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May 14, 1986

# **SUMMARY AND OUTLOOK**

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Prepared for the Federal Open Market Committee

By the staff of the Board of Governors of the Federal Reserve System

## DOMESTIC NONFINANCIAL DEVELOPMENTS

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Recent developments. Available indicators of economic activity continue to display a mixed picture. At the same time, incoming wage and price data show some further improvement in inflation.

The unevenness of economic activity is evident in the sectoral composition of recent employment changes. Since January, employment in the oil and gas industry has plummeted, and the manufacturing sector has sustained widespread losses; the cumulative loss of jobs in these two areas totaled 160,000 by April. These declines have been more than offset by continued strength in hiring at service establishments, sharp increases in construction industry jobs, and, in April, a particularly large advance in employment at finance and real estate offices. On balance, payroll employment growth so far this year has averaged just under a quarter of a million per month--close to the the 1985 pace.

The weakness in industrial output this year has been fairly widespread. In the oil and gas industry, the count of rotary rigs in operation dropped about 60 percent over the first four months of the year. In the factory sector, production of business equipment and consumer durables (other than autos) declined, on balance, between December and March. Auto assemblies, which had been stepped up earlier in the year, were reduced sharply in March--from 8.7 to 7.7 million units (annual rate). April car production moved back up a bit, although with dealer inventories still excessive, current plans call for some cutback in production in May.

The moderate growth in nominal personal income in recent months has been translated into strong real income growth as consumer prices have

decelerated. Real disposable income advanced at a 5-1/2 percent annual rate during the first quarter, after no growth in the second half of last year. Moreover, improvements in household wealth apparently have helped to bolster consumer sentiment, and according to recent surveys, households remain quite bullish in their buying plans.

Consumer expenditures, particularly for nondurable goods, surged in the first quarter. But data for retail sales in April show that spending for consumer goods other than autos dropped back last month. General merchandisers posted another solid gain while spending for household durables declined. After dipping in March, sales of domestic autos rose to an 8 million unit rate in April, as the monthly pattern continues to be influenced by changes in manufacturers' terms. Sales of imported cars also moved up last month, rising to a 3.1 million unit rate.

Lower mortgage interest rates have spurred activity in the housing market. Housing starts remained close to the 2 million unit mark through March--up from the 1-3/4 million unit pace that prevailed during 1985. Sales of new single-family homes were at a record level in March, and the inventory of unsold homes was reduced to the lowest number in a year and a half. Sales of existing homes, however, declined a bit in the first quarter, although field reports suggest that a pickup currently is under way.

Business spending for capital equipment dropped back sharply in the first quarter, after a year-end push by firms to purchase equipment in advance of potential tax law changes. At the same time, the contraction in drilling pulled down spending for nonresidential structures. New orders for nondefense capital goods remained relatively flat, on balance, through March, and new commitments for nonresidential structures appear to be

trending lower. The most recent surveys of business capital spending intentions show expected spending little changed in nominal terms from the 1985 level. Compared with their plans last autumn, firms in the energy sector have made sharp reductions while expected outlays by other businesses are somewhat stronger.

With the exception of the buildup in auto dealers' inventories through March and an estimated first-quarter rise in stocks of construction materials, business inventory positions have changed little in recent months. Manufacturers, who are still facing sluggish demand, drew down stocks last quarter for the fourth consecutive quarter. Nonauto trade establishments generally appear to be increasing their stocks about in line with rising sales.

All the available measures of labor costs point to some further restraint so far this year. For the first quarter, the year-over-year change in hourly compensation for nonfarm businesses is estimated to have moved a bit lower. Wage increases for production workers have been quite small, and employers have been successful in lowering growth in expenditures for fringe benefits. Productivity performance, however, remains disappointing. The first-quarter increase in output per hour in the nonfarm business sector failed to offset the preceding quarter's decline, and productivity, on balance, has been essentially flat for a year and a half.

Consumer prices fell for a second month in March, as retail prices of gasoline and fuel oil continued to drop sharply. The prices of both of these products have fallen nearly 20 percent over the first three months of the year. Over the same period, food prices also have declined a bit. Excluding food and energy items, the CPI has risen at a 4 percent annual rate this year, with little change in the prices of goods but large increases

for some consumer services. According to a separate survey, prices of nonfuel imports, including both consumer and business items, have begun to increase substantially--3-1/2 percent (not annualized) during the three months ending in March.

Outlook. The staff expects that real GNP will grow at a 2 percent annual rate in the current quarter and that the GNP fixed-weighted price index will rise at a 2-1/4 percent rate. The high level of residential construction and moderate growth in consumer spending are projected to provide support for overall economic activity. In addition, federal government purchases are anticipated to increase this quarter; government outlays plunged in the first quarter as CCC purchases fell sharply and defense spending was delayed. Although capital equipment spending is expected to increase, the steep decline in oil and gas well drilling is likely to keep overall outlays for business fixed investment unchanged in the current quarter. Moreover, the expected cutback in auto production, which is anticipated to be reflected in some drawdown in dealer stocks, is projected to be a depressing force on real GNP.

The staff's outlook for the remaining six quarters of the projection is little changed from the March Greenbook. With regard to monetary policy, M1 growth is assumed to be around the upper end of the Committee's 1986 range, and M2 growth is expected to be near the middle of its range. Monetary growth is assumed to slow in 1987, particularly in the case of the narrow aggregate. Interest rates are not anticipated to change significantly in the near term, but may come under some upward pressure as GNP accelerates. For fiscal policy, the current fiscal-year deficit is now projected to

total \$210 billion. For fiscal 1987, a move toward fiscal restraint is assumed with the enactment of around \$35 billion in deficit-reducing measures. As a result, the fiscal 1987 deficit is expected to fall to \$166 billion.

In addition to the stimulus from lower levels of long-term interest rates, the important factors underlying prospects for improved economic growth later this year are the effects of declining oil prices on real income and of a depreciating dollar on the trade balance. As these developments take hold, and as the negative effects of the adjustments in the auto and energy sectors wind down, real GNP is expected to increase at more than a 4 percent annual rate in the second half of this year; in 1987 real GNP growth is projected to average 3-1/4 percent. A pickup in export demand and a slower rise in spending for imports are projected to account for almost a percentage point of the annual rate of growth over the six-quarter period.

In other areas of final demand, the rise in consumer spending is expected to keep pace with income growth, and housing activity should remain at a high level over the forecast horizon. Business capital spending is projected to begin to improve by late this year, after the contraction in petroleum drilling subsidies and higher rates of domestic production spur new outlays for equipment. In contrast, government purchases are projected to be flat. The improvement in real growth over the last six quarters of the projection is expected to reduce the civilian unemployment rate from the current level of just over 7 percent to 6-1/4 percent by the end of 1987.

The effects of declining prices for petroleum-based products are expected to hold down aggregate inflation for much of this year. Although rising import prices should push up domestic prices as the year progresses,

this effect is projected to be more than offset by falling energy prices. Thus, the GNP fixed-weighted price index is projected to rise 2-1/2 percent for the year as a whole--a percentage point less than last year's increase.

In 1987, the staff is expecting inflation to move back to just above the 1985 pace, with the GNP fixed-weighted price index rising 3-3/4 percent over the four quarters of the year. Next year, prices of energy items are expected to stabilize, although the indirect effects of lower energy prices on business costs should continue to be favorable. More than offsetting the influence of energy prices, however, will be the effect of rising prices for imports and for their domestic substitutes. In addition, in an environment of accelerating consumer prices and tighter labor markets, wage demands are projected to pick up.

Detailed data for these projections are in the tables shown on the following pages.



## STAFF GNP PROJECTIONS

## Percent changes, annual rate

		Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
		3/26/86	5/14/86	3/26/86	5/14/86	3/26/86	5/14/86	3/26/86	5/14/86	3/26/86	5/14/86
<b>Annual changes:</b>											
1984	<1>	11.0	11.0	6.5	6.5	4.3	4.3	4.1	4.1	7.5	7.5
1985	<1>	5.7	5.7	2.2	2.2	3.6	3.6	3.3	3.3	7.2	7.2
1986		5.6	5.3	2.5	2.6	3.3	2.7	3.0	2.7	6.9	6.9
1987		7.0	6.8	3.6	3.6	3.7	3.3	3.4	3.1	6.4	6.3
<b>Quarterly changes:</b>											
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>	4.3	4.3	.7	.7	3.9	3.9	3.3	3.3	7.0	7.0
1986	Q1 <1>	6.1	5.8	2.9	3.2	3.3	2.2	3.3	2.5	7.0	7.1
	Q2	5.2	4.1	2.3	2.1	2.9	2.2	2.9	2.1	7.0	7.1
	Q3	6.9	6.7	4.4	4.4	2.9	2.6	2.4	2.2	6.8	6.9
	Q4	7.3	7.4	4.2	4.4	3.4	3.2	2.9	2.8	6.7	6.7
87	Q1	7.2	7.1	3.5	3.6	3.9	3.5	3.6	3.3	6.5	6.5
	Q2	7.1	6.7	3.4	3.3	3.8	3.7	3.6	3.3	6.4	6.4
	Q3	7.2	6.9	3.2	3.2	4.1	3.8	3.9	3.6	6.3	6.3
	Q4	7.3	7.2	2.9	3.1	4.4	4.1	4.3	3.9	6.3	6.2
<b>Two-quarter changes: &lt;2&gt;</b>											
1985	Q2 <1>	5.7	5.7	2.4	2.4	3.5	3.5	3.1	3.1	.1	.1
	Q4 <1>	5.0	5.0	1.9	1.9	3.4	3.4	3.1	3.1	-.3	-.3
1986	Q2	5.7	4.9	2.6	2.7	3.1	2.1	3.1	2.3	.0	.1
	Q4	7.1	7.0	4.3	4.4	3.2	2.9	2.7	2.5	-.3	-.4
1987	Q2	7.2	6.9	3.5	3.5	3.9	3.6	3.6	3.3	-.3	-.3
	Q4	7.2	7.0	3.0	3.2	4.3	3.9	4.1	3.8	-.1	-.2
<b>Four-quarter changes: &lt;3&gt;</b>											
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>	5.4	5.4	2.1	2.1	3.5	3.5	3.1	3.1	-.2	-.2
1986	Q4	6.4	6.0	3.4	3.5	3.1	2.5	2.9	2.4	-.3	-.3
1987	Q4	7.2	7.0	3.2	3.3	4.1	3.8	3.8	3.5	-.4	-.5

&lt;1&gt; Actual.

&lt;2&gt; Percent change from two quarters earlier.

&lt;3&gt; Percent change from four quarters earlier.

CONFIDENTIAL - FR  
CLASS II FOMC

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

	Units	Projection									
		1985		1986			1987				
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<b>Expenditures</b>											
Nominal GNP	Billions of \$	4016.9	4059.3	4116.7	4158.6	4226.9	4302.6	4376.8	4448.6	4523.4	4602.5
Real GNP	Billions of 82\$	3584.1	3590.8	3619.2	3638.3	3678.0	3717.8	3751.2	3781.8	3811.4	3841.0
Real GNP	Percent change	3.0	.7	3.2	2.1	4.4	4.4	3.6	3.3	3.2	3.1
Gross domestic purchases		5.0	3.0	1.5	2.1	3.1	3.6	2.9	2.2	2.1	2.3
Final sales		5.0	1.3	-4	3.2	4.6	4.2	2.9	3.2	3.2	3.1
Private dom. final purchases		4.5	2.2	1.5	3.6	3.9	3.9	2.7	2.3	2.3	2.4
Personal consumption expend.		4.6	.1	4.3	3.2	3.2	3.2	2.5	2.2	2.0	2.0
Durables		24.3	-13.3	-1.5	3.0	4.1	5.4	2.8	3.7	2.9	2.8
Nondurables		1.5	.6	7.7	3.8	2.7	2.9	2.6	1.9	1.9	1.9
Services		1.4	4.4	3.4	2.8	3.3	2.9	2.3	1.9	1.8	1.8
Business fixed investment		2.4	11.3	-13.6	.8	2.6	4.7	4.4	4.2	4.4	4.3
Producers' durable equipment		3.0	13.5	-17.8	11.7	6.0	6.5	6.5	6.5	6.5	6.5
Nonresidential structures		1.2	7.2	-5.1	-16.8	-3.7	1.0	.2	-.3	.0	-.3
Residential structures		8.5	5.7	9.7	16.3	17.6	10.9	1.5	-.5	1.3	2.8
Exports		-5.1	6.6	11.9	5.9	11.3	13.2	11.7	13.3	13.3	12.3
Imports		12.8	24.5	-3.6	4.6	-.6	4.6	4.3	2.6	2.9	4.1
Government purchases		18.2	9.2	-15.1	1.4	.5	.9	.3	.8	1.1	1.4
Federal		37.3	23.4	-32.2	2.3	.1	.9	-.6	.2	-.2	-.3
Defense		22.0	-3.2	-6.9	4.8	4.2	2.3	.3	.7	.7	.2
State and local		4.7	-1.6	2.4	.7	.8	.8	1.0	1.2	2.1	2.7
Change in business inventories	Billions of 82\$	-1.8	-6.3	26.0	16.5	15.0	17.0	23.5	25.0	25.0	26.0
Nonfarm	Billions of 82\$	1.6	18.2	26.7	17.5	16.5	18.0	23.5	25.0	25.0	26.0
Net exports	Billions of 82\$	-119.8	-140.8	-126.0	-126.3	-115.3	-108.9	-103.0	-93.3	-83.6	-76.1
Nominal GNP	Percent change	5.8	4.3	5.8	4.1	6.7	7.4	7.1	6.7	6.9	7.2
<b>Employment and Production</b>											
Nonfarm payroll employment	Millions	98.0	98.8	99.7	100.1	100.8	101.5	102.1	102.7	103.3	103.8
Unemployment rate	Percent*	7.2	7.0	7.1	7.1	6.9	6.7	6.5	6.4	6.3	6.2
Industrial production index	Percent change	2.0	1.9	1.4	-.6	3.9	4.7	4.1	3.6	3.4	3.2
Capacity utilization rate-mfg.	Percent*	80.3	80.0	80.0	79.3	79.6	80.1	80.3	80.5	80.6	80.6
Housing Starts	Millions	1.69	1.77	1.99	1.95	1.90	1.95	1.95	1.95	1.95	1.90
Auto sales	Millions	12.31	10.24	10.65	10.86	10.85	10.70	10.80	10.90	10.90	10.90
Domestic	Millions	9.40	6.84	7.84	7.80	7.80	7.60	7.80	7.80	7.80	7.80
Foreign	Millions	2.90	3.40	2.81	3.06	3.05	3.10	3.00	3.10	3.10	3.10
<b>Income and saving</b>											
Nominal personal income	Percent change	2.3	6.9	5.3	5.5	6.2	7.0	5.9	6.5	6.8	7.2
Real disposable income	Percent change	-4.5	2.3	5.6	4.4	3.0	2.8	2.4	1.6	1.7	2.2
Personal saving rate	Percent*	3.7	4.0	4.3	4.5	4.5	4.3	4.3	4.1	4.0	4.0
Corp. profits with IVA & CCAAdj	Percent change	32.5	-7.5	9.6	.5	6.9	14.8	5.6	.0	2.1	7.7
Profit share of GNP	Percent*	7.7	7.5	7.5	7.5	7.5	7.6	7.6	7.4	7.4	7.4
Federal govt. surplus/deficit	Billions of \$	-201.3	-226.9	-202.3	-203.7	-185.2	-183.0	-168.9	-156.8	-145.9	-140.5
State and local govt. surplus		56.9	58.8	63.3	60.8	55.1	58.2	57.8	60.4	62.2	63.8
<b>Prices and costs</b>											
GNP implicit deflator	Percent change	2.9	3.3	2.5	2.1	2.2	2.8	3.3	3.3	3.6	3.9
GNP fixed-weight price index		2.7	3.9	2.2	2.2	2.6	3.2	3.5	3.7	3.8	4.1
Cons. & fixed invest. prices		2.4	4.4	1.4	.8	2.9	3.5	3.8	4.0	4.0	4.1
CPI		2.6	4.3	1.5	-1.5	2.8	3.7	4.0	4.0	4.2	4.3
Exc. food and energy		3.5	4.9	4.3	4.0	4.4	4.5	4.7	4.7	4.9	5.0
Nonfarm business sector											
Output per hour		.4	-4.1	3.4	.7	2.0	1.9	1.1	.9	.8	1.0
Compensation per hour		2.8	3.2	2.4	3.5	3.6	3.6	4.0	4.0	4.2	4.4
Unit labor costs		2.4	7.6	-1.0	2.8	1.6	1.7	2.9	3.1	3.4	3.4

\* Not at an annual rate.

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

	Units	1979	1980	1981	1982	1983	1984	1985	Projection	
									1986	1987
<u>Expenditures</u>										
Nominal GNP	Billions of \$	2508.2	2732.0	3052.6	3166.0	3401.6	3774.7	3988.5	4201.2	4487.8
Real GNP	Billions of 82\$	3192.4	3187.1	3248.8	3166.0	3277.7	3492.0	3570.0	3663.3	3796.3
Real GNP	Percent change*	.6	-1	.6	-1.9	6.3	4.7	2.1	3.5	3.3
Gross domestic purchases		-4	-1.1	.8	-8	8.2	6.2	3.2	2.5	2.4
Final sales		2.2	-2	.1	.3	3.6	4.3	3.4	2.9	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	3.5	2.2
Durables		-3.8	-5.6	-3.3	9.0	14.5	9.2	5.8	2.7	3.1
Nondurables		.8	-1.4	.5	1.8	4.3	2.0	2.7	4.2	2.1
Services		3.5	2.4	.9	2.3	3.7	2.8	2.4	3.1	1.9
Business fixed investment		5.0	-4.8	5.6	-11.3	11.5	16.5	6.3	-1.6	4.3
Producers' durable equipment		1.6	-6.5	2.2	-12.5	20.3	17.2	5.3	.9	6.5
Nonresidential structures		12.0	-1.8	11.7	-9.1	-2.1	15.2	8.1	-6.4	-1
Residential structures		-7.2	-14.2	-22.4	4.9	38.5	3.5	5.7	13.6	1.3
Exports		13.7	.5	2.4	-13.8	6.9	5.1	-4.8	10.5	12.7
Imports		3.4	-8.8	4.9	-5.9	25.8	17.0	4.7	1.2	3.5
Government purchases		.1	1.0	2.9	3.8	-2.7	8.1	7.4	-3.3	.9
Federal		-3	3.1	9.5	8.2	-7.5	14.7	13.6	-8.5	-2
Defense		3.3	3.1	7.6	8.8	5.2	7.6	5.9	1.0	.5
State and local		.4	-3	-1.3	.6	1.0	3.3	2.6	1.2	1.7
Change in business inventories	Billions of 82\$	15.0	-6.9	23.9	-24.5	-5.5	62.7	5.7	18.6	24.9
Nonfarm	Billions of 82\$	10.4	-2.3	19.0	-23.1	.4	55.9	10.6	19.7	24.9
Net exports	Billions of 82\$	3.6	57.0	49.4	26.3	-19.4	-85.0	-108.4	-119.1	-89.0
Nominal GNP	Percent change*	9.5	9.9	9.3	3.1	10.0	9.0	5.4	6.0	7.0
<u>Employment and Production</u>										
Nonfarm payroll employment	Millions	89.8	90.4	91.2	89.6	90.2	94.5	97.7	100.5	103.0
Unemployment rate	Percent	5.8	7.1	7.6	9.7	9.6	7.5	7.2	6.9	6.3
Industrial production index	Percent change*	.9	-8	-1.0	-7.7	14.3	7.2	1.8	2.3	3.6
Capacity utilization rate-mfg.	Percent	84.6	79.2	78.3	70.3	74.0	80.8	80.3	79.8	80.5
Housing Starts	Millions	1.72	1.30	1.10	1.06	1.71	1.76	1.74	1.95	1.94
Auto sales	Millions	10.68	9.04	8.56	8.00	9.18	10.43	11.09	10.77	10.88
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	3.00	3.08
<u>Income and saving</u>										
Nominal personal income	Percent change*	11.4	12.0	9.2	5.3	7.5	8.6	5.3	6.0	6.6
Real disposable income	Percent change*	.5	1.1	.7	1.0	5.1	3.9	1.3	4.0	2.0
Personal saving rate	Percent	6.8	7.1	7.5	6.8	5.5	6.5	4.6	4.4	4.1
Corp. profits with IVA & CCAadj	Percent change*	-10.7	-6.8	2.3	-19.1	69.5	11.6	9.7	7.8	3.8
Profit share of GNP	Percent	8.0	6.5	6.2	4.7	6.3	7.2	7.4	7.5	7.4
Federal govt. surplus/deficit	Billions of \$	-16.1	-61.3	-63.8	-145.9	-179.4	-172.9	-200.0	-193.5	-153.0
State and local govt. surplus		27.6	26.8	34.1	35.1	48.6	64.4	59.0	59.3	61.0
<u>Prices and costs</u>										
GNP implicit deflator	Percent change*	8.9	9.9	8.7	5.2	3.5	4.1	3.1	2.4	3.5
GNP fixed-weight price index		8.8	9.8	8.5	5.0	3.8	4.2	3.5	2.5	3.8
Cons. & fixed invest. prices		9.5	10.1	8.2	4.4	3.1	3.9	3.2	2.1	4.0
CPI		12.8	12.5	9.4	4.5	3.3	3.9	3.6	1.6	4.1
Exc. food and energy		10.7	12.2	10.2	5.2	4.3	4.8	4.3	4.3	4.8
Nonfarm business sector										
Output per hour		-2.7	1.0	-6	1.0	3.3	.8	-6	2.0	1.0
Compensation per hour		9.7	10.9	8.3	7.2	3.6	3.8	3.7	3.3	4.1
Unit labor costs		12.7	9.7	9.0	6.2	.3	3.0	4.3	1.3	3.2

\* Percent changes are from fourth quarter to fourth quarter.

FEDERAL SECTOR ACCOUNTS  
(Billions of dollars)

	Fiscal Year 1985*	FY1986 <sup>e</sup>		FY1987 <sup>e</sup>		CY 1985*	CY1986 <sup>e</sup> FRB Staff	FRB staff estimates Calendar quarters; not seasonally adjusted								
		Admin. 1/	FRB Staff	Admin. 1/	FRB Staff			1986				1987				
								IV*	I*	II	III	IV	I	II	III	
Budget receipts <sup>2</sup>	734	777	772	850	830	745	779	177	180	219	196	185	195	238	211	
Budget outlays <sup>2</sup>	946	980	982	994	996	961	980	252	241	242	247	251	251	249	245	
Surplus/deficit(-) to be financed <sup>2</sup>	-212	-203	-210	-144	-166	-216	-201	-75	-61	-23	-51	-66	-55	-10	-34	
Means of financing deficit:																
Net borrowing from public	197	204	219	142	166	224	188	91	37	46	45	59	50	18	40	
Decrease in cash operating balance	12	-3	-7	0	-6	-13	16	-14	19	-14	2	9	0	-5	-10	
Other <sup>3</sup>	1	2	-2	2	6	5	-2	-2	5	-9	4	-2	6	-2	4	
Cash operating balance, end of period	17	20	24	20	30	31	15	31	12	26	24	15	15	20	30	
Memo: Sponsored agency borrowing <sup>4</sup>	20	n.a.	9	n.a.	21	21	8	5	0	2	2	4	5	6	6	
<b>NIPA Federal Sector</b>																
Receipts	769	823	813	905	874	785	824	Seasonally adjusted annual rates								
Expenditures	961	1016	1017	1044	1037	985	1018	804	806	812	829	850	865	881	899	
Purchases	343	359	366	373	375	355	362	1030	1009	1016	1014	1033	1034	1038	1045	
Defense	256	270	273	289	289	262	276	385	354	361	364	370	373	377	379	
Nondefense	87	89	93	83	86	94	86	272	267	274	279	285	288	291	293	
All other expenditures	618	657	651	671	663	629	656	113	88	88	85	85	86	86	86	
Surplus/deficit(-)	-192	-193	-205	-139	-164	-199	-194	645	654	654	650	664	661	662	665	
High employment surplus/deficit(-) evaluated at 6 percent unemployment	-155	n.a.	-167	n.a.	-145	-163	-160	-227	-202	-204	-185	-183	-169	-157	-146	
	*--actual			e--estimated				n.a.--not available								

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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

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Recent developments. Interest rates continued to fall in the first half of the intermeeting period, mainly in anticipation of a discount rate cut. But after a 1/2 percentage point cut was announced in mid-April, market rates began to move back up as the foreign exchange value of the dollar dropped sharply and oil prices firmed. The exchange rate and oil price developments apparently eroded market optimism regarding further easing by the System. Since then, long-term interest rates have reversed their earlier declines and are near their levels at the April FOMC meeting, while intermediate-term rates are above them. Short-term rates remain about 25 to 50 basis points below their meeting levels.

In long-term markets, unusually wide spreads persist between yields on private debt instruments--bonds and mortgages--and those on U.S. government securities. These spreads appear to reflect the heavy volume of private borrowing and the lesser degree of call protection on such obligations rather than generalized concerns about default risk. In short-term markets, rate spreads between CDs and Treasury bills generally have narrowed, although there are a few banks with heavy concentrations of energy loans whose CDs carry high premiums.

The monetary aggregates grew rapidly in April. M1 expanded at about a 14 percent annual rate, reflecting, at least in part, earlier declines in market interest rates and, to a small degree, a stronger pace of federal tax refunds than in earlier years. M2 growth, at a 13 percent annual rate, reflected the strength in M1 and also large inflows to its most liquid retail components, notably savings deposits, money market deposit accounts, and money market mutual funds. Offering rates

on these deposits have fallen more slowly than rates on comparable market instruments, while the flattening of the yield curve in recent months seem to have increased the attractiveness of liquid deposits generally. M3 expanded at a 10 percent rate in April as declines in managed liabilities at banks offset in part the strength of the M2 component and sizable flows to institution-only money funds.

The growth of domestic nonfinancial debt during the first quarter is estimated at 9 percent, at an annual rate, appreciably below the hectic year-end pace. Preliminary data suggest some acceleration in April. Federal borrowing is picking up sharply on a seasonally adjusted basis in the current quarter; the Treasury plans to use funds to build cash balances as well as to service the seasonally small deficit. The Treasury already has raised about three-fourths of the expected borrowing total, relying, as in the first quarter, overwhelmingly on sales of marketable coupon securities.

Tax-exempt bond volume was stymied early in the year by tax reform uncertainties, but an increasing volume of municipal issues has been marketed since mid-March, when the House, Senate and Treasury agreed to delay until September the effective date of key restrictions (under HR 3838) on public-purpose issues. Close to half of the long-term municipal issues this year have been refunding bonds, prompted by interest rates several percentage points lower than those on bonds issued a few years ago.

In the corporate sector, gross offerings of long-term debt set records in March and again in April as firms took advantage of the

lowest bond rates in eight years to restructure balance sheets. Some bond proceeds were used to pay down commercial paper, which has contracted sharply since the beginning of the year, and to refinance outstanding bonds with high coupons; business borrowing at banks, meanwhile, was quite weak in April. On balance, a narrow financing gap, some abatement in corporate merger activity since year-end, and the increased attractiveness of equity issuance have greatly reduced net corporate borrowing needs this year. Some proceeds from recent security issues likely are showing up, at least temporarily, in liquid asset holdings of businesses.

In the mortgage markets, too, the lower interest rates have continued to spur a frenetic pace of refinancing activity. Homeowners have demonstrated a strong preference for fixed-rate financing at current yields despite a wide initial rate advantage on adjustable-rate mortgages. Residential mortgage growth, surprisingly, appears to have slowed in the first quarter, perhaps owing to the paperwork crunch which reportedly has slowed closings on home sales. A number of signs suggest, however, that an acceleration in net mortgage debt growth is in train. Real estate loans at banks continued to expand at a strong pace in April. Thrift institutions have been supplementing strong growth in core deposits by issuing CDs and borrowing from the Federal Home Loan Banks; staff at the FHLB Board suggest that the heavy thrift demands for advances likely are related to increases in mortgage lending.

While the trend in mortgage lending appears to be upward, household use of consumer credit appears to be diminishing. The March increase in installment credit, at an 8 percent seasonably adjusted annual rate, was near the lowest monthly growth rate in almost three years.

Auto credit was particularly weak in March, mainly reflecting a slackening in car sales as less attractive financing programs were being offered by the finance subsidiaries of the auto manufacturers. Other categories of consumer credit also decelerated in February and March, however, and accounted for the bulk of the first-quarter slowing in aggregate installment credit growth.

Outlook. Aggregate debt growth is expected to be stronger in the current quarter than in the first, and to run around the upper end of the FOMC's monitoring range through year-end.

In the government sectors, Treasury financing, after rising on a seasonally adjusted basis in the current quarter, should drop in the third quarter, as borrowing moves more in line with the deficit. Debt issuance by the states and localities is expected to remain sizable in coming months, barring some surprise on the tax-reform front.

Borrowing patterns in the business sector are not expected to change dramatically, in the next several months, if interest rates remain close to current levels. The economic projection suggests that the gap between corporate cash flows and capital outlays will continue to be small; unless there is another pickup in merger activity, business net demands on credit markets thus should be little changed. Corporations are likely to continue restructuring balance sheets while market conditions are favorable. Heavy issuance of new equity and longer-maturity bonds, coupled with minimal increases or even paydowns of short-term paper and loans, should persist for a while, although perhaps with some moderation from the recent hectic pace as time passes.



Household borrowing is likely to increase in the near term. Given the declines this year in interest rates and prospects for further increases in housing sales and building activity, the staff anticipates a substantial acceleration in residential mortgage debt formation from the comparatively slow first-quarter pace. Refinancings should continue to boost loan originations; both refinancing and new mortgage demand likely will be concentrated in fixed-rate mortgages with a large share of such loans being sold into pools. The April rebound in auto sales may be mirrored in consumer credit; on the whole, however, in light of the heavy debt burdens faced by many households--and the opportunities to repay installment loans with the proceeds of lower-rate mortgage borrowings--the staff expects that consumer credit growth will remain at a more moderate pace in coming months.

## INTERNATIONAL DEVELOPMENTS

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Recent developments. In foreign exchange markets the dollar has depreciated about 5½ percent further on a weighted-average basis since the last FOMC meeting. Against the yen the decline amounted to 8½ percent, against the mark, about 6½ percent. Market developments over much of the period were centered on expectations, then interpretations, of policy agreements by the countries at the Tokyo summit.

Differentials between U.S. and weighted average foreign interest rates, both long- and short-term, showed little net change over the period. However, there appeared to be a general perception in the market that the U.S. administration wanted the dollar to decline, and that policy would be oriented to that end.

The pace of economic activity in major foreign industrial countries has slowed in recent months. Industrial production fell in

the first quarter in both Japan and Germany. Inflation in most countries slowed further in recent months, reflecting, in large part, the effects of the declines in the dollar and in oil prices. Current account surpluses (in dollar terms) continued at record levels in Japan and Germany in the first quarter, though export volumes in both countries continued to decline, especially sharply in Japan.

Several major debtor developing countries have encountered further difficulties in implementing adjustment programs. Inflation appears to be accelerating in Argentina, after a period of success in price stabilization. Both Mexico and Venezuela are struggling to cope with the effects of oil price weakness on their economies and on their external financing.

Revised U.S. merchandise trade figures for January and February and very preliminary data for March suggest that the first-quarter trade deficit, on a balance of payments basis, was somewhat smaller than the fourth quarter's. Exports rose somewhat, while the value of imports, reflecting declines in oil import prices and volumes, fell. An increase in non-agricultural exports was entirely in volume terms, with prices steady. Non-oil import prices and volumes both appeared to increase.

The large reported net capital inflows in the first quarter took the form of large net foreign purchases of U.S. corporate and Treasury securities and a further reduction in U.S. banks' net claims on their foreign offices. These inflows were partly offset by heavy purchases by U.S. residents of foreign securities.

Foreign purchases of U.S. corporate stocks were a record \$6 billion in the first quarter. Foreign purchases of U.S. Treasury securities amounted to nearly \$8½ billion, though direct purchases by Japanese residents declined sharply.

### Outlook

The staff continues to project a decline in the value of the dollar to a 1986 fourth-quarter level about 10 percent lower than its March level, with a smaller further decline through 1987. The outlook for economic activity abroad remains one of moderate growth, though recent figures for Japan and Germany are somewhat disquieting. The forecast for U.S. trade and current account deficits is essentially unchanged from the last Greenbook, with the current account deficit projected at about \$130 billion this year, declining to about \$115 billion by the fourth quarter of 1987.

May 14, 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	-78.4	-88.7	-75.0	-87.8	-113.4	-95.1	-89.5	-85.2	-84.8	-84.4	-78.7	-71.8	-65.3
Exports of G+S	370.0	395.8	461.7	363.2	367.8	378.4	386.6	400.9	417.3	433.6	452.0	471.2	490.1
Imports of G+S	448.4	484.5	536.9	451.0	481.2	473.6	476.2	486.2	502.2	518.1	530.9	543.1	555.5
Constant 82 \$, Net	-108.4	-119.2	-89.2	-119.8	-140.8	-126.0	-126.5	-115.5	-109.0	-103.2	-93.5	-83.8	-76.2
Exports of G+S	359.9	381.4	427.6	353.5	359.2	369.4	374.6	384.8	396.9	408.0	421.0	434.3	447.2
Imports of G+S	468.3	500.6	516.8	473.3	500.0	495.4	501.0	500.3	505.9	511.2	514.5	518.1	523.4
2. U.S. Merchandise Trade Balance 2/	-124.3	-136.6	-124.7	-131.8	-157.9	-142.7	-135.3	-134.6	-133.5	-132.2	-127.5	-122.2	-116.9
Exports	214.0	227.9	274.5	209.1	211.9	218.9	221.6	229.7	241.2	254.4	267.7	281.0	294.7
Agricultural	29.2	27.4	28.7	26.1	29.3	28.3	27.3	26.9	27.0	27.8	28.4	29.0	29.7
Non-Agricultural	184.8	200.5	245.7	183.0	182.6	190.6	194.4	202.7	214.2	226.6	239.3	252.0	265.0
Imports	338.3	364.4	399.2	340.9	369.9	361.6	357.0	364.3	374.7	386.6	395.3	403.2	411.6
Petroleum and Products	50.4	35.6	38.3	50.1	57.4	41.6	32.7	33.3	34.6	36.1	37.5	38.9	40.8
Non-Petroleum	287.9	328.8	360.8	290.8	312.5	320.0	324.3	331.0	340.1	350.4	357.7	364.3	370.8
3. U.S. Current Account Balance	-117.7	-129.9	-122.5	-117.2	-146.2	-135.7	-128.8	-125.9	-129.3	-130.3	-126.1	-119.7	-113.9
Of Which: Net Investment Income	24.7	21.8	17.5	34.6	32.5	22.7	22.6	21.8	20.2	17.8	17.0	17.6	17.8
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.7	3.1	3.0	3.2	2.5	3.2	2.8	3.1	3.1	3.0	2.9	3.0	2.9
Real GNP--NonOPEC LDC 5/	3.4	2.7	3.6	2.6	2.5	2.4	2.7	3.1	3.4	3.7	3.9	4.2	4.4
Consumer Prices--Ten Ind. 4/	4.3	2.4	2.6	1.4	3.1	1.8	2.4	2.1	2.3	2.7	3.1	2.8	2.9

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