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October 29, 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. Incoming data, on balance, suggest a continued moderate rate of expansion in economic activity. Price inflation, meanwhile, has been pulled up a bit in recent months by a spurt of food price increases and a firming in petroleum prices.

The index of industrial production edged up 0.1 percent in both August and September, after posting a 0.5 percent gain in July. After widespread increases in output in July and August, the September rise in production of consumer goods and business equipment was attributable in large part to higher assemblies of new 1987-model motor vehicles. Elsewhere, output gains for construction supplies and defense and space equipment were offset by declines in business supplies and materials.

Employment growth also slowed in September, as nonfarm payroll employment rose only 80,000 after adjusting for strike activity. The sluggish pace of industrial production was reflected in a decline in manufacturing jobs, on a strike adjusted basis, that more than offset the increase reported for August. The steady advance in employment in trade, finance, and services continued in September, but hiring in these industries was somewhat less rapid than earlier in the year. According to the household survey, the civilian unemployment rate moved back up to 7 percent last month, with increases in joblessness concentrated among younger workers.

Consumer spending, which had been quite robust in the first half, strengthened further in the third quarter. The advance was led by the

record sales of motor vehicles that occurred after manufacturers expanded their buyer incentive programs in late August. Sales of domestic cars, which had averaged 8-1/4 million units (annual rate) in the preceding several months, surged in September to an 11-3/4 million unit rate. Apart from motor vehicles, spending for other goods and services leveled off over the past three months. Real disposable income declined somewhat last quarter, as farm subsidy payments dropped off and consumer prices accelerated, and the personal saving rate dropped to an extraordinarily low 2.9 percent.

Business purchases of motor vehicles also were up sharply last quarter, but spending for other equipment declined, and outlays for nonresidential structures dropped substantially further. As a result, real business fixed investment spending, overall, was estimated by BEA to have been little changed from the second-quarter average. Some indicators of future demand, however, appear a bit more positive--at least in the near term. New orders for nondefense capital goods rose almost 9 percent in September; although aircraft orders accounted for half of the increase, bookings for many other types of equipment also posted sizable gains. To the extent that these orders reflect a desire by firms to install some types of equipment before depreciation rules become less generous next year, their effect on spending beyond the current quarter is uncertain. For structures, data on new commitments continue to point to further declines in office building. However, the plunge in oil and gas well drilling, which accounted for much of the weakness in nonresidential structures over the first three quarters of the year, appears to be ending.

The rate of new housing starts dropped back in recent months to below the 1.7 million unit mark from the peak levels of around 2 million units

recorded in the first half of the year. In the multifamily sector, the decline likely has reflected the beginning of an expected downward adjustment to record high vacancy rates and the prospect of less favorable tax treatment. But single-family starts also have drifted down, from around a 1.25 million unit annual rate in the first half to around 1.1 million units in September. Indicators of underlying market conditions in the single-family market, however, are still on the positive side. Although sales of new homes in August were substantially below the high first-half average, sales of existing homes in September climbed to a seven-year high, and the lowest mortgage interest rates in years have maintained very favorable consumer attitudes toward homebuying, according to surveys.

Price increases have been a bit higher in recent months than earlier in the year, owing mainly to developments in food and energy markets. Consumer food prices rose sharply during the summer as heat and drought in the southeast cut supplies; by September, conditions had improved, but retail food price increases were still running somewhat above overall inflation rates. For energy, the rise in crude oil prices that occurred after OPEC agreed in early August to curtail production apparently has reached the retail level, as the CPI measures for gasoline and heating oil turned up in September, after steep declines throughout much of the year. Excluding food and energy, monthly increases in consumer prices averaged 0.3 percent in August and September—little different from the pace that prevailed earlier this year.

Data from several sources show that labor cost increases have moderated further over the past year. Compensation per hour in the nonfarm

business sector is estimated to have risen at a 2-1/2 percent annual rate over the first three quarters of this year while the Employment Cost Index measure of hourly compensation for private industry workers has increased at a 3-1/2 percent rate. Both measures show improvement from their 4 percent rates of increase during 1985. The detail available from the ECI show that this slowing has been widespread by industry and occupational grouping.

Outlook. The staff projects that real GNP will grow at a 3 percent annual rate in the current quarter, after rising at a 2-1/2 percent rate last quarter according to preliminary estimates. In contrast to the third quarter when domestic final demand was strong, the key expenditure categories contributing to the projected rise in activity this period are inventory investment and net exports.

For autos, although we anticipate that the manufacturers will trim their production schedules from current plans, we project that assemblies will increase from a 7-1/4 million unit annual rate (BEA basis) last quarter to 7-3/4 million units this quarter, contributing around 1/2 percentage point to GNP growth. Because sales of domestic cars are expected to retreat significantly this fall from the torrid pace of the third quarter, a considerable portion of this output is likely to show up as a rebuilding of dealer stocks. In the trade sector, real exports are projected to post another sizable increase in the fourth quarter while oil imports, which surged this summer, are expected to drop back.

Consumer outlays for goods and services other than autos are projected to continue to grow moderately this quarter, and nonauto business equipment spending is expected to get a small lift from anticipated tax law changes. Outlays for residential construction, however, are likely to flatten out,

and spending for nonresidential building is expected to contract further. With non-oil imports leveling off, domestic demands, on balance, are projected to translate more fully into growth in domestic production.

The monetary and fiscal policy assumptions underlying the staff's economic projections are unchanged from the last Greenbook. Growth rates of M2 and M3, after finishing this year around the upper ends of their ranges, are assumed to be well within their ranges in 1987. Interest rates are projected to fluctuate near current levels over the forecast horizon. The fiscal year 1987 deficit is projected to decline to \$178 billion from \$221 billion in fiscal year 1986.

The staff's outlook for real activity in 1987, which shows GNP growth remaining at about a 3 percent rate, also has changed little from the last Greenbook. Sustained growth in real exports, owing to the improvement in the price competitiveness of U.S. goods, continues to be a key element supporting the projection for domestic production. Gross domestic purchases are expected to rise only 1-3/4 percent over the four quarters of 1987, compared with 2-3/4 percent this year. An important factor in the easing in domestic demand is the slower growth in consumer purchasing power, as energy prices turn up and import prices accelerate. Real disposable personal income is projected to rise 2-1/4 percent during 1987, down from 3-1/2 percent in 1986. In the business sector, the pickup in domestic production and ongoing modernization efforts are anticipated to provide support for moderate growth in equipment demand. However, owing to the retrenchment in office building, outlays for nonresidential construction are expected to decline throughout the year. Spending for residential investment is anticipated to be essentially flat.

The rise in real GNP in 1987 is expected to lead to only a small reduction in the margins of slack in labor and product markets. Nonetheless, the staff's projection for inflation continues to show some step-up early next year that is associated with the effects of rapidly rising import prices on the prices of U.S. goods and with the turnaround in energy prices. We are projecting that world oil prices will reach the \$16 per barrel level by early 1987 and remain near that level throughout the year. The GNP fixed-weighted price index is projected to increase a bit more than 3 percent in 1987 after rising 2-1/4 percent this year; the acceleration is sharper for consumer price indexes, which include the direct effects of import prices.

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

October 29, 1986

CONFIDENTIAL - FR
CLASS II FOMC

STAFF GNP PROJECTIONS

Percent changes, annual rate

		Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
		9/17/86	10/29/86	9/17/86	10/29/86	9/17/86	10/29/86	9/17/86	10/29/86	9/17/86	10/29/86
Annual changes:											
1984	<1>	10.5	10.5	6.4	6.4	4.0	4.0	3.8	3.8	7.5	7.5
1985	<1>	6.2	6.2	2.7	2.7	3.7	3.7	3.3	3.3	7.2	7.2
1986		5.4	5.3	2.7	2.6	2.8	2.6	2.6	2.6	7.0	7.0
1987		5.6	5.2	3.0	2.6	2.9	2.8	2.5	2.5	6.6	6.8
Quarterly changes:											
1985	Q1 <1>	6.8	6.8	3.1	3.1	4.2	4.2	3.7	3.7	7.3	7.3
	Q2 <1>	5.8	5.8	2.3	2.3	3.6	3.6	3.3	3.3	7.3	7.3
	Q3 <1>	6.8	6.8	4.1	4.1	2.8	2.8	2.5	2.5	7.2	7.2
	Q4 <1>	5.8	5.8	2.1	2.1	4.0	4.0	3.6	3.6	7.0	7.0
1986	Q1 <1>	6.2	6.2	3.8	3.8	2.5	2.5	2.5	2.5	7.1	7.1
	Q2 <1>	3.0	2.6	.6	.6	1.9	1.7	2.5	1.8	7.2	7.2
	Q3 <1>	5.2	5.7	3.0	2.4	2.7	2.5	2.0	3.6	6.9	6.9
	Q4	5.4	3.9	3.8	3.0	2.4	2.0	1.5	.7	6.8	7.0
1987	Q1	5.8	5.6	2.9	2.7	3.2	3.3	2.8	2.9	6.7	6.9
	Q2	6.0	5.8	3.0	2.7	3.2	3.3	2.9	3.0	6.6	6.9
	Q3	6.0	5.6	3.0	3.0	3.2	2.9	2.8	2.6	6.6	6.8
	Q4	6.3	5.9	3.0	3.0	3.3	3.0	3.2	2.8	6.6	6.7
Two-quarter changes: <2>											
1985	Q2 <1>	6.3	6.3	2.7	2.7	3.9	3.9	3.5	3.5	.1	.1
	Q4 <1>	6.3	6.3	3.1	3.1	3.2	3.2	3.1	3.1	-.3	-.3
1986	Q2 <1>	4.6	4.3	2.2	2.2	2.3	2.1	2.5	2.1	.2	.2
	Q4	5.3	4.8	3.4	2.7	2.5	2.2	1.7	2.1	-.4	-.2
1987	Q2	5.9	5.7	3.0	2.7	3.2	3.3	2.9	2.9	-.2	-.1
	Q4	6.1	5.8	3.0	3.0	3.3	2.9	3.0	2.7	.0	-.2
Four-quarter changes: <3>											
1984	Q4 <1>	8.5	8.5	4.6	4.6	3.9	3.9	3.6	3.6	-1.3	-1.3
1985	Q4 <1>	6.3	6.3	2.9	2.9	3.6	3.6	3.3	3.3	-.2	-.2
1986	Q4	4.9	4.6	2.8	2.4	2.4	2.2	2.1	2.1	-.2	.0
1987	Q4	6.0	5.7	3.0	2.9	3.3	3.1	2.9	2.8	-.2	-.3

<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 \$	4030.5	4087.7	4149.2	4175.6	4234.3	4274.5	4333.3	4394.8	4455.3	4519.5
Real GNP	Billions of 82\$	3603.8	3622.3	3655.9	3661.4	3683.3	3710.6	3734.9	3760.3	3788.0	3816.6
Real GNP	Percent change	4.1	2.1	3.8	.6	2.4	3.0	2.7	2.7	3.0	3.0
Gross domestic purchases		4.6	4.0	3.0	3.6	3.5	.8	1.4	1.8	1.9	2.0
Final sales		6.1	2.7	-1.3	3.4	4.6	.9	2.7	2.3	3.0	3.1
Private dom. final purchases		4.8	3.4	.9	5.6	6.1	-2.3	1.6	1.6	2.0	2.1
Personal consumption expend.		5.3	1.7	3.6	6.2	7.2	-2.7	2.3	2.3	2.1	2.1
Durables		23.8	-11.1	-1.8	14.3	38.4	-24.5	1.3	1.2	1.7	1.8
Nondurables		1.2	1.6	6.5	8.0	.8	1.2	2.3	2.4	2.0	2.1
Services		3.2	6.0	3.2	2.6	3.5	2.4	2.6	2.5	2.2	2.2
Business fixed investment		.1	12.5	-15.1	-.9	.3	.0	-.1	1.7	1.8	1.7
Producers' durable equipment		2.6	18.7	-17.0	19.6	4.4	1.7	1.3	4.0	4.0	4.0
Nonresidential structures		-4.6	.3	-10.8	-35.2	-9.3	-4.1	-3.8	-4.1	-4.0	-4.3
Residential structures		11.7	3.4	11.0	14.5	7.2	-1.7	-3.9	-6.4	1.9	3.7
Exports		-5.8	8.2	7.1	-9.8	15.4	9.9	11.9	10.2	13.4	13.4
Imports		.3	23.3	.2	15.8	20.0	-7.6	-.2	1.3	2.7	2.8
Government purchases		13.9	10.0	-12.3	9.7	3.6	3.4	.6	.5	1.5	1.4
Federal		26.0	22.7	-27.5	11.0	.5	5.7	-.8	-1.3	.7	.4
Defense		15.8	-4.7	-1.0	19.0	.8	6.7	2.4	.3	.9	.8
State and local		5.1	.3	2.6	8.7	6.1	1.5	1.8	2.0	2.1	2.2
Change in business inventories	Billions of 82\$.7	-5.2	39.9	15.1	-4.5	14.8	14.8	18.5	18.6	18.5
Nonfarm	Billions of 82\$	1.4	16.1	37.0	11.0	-5.0	18.5	15.0	19.5	19.5	19.6
Net exports	Billions of 82\$	-113.8	-132.0	-125.9	-153.9	-164.6	-145.2	-134.1	-126.1	-116.9	-107.3
Nominal GNP	Percent change	6.8	5.8	6.2	2.6	5.7	3.9	5.6	5.8	5.6	5.9
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	97.9	98.7	99.4	99.8	100.2	100.7	101.3	101.8	102.4	102.9
Unemployment rate	Percent*	7.2	7.0	7.1	7.2	6.9	7.0	6.9	6.9	6.8	6.7
Industrial production index	Percent change	1.8	2.0	1.2	-2.1	2.3	1.8	2.4	3.0	3.2	3.3
Capacity utilization rate-mfg.	Percent*	80.1	79.9	80.0	79.5	79.8	79.7	79.8	79.9	80.0	80.2
Housing Starts	Millions	1.69	1.77	2.00	1.91	1.76	1.67	1.62	1.63	1.66	1.69
Auto sales	Millions	12.31	10.24	10.65	11.22	12.91	10.15	10.55	10.80	11.00	11.00
Domestic	Millions	9.40	6.84	7.84	8.18	9.43	6.90	7.50	7.60	7.80	7.80
Foreign	Millions	2.90	3.40	2.81	3.05	3.47	3.25	3.05	3.20	3.20	3.20
INCOME AND SAVING											
Nominal personal income	Percent change	3.0	7.4	6.0	6.0	2.1	6.6	5.1	5.7	5.7	5.6
Real disposable income	Percent change	-4.0	2.6	6.5	7.1	-2.2	2.6	3.1	1.8	1.9	2.0
Personal saving rate	Percent*	4.2	4.4	5.0	5.1	2.9	4.1	4.3	4.2	4.1	4.1
Corp. profits with IVA & CCAdj	Percent change	36.2	-13.7	16.0	-4.4	13.9	-6.7	-3.4	3.4	-.6	2.7
Profit share of GNP	Percent*	7.4	7.0	7.1	7.0	7.2	7.0	6.8	6.8	6.7	6.6
Federal govt. surplus/deficit	Billions of \$	-197.5	-217.6	-201.6	-238.1	-195.9	-189.9	-185.7	-176.8	-171.0	-164.9
State and local govt. surplus		59.5	62.5	70.0	59.0	61.8	51.5	56.6	57.7	59.7	61.2
PRICES AND COSTS											
GNP implicit deflator	Percent change	2.5	3.6	2.5	1.8	3.6	.7	2.9	3.0	2.6	2.8
GNP fixed-weight price index		2.8	4.0	2.5	1.7	2.5	2.0	3.3	3.3	2.9	3.0
Cons. & fixed invest. prices		2.7	4.3	1.6	.2	2.7	3.3	3.7	3.5	3.2	3.2
CPI		2.6	4.3	1.5	-1.7	2.6	3.6	4.2	3.6	3.4	3.4
Exc. food and energy		3.5	4.9	4.3	3.4	3.6	3.8	3.7	3.8	3.9	3.9
Nonfarm business sector											
Output per hour		2.2	-3.5	4.3	.5	.2	1.8	.2	.5	.8	1.0
Compensation per hour		3.2	3.7	3.1	2.3	2.3	2.8	3.0	3.1	3.3	3.4
Unit labor costs		1.0	7.4	-1.2	1.8	2.1	1.0	2.8	2.6	2.5	2.4

* Not at an annual rate.

October 29, 1986

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

	Units	Projection								
		1979	1980	1981	1982	1983	1984	1985	1986	1987
EXPENDITURES -----										
Nominal GNP	Billions of \$	2508.2	2732.0	3052.6	3166.0	3405.7	3765.0	3998.1	4208.4	4425.7
Real GNP	Billions of 82\$	3192.4	3187.1	3248.8	3166.0	3279.1	3489.9	3585.2	3677.8	3774.9
Real GNP	Percent change*	.6	-.1	.6	-1.9	6.5	4.6	2.9	2.4	2.9
Gross domestic purchases		-4	-1.1	.8	-.8	8.4	5.9	3.9	2.7	1.8
Final sales		2.2	-.2	.1	.3	3.7	4.4	4.0	1.9	2.8
Private dom. final purchases		1.3	-1.7	-.3	.8	7.7	5.3	4.2	2.5	1.8
Personal consumption expend.		1.4	-.1	.2	2.9	5.4	3.6	3.5	3.5	2.2
Durables		-3.8	-5.6	-3.3	9.0	14.7	8.8	6.2	4.0	1.5
Nondurables		.8	-1.4	.5	1.8	4.4	2.2	2.0	4.1	2.2
Services		3.5	2.4	.9	2.3	3.9	3.3	3.9	2.9	2.4
Business fixed investment		5.0	-4.8	5.6	-11.3	10.8	14.7	6.5	-4.1	1.3
Producers' durable equipment		1.6	-6.5	2.2	-12.5	20.9	16.0	8.1	1.3	3.3
Nonresidential structures		12.0	-1.8	11.7	-9.1	-4.8	12.1	3.3	-15.8	-4.0
Residential structures		-7.2	-14.2	-22.4	4.9	38.1	5.3	7.8	7.6	-1.2
Exports		13.7	.5	2.4	-13.8	5.8	5.5	-3.2	5.2	12.2
Imports		3.4	-8.8	4.9	-5.9	23.8	16.5	5.8	6.5	1.6
Government purchases		.1	1.0	2.9	3.8	-2.7	7.7	8.4	.8	1.0
Federal		-.3	3.1	9.5	8.2	-8.1	14.2	14.3	-3.8	-.2
Defense		3.3	3.1	7.6	8.8	5.1	6.8	5.9	6.1	1.1
State and local		.4	-.3	-1.3	.6	1.5	3.1	3.7	4.7	2.0
Change in business inventories	Billions of 82\$	15.0	-6.9	23.9	-24.5	-6.4	59.2	9.0	16.3	17.6
Nonfarm	Billions of 82\$	10.4	-2.3	19.0	-23.1	-.1	54.3	10.9	15.4	18.4
Net exports	Billions of 82\$	3.6	57.0	49.4	26.3	-19.9	-83.6	-108.2	-147.4	-121.1
Nominal GNP	Percent change*	9.5	9.9	9.3	3.1	10.4	8.5	6.3	4.6	5.7
EMPLOYMENT AND PRODUCTION -----										
Nonfarm payroll employment	Millions	89.8	90.4	91.2	89.6	90.2	94.5	97.6	100.0	102.1
Unemployment rate	Percent	5.8	7.1	7.6	9.7	9.6	7.5	7.2	7.0	6.8
Industrial production index	Percent change*	.9	-.8	-1.0	-7.7	14.3	6.6	1.7	.8	3.0
Capacity utilization rate-mfg.	Percent	84.6	79.3	78.3	70.3	74.0	80.5	80.1	79.8	80.0
Housing Starts	Millions	1.72	1.30	1.10	1.06	1.71	1.76	1.74	1.83	1.65
Auto sales	Millions	10.68	9.04	8.56	8.00	9.18	10.43	11.09	11.23	10.84
Domestic	Millions	8.36	6.62	6.24	5.77	6.77	7.97	8.24	8.09	7.68
Foreign	Millions	2.32	2.42	2.32	2.23	2.41	2.46	2.84	3.15	3.16
INCOME AND SAVING -----										
Nominal personal income	Percent change*	11.4	12.0	9.2	5.3	7.8	8.4	6.1	5.2	5.5
Real disposable income	Percent change*	.5	1.1	.7	1.0	5.1	4.2	1.9	3.4	2.2
Personal saving rate	Percent	6.8	7.1	7.5	6.8	5.4	6.3	5.1	4.3	4.2
Corp. profits with IVA & CCAdj	Percent change*	-10.7	-6.8	2.3	-19.1	70.1	6.6	7.8	4.2	.5
Profit share of GNP	Percent	8.0	6.5	6.2	4.7	6.3	7.0	7.0	7.1	6.7
Federal govt. surplus/deficit	Billions of \$	-16.1	-61.3	-63.8	-145.9	-176.0	-170.0	-198.0	-206.4	-174.6
State and local govt. surplus		27.6	26.8	34.1	35.1	47.5	68.5	61.7	60.6	58.8
PRICES AND COSTS -----										
GNP implicit deflator	Percent change*	8.9	9.9	8.7	5.2	3.6	3.6	3.3	2.1	2.8
GNP fixed-weight price index		8.8	9.8	8.5	5.0	3.9	3.9	3.6	2.2	3.1
Cons. & fixed invest. prices		9.5	10.1	8.2	4.4	3.3	3.6	3.4	1.9	3.4
CPI		12.7	12.5	9.6	4.5	3.3	4.1	3.5	1.5	3.7
Exc. food and energy		10.7	12.2	10.2	5.2	4.3	4.8	4.3	3.8	3.8
Nonfarm business sector										
Output per hour		-2.7	1.0	-.6	1.0	3.6	1.0	.2	1.7	.6
Compensation per hour		9.7	10.9	8.3	7.3	3.3	4.3	3.9	2.6	3.2
Unit labor costs		12.7	9.8	9.0	6.2	-.3	3.2	3.7	.9	2.6

* Percent changes are from fourth quarter to fourth quarter.

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1985*	Fiscal Year 1986*	FY1987e		CY 1985*	CY1986e FRB Staff	1985 IV*	FRB Staff Estimates						
			Admin ¹	FRB Staff				I*	1986			IV	1987	
								I*	II*	III*	IV	I	II	III
								Not seasonally adjusted						
Budget receipts ²	734	769	831	825	745	785	177	180	215	198	193	191	237	204
Budget outlays ²	946	990	975	1003	961	989	252	241	245	251	252	247	251	253
Surplus/deficit(-) to be financed ²	-212	-221	-144	-178	-216	-205	-75	-61	-30	-54	-59	-56	-14	-49
Means of financing deficit:														
Borrowing from public	197	236	144	173	224	204	91	37	51	58	59	35	24	55
Cash balance decrease ³	13	-14	0	1	-13	3	-14	19	-12	-7	3	13	-5	-10
Other ³	1	-1	0	4	5	-3	-2	5	-8	3	-3	8	-5	4
Cash operating balance, end of period	17	31	20	30	31	28	31	12	25	31	28	15	20	30
Memo: Sponsored agency borrowing ⁴	20	13	n. a.	20	20	11	5	-2	5	5	3	5	6	6
NIPA Federal Sector								Seasonally adjusted annual rates						
Receipts	771	810	890	865	787	823	806	800	808	828	855	856	869	879
Expenditures	963	1024	1033	1046	985	1029	1023	1002	1046	1024	1045	1042	1045	1050
Purchases	341	367	375	378	354	366	381	356	368	366	373	377	379	382
Defense	254	272	290	290	259	276	268	266	278	277	284	289	292	294
Nondefense	88	95	84	88	95	89	113	89	89	89	89	88	87	88
All other expend.	621	656	658	668	631	663	643	646	678	658	672	665	666	668
Surplus/deficit(-)	-191	-213	-143	-181	-198	-206	-218	-202	-238	-196	-190	-186	-177	-171
High-employment surplus/ deficit(-) evaluated at 6 percent unemp.	-151	-176	n. a.	-144	-159	-169	-181	-168	-199	-157	-151	-148	-139	-136
	*--actual		e--estimated				n. a.--not available							

Note: Details may not add to totals due to rounding

1. Mid-Session Review of the 1987 Budget (August 1987). The Congressional Budget Office baseline estimates published in August indicated receipts of \$828 billion and outlays of \$1012 billion in FY1987.
2. Includes outlays formerly classified as off-budget (e.g. Federal Financing Bank and Strategic Petroleum Reserve) and social security receipts and outlays classified as off-budget under current law.
3. Checks issued less checks paid, accrued items, and other transactions.
4. Sponsored agency borrowing includes net debt issuance by Federal Home Loan Banks, Federal Home Loan Mortgage Corporation (excluding participation certificates), Federal National Mortgage Association (excluding mortgage-backed securities), Farm Credit Banks, and Student Loan Marketing Association marketable debt. The Administration's definition of borrowing by these agencies is somewhat broader.

DOMESTIC FINANCIAL DEVELOPMENTS

Recent developments. Interest rates are down a bit since the last FOMC meeting. Short-term rates have rippled during the intermeeting period in response to incoming information on the economy. Most intermediate- and long-term security yields have moved a touch lower. However, they remain, with the exception of tax-exempt rates, noticeably above their spring lows. Mortgage loan rates also have declined, but not enough to narrow appreciably the still-large spreads relative to bond yields, especially Treasuries.

Growth in M1 and M2 slowed markedly in September, but early evidence points to some rebound in October. M1 rose at a 10 percent annual rate in September, the lowest in seven months, as demand deposits leveled off and other checkable deposits grew less rapidly. In October, demand deposit growth remained low while OCDs reaccelerated. In M2, the nontransactions component also contributed to the slowing of this aggregate in September, as overnight RPs contracted after rising sharply in July and August. Savings accounts continued to grow rapidly into October, as the rates on these accounts have been very slow to adjust to earlier declines in market yields; rates on small time deposits have shown less inertia, and savers evidently have not found the rates attractive enough to commit their money to these less liquid accounts. M3 growth, at a 9 percent rate in September, was unchanged from a month earlier; there appears to have been some slowing in early October. Through September, M1 remained well above its 1986 range, while M2 and M3 were near the upper bounds of their annual targets.

Special factors--including legislative action--have affected the timing of nonfinancial debt growth recently, but the underlying growth has remained brisk. Borrowing by governmental units was relatively light as the fall began, but has picked up more recently. In the federal sector, debt ceiling constraints in late September and early October forced the Treasury to scale back its auction schedule and draw down its cash balances; it has since resumed an active borrowing pace to cover another huge quarterly deficit. In the municipal securities market, tax-exempt bond offerings fell sharply after the September 1 effective date for new restrictions on public-purpose issues; after surging to \$26 billion in August, total bond volume dropped to \$5 billion in September and remained low through mid-October as many issuers awaited final passage of the tax legislation.

Borrowing by nonfinancial firms slowed in September in both the short- and long-term credit markets before rebounding some at the short end in early October. Bank loans to businesses were flat in September, and corporations paid down commercial paper. Gross bond offerings fell off in September and declined further in October.

Auto credit likely produced a spike in the September growth of consumer installment credit. Part of the funding for these low-rate loans was provided through issuance of \$4 billion in bonds collateralized by GMAC auto loans and sliced into several maturity tranches. Outside of the auto category, consumer borrowing has slowed in recent months, and even including auto loans, consumer credit growth so far this year has been only about half as rapid as during 1984-85. It may be that debt servicing problems are causing borrowers and lenders to act more cautiously, but this is not yet apparent in any surveys of attitudes.

Home mortgage lending continued very strong through the third quarter. The availability of fixed-rate mortgages in the 10 percent area and of more attractively priced ARMs helped to sustain both home purchases and refinancings at high levels. Although expanding their portfolios rather slowly, FSLIC-insured thrifts originated a record volume of loans in the third quarter; federally sponsored pass-through securities continued to be the dominant vehicle for mortgage credit expansion.

Outlook. Total nonfinancial debt growth for the fourth quarter likely will remain near the third-quarter pace before slowing somewhat in 1987 in response to federal deficit-reduction measures and some easing in private-sector credit demand. After a slow start owing to the debt ceiling constraint, Treasury borrowing over the remainder of this quarter will be high. A larger share of this borrowing will be through sales of marketable securities; issuance of nonmarketable SLGs should decline, largely because state and local offerings of advance refunding bonds are likely to be moderate in light of new restrictions contained in the tax reform package. The reduced size of the federal deficit in the current fiscal year should begin to show through in Treasury financing requirements early in calendar 1987. Federal sales of physical assets and loans will influence the timing of Treasury borrowing next year, but few of these sales are likely to occur before the spring. Overall tax-exempt borrowing should continue to grow moderately through the end of this year and ease further in 1987, although the next couple of months could see a surge in private-purpose offerings as states attempt to use their 1986 authorizations.

Business borrowing probably will strengthen a bit during the remainder of this year, boosted by some widening in the financing gap and by mergers

advanced into 1986 to avoid the less favorable tax treatment of deals completed after December 31. Moving into 1987, a further widening in the financing gap should be offset by some moderation in merger-related borrowing. Businesses are expected to continue tapping the long-term markets in volume as they seek to strengthen their debt structures.

Household borrowing in mortgage markets seems likely to remain relatively strong: home sales have been robust and should remain so into the next year. The widespread securitization of mortgage credit has broadened the effective lender base, and the recent tax changes include some provisions likely to favor expansion of mortgage securities over time. Consumer credit growth, on the other hand, is nearly certain to have fallen off in October and is projected to remain subdued in subsequent months, against a backdrop of reduced consumer spending and less attractive auto financing terms.

INTERNATIONAL DEVELOPMENTS

Recent developments. The weighted-average foreign exchange value of the dollar is about the same as it was at the time of the September FOMC meeting. During the first three weeks of the intermeeting period, the dollar exhibited considerable weakness, particularly against the mark,

. Subsequently, the dollar has strengthened, especially against the yen. Short-term and long-term interest rate differentials moved slightly against the dollar during the intermeeting period. U.K. short-term rates increased by some 150 basis points as the U.K. authorities took steps to counteract strong downward pressures on the pound.

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Partial data for September indicate that foreign G-10 official assets in the United States increased \$5 billion (roughly the same as in August), reflecting in part investments by the United Kingdom of part of the proceeds of its recent \$4 billion Eurobond issue. In August, foreigners other than official institutions purchased (net) about \$5-1/4 billion in private U.S. securities and sold (net) \$1/2 billion in U.S. Treasury obligations; U.S. investors sold (net) about \$1-1/4 billion in foreign securities. There was a net capital inflow of nearly \$13-1/2 billion into U.S. banking offices in August.

Following the recovery in real economic activity in most foreign industrial countries in the second quarter, available data for the third quarter indicate further moderate expansion in Germany, France, the United Kingdom, and, to a lesser extent, in Japan. German industrial production

(s.a.) in July and August (average) was 1-3/4 percent above its second-quarter level, while in Japan the third quarter figure was 3/4 percent below the level recorded in the second quarter. Inflation rates in the foreign industrial countries remain modest, and external surpluses in Japan and Germany continue at record rates. Despite a slight narrowing of Japan's trade surplus in September, the cumulative Japanese trade surplus for the first nine months of this year was \$80 billion (s.a.a.r.); the outcome for the full year 1985 was \$46 billion.

At the end of September, Mexico reached agreement with its bank advisory committee on a debt rescheduling and a new \$6 billion loan package. The IMF, which provisionally approved an 18-month stand-by arrangement for Mexico on September 8, has requested the banks to assemble a critical mass of commitments to the new money package by the end of October. The IMF approved on October 24 a new stand-by arrangement for the Philippines; negotiations on a debt rescheduling between the Philippines and its bank creditors began on October 27. The Nigerian currency has depreciated sharply following the introduction of a second tier foreign exchange auction market. In Argentina, the austral's recent rate of depreciation appears to be insufficient to keep the currency from appreciating further in real terms, and in Brazil, the recent mini-devaluation of the cruzado will offset some of the effects of the inflation recorded so far under the Cruzado Plan.

During the second quarter, U.S.-chartered banks' claims on foreigners declined over \$3 billion; the decline was about \$10 billion on an exchange-rate-adjusted basis. Claims on non-OPEC developing countries dropped nearly \$2 billion, on an unadjusted basis, bringing the cumulative

decline since the end of 1984 to \$10 billion and slightly more on an exchange-rate-adjusted basis. (The data for U.S.-chartered banks reflect in part the 1985 sale of over \$2 billion in claims on non-OPEC developing countries by Crocker Bank to its non-U.S. parent.) Data through the first half of 1986 for all BIS-reporting banks show erratic quarterly changes but no clear trend in claims on non-OPEC developing countries since the end of 1984 on an exchange-rate-adjusted basis; there was a decline of nearly \$5 billion in the first half of this year--all in the first quarter--after a rise of \$11 billion last year.

For July and August combined, the U.S. merchandise trade deficit is estimated to have been \$150 billion (s.a.a.r.) on a balance-of-payments basis--roughly the same rate as the deficits recorded in the previous three quarters. (Preliminary census data for September and revised census data for August will be released on October 30.) Both exports and imports rose somewhat in the July-August period. The value of total exports rose about 2-1/2 percent from second-quarter levels, with a sharp increase in exports of civilian aircraft accounting for most of the increase in the total. The value of imports in July-August rose 3 percent from the second-quarter level; the value of oil imports was roughly unchanged, with a sharp rise in volume offsetting a sharp decline in price.

Outlook. The staff continues to project a moderate decline in the value of the dollar through the end of 1987, although the risk of a sharper drop remains as market participants continue to observe and assess the modest pace of adjustment in the (nominal) U.S. external accounts. The outlook for the U.S. current account is a gradual reduction in the deficit during the course of 1987: the current account deficit in the fourth

quarter of this year is expected to be about \$155 billion (s.a.a.r.) and is projected to decline to about \$140 billion by the fourth quarter of 1987. The deficit for 1987 as a whole is projected to be about the same as that now projected for 1986 (about \$145 billion). Because the prices of imports are projected to rise twice as fast as export prices, the balance on real net exports is projected to show a substantially larger improvement than will be recorded in nominal terms in the current account balance.

October 29, 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-	Q4-	Q1-	Q2-	Q3-	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current \$, Net	-78.9	-105.1	-103.2	-83.7	-105.3	-93.7	-104.5	-110.1	-112.0	-108.4	-105.0	-101.6	-97.7
Exports of G+S	369.7	373.4	420.7	362.3	368.2	374.8	363.0	373.5	382.2	396.6	410.9	428.5	446.8
Imports of G+S	448.6	478.5	524.0	446.0	473.6	468.5	467.5	483.7	494.4	505.1	516.1	530.2	544.6
Constant 82 \$, Net	-108.2	-147.4	-120.9	-113.8	-132.0	-125.9	-153.9	-164.6	-145.1	-134.0	-126.0	-116.7	-107.1
Exports of G+S	362.3	371.0	409.9	355.8	362.9	369.2	359.8	372.9	382.0	392.9	402.6	415.4	428.8
Imports of G+S	470.5	518.3	530.9	469.6	494.8	495.1	513.6	537.5	527.1	526.9	528.6	532.2	535.9
2. U.S. Merchandise Trade Balance 2/	-124.4	-147.5	-144.4	-126.7	-149.4	-145.8	-144.1	-148.0 ^P	-151.9	-149.2	-145.6	-143.0	-139.7
Exports	214.4	219.8	250.4	210.0	210.9	214.6	219.2	222.0 ^P	223.4	233.7	244.2	255.8	268.0
Agricultural	29.6	26.1	27.7	26.7	28.5	28.4	24.6	26.0 ^P	25.5	27.1	27.5	27.8	28.4
Non-Agricultural	184.8	193.7	222.8	183.3	182.4	186.2	194.5	196.0 ^P	197.9	206.6	216.7	228.0	239.7
Imports	338.9	367.3	394.8	336.7	360.3	360.5	363.3	370.0 ^P	375.3	382.9	389.8	398.9	407.7
Petroleum and Products	50.5	34.8	39.0	49.5	56.5	40.1	31.3	32.0 ^P	35.7	38.2	38.7	39.4	39.9
Non-Petroleum	288.3	332.5	355.8	287.2	303.8	320.4	331.9	338.0 ^P	339.6	344.7	351.1	359.5	367.8
3. U.S. Current Account Balance	-117.7	-144.3	-145.1	-113.8	-134.8	-136.2	-138.9	-146.8 ^P	-155.2	-149.1	-146.9	-143.8	-140.4
Of Which: Net Investment Income	25.2	18.4	10.6	33.0	37.0	26.1	21.2	14.8 ^P	11.6	10.4	10.2	10.8	10.9
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.8	2.6	2.7	3.0	2.4	-0.2	5.4	3.0	2.8	2.4	2.4	2.2	2.3
Real GNP--NonOPEC LDC 5/	3.6	3.6	4.1	3.3	3.5	3.6	3.8	4.0	4.1	4.2	4.2	4.1	4.0
Consumer Prices--Ten Ind. 4/	4.3	2.1	2.5	1.4	3.1	1.7	1.7	0.3	3.0	2.6	3.0	2.7	3.3

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