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March 26, 1986

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. Recent economic indicators have been mixed, but lower interest rates, falling oil prices, and a depreciating dollar appear to be laying the groundwork for stronger growth in real activity later this year. Inflation is currently being damped by price declines for energy and food.

Labor demand, overall, has continued to increase at a brisk pace in early 1986, with nonfarm payroll employment up 225,000 in February after a large increase the previous month. Most of the February gain in employment was in trade and services; manufacturing employment, in contrast, turned down after four months of growth. The unemployment rate fell in January, but then rose sharply in February to 7.3 percent, partly reflecting a sizable drop in employment among agricultural workers.

Industrial production was little changed in January and fell 0.6 percent in February. Declines occurred in most major sectors in February, with a particularly sharp drop in oil and gas drilling. The limited data that are available for March show a further fall in drilling activity and a drop in steel production. In addition, auto assemblies, though still at a relatively high level, appear to have turned down in March after four months of increase; sales in the first quarter, while up sharply on average from the fourth-quarter pace, have fallen short of assemblies, and dealers' inventories have continued to grow.

Consumer spending appears to have risen at a moderate pace in the first quarter, with a major element of strength being the rebound in domestic car sales. In contrast, sales of foreign cars have dropped back from the

exceptionally high level of late 1985, probably reflecting limited supplies of Japanese models. The rise in spending for other goods and services appears to have slowed after a particularly strong advance late last year. Real income growth has picked up in recent months, and the personal saving rate has risen a bit from the unusually low levels of last fall. Consumer optimism still appears to be high, buoyed recently by lower interest rates and falling oil prices.

Declines in mortgage interest rates are generating a vigorous expansion in housing activity. Total private housing starts averaged about 2 million units at an annual rate in January and February--up 15 percent from the fourth-quarter pace. Except for a one-month spurt in 1984, single-family starts so far this quarter have been at the highest level in nearly seven years. Multifamily starts remained strong into early 1986, but with vacancy rates high, the strength in this sector probably is unsustainable.

Business investment spending apparently weakened in the first quarter, after a strong gain toward the end of 1985. Real outlays for structures, which rose at more than a 7 percent annual rate in the fourth quarter, probably were pulled down in the first quarter by the collapse in oil and gas drilling. In addition, shipments of nondefense capital goods in January and February were below the advanced level of the fourth quarter; both the upswing in equipment spending late last year and the subsequent falloff may reflect the efforts of firms to lock in tax advantages that may be eliminated if the House tax reform bill were enacted. For 1986 as a whole, survey data on capital spending plans suggest that businesses still anticipate small increases in nominal investment spending.

Diverse patterns of inventory investment continue to be apparent in the manufacturing and trade sectors. Manufacturers are exhibiting cautious inventory behavior and, through January, had pared real stocks for six consecutive months, despite a gradual uptrend in shipments over the same period. In contrast, trade inventories have continued to accumulate and, recently, at a faster pace than through much of 1985. Even in trade, however, stocks generally do not appear excessive, the major exception being the buildup in auto dealers' inventories.

Declines in energy prices have dominated the recent inflation indicators. Crude oil prices plunged early this year, and the retail prices of gasoline and fuel oil have fallen substantially. In addition, retail food prices turned down in February, after a temporary surge late last year. Taken together, these developments in the food and energy sectors led to a sizable drop in producer prices in February and a decline in consumer prices as well. Recent price increases for items other than food and energy have been toward the low end of the range that prevailed over the past year. Although there continue to be scattered reports of large price hikes for some foreign goods, particularly Japanese cars, these increases have thus far had only a small impact on consumer prices.

Outlook. The staff expects real GNP growth to average around 2-1/2 percent in the first half of 1986. Stronger growth is anticipated later in the year and on into 1987. The rate of GNP growth projected for the first quarter--close to 3 percent at an annual rate--is based on the assumption of a small rise in domestic demand, a moderate advance in exports,

and a partial reversal of the fourth-quarter surge in imports. Spending for residential construction was a notable element of strength in the first quarter; business fixed investment appears to have been a major area of weakness. Inflation, as measured by the fixed-weighted price index for gross national product, is estimated to have been about 3-1/4 percent in the first quarter, down from the fourth-quarter rate.

Although the expected pace of expansion in the first half is a shade weaker than in the last projection, a number of recent developments seem to be providing the basis for stronger growth later in the year. In particular, in view of recent developments in world oil markets, the path assumed for crude oil prices has been revised down further this month; the average price of imported oil is now assumed to fall to \$16 per barrel by summer and remain around that level over the balance of the forecast horizon. In addition, the staff is assuming that the exchange value of the dollar, which continued to fall rapidly in the first quarter, will decline nearly 20 percent over the year as a whole--a substantially larger depreciation than in the last Greenbook. A further moderate depreciation is assumed for 1987.

The staff's fiscal policy assumptions have changed little since the last Greenbook. For fiscal year 1986, the total budget deficit, including off-budget outlays, is expected to be around \$205 billion, and for fiscal 1987 it is assumed that enough deficit-reducing initiatives will be enacted to reduce the deficit to about \$165 billion. Adjusting the fiscal year 1987 projection for the Administration's stronger growth assumptions, the assumed policy changes would be sufficient to prevent the automatic triggering of cutbacks required under the Gramm-Rudman-Hollings Act.

With regard to monetary assumptions, M1 growth is expected to be in the upper part of the range adopted at the February meeting, while M2 growth is expected to be around the middle of its range. For 1987, growth in M1 is expected to moderate, but little change is projected for the expansion of M2. Under these monetary conditions the economic projection appears to be broadly consistent with interest rates generally around current levels.

The projected step-up in activity in the second half of 1986 is expected to bring real GNP growth for the year as a whole to about 3-1/2 percent, and an additional increase of 3-1/4 percent is projected for 1987. For each of these years, the forecast of real growth has been revised up nearly 1/2 percentage point since the last Greenbook.

The external sector is expected to begin providing stimulus for real activity this year, after a sustained period in which weak export growth and continued import substitution retarded the growth of domestic production. With the dollar down substantially, and assumed to depreciate further, export demand is expected to rise considerably over the forecast horizon; import growth, in contrast, is likely to be damped. In the domestic economy, a lower level of mortgage interest rates should result in a high level of housing activity over the forecast horizon, and consumer spending should benefit from recent stock market gains, as well as the boost to real income from lower energy prices. In the business sector, lower financing costs and gradual increases in operating rates should provide support to investment

outlays; however, weakness in the energy sector, particularly in the near term, and an end to the boom in office building are expected to be constraining influences. Government purchases seem likely to show little if any, growth, at either the federal or state and local levels.

Inflation is projected to ease further in the near term, but then turn up moderately by year-end as the effects of a depreciating dollar and a strengthening economy begin to outweigh the impact of falling energy prices. With the unemployment rate dropping to around 6-1/4 percent by the end of 1987, the rate of increase in wages probably will pick up moderately. The fixed-weighted price index for GNP, after rising just over 3 percent in 1986, is projected to accelerate to about a 4 percent increase in 1987.

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STAFF GNP PROJECTIONS

Percent changes, annual rate

		Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate	
		2/5/86	3/26/86	2/5/86	3/26/86	2/5/86	3/26/86	2/5/86	3/26/86	2/5/86	3/26/86
Annual changes:											
1984	<1>	11.0	11.0	6.6	6.6	4.2	4.2	4.0	4.0	7.5	7.5
1985	<1>	5.8	5.7	2.3	2.2	3.6	3.6	3.3	3.3	7.2	7.2
1986		6.2	5.6	2.7	2.5	3.7	3.3	3.4	3.0	6.7	6.9
1987		6.5	7.0	2.9	3.6	3.8	3.7	3.5	3.4	6.5	6.4
Quarterly changes:											
1985	Q1 <1>	6.9	6.9	3.7	3.7	3.5	3.5	3.0	3.0	7.3	7.3
	Q2 <1>	4.5	4.5	1.1	1.1	3.6	3.6	3.3	3.3	7.3	7.3
	Q3 <1>	5.8	5.8	3.0	3.0	2.7	2.7	2.9	2.9	7.2	7.2
	Q4 <1>	5.9	4.3	2.4	.7	4.5	3.9	3.3	3.3	7.0	7.0
	Q1	7.2	6.1	3.3	2.9	4.0	3.3	4.0	3.3	6.8	7.0
	Q2	5.8	5.2	2.3	2.3	3.4	2.9	3.4	2.9	6.7	7.0
	Q3	6.2	6.9	3.1	4.4	3.4	2.9	3.0	2.4	6.7	6.8
	Q4	6.5	7.3	3.3	4.2	3.5	3.4	3.1	2.9	6.6	6.7
1987	Q1	6.4	7.2	2.6	3.5	3.8	3.9	3.7	3.6	6.6	6.5
	Q2	6.8	7.1	3.1	3.4	4.0	3.8	3.6	3.6	6.5	6.4
	Q3	7.0	7.2	3.0	3.2	4.2	4.1	3.9	3.9	6.5	6.3
	Q4	7.0	7.3	2.6	2.9	4.5	4.4	4.3	4.3	6.5	6.3
Two-quarter changes: <2>											
1985	Q2 <1>	5.7	5.7	2.4	2.4	3.5	3.5	3.1	3.1	.1	.1
	Q4 <1>	5.9	5.0	2.7	1.9	3.6	3.4	3.1	3.1	-.3	-.3
1986	Q2	6.5	5.7	2.8	2.6	3.7	3.1	3.7	3.1	-.3	.0
	Q4	6.3	7.1	3.2	4.3	3.5	3.2	3.0	2.7	-.1	-.3
1987	Q2	6.6	7.2	2.9	3.5	3.9	3.9	3.6	3.6	-.1	-.3
	Q4	7.0	7.2	2.8	3.0	4.3	4.3	4.1	4.1	.0	-.1
Four-quarter changes: <3>											
1984	Q4 <1>	9.0	9.0	4.7	4.7	4.2	4.2	4.1	4.1	-1.3	-1.3
1985	Q4 <1>	5.8	5.4	2.5	2.1	3.5	3.5	3.1	3.1	-.2	-.2
1986	Q4	6.4	6.4	3.0	3.4	3.6	3.1	3.4	2.9	-.4	-.3
1987	Q4	6.8	7.2	2.8	3.2	4.1	4.1	3.9	3.8	-.1	-.4

<1> Actual.

<2> Percent change from two quarters earlier.

<3> Percent change from four quarters earlier.

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

	Units	Projection									
		1985		1986				1987			
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Expenditures											
Nominal GNP	Billions of \$	4016.9	4059.3	4120.2	4173.0	4242.9	4317.9	4393.5	4469.8	4548.3	4629.0
Real GNP	Billions of 82\$	3584.1	3590.8	3616.5	3636.8	3675.9	3714.2	3746.3	3777.7	3807.3	3834.2
Real GNP	Percent change	3.0	.7	2.9	2.3	4.4	4.2	3.5	3.4	3.2	2.9
Gross domestic purchases		5.0	3.0	1.4	2.5	3.3	3.2	2.7	2.2	2.0	2.1
Final sales		5.0	1.3	.1	2.2	4.2	4.3	3.0	3.4	3.2	3.0
Private dom. final purchases		4.5	2.2	.8	4.4	4.2	3.8	2.7	2.4	2.2	2.3
Personal consumption expend.		4.6	.1	2.5	3.3	3.4	3.3	2.5	2.2	2.0	2.0
Durables		24.3	-13.3	4.1	4.2	5.2	5.3	2.7	3.6	2.9	2.7
Nondurables		1.5	.6	1.0	3.8	3.2	2.9	2.6	2.0	2.0	1.9
Services		1.4	4.4	3.2	2.6	3.1	2.9	2.3	1.9	1.8	1.8
Business fixed investment		2.4	11.3	-11.9	4.7	3.1	4.1	4.2	4.2	3.9	3.9
Producers' durable equipment		3.0	13.5	-13.0	13.5	6.0	6.0	6.0	6.0	5.5	5.5
Nonresidential structures		1.2	7.2	-9.7	-10.4	-2.3	.5	.6	.7	.5	.5
Residential structures		8.5	5.7	14.7	18.6	16.4	8.9	2.0	.4	1.0	2.6
Exports		-5.1	6.6	5.2	5.9	12.2	13.5	11.7	13.0	14.2	13.1
Imports		12.8	24.5	-6.2	6.6	1.9	3.3	3.7	1.4	2.9	5.0
Government purchases		18.2	9.2	-9.0	-5.2	-1.3	1.0	.3	.9	1.1	1.5
Federal		37.3	23.4	-19.2	-12.2	-3.8	1.2	-.6	.4	-.2	-.1
Defense		22.0	-3.2	4.4	-3.1	-1.6	2.7	.2	.8	1.0	.0
State and local		4.7	-1.6	.8	.9	.8	.9	1.1	1.3	2.1	2.8
Change in business inventories	Billions of 82\$	-1.8	-6.3	18.5	19.0	21.0	21.0	25.5	26.0	26.0	25.0
Nonfarm	Billions of 82\$	1.6	18.2	23.0	19.5	21.5	21.0	25.5	26.0	26.0	25.0
Net exports	Billions of 82\$	-119.8	-140.8	-128.3	-130.9	-122.6	-114.4	-108.1	-97.3	-86.9	-79.8
Nominal GNP	Percent change	5.8	4.3	6.1	5.2	6.9	7.3	7.2	7.1	7.2	7.3
Employment and Production											
Nonfarm payroll employment	Millions	98.0	98.8	99.7	100.2	100.7	101.3	102.0	102.6	103.1	103.6
Unemployment rate	Percent*	7.2	7.0	7.0	7.0	6.8	6.7	6.5	6.4	6.3	6.3
Industrial production index	Percent change	2.0	1.8	1.8	1.5	4.8	4.6	3.8	3.9	3.4	3.3
Capacity utilization rate-mfg.	Percent*	80.3	80.1	79.9	79.7	80.2	80.6	80.8	81.0	81.1	81.2
Housing Starts	Millions	1.69	1.77	1.95	1.95	1.90	1.95	1.95	1.95	1.95	1.90
Auto sales	Millions	12.31	10.24	10.80	10.66	10.70	10.80	10.80	10.85	10.85	10.85
Domestic	Millions	9.40	6.84	8.00	7.66	7.70	7.70	7.80	7.80	7.80	7.80
Foreign	Millions	2.90	3.40	2.80	3.00	3.00	3.10	3.00	3.05	3.05	3.05
Income and saving											
Nominal personal income	Percent change	2.3	6.9	6.6	5.5	6.1	6.6	6.2	6.5	6.9	7.1
Real disposable income	Percent change	-4.5	2.3	5.7	3.6	2.9	2.4	2.5	1.2	1.6	1.8
Personal saving rate	Percent*	3.7	4.0	4.7	4.8	4.6	4.4	4.4	4.2	4.0	4.0
Corp. profits with IVA & CCAdj	Percent change	32.5	.0	-10.3	14.2	9.4	16.3	3.4	2.8	4.1	9.6
Profit share of GNP	Percent*	7.7	7.6	7.3	7.5	7.5	7.7	7.6	7.5	7.4	7.5
Federal govt. surplus/deficit	Billions of \$	-201.3	-224.2	-215.4	-195.0	-176.0	-172.4	-162.5	-149.5	-138.0	-132.1
State and local govt. surplus		56.9	59.4	66.1	58.6	56.5	57.1	59.0	62.4	64.4	65.7
Prices and costs											
GNP implicit deflator	Percent change	2.9	3.3	3.3	2.9	2.4	2.9	3.6	3.6	3.9	4.3
GNP fixed-weight price index		2.7	3.9	3.3	2.9	2.9	3.4	3.9	3.8	4.1	4.4
Cons. & fixed invest. prices		2.4	4.4	2.4	1.6	3.0	3.7	4.1	4.1	4.4	4.4
CPI		2.6	4.3	1.8	-2	2.6	3.7	4.1	4.1	4.4	4.4
Exc. food and energy		3.5	4.9	4.4	4.6	4.6	4.7	4.9	4.9	5.2	5.3
Nonfarm business sector											
Output per hour		.4	-3.1	-.1	1.1	2.0	1.8	1.1	1.0	.9	.9
Compensation per hour		2.8	3.3	4.1	3.8	3.8	3.9	4.3	4.3	4.5	4.7
Unit labor costs		2.4	6.6	4.2	2.7	1.8	2.1	3.2	3.3	3.6	3.8

Not at an annual rate.

	Units	1979	1980	1981	1982	1983	1984	1985	Projection	
									1986	1987
Expenditures										
Nominal GNP	Billions of \$	2508.2	2732.0	3052.6	3166.0	3401.6	3774.7	3988.5	4213.5	4510.2
Real GNP	Billions of 82\$	3192.4	3187.1	3248.8	3166.0	3275.2	3492.0	3570.0	3660.8	3791.4
Real GNP	Percent change*	.6	-.1	.6	-1.9	6.3	4.7	2.1	3.4	3.2
Gross domestic purchases		-.4	-1.1	.8	-.8	8.2	6.2	3.2	2.6	2.2
Final sales		2.2	-.2	.1	.3	3.6	4.3	3.4	2.7	3.1
Private dom. final purchases		1.3	-1.7	-.3	.8	7.6	5.3	3.7	3.2	2.4
Personal consumption expend.		1.4	-.1	.2	2.9	5.3	3.4	3.0	3.1	2.2
Durables		-3.8	-5.6	-3.3	9.0	14.5	9.2	5.8	4.7	3.0
Nondurables		.8	-1.4	.5	1.8	4.3	2.0	2.7	2.7	2.1
Services		3.5	2.4	.9	2.3	3.7	2.8	2.4	2.9	1.9
Business fixed investment		5.0	-4.8	5.6	-11.3	11.5	16.5	6.3	-.2	4.0
Producers' durable equipment		1.6	-6.5	2.2	-12.5	20.3	17.2	5.3	2.6	5.7
Nonresidential structures		12.0	-1.8	11.7	-9.1	-2.1	15.2	8.1	-5.6	.6
Residential structures		-7.2	-14.2	-22.4	4.9	38.5	3.5	5.7	14.6	1.5
Exports		13.7	.5	2.4	-13.8	6.9	5.1	-4.8	9.1	13.0
Imports		3.4	-8.8	4.9	-5.9	25.8	17.0	4.7	1.3	3.2
Government purchases		.1	1.0	2.9	3.8	-2.7	8.1	7.4	-3.7	1.0
Federal		-.3	3.1	9.5	8.2	-7.5	14.7	13.6	-8.8	-.1
Defense		3.3	3.1	7.6	8.8	5.2	7.6	5.9	.5	.5
State and local		.4	-.3	-1.3	.6	1.0	3.3	2.6	.9	1.8
Change in business inventories	Billions of 82\$	15.0	-6.9	23.9	-24.5	-5.5	62.7	5.7	19.9	25.6
Nonfarm	Billions of 82\$	10.4	-2.3	19.0	-23.1	.4	55.9	10.6	21.3	25.6
t exports	Billions of 82\$	3.6	57.0	49.4	26.3	-21.9	-85.0	-108.4	-124.1	-93.0
nal GNP	Percent change*	9.5	9.9	9.3	3.1	10.0	9.0	5.4	6.4	7.2
Employment and Production										
Nonfarm payroll employment	Millions	89.8	90.4	91.2	89.6	90.2	94.5	97.7	100.5	102.8
Unemployment rate	Percent	5.8	7.1	7.6	9.7	9.6	7.5	7.2	6.9	6.4
Industrial production index	Percent change*	.9	-.8	-1.0	-7.7	14.3	7.2	1.8	3.2	3.6
Capacity utilization rate-mfg.	Percent	84.6	79.2	78.3	70.3	74.0	80.8	80.3	80.1	81.0
Housing Starts	Millions	1.72	1.30	1.10	1.06	1.71	1.76	1.74	1.94	1.94
Auto sales	Millions	10.68	9.04	8.56	8.00	9.18	10.43	11.09	10.74	10.84
Domestic	Millions	8.36	6.62	6.24	5.77	6.77	7.97	8.24	7.77	7.80
Foreign	Millions	2.32	2.42	2.32	2.23	2.41	2.46	2.84	2.98	3.04
Income and saving										
Nominal personal income	Percent change*	11.4	12.0	9.2	5.3	7.5	8.6	5.3	6.2	6.7
Real disposable income	Percent change*	.5	1.1	.7	1.0	5.1	3.9	1.3	3.7	1.8
Personal saving rate	Percent	6.8	7.1	7.5	6.8	5.5	6.5	4.6	4.7	4.1
Corp. profits with IVA & CCAdj	Percent change*	-10.7	-6.8	2.3	-19.1	69.5	11.6	11.9	6.9	5.0
Profit share of GNP	Percent	8.0	6.5	6.2	4.7	6.3	7.2	7.4	7.5	7.5
Federal govt. surplus/deficit	Billions of \$	-16.1	-61.3	-63.8	-145.9	-179.4	-172.9	-199.3	-189.7	-145.5
State and local govt. surplus		27.6	26.8	34.1	35.1	48.6	64.4	59.2	59.6	62.9
Prices and costs										
GNP implicit deflator	Percent change*	8.9	9.9	8.7	5.2	3.5	4.1	3.1	2.9	3.8
GNP fixed-weight price index		8.8	9.8	8.5	5.0	3.8	4.2	3.5	3.1	4.1
Cons. & fixed invest. prices		9.5	10.1	8.2	4.4	3.1	3.9	3.2	2.7	4.3
CPI		12.8	12.5	9.4	4.5	3.3	3.9	3.6	2.0	4.3
Exc. food and energy		10.7	12.2	10.2	5.2	4.3	4.8	4.3	4.6	5.1
Nonfarm business sector										
Output per hour		-2.7	1.0	-.6	1.0	3.3	.8	-.4	1.2	1.0
Compensation per hour		9.7	10.9	8.3	7.2	3.6	3.8	3.7	3.9	4.4
Unit labor costs		12.7	9.7	9.0	6.2	.3	3.0	4.1	2.7	3.4

* Percent changes are from fourth quarter to fourth quarter.

March 26, 1986

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1985*	FY1986 ^e		FY1987 ^e		CY 1985*	CY1986 ^e FRB Staff	FRB staff estimates								
		Admin. 1/	FRB Staff	Admin. 1/	FRB Staff			Calendar quarters; not seasonally adjusted								
								1985 IV*	1986			1987				
								I	II	III	IV	I	II	III		
Budget receipts ²	734	777	776	850	832	745	786	177	180	222	196	187	195	239	211	
Budget outlays ²	946	980	980	994	996	961	979	252	243	243	241	251	251	249	245	
Surplus/deficit(-) to be financed ²	-212	-203	-204	-144	-164	-216	-193	-75	-63	-21	-45	-64	-56	-9	-34	
Means of financing deficit:																
Net borrowing from public	197	204	211	142	159	224	171	91	36	30	54	50	53	18	38	
Decrease in cash operating balance	12	-3	-13	0	0	-13	16	-14	19	-7	-11	15	0	-5	-10	
Other ³	1	2	6	2	5	5	7	-2	8	-3	3	-1	4	-3	6	
Cash operating balance, end of period	17	20	30	20	30	31	15	31	12	19	30	15	15	20	30	
Memo: Sponsored agency borrowing ⁴	20	n.a.	13	n.a.	23	21	13	5	-2	5	5	5	6	6	6	
<u>NIPA Federal Sector</u>								<u>Seasonally adjusted annual rates</u>								
Receipts	769	823	820	905	882	785	833	806	815	821	838	858	872	889	907	
Expenditures	961	1016	1023	1044	1037	985	1023	1030	1031	1016	1014	1031	1034	1038	1045	
Purchases	343	359	371	373	374	355	367	385	372	364	363	369	373	376	379	
Defense	256	270	276	289	289	262	279	272	277	277	278	284	287	290	293	
Nondefense	87	89	95	83	86	94	88	113	95	88	85	85	86	86	86	
All other expenditures	618	657	652	671	663	629	656	645	659	652	651	662	661	662	666	
Surplus/deficit(-)	-192	-193	-203	-139	-156	-199	-190	-224	-215	-195	-176	-172	-163	-150	-138	
High employment surplus/deficit(-) evaluated at 6 percent unemployment	-155	n.a.	-166	n.a.	-137	-163	-156	-185	-177	-157	-145	-147	-142	-133	-125	
		*--actual		e--estimated				n.a.--not available								

1. Budget of the United States Government, Fiscal Year 1987 (February 1986). The Congressional Budget Office baseline estimates published in February indicated receipts of \$778 billion and \$844 billion, outlays of \$986 billion and \$1025 billion, and deficits of \$208 and \$181 billion in FY1986 and FY1987 respectively.
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, FHLMC (excluding participation certificates), FNMA (excluding mortgage-backed securities), Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, and Student Loan Marketing Association marketable debt on a payment basis. The Administration's definition of borrowing by these agencies is somewhat broader.

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

DOMESTIC FINANCIAL DEVELOPMENTS

Recent developments. Prices of stocks and bonds soared over the intermeeting period. The rally was given considerable impetus by developments in the oil market, but continued optimism about the outlook for federal budgetary developments, favorable interpretations of economic indicators, and the recent reduction in the discount rate also played a role. Yields on long-term Treasury bonds fell about 1-1/4 percentage points on balance, and broad measures of stock prices rose nearly 10 percent. In the home mortgage market, fixed-rate loan costs dropped about 3/4 of a percentage point.

Short-term interest rates also declined over the intermeeting period, but less than yields in longer-term markets, and the yield curve flattened appreciably. Federal funds traded mainly between 7-3/4 and 8 percent before the discount rate cut and about 7-3/8 percent more recently. Treasury bill rates dropped around 70 basis points over the intermeeting interval, while rates on private money market instruments fell a little less. The prime rate was reduced from 9-1/2 to 9 percent.

M1 and M2 accelerated in February and March, leaving these aggregates somewhat above and somewhat below their respective longer-run ranges. The pickup in the narrow aggregate reflected more rapid growth of demand deposits. The nontransactions component of M2 remained rather weak in February, perhaps restrained by continued large inflows to bond and stock funds, but the sluggish response of retail offering rates to recent movements in market yields evidently boosted flows to core deposits, especially MMDAs, in March. Money market mutual funds also expanded more rapidly, as their rates similarly lagged the decline in yields available in the market.

M3 expansion remained moderate, however, as banks sharply cut back issuance of large time deposits, leaving that aggregate near the center of its longer-run range.

Growth of domestic nonfinancial sector debt dropped off sharply in the first quarter from its distorted pace of the previous quarter. Offerings of tax-exempt securities nearly dried up after the turn of the year, owing to continued uncertainties about the tax status of issues placed after 1985. The pace of tax-exempt issuance strengthened in March, although activity was temporarily disrupted prior to the defeat of a proposal by Senator Packwood to subject all outstanding tax-exempt securities to the alternative minimum personal tax.

Net Treasury borrowings totaled only about \$36 billion during the first quarter, despite a federal deficit of \$63 billion. Most of the remainder was financed by drawing on the large cash balance that the Treasury had accumulated during December. The Treasury raised all its new funds this quarter in the coupon market, paying down about \$7 billion of bills.

Aggregate borrowing by nonfinancial business firms appears to have declined in the first quarter, as the corporate financing gap continued narrow and share retirements resulting from mergers and restructurings moderated. The sum of business loans at commercial banks and commercial paper issued by nonfinancial firms is estimated to have been about flat over the first quarter. With much-reduced long-term borrowing costs, firms concentrated their credit demands on bond markets, with robust issuance in the domestic and Euro markets. Much of the corporate bond volume featured

longer maturities. The stock market rally also induced firms to issue a large volume of new equity shares in February and March.

The drop in interest rates appears to have boosted net mortgage flows in recent weeks. In addition, refinancing activity has picked up sharply. With the cost of fixed-rate financing dropping appreciably more than initial adjustable rates--and to single-digit levels for the first time since 1978--the share of conventional loans closed with fixed rates rose to 62 percent in early February; field reports suggest a further rise since then. The volume of mortgage assets at FSLIC-insured institutions rose briskly in January, mainly reflecting a sharp rise in holdings of mortgage-backed securities. Mortgage flows have received continuing support from the pass-through securities market, with a robust pace of issuance during January and February. Real estate lending at commercial banks has remained strong so far in 1986, near last year's 12 percent pace.

Growth in consumer installment credit picked up in January, prompted largely by new reduced-rate auto financing programs. Commercial bank figures and the continuation of the auto incentive programs suggest further sizable gains in consumer credit in February. Responding to previous drops in market rates, a broad decline in consumer lending rates appears to be in process, perhaps bolstering consumer credit demands. Delinquency rates and personal bankruptcy rates both are suggesting increased strains on household budgets.

Outlook. The staff expects that the pace of economic expansion foreseen for coming months will be accompanied by continued relatively moderate credit demands. Net borrowing by the nonfinancial business sector is expected to remain relatively light over the next few months, with cash flows

keeping pace with a small net increase in capital expenditures. Also, the recent rally in share prices is expected to encourage further issuance of new equity shares, while share retirements associated with mergers and restructurings may continue at a reduced pace. The composition of business borrowing is likely to remain heavily tilted toward the bond market, given the reduced differential between short- and long-term interest rates and the apparent desire of many firms to lengthen their debt maturities.

Although seasonal inflows of tax receipts will reduce the federal deficit in the second quarter, debt issuance by the Treasury will rise on a seasonally adjusted basis, as borrowing moves into closer alignment with the deficit. Sales of Treasury securities probably will remain concentrated in the coupon area. In the state and local sector, borrowing likely will increase somewhat from the depressed pace early this year; overall issue volume in the tax-exempt sector will remain moderate, however, given the inhibitions to private-purpose financing.

In the household sector, mortgage flows are expected to be well maintained in the second quarter while expansion in consumer credit is likely to taper off. The reduction in mortgage rates is encouraging a stronger pace of homebuilding and the surge of refinancing activity may well occasion some net borrowing against existing equity. The proportion of mortgages being issued with fixed-rate terms should continue high as a result of the flattening of the yield curve, with the mortgage-backed securities market remaining an important channel for funds. It is anticipated that growth in consumer credit will trend downward, in part owing to mounting household debt burdens. However, there appear to be few

impediments to consumer credit from the supply side. Surveys and industry contacts indicate that lenders remain enthusiastic, with profit margins still attractive on consumer loans--even after charge-off expenses.

INTERNATIONAL DEVELOPMENTS

Recent developments. The weighted-average exchange value of the dollar has declined about 2 percent further since the last FOMC meeting, bringing its total depreciation to 15 percent since the G-5 announcement of last September. The dollar's weighted-average value is about 28 percent lower than its peak in February 1985. The dollar declined sharply in the first half of the intermeeting period as data on U.S. economic activity disappointed market expectations and sharp declines in crude oil prices raised concerns about U.S. banks' exposure to the energy sector and to oil-producing developing countries. Statements by some G-5 officials that apparently gave market participants the impression that policies would not be adjusted to lend support to the dollar may also have contributed to the dollar's decline. The dollar steadied in early March when, within a short period, official lending rates were lowered by the central banks of Germany, Japan, the United States, Netherlands, France, Sweden, Italy, and the United Kingdom. The dollar subsequently rose after Bank of Japan officials acted to intervene visibly in the market and announced additional policy steps to curb yen appreciation.

Substantial net capital inflows, both official and private, were recorded in January. Foreign purchases of U.S. corporate stocks, although down somewhat from the very high rate in December, remained strong in January at \$1.6 billion. Foreign purchases of U.S. corporate bonds in January were \$3.25 billion, below the record high average monthly rate of \$6.1 billion during the fourth quarter of last year. In contrast, private foreigners on net sold a small amount of U.S. Treasury securities in January. Bank-reported inflows were also large in January and consisted primarily of inflows from own foreign offices. Through February, these inflows had not been reversed. Foreign official reserve assets held in the United States rose \$2 billion in January as increased holdings of both the G-10 countries and OPEC more than offset reductions in the reserve assets of other countries.

Merchandise trade data are available on a preliminary, unrevised and not seasonally adjusted basis for the month of January. These data, which are subject to substantial revision, showed a trade deficit in January that was somewhat larger than in December. Exports in January were little changed from low December levels and imports rose.

In world oil markets, spot prices continued to fall through March; since December, spot prices have fallen more than 50 percent. OPEC members meeting from March 16-24 could not agree on how to allocate a reduced rate of production among member countries.

In the major foreign industrial countries growth continues to be moderate. Economic activity appears to be slowing in Japan, but remains strong in Germany and Canada. Industrial production recently rose in the latter two countries and in the United Kingdom, but declined in

Japan, France, and Italy. Inflation abroad remains low, with rates already very low in Germany and Japan and with France and Italy experiencing some further decline in the rate of consumer price increases. The most recent trade and current account data continue to show record trade surpluses in Germany and Japan.

Among the developing countries the continuing decline of world oil prices is having a major effect. Mexican export earnings and public sector revenues are sharply lower as a result. However, the Finance Ministry has revised its outlook for Mexico's current account and prospective debt restructuring, and, as a result, its estimate of Mexico's net external financing needs in 1986 remains at \$4 billion. Brazil has recently announced a major new anti-inflation program that includes pegging the new currency, the cruzado (1,000 cruzeiros equals one cruzado), to the dollar (thereby ending the system of daily devaluation), abolition of indexed treasury securities, and a system of wage and price controls. New understandings between Argentina and the IMF regarding quantitative performance tests led to reinstatement of the IMF stand-by agreement and a drawing from the Fund by Argentina.

Outlook. The staff projects the dollar will continue to decline through the forecast period to a level that by the fourth quarter of 1987 is about 10 percent below that projected in the last Greenbook; somewhat faster depreciation is expected in the remaining quarters of 1986, followed by a more moderate pace in 1987. Lower oil prices will contribute to sustaining growth in industrial countries abroad at about its current average pace and to lowering inflation from the rate previously forecast. Growth in the developing countries is likely to be

somewhat slower this year as the oil-exporting countries experience sharply lower export prices. Although U.S. growth is now expected to be somewhat stronger than was last forecast, the effects of reduced oil prices and a lower path for the dollar are sufficient to support a slight reduction in the forecast for the U.S. current account deficit both for this year and next, to about \$130 billion for 1986 and \$120 billion in 1987. This forecast incorporates the assumption of U.S. oil import prices stabilizing at about \$16 per barrel, approximately \$10 below the average price recorded in 1985.

MARCH 25, 1986

OUTLOOK FOR U.S. NET EXPORTS AND RELATED ITEMS
(BILLIONS OF DOLLARS, SEASONALLY ADJUSTED ANNUAL RATES)

	ANNUAL		1985		1986				1987				
	1985-	1986-P	1987-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP EXPORTS AND IMPORTS 1/													
CURRENT \$, NET	-78.3	-91.4	-74.7	-87.5	-113.2	-98.3	-92.8	-88.2	-86.4	-85.1	-78.9	-70.9	-64.0
EXPORTS OF G+S	370.1	393.6	461.2	363.4	368.0	374.9	384.4	399.4	415.7	432.1	450.5	470.9	491.1
IMPORTS OF G+S	448.4	485.0	535.9	451.0	481.1	473.2	477.2	487.6	502.1	517.2	529.4	541.8	555.1
CONSTANT 82 \$, NET	-108.2	-123.8	-92.8	-119.5	-140.5	-128.0	-130.7	-122.4	-114.2	-107.8	-97.0	-86.7	-79.5
EXPORTS OF G+S	360.0	376.1	422.7	353.7	359.4	363.8	369.0	379.7	391.9	402.9	415.4	429.5	442.9
IMPORTS OF G+S	468.2	499.9	515.5	473.2	499.9	491.8	499.7	502.1	506.1	510.7	512.5	516.2	522.4
2. U.S. MERCHANDISE TRADE BALANCE 2/	-124.2	-136.7	-123.0	-131.7	-157.8	-142.5	-136.5	-134.3	-133.3	-131.3	-126.1	-120.2	-114.6
EXPORTS	214.0	225.9	275.2	209.2	212.0	214.2	219.5	228.8	240.9	254.6	268.0	281.9	296.2
AGRICULTURAL	29.2	27.7	29.2	26.1	29.3	28.8	27.5	27.3	27.4	28.2	28.8	29.5	30.2
NONAGRICULTURAL	184.8	198.1	246.0	183.0	182.7	185.5	192.0	201.5	213.5	226.4	239.2	252.4	266.0
IMPORTS	338.3	362.5	398.2	340.9	369.8	356.8	356.0	363.1	374.2	385.9	394.2	402.1	410.8
PETROLEUM AND PRODUCTS	50.4	35.0	36.4	50.1	57.4	41.0	33.4	32.3	33.4	34.9	35.5	36.6	38.7
NONPETROLEUM	287.9	327.5	361.8	290.7	312.4	315.7	322.7	330.8	340.8	351.0	358.7	365.5	372.1
3. U.S. CURRENT ACCOUNT BALANCE	-117.5	-130.0	-119.8	-116.9	-146.0	-134.2	-130.1	-126.8	-128.7	-128.7	-123.9	-116.5	-110.2
OF WHICH: NET INVESTMENT INCOME	24.8	23.5	19.3	34.7	32.6	26.5	23.5	22.9	21.3	19.1	18.5	19.7	19.9
4. FOREIGN OUTLOOK 3/													
REAL GNP--TEN INDUSTRIAL 4/	2.7	3.1	2.9	3.7	3.0	3.0	2.7	3.0	3.0	2.9	2.9	2.9	2.8
REAL GNP--NONOPEC LDC 5/	3.7	3.2	4.0	3.1	3.0	3.0	3.2	3.5	3.7	3.9	4.2	4.5	4.8
CONSUMER PRICES--TEN IND. 4/	4.3	2.7	2.9	1.4	3.2	2.4	2.9	2.3	2.6	2.9	3.3	3.0	3.0

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