Prefatory Note

The attached document represents the most complete and accurate version available based on original copies culled from the files of the FOMC Secretariat at the Board of Governors of the Federal Reserve System. This electronic document was created through a comprehensive digitization process which included identifying the best-preserved paper copies, scanning those copies,[1] and then making the scanned versions text-searchable.[2] Though a stringent quality assurance process was employed, some imperfections may remain.

Please note that this document may contain occasional gaps in the text. These gaps are the result of a redaction process that removed information obtained on a confidential basis. All redacted passages are exempt from disclosure under applicable provisions of the Freedom of Information Act.

---

[1] In some cases, original copies needed to be photocopied before being scanned into electronic format. All scanned images were deskewed (to remove the effects of printer- and scanner-introduced tilting) and lightly cleaned (to remove dark spots caused by staple holes, hole punches, and other blemishes caused after initial printing).

[2] A two-step process was used. An advanced optimal character recognition computer program (OCR) first created electronic text from the document image. Where the OCR results were inconclusive, staff checked and corrected the text as necessary. Please note that the numbers and text in charts and tables were not reliably recognized by the OCR process and were not checked or corrected by staff.

December 9, 1987

SUMMARY AND OUTLOOK

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

TABLE OF CONTENTS

DOMESTIC FINANCIAL DEVELOPMENTS **III**

Tables

INTERNATIONAL DEVELOPMENTS **IV**

Tables

Recent developments. Available data suggest that output is expanding moderately in the current quarter. Spending indicators point to some slowing in both consumption and fixed investment from the rapid third-quarter pace, largely for reasons unrelated to the stock market collapse; however, gains in real net exports and a more rapid accumulation of nonfarm inventories likely are providing considerable support to activity. Wage and price inflation trends remain stable.

Payroll employment rose nearly 275,000 in November, an impressive increase coming on the heels of a huge gain of more than half a million jobs in October. Employment in the manufacturing sector continued to display vigor in October and November, with hiring widespread across durable and nondurable industries. Meanwhile, job growth in the service-producing sector continued at a brisk pace. Aggregate hours worked by production and nonsupervisory workers have remained on a strong uptrend, with monthly gains averaging about 0.3 percent since June. The civilian unemployment rate fell back to 5.9 percent in November.

The index of industrial production showed a 0.6 percent increase in October, the bulk of which reflected a rise in output of motor vehicles. Preliminary physical product data for November, in conjunction with the labor market data, point to a further increase in industrial production.

Consumer spending has weakened this quarter, largely because of a drop in purchases of new cars after incentive programs ended in

September. Sales of domestically produced new cars remained lackluster through mid-November. As a consequence, domestic manufacturers reinstated limited incentive programs, and auto sales rebounded in the final 10-day selling period last month. Purchases of light trucks and foreign autos also dropped back a bit in October and November, but have remained more buoyant than sales of domestically produced new cars. Spending on goods and services other than motor vehicles appears to have registered a moderate gain, in real terms, in October. However, surveys of consumer sentiment show a marked deterioration since the mid-October stock market plunge. Retail sales data for November will be released this Friday.

Residential construction activity declined in October. Starts of multifamily units remained on the downtrend that has been evident for nearly two years, responding to persistently high rental vacancy rates and the effects of adverse changes in tax laws. In the single-family market, starts fell to 1.1 million units at an annual rate, a bit below the average recorded since May; the October figures were heavily influenced by the earlier runup in mortgage interest rates and provide little insight into the net effect of the recent declines in stock prices and mortgage interest rates.

Business fixed investment appears to have decelerated markedly from the exceptional pace of the third quarter. Outlays for capital equipment have been held down by the drop in auto sales and a sharp decline in purchases of heavy trucks. Outside of motor vehicles, equipment demand remained strong early in the current quarter. Nominal shipments of nondefense capital goods, although down somewhat in October, remained above the third-quarter average. Moreover, new orders moved up further, suggesting that shipments are likely to retain some momentum in the near term. Spending for nonresidential structures has softened in recent months; petroleum drilling appears to have flattened out, and nonresidential construction put-in-place declined in September and October. The McGraw-Hill survey of capital spending intentions for 1988 indicates nominal outlays are expected to be about 6-1/4 percent above their 1987 level, implying only small real gains in coming quarters.

Information on current-quarter inventory investment is limited. Manufacturers' inventories rose appreciably in October, extending the trend that began this summer. Nonetheless, factory stocks remain low relative to shipments by historical standards. In the auto sector, production exceeded sales in both October and November, and dealer stocks, once again, have risen to uncomfortable levels. At other retail trade establishments, inventories at the end of September were at the high end of the range that has prevailed over the past year.

In the aggregate, price and wage inflation have shown no clear departures from the average rates posted over the first three quarters of the year. Retail energy prices dropped in October, and crude oil prices have edged down in recent weeks. However, apart from energy, consumer price increases appear to have picked up a bit in recent months. Food prices rose 0.4 percent in October, after a comparable rise the preceding month. Excluding food and energy, consumer prices rose 0.5 percent in October, boosted by larger increases for new cars, apparel, and owners' equivalent rent. At the earlier stages of processing, producer prices for finished goods turned down in October, but prices for intermediate and crude materials remained on a strong uptrend. With respect to labor costs, information on the current quarter is confined to the hourly earnings index, which increased 0.5 percent in November and is up 2-1/2 percent over the past 12 months.

Outlook. The staff expects real GNP to grow at a 3 percent annual rate in the current quarter, somewhat slower than the average over the first three quarters of this year. Prices, as measured by the GNP fixed-weighted price index, are projected to rise about 3-3/4 percent at an annual rate.

In the absence of much information on spending beyond October, the staff has relied heavily on the labor market data, which suggest that activity in the current quarter is advancing a little more rapidly than projected in the last Greenbook. With regard to the composition of spending, consumption is projected to decline and business fixed investment is expected to increase only slightly, owing in part to the drop in purchases of motor vehicles. Nevertheless, the production of new cars is expected to be higher than in the third quarter, providing a significant boost to real GNP in the form of a sharp swing in auto inventories. Outside of autos, consumption and business fixed investment are expected to rise, but the latter at a much slower pace than occurred in the third quarter. Residential construction activity is anticipated to decline, in lagged response to the downtrend in starts through October. In contrast to domestic demands, exports are expected to register another strong rise. Meanwhile, imports are projected to drop back, reflecting a decline in oil imports from an elevated third-quarter level.

The contour of the projection of real GNP in 1988 is still dominated by the anticipated effects of the decline in the stock market and the accompanying financial market developments. Growth rates of M2 and M3 in 1988 are expected to be in the lower halves of the tentative ranges established by the FOMC. Interest rates are expected to drift down somewhat in coming months, and then to move up over the second half of next year, in response to more rapid growth in real output and emerging pressures on wages and prices. Although the foreign exchange value of the dollar is somewhat lower at this juncture than previously anticipated, it is projected to fall to about the same level by the end of 1988 as in the last Greenbook.

The federal budget deficit on a unified basis is projected to be about $165 billion in fiscal year 1988, essentially the same as in the October Greenbook. We are assuming enactment of the deficit-reduction compromise negotiated by the administration and Congress, but with allowance for some slippage; we have trimmed the ultimate budgetary effect to be a few billion dollars less than the $30 billion specified for fiscal year 1988. On the whole, fiscal policy remains a moderately restraining force on aggregate demand.[1]

---

1. Given the likely character of the compromise, our translation of the deficit reduction package to a National Income and Product Account (NIPA) basis--which analytically is more useful for assessing economic
(Footnote continues on next page)

Real GNP is projected to expand at a bit less than 1-1/2 percent at an annual rate in the first half of 1988. As was the case in the previous projection, consumer spending remains the critical element in the projected first-half slowdown in real GNP. Although incoming information has not shed much light on the situation, the deterioration in household balance sheets and the uncertainty about income and employment prospects that were engendered by the decline in the stock market still are expected to lead to some hesitation in consumer spending over the near term. The growth in plant and equipment spending is projected to slow in response to the sluggish pace of sales and resultant diminished requirements for additional capacity. The projection anticipates that producers--alert to the risk of such a development--will undertake adjustments to output rather promptly, thus preventing a substantial accumulation of unwanted inventories.

Activity is expected to recover to a 2-1/2 to 3 percent pace in the second half of next year. We anticipate that the bulk of the adjustment of consumption to the lower level of wealth will be complete by midyear and spending then should increase about in line with disposable income. In addition, lower mortgage interest rates are expected to stimulate a modest pickup in residential construction in the second half. The external sector provides a substantial positive contribution to activity over the entire projection horizon; real mechandise exports are expected to continue growing rapidly, and

---

(Footnote continued from previous page)
and credit market effects--probably will be closer to $20 billion. The difference between the unified budget and NIPA estimates largely reflects asset sales and timing adjustments for taxes.

domestic producers should begin to benefit from reduced import penetration.

The GNP fixed-weighted price index is projected to rise a bit more than 4 percent over the four quarters of 1988, about the same as in 1987. Energy prices are expected to be virtually flat in 1988, after this year's rebound. However, a further acceleration of nonpetroleum import prices is projected to continue to place upward pressure on inflation. Moreover, nominal gains in compensation are expected to pick up in response to past and prospective consumer price increases. Nevertheless, concerns about the economic outlook and continuing efforts to improve competitiveness in the tradable goods sector are expected to damp real wages over the projection horizon. The degree of slack in labor and product markets is viewed as an essentially neutral influence on wage and price inflation over the projection horizon.

Details of the staff projection are shown in the accompanying tables.

CONFIDENTIAL - FR
CLASS II FOMC

December 9, 1987

STAFF GNP PROJECTIONS

Percent changes, annual rate

		Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
		10/28/87	12/9/87	10/28/87	12/9/87	10/28/87	12/9/87	10/28/87	12/9/87	10/28/87	12/9/87
Annual changes:											
1985	<1>	6.3	6.3	3.0	3.0	3.6	3.6	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		5.7	5.8	2.7	2.8	3.3	3.5	2.9	2.9	6.2	6.2
1988		5.6	5.7	2.0	2.3	3.9	3.9	3.5	3.3	6.2	6.3
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>	6.3	6.3	2.5	2.5	4.1	4.1	3.5	3.5	6.2	6.2
	Q3 <1>	6.2	7.0	3.8	4.1	2.7	3.3	2.4	2.8	6.0	6.0
	Q4	5.0	5.4	2.2	3.0	3.3	3.7	2.6	2.5	6.1	6.0
1988	Q1	4.8	5.1	.8	1.1	4.3	4.1	4.0	3.9	6.2	6.2
	Q2	5.3	5.0	1.4	1.6	4.1	3.8	3.8	3.4	6.3	6.3
	Q3	6.9	6.3	2.6	2.6	4.2	4.1	4.1	3.7	6.3	6.3
	Q4	7.2	7.0	2.9	2.9	4.4	4.3	4.2	3.9	6.2	6.2
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>	7.5	7.5	3.4	3.4	4.4	4.4	3.9	3.9	-.7	-.7
	Q4	5.6	6.2	3.0	3.5	3.0	3.6	2.5	2.6	-.1	-.2
1988	Q2	5.0	5.1	1.1	1.4	4.2	4.0	3.9	3.7	.2	.3
	Q4	7.0	6.7	2.8	2.8	4.3	4.2	4.1	3.8	-.1	-.1
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	6.5	6.8	3.2	3.5	3.7	4.0	3.2	3.2	-.8	-.9
1988	Q4	6.0	5.9	1.9	2.1	4.3	4.1	4.0	3.7	.1	.2

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

December 9, 1987

CONFIDENTIAL - FR
CLASS II FOMC

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

	Units	1986		1987				1988			
							Projection				
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of $	4265.9	4288.1	4377.7	4445.1	4520.5	4580.7	4638.2	4695.4	4768.2	4849.4
Real GNP	Billions of 82$	3718.0	3731.5	3772.2	3795.3	3833.4	3861.6	3872.5	3887.9	3912.8	3941.2
Nominal GNP	Percent change	5.3	2.1	8.6	6.3	7.0	5.4	5.1	5.0	6.3	7.0
Real GNP		1.4	1.5	4.4	2.5	4.1	3.0	1.1	1.6	2.6	2.9
Gross domestic product		1.2	2.2	4.2	2.8	4.1	2.9	1.2	1.6	2.6	2.9
Gross domestic purchases		3.0	.4	2.5	2.1	4.2	1.0	-.6	.1	1.2	1.8
Final sales		3.9	3.7	-2.3	3.5	5.8	3.0	.7	2.0	2.9	3.0
Private dom. final purchases		5.9	1.2	-3.2	2.9	6.9	-1.6	.6	.6	1.8	2.2
Personal consumption expend.		7.3	.5	-.7	1.9	4.9	-2.1	.3	.5	1.8	2.2
Durables		44.9	-6.3	-21.2	10.5	22.4	-18.5	-.9	-1.5	3.7	5.3
Nondurables		-.1	.2	1.3	-1.9	-1.2	-1.2	-.5	.0	.7	.9
Services		2.6	3.0	5.4	2.1	4.1	3.1	1.3	1.4	2.0	2.1
Business fixed investment		-3.0	5.1	-14.6	11.7	26.3	1.9	3.5	1.8	1.5	1.6
Producers' durable equipment		3.1	4.7	-15.3	16.5	27.5	2.8	4.0	3.0	2.5	2.5
Nonresidential structures		-16.6	6.3	-12.8	.0	23.0	-.6	2.2	-1.4	-1.2	-.9
Residential structures		9.7	2.2	-7.7	-2.8	-6.0	-3.9	-2.7	-1.2	2.3	4.2
Exports		10.6	9.5	10.2	17.9	19.4	14.0	12.3	11.3	12.0	12.0
Imports		20.1	-.8	-5.2	11.1	16.3	-2.9	-2.7	-1.6	.7	2.3
Government purchases		3.0	7.9	-6.2	3.8	1.3	12.3	-7.5	.1	.5	.4
Federal		2.4	15.2	-18.6	6.6	.8	26.5	-17.6	-1.8	-1.0	-1.4
Defense		16.4	-10.5	7.6	9.8	2.8	-6.0	-5.3	-3.4	-2.2	-2.5
State and local		3.5	2.4	5.0	1.7	1.6	2.2	1.3	1.6	1.7	1.8
Change in business inventories	Billions of 82$	6.1	-14.4	47.6	39.0	24.1	24.2	28.6	24.7	21.8	21.2
Nonfarm	Billions of 82$	.1	2.3	43.9	22.7	9.4	34.2	26.4	24.0	21.5	21.5
Net exports	Billions of 82$	-161.6	-151.8	-135.2	-132.7	-134.9	-116.4	-99.3	-84.6	-71.9	-61.2
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	99.8	100.4	101.1	101.7	102.3	103.1	103.4	103.7	104.0	104.5
Unemployment rate	Percent*	6.9	6.9	6.7	6.2	6.0	6.0	6.2	6.3	6.3	6.2
Industrial production index	Percent change	1.3	3.8	3.2	4.2	8.3	3.7	1.0	2.6	3.9	4.6
Capacity utilization rate-mfg.	Percent*	79.5	79.8	80.0	80.5	81.4	81.7	81.3	81.3	81.5	81.9
Housing Starts	Millions	1.76	1.70	1.79	1.61	1.61	1.54	1.55	1.58	1.58	1.59
Auto sales	Millions	12.91	11.32	9.66	10.26	11.42	9.68	9.65	9.40	9.75	9.95
Domestic	Millions	9.43	7.66	6.86	7.20	7.84	6.45	6.57	6.50	6.80	7.00
Foreign	Millions	3.47	3.66	2.80	3.06	3.58	3.22	3.08	2.90	2.95	2.95
INCOME AND SAVING											
Nominal personal income	Percent change	3.1	4.6	7.8	5.2	5.3	8.4	4.9	4.1	4.8	7.8
Real disposable income	Percent change	-1.0	.5	2.7	-4.3	4.0	5.3	1.9	-.5	1.3	2.2
Personal saving rate	Percent*	3.6	3.6	4.4	3.0	2.8	4.5	4.9	4.6	4.5	4.5
Corp. profits with IVA & CCAdj	Percent change	5.9	-7.2	19.7	3.9	24.8	-4.9	-12.3	2.5	15.3	8.9
Profit share of GNP	Percent*	6.7	6.6	6.7	6.7	6.9	6.8	6.5	6.4	6.6	6.6
Federal govt. surplus/deficit	Billions of $	-203.7	-188.7	-170.5	-139.2	-137.2	-179.3	-175.3	-163.7	-160.5	-162.0
State and local govt. surplus		59.6	50.6	41.0	50.6	45.7	45.4	47.8	49.2	51.9	57.5
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.6	.7	4.2	3.5	2.8	2.5	3.9	3.4	3.7	3.9
GNP fixed-weight price index		2.6	2.3	4.5	4.1	3.3	3.7	4.1	3.8	4.1	4.3
Cons. & fixed invest. prices		3.1	3.0	5.1	4.7	3.8	3.7	4.2	4.2	4.4	4.6
CPI		2.5	2.6	5.3	4.9	4.0	3.8	3.8	4.3	4.5	5.0
Exc. food and energy		3.7	3.8	4.4	4.7	3.6	4.5	4.3	4.8	5.1	5.3
Nonfarm business sector											
Output per hour		-.6	.0	.4	1.4	3.6	-.8	.3	.6	1.5	1.5
Compensation per hour		2.8	4.0	1.1	3.0	3.8	3.0	4.7	3.8	4.0	4.3
Unit labor costs		3.5	4.0	.8	1.5	.2	3.8	4.4	3.2	2.5	2.8

* Not at an annual rate.

December 9, 1987

CONFIDENTIAL - FR
CLASS II FOMC

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	4481.0	4737.8
Real GNP	Billions of 82$	3187.1	3248.8	3166.0	3279.1	3501.4	3607.5	3713.3	3815.6	3903.6
Real GNP	Percent change*	-.1	.6	-1.9	6.5	5.1	3.3	2.2	3.5	2.1
Gross domestic product		.3	.3	-1.6	6.6	5.3	3.5	2.6	3.5	2.1
Gross domestic purchases		-1.1	.8	-.8	8.4	6.4	4.1	2.7	2.4	.6
Final sales		-.2	.1	.3	3.7	4.7	4.6	2.6	2.4	2.2
Private dom. final purchases		-1.7	-.3	.8	7.7	5.6	4.6	3.2	1.2	1.3
Personal consumption expend.		-.1	.2	2.9	5.4	4.1	4.5	4.1	.9	1.2
Durables		-5.6	-3.3	9.0	14.7	10.8	6.6	12.4	-3.5	1.6
Nondurables		-1.4	.5	1.8	4.4	2.3	2.9	2.9	-.7	.3
Services		2.4	.9	2.3	3.9	3.5	5.0	2.4	3.7	1.7
Business fixed investment		-4.8	5.6	-11.3	10.8	13.8	4.7	-4.7	5.2	2.1
Producers' durable equipment		-6.5	2.2	-12.5	20.9	14.9	7.0	.2	6.6	3.0
Nonresidential structures		-1.8	11.7	-9.1	-4.8	11.8	.1	-15.4	1.6	-.3
Residential structures		-14.2	-22.4	4.9	38.1	6.1	6.0	12.5	-5.1	.6
Exports		.5	2.4	-13.8	5.8	5.9	-2.7	5.9	15.3	11.9
Imports		-8.8	4.9	-5.9	23.8	17.4	5.2	8.9	4.4	-.3
Government purchases		1.0	2.9	3.8	-2.7	7.9	8.7	2.4	2.6	-1.7
Federal		3.1	9.5	8.2	-8.1	13.0	14.9	-.2	2.6	-5.7
Defense		3.1	7.6	8.8	5.1	6.5	7.0	4.8	3.4	-3.3
State and local		-.3	-1.3	.6	1.5	4.4	4.0	4.6	2.6	1.6
Change in business inventories	Billions of 82$	-6.9	23.9	-24.5	-6.4	62.3	7.4	13.8	33.7	24.1
Nonfarm	Billions of 82$	-2.3	19.0	-23.1	-.1	57.8	12.0	15.4	27.5	23.3
Net exports	Billions of 82$	57.0	49.4	26.3	-19.9	-84.0	-108.2	-145.8	-129.8	-79.3
inal GNP	Percent change*	9.9	9.3	3.1	10.4	8.6	6.6	4.5	6.8	5.9
YMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	90.4	91.2	89.6	90.2	94.5	97.5	99.6	102.1	103.9
Unemployment rate	Percent	7.1	7.6	9.7	9.6	7.5	7.2	7.0	6.2	6.3
Industrial production index	Percent change*	-.8	-1.0	-7.7	14.3	6.6	1.7	1.0	4.8	3.0
Capacity utilization rate-mfg.	Percent	79.3	78.2	70.3	73.9	80.5	80.1	79.7	80.9	81.5
Housing Starts	Millions	1.30	1.10	1.06	1.71	1.77	1.74	1.82	1.64	1.57
Auto sales	Millions	9.04	8.56	8.00	9.18	10.43	11.09	11.52	10.26	9.69
Domestic	Millions	6.62	6.24	5.77	6.77	7.97	8.24	8.28	7.09	6.72
Foreign	Millions	2.42	2.32	2.23	2.41	2.46	2.84	3.25	3.16	2.97
INCOME AND SAVING										
Nominal personal income	Percent change*	12.0	9.2	5.3	7.8	8.4	6.8	5.5	6.7	5.4
Real disposable income	Percent change*	1.1	.7	1.0	5.1	4.3	2.8	3.6	1.9	1.2
Personal saving rate	Percent	7.1	7.5	6.8	5.4	6.1	4.5	4.3	3.7	4.7
Corp. profits with IVA & CCAdj	Percent change*	-6.8	2.3	-19.1	70.1	7.4	4.1	1.2	10.2	3.1
Profit share of GNP	Percent	6.5	6.2	4.7	6.3	7.1	6.9	6.7	6.8	6.5
Federal govt. surplus/deficit	Billions of $	-61.3	-63.8	-145.9	-176.0	-169.6	-196.0	-204.7	-156.6	-165.4
State and local govt. surplus		26.8	34.1	35.1	47.5	64.6	63.1	56.8	45.7	51.6
PRICES AND COSTS										
GNP implicit deflator	Percent change*	9.9	8.7	5.2	3.6	3.4	3.1	2.2	3.2	3.7
GNP fixed-weight price index		9.8	8.5	5.0	3.9	3.7	3.6	2.3	4.0	4.1
Cons. & fixed invest. prices		10.1	8.2	4.4	3.3	3.3	3.5	2.0	4.3	4.4
CPI		12.5	9.6	4.5	3.2	4.1	3.5	1.3	4.5	4.4
Exc. food and energy		12.2	10.2	5.2	4.2	4.7	4.3	3.9	4.3	4.9
Nonfarm business sector										
Output per hour		1.0	-.6	1.0	3.6	1.5	1.0	1.5	1.2	1.0
ensation per hour		10.9	8.3	7.3	3.3	4.2	4.8	3.4	2.7	4.2
t labor costs		9.8	9.0	6.2	-.3	2.6	3.7	1.9	1.6	3.2

* Percent changes are from fourth quarter to fourth quarter.

CONFIDENTIAL - FR
CLASS II FOMC

December 9, 1987

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

	1986		1987				1988 (Projection)				1985	1986	1987 (Projection)	1988 (Projection)
	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	23.1	38.1	28.2	10.8	15.4	24.9	28.4	115.7	80.6	130.1	79.6
Gross domestic product	10.6	20.4	38.3	25.8	37.7	27.2	11.5	15.7	25.2	28.1	121.5	92.7	129.0	80.5
Gross domestic purchases	28.1	3.7	24.1	20.6	40.3	9.7	-6.3	.7	12.3	17.7	150.2	103.1	94.7	24.4
Final sales	35.2	33.9	-21.3	31.8	53.0	28.1	6.4	19.3	27.8	29.0	159.0	93.3	91.6	82.6
Private dom. final purchases	44.4	9.5	-25.7	22.2	52.8	-13.0	4.6	4.4	14.2	17.5	133.0	97.7	36.3	40.7
Personal consumption expend.	43.2	3.0	-4.6	11.6	29.7	-13.3	1.9	2.9	11.3	13.6	102.1	97.3	23.4	29.7
Durables	35.9	-6.5	-23.1	9.5	20.0	-20.2	-.9	-1.5	3.5	5.0	22.0	43.9	-13.8	6.1
Nondurables	-.2	.5	2.9	-4.2	-2.7	-2.6	-1.1	.0	1.5	2.0	24.5	24.6	-6.6	2.4
Services	7.5	8.9	15.8	6.2	12.3	9.6	3.9	4.4	6.3	6.6	55.7	28.6	43.9	21.2
Business fixed investment	-3.3	5.5	-17.2	11.9	26.3	2.1	4.0	2.1	1.8	1.9	20.8	-22.0	23.1	9.8
Producers' durable equipment	2.4	3.6	-13.0	11.9	19.9	2.3	3.3	2.5	2.1	2.2	20.7	.6	21.1	10.2
Nonresidential structures	-5.7	1.9	-4.2	.0	6.4	-.2	.7	-.4	-.4	-.3	.1	-22.6	2.0	-.4
Residential structures	4.6	1.1	-4.0	-1.4	-3.0	-1.9	-1.3	-.6	1.1	2.0	10.1	22.5	-10.3	1.2
Change in business inventories	-22.0	-20.5	62.0	-8.6	-14.9	.1	4.4	-3.9	-2.9	-.6	-43.3	-12.8	38.6	-3.0
Nonfarm	-23.8	2.2	41.6	-21.2	-13.3	24.8	-7.8	-2.4	-2.5	.0	-22.0	-14.4	31.9	-12.7
Farm	1.8	-22.6	20.3	12.6	-1.6	-24.7	12.2	-1.5	-.4	-.6	-21.2	1.6	6.6	9.7
Net exports	-14.8	9.8	16.6	2.5	-2.2	18.5	17.1	14.7	12.6	10.7	-34.5	-22.5	35.4	55.1
Exports	9.4	8.7	9.5	16.7	18.8	14.4	13.2	12.5	13.6	13.9	-10.1	21.8	59.4	53.2
Imports	24.2	-1.1	-7.1	14.2	21.0	-4.2	-3.9	-2.2	1.0	3.2	24.4	44.3	23.9	-1.9
Government purchases	5.6	14.6	-12.2	7.1	2.4	22.6	-15.3	.2	1.0	.8	60.5	18.1	19.9	-13.2
Federal	2.0	12.0	-17.3	5.3	.7	20.2	-16.7	-1.5	-.9	-1.2	44.8	-.7	8.9	-20.2
Defense	9.7	-7.1	4.7	6.1	1.8	-4.1	-3.5	-2.2	-1.4	-1.6	15.8	11.6	8.5	-8.7
Nondefense	-7.6	19.1	-22.0	-.8	-1.2	24.4	-13.2	.7	.5	.4	29.0	-12.3	.4	-11.5
State and local	3.6	2.5	5.2	1.8	1.7	2.4	1.4	1.7	1.9	2.0	15.7	18.7	11.1	7.0

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1986*	Fiscal Year 1987*	FY1988e Admin[1]	FY1988e FRB Staff	CY 1986*	CY1987e FRB Staff	1986 IV*	1987 I*	1987 II*	1987 III*	FRB Staff Estimates 1987 IV	FRB Staff Estimates 1988 I	FRB Staff Estimates 1988 II	FRB Staff Estimates 1988 III
							Not seasonally adjusted							
Budget receipts[2]	769	854	909	897	782	870	190	194	254	217	205	206	261	225
Budget outlays[2]	990	1002	1032	1062	991	1035	254	252	251	245	286	238	265	273
Surplus/deficit(-) to be financed[2]	-221	-148	-123	-165	-209	-165	-64	-59	3	-29	-81	-32	-4	-48
Means of financing:														
Borrowing from public	236	150	107	153	215	143	69	28	32	22	62	32	22	37
Cash balance decrease	-14	-5	0	11	0	15	0	22	-31	4	20	0	-14	5
Other[3]	-1	3	1	1	-6	7	-6	9	-3	3	-2	0	-4	7
Cash operating balance, end of period	31	36	20	25	31	16	31	9	40	36	16	16	30	25
Memo: Sponsored agency borrowing[4]	14	16	n.a.	31	14	20	5	-4	7	8	9	4	9	9
NIPA Federal Sector							Seasonally adjusted annual rates							
Receipts	816	894	968	944	827	912	853	879	923	921	927	940	952	957
Expenditures	1027	1053	1089	1114	1032	1069	1041	1050	1062	1058	1106	1115	1116	1118
Purchases	369	373	395	391	366	380	369	367	380	379	395	388	389	391
Defense	275	289	301	295	278	293	279	288	295	296	294	295	295	295
Nondefense	93	84	94	96	88	87	90	79	85	83	100	93	95	96
All other expend.	658	679	694	723	666	689	673	683	683	679	712	727	726	726
Surplus/deficit(-)	-211	-159	-121	-170	-205	-157	-189	-171	-139	-137	-179	-175	-164	-161
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-190	-141	n.a.	-158	-183	-144	-163	-151	-123	-128	-173	-164	-149	-146

*--actual e--estimated n.a.--not available

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

1. <u>Mid-session Review of the 1988 Budget</u> (August 1987). The Congressional Budget Office baseline estimates released August 19 indicated receipts of $897 billion, outlays of $1080 billion, and the deficit of $183 billion in FY1988.
2. Includes social security receipts and outlays, which are classified as off-budget under current law.
3. Checks issued less checks paid, accrued items, and other transactions.
4. Sponsored agency borrowing includes net debt issuance by Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation (excluding participation certificates), the Federal National Mortgage Association (excluding mortgage-backed securities), Farm Credit Banks, the Student Loan Marketing Association, and the Financing Corporation. The Administration's definition of borrowing by these agencies is somewhat broader.

Recent Developments

Financial markets have settled down somewhat since the November FOMC, but participants remain wary in light of the October stock market collapse and domestic and international economic uncertainties. While federal funds have continued to trade at about the early November level, most other short-term interest rates have moved up a little, although they remain well below pre-crash levels. Three- and six-month rates have moved up only marginally, while private one-month rates have climbed substantially more, reflecting year-end seasonal pressures.

Longer-term rates on nonfederal debt, by contrast, have drifted down somewhat more since the last FOMC, and most are currently 1 to 1-1/2 percentage points below rates prevailing just before the stock market collapse. Tensions associated with the late October flight to quality seem to have abated; rates on long Treasuries are almost unchanged on balance over the intermeeting period, while municipal and corporate bond rates have fallen 20 to 40 basis points. Commitment rates on conventional home mortgages have declined by comparable amounts.

The post-crash surge in the monetary aggregates likewise shows signs of unwinding. M1 declined at a 6 percent rate during November, despite continued strong growth in currency early in the month, as both demand and other checkable deposits fell from October-average levels. M2 was essentially flat during the month, after 7 percent growth in October, as a small increase in the nontransactions component roughly offset the drop in M1. Small time deposits at banks and thrifts grew briskly in both October and November in response to relatively favorable rates, and balances in money market mutual funds increased in November, while savings deposits, MMDAs and overnight RPs recorded declines. M3 decelerated to around 5 percent growth, but the non-M2 components--especially large time deposits--surged at the fastest rates in several years. Balances in institution-only MMMFs jumped as their yields adjusted downward with the usual lag to changes in market rates.

Bank credit was essentially flat in November after several months of expansion. Banks' holdings of securities advanced a little; most of the increase reportedly was in CMOs. A small decline in loan portfolios was heavily concentrated in security loans--mostly to brokers and dealers--as the late October bulge unwound and the issuance of equities and some other securities dropped to very low levels. Growth in banks' business loans slowed during the month, but real estate and consumer loans advanced at rates comparable to recent experience.

Gross public offerings of corporate securities dropped further in November, to a pace less than half that recorded in the first half of the year. Particularly affected were low-grade offerings, which were negligible, and new Eurobond issues, which fell sharply during the month. New stock offerings were less than $1 billion, compared with more than $5 billion per month earlier in the year. Business loans at banks and nonfinancial commercial paper rose only a little, too, in November.

The federal budget deficit is projected to be around $81 billion in the current quarter, and the Treasury is expected to borrow, net, around $62 billion from the public, financing most of the rest with drawdowns of cash balances from the high levels reached at the end of the third quarter. Federal borrowing in the fourth quarter will be predominantly in the form of coupon issues.

Gross issuance of municipal bonds remained comparatively light in November. Offerings for new capital were up, while refunding activity was minimal. Although spreads between tax-exempt and taxable bond rates have widened a bit recently, they remain small; one factor is uneasiness about tax proposals that would reduce the attractiveness of municipal securities to some investors. Although several major investment firms have announced drastic cutbacks in their municipal finance activities, reportedly there has been little impact on trading in the tax-exempt markets.

Interest rates on fixed-rate home mortgages moved down with other long rates early in the intermeeting period, and since mid-November they have held at a little over 10-1/2 percent on new commitments. While the initial advantage of ARM rates over fixed-rate loans has diminished somewhat, the spread is still attractive, and in early November more than 60 percent of conventional loans closed had adjustable-rate features. Overall residential mortgage credit growth may be picking up a bit after some slowing in the third quarter; thrift institutions added a large volume of loans--presumably ARMs-- to their balance sheets in October. Growth in home equity lines of credit at large commercial banks has slowed in recent months, but still is considerable. Consumer installment credit decelerated to a 7-1/2 percent annual rate in October, and for the year to date is running well below the 1986 pace.

Outlook

While the initial shock of October 19 has dissipated to a degree and markets seem to be functioning more smoothly, sentiment remains edgy. Anxieties about the economy and the dollar have not been alleviated, and some concern remains about the ability of the market structures to withstand any further adversities. These factors suggest a likelihood of continued volatility in financial markets. On balance, the staff forecast anticipates that both short- and long-term interest rates will decline somewhat further on balance over the next several months, against a backdrop of weaker economic expansion.

Overall debt growth in the economy likely will continue to be moderate by comparison with the past several years. However rocky the present course of budget talks, federal debt growth is on a slow downward trend. State and local borrowing is likely to remain low by the standards of recent years.

In the business sector, the staff projection is for a gradual uptrend in economic profits. Combined with the weak outlook for investment, the corporate financing gap, although growing from what it was through the third quarter, is expected to be only moderate. Gross stock issuance is expected to remain low for some time and merger activity has receded, but corporate repurchases of their own shares may be stimulated by lower equity prices, so net equity issuance is projected to remain substantially negative through the current forecast period. Funds raised by businesses in the credit markets, therefore, are expected to remain sizable. The expected environment should be conducive to continued reliance on the bond markets, with high quality borrowers probably receiving the best reception; lower-rated issuers seeking to arrange restructurings involving asset sales may encounter resistance until the stock market strengthens appreciably.

Households can be expected to manifest greater caution in their borrowing behavior in the anticipated environment of weaker employment conditions. Thus, consumer credit expansion, after having picked up a bit in the past few months, seems likely to taper off again. The staff projects that mortgage debt growth will remain substantial through the forecast period, however, so that total household debt is likely to continue rising faster than nominal personal income.

Overall, the domestic nonfinancial debt aggregate, after growing around 9-1/2 percent in 1987--near the middle of the annual monitoring range--is expected to post a somewhat smaller increase next year.

Since the last FOMC meeting, the trade-weighted foreign exchange value of the dollar in terms of the other G-10 currencies has declined more than 2-3/4 percent. The decline has been about 3-1/2 percent against the yen, but about 2-3/4 percent against the mark. Selling pressure on the dollar was fueled intermittently by disappointment with the course of efforts to reduce the U.S. federal deficit and by statements from officials in the United States and Germany that suggested international efforts to stabilize exchange rates were being lessened. Following concerted reductions of official interest rates in Europe, the dollar has rebounded somewhat.

Interest rate reductions abroad occurred in three rounds. Early in the intermeeting period the Bundesbank lowered its Lombard rate and announced a reduction in the rate at which the next repurchase tender would be offered. Several European countries followed by lowering official lending rates, with the exception of France where Bank of France rates were raised in order to contribute to greater stability of the franc relative to the mark. Late in November, official rates were again lowered in Germany and several other European countries. Last week, the Bundesbank lowered its discount rate 1/2 percentage point to a record 2.5 percent, and many other European central banks lowered official lending rates as well. Short-term market interest rates abroad have generally declined in response to these actions.

Equity prices in Germany and Japan have continued to decline. Since the last FOMC meeting, the stock index for the Tokyo market has dropped about 3 percent, while the index for the Frankfurt market declined about 13 percent. Long-term interest rates have fallen in both Germany and Japan since early November.

The Desk purchased a total of $1,297 million ($433 million against yen and $864 million against marks) during the intermeeting period.

Economic growth in the major foreign industrial countries increased markedly in the third quarter. Real GNP rose 8.4 percent (s.a.a.r.) in Japan, as domestic demand grew 7.6 percent and net exports made a small positive contribution to growth. Growth was particularly strong in residential investment. German real GNP grew 5.7 percent (s.a.a.r.) in the third quarter, mainly in response to domestic demand, which increased 4.6 percent. Industrial production data for October show some further expansion of activity in Japan and Germany. GDP growth in the third quarter was strong in France, the United Kingdom, and Canada, as well.

The presidents of eight Latin American nations met in Acapulco at the end of November and discussed the external debt situation among other topics. No new proposals emerged from the meeting. Signing of the interim financing arrangement reached between Brazil and its foreign creditor banks on a $4.5 billion package is now scheduled for December 15. The proceeds are to be used in several stages to bring Brazil current through December 31, 1987, on interest due to commercial banks.

Mexico's financial markets have been disrupted by collapses in the stock market and in the free market value of the peso against the dollar. Mexican officials have announced new anti-inflationary measures which include tighter controls on prices of basic consumer products and further easing of import controls. Ecuador signed an IMF letter of intent for a stand-by arrangement in early December and has resumed interest payments to banks; it also received a $31 million bridge loan from the U.S. Treasury. A $500 million bridge loan involving the U.S. Treasury, other industrial countries, and some Latin American countries, was dispersed to Argentina on November 12. Repayment of part of that loan from an IMF disbursement occurred this week.

The U.S. merchandise trade deficit for the third quarter of 1987 was about the same as in the second quarter. The value of exports increased 9 percent from the second quarter while that of imports rose 6 percent; in both cases the change was largely in volume terms. Nearly half of the increase in exports was in capital goods, particularly civilian aircraft and business machines. There was also a substantial increase in shipments of agricultural commodities, mainly soybeans and wheat. Oil imports accounted for about 50 percent of the increase in imports in the third quarter. The volume of oil imports rose 22 percent; the price of oil rose on average for the quarter but declined in September, reflecting declining world spot market prices during the summer. The value of non-oil imports rose 3 percent, with imports of capital goods and passenger cars from areas other than Canada particularly strong. Trade data for the month of October will be released

Thursday, December 10; these data will be summarized in the Greenbook Supplement.

Foreign official reserve holdings of dollars in the United States increased sharply in October, as intervention to support the dollar resumed. Partial information covering November indicates that the reserves held in the United States by the non-U.S. members of the G-10 and Taiwan continued to increase. Private foreigners added to their net holdings of U.S. equities in October; the total increase was down from September, but higher than the third-quarter monthly average. Foreign net purchases of U.S. corporate bonds declined in October, reflecting the weakness in new Eurobond issues by U.S. corporations in September and October; this weakness continued in November. In contrast, almost $5 billion in U.S. Treasury securities were sold, net, by private foreigners in October, more than accounted for by Japanese residents. Bank-reported inflows were negligible in October, down sharply from September.

Outlook. The weighted-average foreign exchange value of the dollar is expected to decline during 1988 at a moderate rate, with the level by the end of the period essentially unchanged from that projected in the October Greenbook. During the intermeeting period, the dollar declined at a somewhat faster pace than that incorporated into the previous forecast. In recent days, however, economic policy authorities abroad have significantly lowered official central bank lending rates, with short-term foreign market rates tending to decline as well. Data on economic activity abroad during the third quarter suggest greater near-term strength in domestic demand, which should have favorable implications for U.S. external balances. These factors are expected in the near term to provide support for the dollar. Market reactions to the prospects for continued adjustment of global external imbalances are likely to contribute to a moderate decline of the dollar over the forecast horizon, as projected, although the risk of a more rapid decline remains.

Economic activity in the other industrial countries was stronger in the third quarter than previously had been anticipated. As a result, the staff forecast for average growth of real GNP in the other G-10 countries over the four quarters of 1987 has been raised to about 2-3/4 percent. The effects of the changes in exchange rates that have already occurred and that are projected for 1988, plus some impact from the declines in stock markets since mid-October, are expected to contribute to a slowing of activity abroad during 1988. The projection of 2 percent average growth of real GNP in the other G-10 countries during 1988 is only slightly higher than that presented in the last Greenbook.

The staff outlook for the U.S. current account balance is for a gradual improvement over the forecast period, with the deficit reaching about $128 billion at an annual rate by the fourth quarter of 1988, compared with an estimated $168 billion in the third quarter of this year. As import prices are projected to rise faster than export prices in both 1987 and 1988, changes in nominal trade and current account balances will mask a larger rise in real net exports of goods and services.

Strictly Confidential (FR)
Class II FOMC

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-	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current $, Net	-105.5	-114.4	-89.1	-110.5	-116.9	-112.2	-118.4	-119.8	-107.3	-100.2	-91.6	-84.7	-79.9
Exports of G+S	376.2	425.7	501.7	376.6	383.3	397.3	416.5	434.6	454.2	473.1	491.3	511.0	531.4
Imports of G+S	481.7	540.0	590.8	487.1	500.2	509.5	534.8	554.4	561.5	573.3	582.9	595.7	611.3
Constant 82 $, Net	-145.8	-129.8	-79.3	-161.6	-151.8	-135.2	-132.7	-134.9	-116.4	-99.3	-84.6	-72.0	-61.2
Exports of G+S	377.4	423.3	480.5	379.6	388.3	397.8	414.5	433.3	447.7	460.9	473.3	486.9	500.9
Imports of G+S	523.2	553.1	559.8	541.2	540.1	533.0	547.2	568.2	564.0	560.2	557.9	558.9	562.1
2. U.S. Merchandise Trade Balance 2/	-144.3	-155.6	-135.7	-148.5	-154.4	-155.0	-158.2	-159.3	-149.9	-144.6	-137.5	-131.8	-128.7
Exports	224.4	251.0	311.4	226.1	228.1	228.0	240.4	261.1	274.5	289.7	304.4	318.9	332.6
Agricultural	27.0	30.2	35.2	26.6	28.1	26.1	28.7	33.7	32.5	33.5	34.6	35.9	36.9
Non-Agricultural	197.3	220.8	276.2	199.6	200.0	201.9	211.7	227.4	242.1	256.2	269.9	283.0	295.7
Imports	368.7	406.6	447.1	374.6	382.5	383.0	398.6	420.4	424.5	434.3	441.9	450.7	461.3
Petroleum and Products	33.8	42.4	44.3	31.6	32.0	34.8	39.9	50.5	44.4	42.9	43.7	44.8	46.0
Non-Petroleum	334.9	364.2	402.7	343.0	350.4	348.2	358.7	369.9	380.1	391.4	398.2	405.9	415.3
3. U.S. Current Account Balance	-141.4	-157.1	-135.0	-146.3	-151.9	-147.1	-164.5	-168.4	-148.4	-144.1	-138.0	-130.0	-127.9
Of Which: Net Investment Income	20.8	12.5	10.2	21.3	18.0	22.0	6.4	4.7	17.1	11.6	9.0	10.1	10.0
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.5	2.5	2.2	2.2	1.6	1.2	3.3	4.5	1.9	1.5	1.9	2.0	2.0
Real GNP--NonOPEC LDC 5/	4.6	3.9	4.3	4.3	3.8	3.5	3.7	4.0	4.2	4.4	4.4	4.3	4.3
Consumer Prices--Ten Ind. 4/	2.0	2.1	2.6	0.1	2.1	2.4	3.4	1.7	2.5	2.5	3.0	2.5	3.2

1/ National Income and Product Account data.
2/ International accounts basis.
3/ Percent change, annual rates.
4/ Weighted by multilateral trade-weights of G-10 countries plus Switzerland; prices are not seasonally adjusted.
5/ Weighted by share in NonOPEC LDC GNP.
P/ Projected