes. Even if settlements were to be reached soon at Ford and Chrysler of Canada, some disruption at GM in October is a significant possibility. One way or another, our assessment of the underlying demand picture in the auto market leads us to believe that assemblies in the fourth quarter will fall appreciably below the automakers' announced plans.

Financial specifications in the forecast have changed little this month. Reflecting the stronger growth in the economy, interest rates are anticipated to rise a bit more than previously projected in the next few quarters. The expected further rise in long-term bond yields is small, however, with some flattening of the term structure being anticipated. M2 growth is expected to fall below the lower end of its range for 1987 and then to run near the bottom of its tentative range for 1988. M3 growth is anticipated to be around the bottom of the target range for

this year and in the lower portion of the range in 1988. The foreign-exchange value of the dollar against other G-10 countries still is expected to decline moderately, at roughly the same rate that was projected in the last Greenbook.

With fiscal 1987 almost over, the deficit is estimated at \$160 billion, down from \$221 billion in 1986. Some of the improvement reflects the one-time effects of tax reform, asset sales, loan prepayments, and shifts in the timing of some outlays. As a result, the deficit is projected to hold steady at about \$160 billion in 1988 despite the assumption (as in previous Greenbooks) of an additional \$25 billion in deficit-reducing measures.

The growth of real GNP in 1988 still is expected to average close to 2-1/2 percent at an annual rate, and the major features 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 should limit increases in real income and consumer spending; budgetary pressures probably will constrain government purchases at the federal, state, and local levels; and high vacancy rates and rising mortgage rates are expected to damp construction activity. Reflecting these developments, real gross domestic purchases are projected to grow at only a 1-1/4 percent annual rate over the four quarters of 1988.

Inflation is projected to moderate in the second half of 1987. As measured by the fixed-weighted price index for gross national product, prices are projected to increase at an annual rate of 3-1/4 percent in the third quarter and 3-1/2 percent in the fourth--about a percentage point lower than the pace of the first half. Inflation is projected to move back up in 1988 with the GNP price index expected to rise 4-1/2 percent. On the assumption that no major price swings will occur in the international oil market, energy price changes are expected to be relatively small after the current quarter. But pressures from rising import prices are likely to persist through the end of the forecast horizon. In addition, higher excise taxes at the federal and state and local government levels are assumed to boost prices at the beginning of 1988.

Moreover, with the civilian unemployment rate projected to edge below 6 percent, labor market slack will no longer be a damping influence on wages. As a result, the import-led pickup in prices is expected to feed through directly into labor costs and compensation gains are expected to increase noticeably next year. A scheduled increase in the social security tax rate also is expected to add to the 1988 acceleration in hourly compensation, but no minimum wage hike has been assumed.

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

September 16, 1987

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)			
	8/12/87	9/16/87	8/12/87	9/16/87	8/12/87	9/16/87	8/12/87	9/16/87	8/12/87	9/16/87		
Annual changes:												
1985	<1>	6.3	6.3	3.0	3.0	3.5	3.5	3.2	3.2	7.2	7.2	
1986	<1>	5.6	5.6	2.9	2.9	2.7	2.7	2.6	2.6	7.0	7.0	
1987		5.8	5.8	2.6	2.7	3.5	3.5	3.1	3.1	6.3	6.2	
1988		6.4	6.6	2.5	2.8	4.1	4.2	3.8	3.7	6.0	5.9	
Quarterly changes:												
1986	Q1	<1>	7.0	7.0	5.4	5.4	2.2	2.2	1.8	1.8	7.1	7.1
	Q2	<1>	3.6	3.6	.6	.6	2.2	2.2	2.9	2.9	7.1	7.1
	Q3	<1>	5.3	5.3	1.4	1.4	2.6	2.6	3.6	3.6	6.9	6.9
	Q4	<1>	2.1	2.1	1.5	1.5	2.3	2.3	.7	.7	6.9	6.9
1987	Q1	<1>	8.6	8.6	4.4	4.4	4.5	4.5	4.2	4.2	6.7	6.7
	Q2	<1>	6.7	6.6	2.6	2.3	4.3	4.3	3.8	3.8	6.2	6.2
	Q3		6.4	6.8	2.6	3.5	3.6	3.2	3.7	3.3	6.1	6.0
	Q4		5.7	5.7	2.7	3.0	3.5	3.5	2.9	2.6	6.1	6.0
1988	Q1		6.6	6.9	2.5	2.9	4.5	4.6	4.0	4.0	6.0	5.9
	Q2		6.6	7.0	2.4	2.6	4.2	4.4	4.1	4.2	6.0	5.9
	Q3		6.6	6.7	2.4	2.4	4.4	4.5	4.1	4.2	6.0	5.9
	Q4		6.7	6.8	2.3	2.3	4.5	4.6	4.3	4.4	6.0	5.9
Two-quarter changes: <2>												
1986	Q2	<1>	5.3	5.3	3.0	3.0	2.1	2.1	2.3	2.3	.0	.0
	Q4	<1>	3.7	3.7	1.5	1.5	2.5	2.5	2.1	2.1	-.2	-.2
1987	Q2	<1>	7.6	7.6	3.5	3.4	4.5	4.5	4.0	4.0	-.7	-.7
	Q4		6.1	6.2	2.6	3.3	3.6	3.3	3.3	3.0	-.1	-.2
1988	Q2		6.6	7.0	2.4	2.7	4.3	4.5	4.1	4.1	-.1	-.1
	Q4		6.6	6.7	2.4	2.3	4.4	4.6	4.2	4.3	.0	.0
Four-quarter changes: <3>												
1985	Q4	<1>	6.6	6.6	3.3	3.3	3.6	3.6	3.1	3.1	-.2	-.2
1986	Q4	<1>	4.5	4.5	2.2	2.2	2.3	2.3	2.2	2.2	-.2	-.2
1987	Q4		6.8	6.9	3.1	3.3	4.0	3.9	3.7	3.5	-.8	-.9
1988	Q4		6.6	6.8	2.4	2.5	4.4	4.5	4.1	4.2	-.1	-.1

<1> Actual.

<2> Percent change from two quarters earlier.

<3> Percent change from four quarters earlier.

September 16, 1987

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

	Units	Projection									
		1986		1987				1988			
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of \$	4265.9	4288.1	4377.7	4447.7	4521.0	4584.4	4661.9	4741.1	4818.7	4898.2
Real GNP	Billions of 82\$	3718.0	3731.5	3772.2	3793.7	3826.6	3855.1	3882.3	3907.6	3930.6	3952.6
Nominal GNP	Percent change	5.3	2.1	8.6	6.6	6.8	5.7	6.9	7.0	6.7	6.8
Real GNP		1.4	1.5	4.4	2.3	3.5	3.0	2.9	2.6	2.4	2.3
Gross domestic product		1.2	2.2	4.2	2.6	3.4	3.1	2.9	2.6	2.5	2.3
Gross domestic purchases		3.0	.4	2.5	2.0	3.2	1.2	1.2	1.2	1.2	1.1
Final sales		3.9	3.7	-2.3	3.4	5.7	1.9	3.4	2.6	2.7	2.3
Private dom. final purchases		5.9	1.2	-3.2	2.8	6.2	-.2	1.7	1.5	1.6	1.3
Personal consumption expend.		7.3	.5	-.7	2.1	6.5	-.8	1.9	1.6	1.6	1.3
Durables		44.9	-6.3	-21.2	9.0	26.7	-16.1	3.6	1.9	1.7	.4
Nondurables		-.1	.2	1.3	-1.8	1.9	1.9	.9	.8	.8	.6
Services		2.6	3.0	5.4	3.0	3.9	2.8	2.2	2.2	2.2	2.1
Business fixed investment		-3.0	5.1	-14.6	9.3	9.9	6.4	4.2	3.6	3.1	2.6
Producers' durable equipment		3.1	4.7	-15.3	12.7	15.0	7.1	6.0	5.0	4.5	4.0
Nonresidential structures		-16.6	6.3	-12.8	1.0	-2.7	4.6	-.4	-.4	-.8	-1.4
Residential structures		9.7	2.2	-7.7	-2.2	-4.9	-7.3	-6.9	-5.5	-2.3	-1.5
Exports		10.6	9.5	10.2	12.1	20.2	13.5	14.4	14.0	12.0	11.2
Imports		20.1	-.8	-5.2	7.4	13.3	-2.2	-.4	1.5	1.5	1.8
Government purchases		3.0	7.9	-6.2	4.2	1.4	1.3	1.5	.0	.7	.7
Federal		2.4	15.2	-18.6	7.3	.6	.0	.3	-3.2	-1.6	-1.4
Defense		16.4	-10.5	7.6	10.7	-4.2	-4.4	-5.9	-4.9	-2.8	-2.5
State and local		3.5	2.4	5.0	2.0	1.9	2.4	2.4	2.5	2.4	2.3
Change in business inventories	Billions of 82\$	6.1	-14.4	47.6	37.8	18.6	29.3	24.5	25.0	22.5	22.0
onfarm	Billions of 82\$.1	2.3	43.9	23.4	13.4	26.3	25.0	26.0	23.5	23.0
exports	Billions of 82\$	-161.6	-151.8	-135.2	-133.3	-131.3	-114.4	-98.8	-85.7	-74.3	-63.7
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	99.8	100.4	101.1	101.7	102.2	102.7	103.3	103.8	104.2	104.6
Unemployment rate	Percent*	6.9	6.9	6.7	6.2	6.0	6.0	5.9	5.9	5.9	5.9
Industrial production index	Percent change	1.9	3.2	3.4	4.1	7.4	3.7	4.1	3.7	3.5	3.2
Capacity utilization rate-mfg.	Percent*	79.7	79.8	80.2	80.5	81.3	81.5	81.7	81.8	81.9	81.9
Housing Starts	Millions	1.76	1.70	1.79	1.62	1.60	1.55	1.52	1.51	1.48	1.47
Auto sales	Millions	12.91	11.32	9.66	10.26	11.55	10.00	10.30	10.45	10.65	10.65
Domestic	Millions	9.43	7.66	6.86	7.20	8.06	6.93	7.20	7.35	7.50	7.50
Foreign	Millions	3.47	3.66	2.80	3.06	3.49	3.07	3.10	3.10	3.15	3.15
INCOME AND SAVING											
Nominal personal income	Percent change	3.1	4.6	7.8	5.7	5.8	7.1	7.3	6.1	5.3	7.7
Real disposable income	Percent change	-1.0	.5	2.7	-3.9	8.1	2.7	2.0	-.3	.7	1.6
Personal saving rate	Percent*	3.6	3.6	4.4	3.0	3.4	4.2	4.2	3.7	3.5	3.6
Corp. profits with IVA & CCAdj	Percent change	5.9	-7.2	19.7	3.4	4.5	13.1	-10.5	7.0	12.8	2.2
Profit share of GNP	Percent*	6.7	6.6	6.7	6.7	6.6	6.7	6.5	6.5	6.5	6.5
Federal govt. surplus/deficit	Billions of \$	-203.7	-188.7	-170.5	-141.9	-167.2	-180.4	-180.7	-160.9	-152.7	-149.2
State and local govt. surplus		59.6	50.6	41.0	49.6	47.1	48.4	52.7	55.3	56.6	57.8
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.6	.7	4.2	3.8	3.3	2.6	4.0	4.2	4.2	4.4
GNP fixed-weight price index		2.6	2.3	4.5	4.3	3.2	3.5	4.6	4.4	4.5	4.6
Cons. & fixed invest. prices		3.1	3.0	5.1	5.0	3.5	3.6	4.6	4.8	5.0	5.1
CPI		2.5	2.6	5.3	4.9	3.8	3.9	4.5	5.1	5.1	5.3
Exc. food and energy		3.7	3.8	4.4	4.7	3.9	4.7	5.1	5.6	5.8	5.9
Nonfarm business sector											
Output per hour		-.6	.0	.4	1.3	1.2	.6	1.0	1.0	1.0	1.1
Compensation per hour		2.8	4.0	1.1	3.0	3.4	3.6	5.0	4.2	4.7	5.0
Unit labor costs		3.5	4.0	.8	1.7	2.2	3.0	4.0	3.2	3.7	3.9

* Not at an annual rate.

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

	Units									Projection	
		1980	1981	1982	1983	1984	1985	1986	1987	1988	
EXPENDITURES											
Nominal GNP	Billions of \$	2732.0	3052.6	3166.0	3405.7	3772.2	4010.3	4235.0	4482.7	4780.0	
Real GNP	Billions of 82\$	3187.1	3248.8	3166.0	3279.1	3501.4	3607.5	3713.3	3811.9	3918.3	
Real GNP	Percent change*	-.1	.6	-1.9	6.5	5.1	3.3	2.2	3.3	2.5	
Gross domestic product		.3	.3	-1.6	6.6	5.3	3.5	2.6	3.3	2.6	
Gross domestic purchases		-1.1	.8	-.8	8.4	6.4	4.1	2.7	2.2	1.2	
Final sales		-.2	.1	.3	3.7	4.7	4.6	2.6	2.1	2.7	
Private dom. final purchases		-1.7	-.3	.8	7.7	5.6	4.6	3.2	1.3	1.5	
Personal consumption expend.		-.1	.2	2.9	5.4	4.1	4.5	4.1	1.7	1.6	
Durables		-5.6	-3.3	9.0	14.7	10.8	6.6	12.4	-2.3	1.9	
Nondurables		-1.4	.5	1.8	4.4	2.3	2.9	2.9	.8	.8	
Services		2.4	.9	2.3	3.9	3.5	5.0	2.4	3.8	2.1	
Business fixed investment		-4.8	5.6	-11.3	10.8	13.8	4.7	-4.7	2.2	3.4	
Producers' durable equipment		-6.5	2.2	-12.5	20.9	14.9	7.0	.2	4.1	4.9	
Nonresidential structures		-1.8	11.7	-9.1	-4.8	11.8	.1	-15.4	-2.7	-.7	
Residential structures		-14.2	-22.4	4.9	38.1	6.1	6.0	12.5	-5.5	-4.1	
Exports		.5	2.4	-13.8	5.8	5.9	-2.7	5.9	13.9	12.9	
Imports		-8.8	4.9	-5.9	23.8	17.4	5.2	8.9	3.1	1.1	
Government purchases		1.0	2.9	3.8	-2.7	7.9	8.7	2.4	.1	.7	
Federal		3.1	9.5	8.2	-8.1	13.0	14.9	-.2	-3.2	-1.5	
Defense		3.1	7.6	8.8	5.1	6.5	7.0	4.8	2.2	-4.1	
State and local		-.3	-1.3	.6	1.5	4.4	4.0	4.6	2.8	2.4	
Change in business inventories	Billions of 82\$	-6.9	23.9	-24.5	-6.4	62.3	7.4	13.8	33.3	23.5	
Nonfarm	Billions of 82\$	-2.3	19.0	-23.1	-.1	57.8	12.0	15.4	26.7	24.4	
Net exports	Billions of 82\$	57.0	49.4	26.3	-19.9	-84.0	-108.2	-145.8	-128.6	-80.6	
Nominal GNP	Percent change*	9.9	9.3	3.1	10.4	8.6	6.6	4.5	6.9	6.8	
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	90.4	91.2	89.6	90.2	94.5	97.5	99.6	102.0	104.0	
Unemployment rate	Percent	7.1	7.6	9.7	9.6	7.5	7.2	7.0	6.2	5.9	
Industrial production index	Percent change*	-.8	-1.0	-7.7	14.3	6.6	1.7	1.1	4.7	3.6	
Capacity utilization rate-mfg.	Percent	79.3	78.3	70.3	74.0	80.5	80.1	79.7	80.8	81.8	
Housing Starts	Millions	1.30	1.10	1.06	1.71	1.77	1.74	1.82	1.64	1.49	
Auto sales	Millions	9.04	8.56	8.00	9.18	10.43	11.09	11.52	10.37	10.51	
Domestic	Millions	6.62	6.24	5.77	6.77	7.97	8.24	8.28	7.26	7.39	
Foreign	Millions	2.42	2.32	2.23	2.41	2.46	2.84	3.25	3.10	3.13	
INCOME AND SAVING											
Nominal personal income	Percent change*	12.0	9.2	5.3	7.8	8.4	6.8	5.5	6.6	6.6	
Real disposable income	Percent change*	1.1	.7	1.0	5.1	4.3	2.8	3.6	2.3	1.0	
Personal saving rate	Percent	7.1	7.5	6.8	5.4	6.1	4.5	4.3	3.7	3.8	
Corp. profits with IVA & CCAdj	Percent change*	-6.8	2.3	-19.1	70.1	7.4	4.1	1.2	10.0	2.5	
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	-165.0	-160.9	
State and local govt. surplus		26.8	34.1	35.1	47.5	64.6	63.1	56.8	46.5	55.6	
PRICES AND COSTS											
GNP implicit deflator	Percent change*	9.9	8.7	5.2	3.6	3.4	3.1	2.2	3.5	4.2	
GNP fixed-weight price index		9.8	8.5	5.0	3.9	3.7	3.6	2.3	3.9	4.5	
Cons. & fixed invest. prices		10.1	8.2	4.4	3.3	3.3	3.5	2.0	4.3	4.9	
CPI		12.5	9.6	4.5	3.2	4.1	3.5	1.3	4.4	5.0	
Exc. food and energy		12.2	10.2	5.2	4.2	4.7	4.3	3.9	4.4	5.6	
Nonfarm business sector											
Output per hour		1.0	-.6	1.0	3.6	1.5	1.0	1.5	.9	1.0	
Compensation per hour		10.9	8.3	7.3	3.3	4.2	4.8	3.4	2.8	4.7	
Unit labor costs		9.8	9.0	6.2	-.3	2.6	3.7	1.9	1.9	3.7	

* Percent changes are from fourth quarter to fourth quarter.

	Projection										Projection			
	1986		1987				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	21.5	32.9	28.5	27.2	25.2	23.0	22.0	115.7	80.6	123.6	97.5
Gross domestic product	10.6	20.4	38.3	24.1	31.5	28.9	27.9	25.2	24.0	22.1	121.5	92.7	122.8	99.1
Gross domestic purchases	28.1	3.7	24.1	19.6	30.9	11.7	11.6	12.2	11.6	11.4	150.2	103.1	86.3	46.7
Final sales	35.2	33.9	-21.3	31.4	52.1	17.8	32.0	24.7	25.5	22.5	159.0	93.3	80.0	104.8
Private dom. final purchases	44.4	9.5	-25.7	21.6	47.4	-1.6	13.5	11.6	12.8	10.5	133.0	97.7	41.8	48.5
Personal consumption expend.	43.2	3.0	-4.6	13.1	39.5	-4.9	12.2	10.3	10.4	8.2	102.1	97.3	43.1	41.0
Durables	35.9	-6.5	-23.1	8.2	23.4	-17.5	3.5	1.8	1.7	.4	22.0	43.9	-9.0	7.4
Nondurables	-.2	.5	2.9	-4.1	4.2	4.1	2.0	1.8	1.9	1.3	24.5	24.6	7.1	6.9
Services	7.5	8.9	15.8	9.0	11.8	8.5	6.7	6.7	6.8	6.5	55.7	28.6	45.1	26.7
Business fixed investment	-3.3	5.5	-17.2	9.6	10.4	7.0	4.7	4.0	3.5	3.0	20.8	-22.0	9.8	15.3
Producers' durable equipment	2.4	3.6	-13.0	9.3	11.2	5.6	4.9	4.1	3.8	3.4	20.7	.6	13.2	16.2
Nonresidential structures	-5.7	1.9	-4.2	.3	-.8	1.4	-.1	-.1	-.2	-.4	.1	-22.6	-3.4	-.9
Residential structures	4.6	1.1	-4.0	-1.1	-2.4	-3.6	-3.4	-2.7	-1.1	-.7	10.1	22.5	-11.2	-7.8
Change in business inventories	-22.0	-20.5	62.0	-9.8	-19.2	10.7	-4.8	.5	-2.5	-.5	-43.3	-12.8	43.7	-7.3
Nonfarm	-23.8	2.2	41.6	-20.5	-10.0	12.9	-1.3	1.0	-2.5	-.5	-22.0	-14.4	24.0	-3.3
Farm	1.8	-22.6	20.3	10.6	-9.1	-2.2	-3.5	-.5	.0	.0	-21.2	1.6	19.6	-4.0
Net exports	-14.8	9.8	16.6	1.9	2.0	16.8	15.7	13.0	11.4	10.6	-34.5	-22.5	37.4	50.8
Exports	9.4	8.7	9.5	11.5	19.3	13.8	15.2	15.2	13.6	13.1	-10.1	21.8	54.0	57.0
Imports	24.2	-1.1	-7.1	9.6	17.2	-3.0	-.5	2.1	2.1	2.5	24.4	44.3	16.7	6.2
Government purchases	5.6	14.6	-12.2	7.9	2.6	2.6	2.8	.0	1.3	1.4	60.5	18.1	.9	5.5
Federal	2.0	12.0	-17.3	5.8	.5	.0	.2	-2.7	-1.3	-1.2	44.8	-.7	-11.0	-5.0
Defense	9.7	-7.1	4.7	6.6	-2.8	-2.9	-3.9	-3.2	-1.8	-1.6	15.8	11.6	5.6	-10.5
Nondefense	-7.6	19.1	-22.0	-.8	3.3	2.9	4.1	.5	.5	.4	29.0	-12.3	-16.6	5.5
State and local	3.6	2.5	5.2	2.1	2.1	2.6	2.6	2.7	2.6	2.6	15.7	18.7	12.0	10.5

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1986*	FY1987e		FY1988e		CY 1987e		FRB Staff Estimates							
		Admin ¹	FRB Staff	Admin ¹	FRB Staff	1986 IV*	I*	II*	1987 III	IV	I	1988 II	III		
Not seasonally adjusted															
Budget receipts ²	769	859	852	909	901	782	866	190	194	254	215	204	205	266	227
Budget outlays ³	990	1017	1012	1032	1062	991	1038	253	252	251	255	280	245	264	273
Surplus/deficit ⁴ (-) to be financed ⁴	-221	-158	-160	-123	-161	-209	-171	-63	-59	2	-40	-75	-41	1	-46
Means of financing:															
Borrowing from public	236	162	171	107	136	215	149	69	28	32	42	48	32	8	48
Cash balance decrease	-14	11	-15	0	21	0	8	0	22	-31	-6	24	8	-5	-5
Other	-1	0	4	1	3	-6	14	-6	9	-3	4	4	1	-4	3
Cash operating balance, end of period	31	20	46	20	25	31	23	31	9	40	46	23	15	20	25
Memo: Sponsored agency borrowing	14	n.a.	13	n.a.	23	13	15	4	-4	7	6	6	4	7	6
Seasonally adjusted annual rates															
Receipts	816	875	888	968	942	827	902	853	879	922	897	910	936	957	966
Expenditures	1027	1061	1055	1089	1111	1032	1067	1041	1050	1064	1065	1090	1116	1118	1119
Purchases	369	385	374	395	388	366	377	369	367	380	380	382	389	389	391
Defense	275	291	289	301	294	278	293	279	288	295	294	294	295	294	294
Nondefense	93	94	85	94	93	88	85	90	79	85	86	88	94	95	96
All other expend.	658	676	681	694	723	666	690	673	683	683	685	708	728	729	729
Surplus/deficit(-)	-211	-186	-167	-121	-169	-205	-165	-189	-171	-142	-167	-180	-181	-161	-153
High-employment surplus/ deficit(-) evaluated at 6 percent unemp.	-190	n.a.	-149	n.a.	-162	-183	-151	-163	-151	-125	-156	-171	-174	-156	-148

*--actual

e--estimated

n.a.--not available

Note: Details may not add to totals due to rounding

1. Mid-session Review of the 1988 Budget (August 1987). The Congressional Budget Office baseline estimates released August 19 indicated receipts of \$853 and \$897 billion, outlays of \$1010 and \$1080 billion, and deficits of \$157 and \$183 billion in FY1987 and FY1988, respectively. The CBO estimate of the FY1988 deficit with the policies of the Congressional Budget Resolution is \$146 billion.
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 formed to recapitalize the Federal Savings and Loan Insurance Corporation. The Administration's definition of borrowing by these agencies is somewhat broader.

DOMESTIC FINANCIAL DEVELOPMENTS

Recent developments. Market interest rates moved up early in the intermeeting period amid pressures on the dollar, concerns about inflation, and potential policy actions by the Fed. Rates rose further following the discount rate increase. On balance, long rates are up more than 1/2 percentage point; increases in short rates range between 30 and 75 basis points. Equity prices have fluctuated widely; major indexes posted record highs in late August, but retraced these gains as interest rates moved higher and currently are about 3 percent below levels at the August meeting.

Growth in the monetary aggregates increased in August from the sluggish pace of recent months. M2 expanded at near a 6 percent annual rate, partly reflecting faster growth in its M1 component as the runoff in demand deposits ended and other checkable deposits accelerated slightly. The strongest growth among nontransactions components of M2 occurred in RP liabilities at banks, which rose sharply in association with a surge in acquisitions of Treasury securities for trading accounts, and in money market mutual funds. Bolstered by M2 and faster growth in managed liabilities, M3 expanded at a 7-1/2 percent annual rate in August. Since the fourth quarter of 1986, M2 and M3 have increased at annual rates of 4 and 5 percent respectively, placing them below the low ends of their target ranges.

Banks added substantial amounts to both their loan and securities portfolios in August, lifting bank credit growth to nearly an 11 percent annual rate. Sizable acquisitions of Treasury securities in early August more than offset continued runoffs in "other"--primarily tax-exempt--securities. After no growth in July, total loans at banks rose at close to

a 9 percent rate in August; consumer loans accelerated to an 8-1/2 percent growth rate, the fastest in a year, and real estate lending was brisk. Business loans were little changed after running off in July.

The sluggishness in business loan growth in August was accompanied by further contractions in outstanding commercial paper of nonfinancial businesses. Paydowns of paper were most evident in merger-related programs, reflecting steps by restructured firms to fund earlier short-term borrowings. In addition, higher interest rates have damped corporate enthusiasm for longer-term borrowing. The volume of corporate bond offerings, while heavy through July, dropped off sharply in August and early September. Offerings by industrial firms in August were the lowest in two years and thus far the September volume appears even smaller. The recent lower bond volume coupled with the weakness in short-term borrowing suggests that total net borrowing by businesses has slackened in the third quarter. Equity issuance also has been light despite high price-earnings ratios. Meanwhile, retirements of stock continue at a hectic pace as merger and restructuring activity apparently has not abated.

In municipal markets, the volume of long-term tax-exempt offerings was light in July and August, and there is no indication of a pickup in September. Higher interest rates have contributed to a sharp reduction in advance refunding issuance since June, while offerings of bonds for new capital have continued to be restrained this year by restrictions imposed under tax reform.

In the household sector, consumer installment credit expanded more than 7 percent at an annual rate in July after rising at a 9-1/2 percent rate in June. Strength in retail sales, especially durable goods, likely

contributed to this growth, which was well above the first-half pace. In addition, the rebound in consumer credit may reflect some abatement in the substitution of home equity borrowing for traditional consumer credit balances.

Since the August FOMC meeting, the average contract rate on new commitments for 30-year fixed-rate conventional home mortgages has risen about 60 basis points, and now stands almost 2 percentage points above its March low. On September 4 the Veterans Administration announced an increase in its ceiling rate from 10 to 10.5 percent. The rise in long-term mortgage rates since March has slowed mortgage borrowing generally and diverted activity from fixed-rate into adjustable-rate loans. Initial rates on one-year ARMs have risen only slightly since mid-July amid reports that lenders--especially thrift institutions--are offering larger initial discounts to increase their shares of this market. About half of conventional home mortgages closed in July and August were adjustable rate.

In the federal sector, the Treasury is expected to borrow, net, \$42 billion from the public in the current quarter to finance a deficit that we estimate to be almost that large. Most of this financing already has been completed, entirely through the sale of marketable coupon issues. Borrowing by federally sponsored agencies has fallen this quarter largely because of the Federal Home Loan Banks, whose needs for funds have diminished in line with demands for advances by thrift institutions.

Outlook. With credit demands damped by rising interest rates, debt growth is projected to remain around the less rapid pace that has emerged this year. The domestic nonfinancial sector debt aggregate is expected to

grow about 8-1/2 percent at an annual rate in the second half of this year and to continue near this pace in 1988.

Federal sector borrowing is expected to rise slightly more than seasonally in the fourth quarter, as the deficit widens to an estimated \$75 billion. Staff anticipates that something under \$50 billion will be raised in public borrowing, with roughly \$24 billion coming from a drawdown of the Treasury's sizable cash balances. Looking further ahead, Treasury credit needs in 1988 are projected--based on current fiscal assumptions--to be somewhat less than in 1987, implying a modest reduction in the percentage growth of outstanding federal debt.

In the corporate sector, the financing gap is expected to widen over the projection period, as capital expenditures outpace internal funds growth. The effects of an elevated financing gap on corporate credit needs, however, likely will be offset in part by reduced borrowing to finance share retirements, if, as assumed, the pace of merger and restructuring activity subsides. Any increase in borrowing by firms is likely to be concentrated in short-term credit markets.

Municipal bond issuance also should remain low, as refunding efforts are discouraged by higher rates. In addition, state and local government outlays for construction are anticipated to taper off, and these governmental units have accumulated a large volume of financial assets in the past few years that may be available to fund expenditures and retire debt.

Household debt growth is expected to slow a little as higher interest rates damp activity in housing markets. In addition to a lower level of home building, reduced turnover of existing homes will tend to lower borrowing. We expect a pickup in consumer credit growth in the current

quarter, associated with auto incentive programs. Although slower growth is expected in the fourth quarter and in 1988, consistent with the outlook for consumer spending, consumer credit is not expected to be as sluggish as earlier this year.

INTERNATIONAL DEVELOPMENTS

Recent developments. Since the last meeting of the FOMC, the weighted-average foreign exchange value of the dollar against the other G-10 currencies has declined about 1-3/4 percent. The decline has been fairly even across the currencies of the major foreign industrial currencies, including the mark and yen. Selling pressure on the dollar intensified after the release in mid-August of worse-than-expected U.S. merchandise trade data for June. The dollar rose slightly later in the period after the 1/2 point increase in the discount rate by the Federal Reserve and the widening of short-term interest rate differentials favoring the dollar.

The Desk sold a total of \$350 million equivalent of yen and \$50 million equivalent of marks during the intermeeting period.

Long-term interest rates rose substantially in the United States during the intermeeting period; yields on long-term Japanese and German bonds also rose, but somewhat less than dollar rates.

The average pace of economic growth in the major foreign industrial economies increased in the second quarter after a very weak first quarter. Available evidence on the pace of economic activity since the second quarter has been mixed. German GNP rebounded in the second quarter, reversing a first-quarter decline but leaving GNP no higher than its third-quarter 1986 level. Industrial production in Germany also rebounded in the second quarter to reverse an earlier

decline, but fell again in July. Industrial production in Japan declined on balance in the second quarter, but rose in July. Twelve-month changes in consumer prices have edged higher recently in the major foreign industrial countries but remain generally low. Evidence of adjustment in trade and current account balances abroad is present in recent data, especially for Japan, but these balances remain at or near record highs for the year to date in Japan and Germany.

After meeting with U.S. officials, Brazil's Finance Minister stated that his earlier proposals to exchange debt to commercial banks for bonds at a rate reflecting part of the market discount on loans would be a voluntary option and would not be unilaterally imposed on banks by Brazil. In Argentina, the Radical Party of President Alfonsín lost its majority in the Chamber of Deputies and several gubernatorial posts in elections on September 6. The outcome was attributed in the press to the poor performance of the economy. Mexico's plans to increase subsidies to state enterprises puts in jeopardy the Mexican commitment to the IMF to raise additional government revenues this year by increasing prices of public enterprise products.

The U.S. merchandise trade balance recorded a deficit of \$158 billion (annual rate) for the second quarter on a seasonally adjusted, balance of payments basis. The value of exports rose about 5 percent from the revised first-quarter levels, with most of the increase in volume and spread across agricultural products, machinery, and industrial supplies. The value of imports increased almost 4 percent from the first quarter, with the rise concentrated in imports of petroleum and oil products. For July, on a seasonally unadjusted c.i.f. basis, the merchandise trade deficit was \$198 billion (annual

rate), the largest single monthly deficit recorded so far this year. After correcting for seasonal factors and transforming the data to a balance of payments basis, the staff estimates the July deficit to have been about unchanged from the June deficit and only slightly larger than the second-quarter average. The current account deficit widened in the second quarter to a record \$164 billion (annual rate), somewhat above the first-quarter figure.

Foreign official reserve assets in the United States declined \$6 billion in July. Only a fraction of this decline was attributable to intervention sales of dollars; much of the decline was associated with the inability of foreign officials to rollover maturing holdings of Treasury securities because of the debt ceiling and the postponement of the weekly Treasury auctions. Private foreign holdings of U.S. securities continued to increase in July; net purchases of corporate bonds rose to \$3 billion in July, up from the second-quarter rate, while foreign net purchases of stock were \$2.3 billion, slightly above the low June figure but less than the monthly average for the second quarter. Private foreign net purchases of U.S. Treasury securities were small in July, down from the June level.

Outlook. The staff continues to expect a moderate decline in the weighted-average foreign exchange value of the dollar over the forecast horizon. The outlook for real economic activity in the major foreign industrial countries calls for real GNP growth to remain at or below 2 percent, on average, through the end of 1988. Recent data for the second quarter and for July show a somewhat higher level of U.S. imports than previously expected. In addition, an increase in the value of oil imports in the third quarter, partly in response to

tensions in the Persian Gulf, is expected to result in a rise in the value of merchandise imports in that quarter. These factors explain the revision in the staff outlook for the deficit in the U.S. current account balance in 1987 to \$160 billion, slightly larger than the previous forecast and the 1986 deficit. The current account balance is expected to improve during 1988, to an annual rate of about \$145 billion by the fourth quarter. The balance of real net exports is expected to continue to show significant improvement.

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	-115.6	-99.1	-110.5	-116.9	-112.2	-118.6	-118.4	-113.0	-107.6	-100.8	-96.4	-91.6
Exports of G+S	376.2	423.3	503.9	376.6	383.3	397.3	411.0	433.0	451.9	472.7	494.4	514.3	534.1
Imports of G+S	481.7	539.0	603.1	487.1	500.2	509.5	529.7	551.6	565.1	580.4	595.2	610.8	625.8
Constant 82 \$, Net	-145.8	-128.6	-80.6	-161.6	-151.8	-135.2	-133.3	-131.3	-114.4	-98.8	-85.7	-74.3	-63.7
Exports of G+S	377.4	419.5	479.0	379.6	388.3	397.8	409.3	428.6	442.3	457.5	472.7	486.3	499.4
Imports of G+S	523.2	548.1	559.6	541.2	540.1	533.0	542.6	559.8	556.8	556.3	558.4	560.5	563.0
2. U.S. Merchandise Trade Balance 2/	-144.3	-158.1	-146.2	-148.5	-154.4	-155.0	-158.1	-162.0	-157.3	-153.3	-147.9	-143.6	-140.0
Exports	224.4	248.6	304.6	226.1	228.1	228.0	239.9	256.9	269.7	283.9	298.3	311.6	324.5
Agricultural	27.0	28.7	30.7	26.6	28.1	26.1	28.6	30.8	29.2	29.5	30.4	31.1	31.7
Non-Agricultural	197.3	219.9	273.9	199.6	200.0	201.9	211.3	226.1	240.5	254.3	267.8	280.5	292.8
Imports	368.7	406.7	450.7	374.6	382.5	383.0	398.0	418.9	427.0	437.1	446.1	455.2	464.5
Petroleum and Products	33.8	42.3	44.0	31.6	32.0	34.8	40.0	49.7	44.7	43.1	43.7	44.2	45.2
Non-Petroleum	334.9	364.5	406.7	343.0	350.4	348.2	358.0	369.3	382.3	394.0	402.4	411.1	419.3
3. U.S. Current Account Balance	-141.4	-161.3	-151.7	-146.3	-151.9	-147.1	-164.4	-171.7	-162.0	-158.2	-152.3	-149.0	-147.4
Of Which: Net Investment Income	20.8	10.2	4.3	21.4	18.0	22.0	6.4	2.1	10.1	6.0	5.4	3.4	2.4
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.4	2.0	1.9	2.0	1.6	1.3	2.9	1.5	2.0	1.8	1.8	1.8	1.9
Real GNP--NonOPEC LDC 5/	4.5	4.2	4.3	4.5	4.3	4.2	4.1	4.1	4.0	4.1	4.4	4.8	5.1
Consumer Prices--Ten Ind. 4/	2.0	2.2	2.8	0.1	2.1	2.4	3.4	2.2	2.6	2.7	3.1	2.6	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