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December 10, 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. Labor market data suggest that output is continuing to expand at a moderate pace in the current quarter, while the indicators of spending suggest that growth of domestic demand has slowed. Price pressures remain limited, but they are more visible now that the direct effects of the world oil price drop have been largely exhausted.

Payroll employment increased roughly 250,000 in both October and November. Although much of the gain over this two-month period was in the private service-producing sector, hiring also rose moderately in manufacturing, and the workweek lengthened. Aggregate hours in November for production and nonsupervisory workers were a full percentage point above the third-quarter average. The civilian unemployment rate has held steady over the past three months at 7.0 percent.

The index of industrial production was unchanged in October, but available information for November indicates that the index probably registered a healthy gain in that month.

Consumer spending, which grew rapidly over the first three quarters of 1986, appears to have weakened this quarter, reflecting a plunge in motor vehicle purchases after the ending of the major incentive programs in early October. In addition, spending for goods and services other than motor vehicles is not exhibiting the vigor of previous quarters; in real terms, the October level of these outlays probably was little changed from the third-quarter average. Sales of domestic cars remained relatively low in November, prompting automakers to reinstate limited incentive programs for a few models. Sales of foreign cars in the past two months roughly matched the advanced third-quarter level.

The impetus to economic activity from residential construction spending appears to be waning, as housing starts in October remained at the reduced September pace. Pressured by high vacancy rates and adverse tax law changes, starts of multifamily units in September and October were about 25 percent below the average for the first half. Starts of single-family homes also have drifted lower since the early months of the year, and sales of new homes have been disappointing recently. Other housing indicators have been more favorable. In particular, existing home sales have been exceptionally strong in recent months; and consumer attitudes toward home purchase continue to be buoyed by favorable interest rate movements.

Business investment spending remains sluggish. Shipments of non-defense capital goods increased in October, but sales of heavy-weight trucks were down, and business purchases of cars and light trucks probably declined sharply after the auto incentive programs ended. Meanwhile, new orders for nondefense capital goods fell 5 percent in October, suggest- that this sector may be quite weak moving into early 1987. Construction spending has firmed recently, but prospects for the sector continue to be clouded by the large overhang of vacant office space and tax reform. The initial surveys of capital spending plans for 1987 suggest that, overall, nominal spending for plant and equipment is likely to be little changed from this year's level.

The current quarter information on inventory investment is quite limited. In the auto sector, production has been running higher than sales since the incentive programs ended, and dealers' stocks, which were pulled down at a very rapid pace in the third quarter, have recently been rising. In manufacturing, book value inventories fell moderately in October, maintaining the downtrend that has been evident for a year and a half. Qualitative reports suggest that merchants generally consider the current level of nonauto trade inventories to be in a satisfactory range.

Inflation remains relatively low, with the consumer price index up 0.2 percent in October and the producer price index up 0.3 percent. In the food sector, some upward price pressures continue to be evident, but the recent rate of increase has been much slower than during the summer. Excluding food and energy, the consumer price index has risen at an annual rate of about 3-3/4 percent so far this year. Although the dockside prices of nonpetroleum imports have risen noticeably in recent quarters, the effect on consumer prices has been small, except for a few items such as automobiles and photographic equipment. The prices of some industrial commodities also have firmed in recent months. More generally, however, cost increases continue to be small for both materials and labor.

Outlook. The staff still expects real GNP to rise at an annual rate of about 3 percent in the current quarter. Inflation, as measured by the GNP fixed-weighted price index, is expected to be around the 2 percent mark this period--essentially the same as the average pace during the first three quarters.

Few of the available data on spending extend beyond October. Thus, assessing the prospects for real GNP this quarter, considerable weight was given to the recent labor market indicators, which show a clear pattern of continued expansion through November. With regard to the sectoral composition of growth, the staff is projecting a sharp improvement in the volume of in net exports this quarter, reflecting both a drop in imports--mainly of petroleum from the high third-quarter level—and an increase in exports, particularly of agricultural products. In addition, small spending gains seem likely in a number of domestic sectors, including nonauto consumption, nonresidential construction, and government. Consumer and business spending for autos will be down sharply this quarter; but, with auto assemblies up slightly from the third-quarter pace, this drop should be offset in the GNP accounts by a swing toward renewed accumulation of auto dealers' stocks. Spending for residential contruction is projected to edge lower after strong gains in the three previous quarters.

In 1987, real GNP is expected to rise close to 3 percent, and in general the composition and logic of the forecast remains much the same as in previous Greenbooks. Fiscal policy is expected to shift toward restraint, with the unified budget deficit in 1987 projected to decline to $179 billion from $221 billion in fiscal year 1986. With respect to monetary policy, M2 and M3, after closing out this year toward the upper ends of their respective ranges, are assumed to be well within their ranges in 1987. Interest rates are projected to fluctuate around their recent levels over the forecast horizon.

As before, the depreciation of the U.S. dollar--both past and anticipated--continues to be a key element shaping the 1987 forecast. As world trade flows adjust to increased U.S. competitiveness, export growth is likely to accelerate next year, and rising import prices are projected to limit import growth. All told, the turnaround in trade is projected to contribute, directly, roughly 1 percentage point to next year's rise in real GNP.

Gross domestic purchases, which rose at about a 4 percent rate in 1985 and, probably, at about a 2-1/2 percent rate in 1986, are expected to slow still further in 1987, to a rate of growth of 2 percent. Fiscal restraint, the likely weakness in multifamily housing and nonresidential construction, and the damping influence of higher import prices on the growth of real income and consumption are the main factors expected to limit the rise in gross domestic purchases. Given the recent data on new orders, business equipment spending probably also will be weak early in the year. However, over the year as a whole, equipment spending should be supported by the continuing needs for replacement and modernization, as well as improved sales prospects associated partly with a more favorable trade outlook. The prevailing interest rate environment is expected to lead to some firming in single-family housing starts over the course of the year. In addition, in the overall context of fiscal restraint, tax reform is likely to shift income to households and thereby provide support for continued growth in consumer spending next year.

The price pressures associated with exchange rate depreciation are expected to become more intense in 1987. In addition, retail energy prices are projected to show a moderate upswing, owing to an expected further rise in crude oil prices next year—to around $16 per barrel—as well as the lagged effects of the oil price increases seen in the second half of this year. Nevertheless, with the margins of slack in labor and product markets expected to decline only slightly in 1987, the overall rise in inflation should be limited. The GNP fixed-weighted price index, which nets out the direct effect of higher import prices, is projected to rise about 3 percent next year after an increase of 2-1/4 percent over the four quarters of 1986. Measures of consumer prices, which reflect the direct import effects, will likely show a sharper acceleration than the GNP index.

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

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STAFF GNP PROJECTIONS

Percent changes, annual rate

	Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)	
	10/29/86	12/10/86	10/29/86	12/10/86	10/29/86	12/10/86	10/29/86	12/10/86	10/29/86	12/10/86
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	5.3	5.4	2.6	2.6	2.6	2.6	2.6	2.6	7.0	7.0
1987	5.2	5.1	2.6	2.6	2.8	2.7	2.5	2.4	6.8	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>	2.6	2.6	.6	.6	1.7	1.7	1.8	1.8	7.2	7.2
Q3 <1>	5.7	6.4	2.4	2.9	2.5	2.4	3.6	3.6	6.9	6.9
Q4	3.9	3.9	3.0	3.1	2.0	2.1	.7	.8	7.0	7.0
1987 Q1	5.6	5.2	2.7	2.4	3.3	3.0	2.9	2.8	6.9	6.9
Q2	5.8	5.5	2.7	2.7	3.3	3.0	3.0	2.7	6.9	6.9
Q3	5.6	5.6	3.0	2.9	2.9	2.8	2.6	2.6	6.8	6.8
Q4	5.9	5.7	3.0	3.0	3.0	2.8	2.8	2.6	6.7	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>	4.3	4.3	2.2	2.2	2.1	2.1	2.1	2.1	.2	.2
Q4	4.8	5.2	2.7	3.0	2.2	2.3	2.1	2.2	-.2	-.2
1987 Q2	5.7	5.4	2.7	2.5	3.3	3.0	2.9	2.8	-.1	-.1
Q4	5.8	5.7	3.0	3.0	2.9	2.8	2.7	2.6	-.2	-.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	4.6	4.8	2.4	2.6	2.2	2.2	2.1	2.2	.0	.0
1987 Q4	5.7	5.5	2.9	2.8	3.1	2.9	2.8	2.7	-.3	-.3

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

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

							Projection				
		1985		1986				1987			
	Units	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of $	4030.5	4087.7	4149.2	4175.6	4241.1	4282.3	4337.3	4395.6	4456.1	4518.1
Real GNP	Billions of 82$	3603.8	3622.3	3655.9	3661.4	3687.3	3715.9	3737.7	3762.7	3790.0	3818.2
Real GNP	Percent change	4.1	2.1	3.8	.6	2.9	3.1	2.4	2.7	2.9	3.0
Gross domestic product		4.4	1.9	3.7	1.4	2.9	3.4	2.5	2.7	2.9	3.0
Gross domestic purchases		4.6	4.0	3.0	3.6	3.8	.1	1.6	2.0	2.0	2.1
Final sales		6.1	2.7	-1.3	3.4	5.2	.4	2.1	2.7	3.1	3.0
Private dom. final purchases		4.8	3.4	.9	5.6	5.7	-3.5	1.6	2.4	2.4	2.4
Personal consumption expend.		5.3	1.7	3.6	6.2	6.5	-4.0	3.0	2.6	2.2	2.1
Durables		23.8	-11.1	-1.8	14.3	39.7	-26.5	2.2	2.4	2.9	2.0
Nondurables		1.2	1.6	6.5	8.0	-1.1	.1	3.1	2.6	1.9	2.2
Services		3.2	6.0	3.2	2.6	3.4	1.3	3.1	2.6	2.3	2.0
Business fixed investment		.1	12.5	-15.1	-.9	-.1	-2.0	-4.0	4.2	2.7	2.7
Producers' durable equipment		2.6	18.7	-17.0	19.6	3.4	-5.8	-3.6	7.0	4.7	4.7
Nonresidential structures		-4.6	.3	-10.8	-35.2	-8.2	8.1	-5.0	-2.4	-2.3	-2.2
Residential structures		11.7	3.4	11.0	14.5	9.7	-1.3	-2.8	-4.1	3.8	6.0
Exports		-5.8	8.2	7.1	-9.8	9.3	13.4	8.8	7.7	12.3	12.8
Imports		.3	23.3	.2	15.8	14.7	-11.1	1.3	1.3	2.6	3.4
Government purchases		13.9	10.0	-12.3	9.7	7.6	2.0	.6	.5	.9	.7
Federal		26.0	22.7	-27.5	11.0	8.1	1.9	-1.3	-1.7	-.9	-1.8
Defense		15.8	-4.7	-1.0	19.0	16.1	-1.2	.2	-.6	-.8	-1.4
State and local		5.1	.3	2.6	8.7	7.3	2.0	2.1	2.3	2.4	2.6
Change in business inventories	Billions of 82$	.7	-5.2	39.9	15.1	-5.7	19.5	21.8	22.3	21.0	21.4
Nonfarm	Billions of 82$	1.4	16.1	37.0	11.0	-9.0	21.2	22.0	23.3	21.4	21.5
Net exports	Billions of 82$	-113.8	-132.0	-125.9	-153.9	-163.6	-136.4	-130.0	-124.5	-116.2	-108.2
Nominal GNP	Percent change	6.8	5.8	6.2	2.6	6.4	3.9	5.2	5.5	5.6	5.7
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	97.9	98.7	99.4	99.8	100.3	101.1	101.5	102.0	102.5	103.0
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	2.1	2.0	2.8	3.3	3.3
Capacity utilization rate-mfg.	Percent*	80.1	79.9	80.0	79.5	79.7	79.7	79.6	79.7	79.9	80.1
Housing Starts	Millions	1.69	1.77	2.00	1.91	1.74	1.64	1.65	1.66	1.70	1.72
Auto sales	Millions	12.31	10.24	10.65	11.22	12.91	10.71	10.46	10.70	10.95	10.95
Domestic	Millions	9.40	6.84	7.84	8.18	9.43	7.26	7.37	7.50	7.70	7.70
Foreign	Millions	2.90	3.40	2.81	3.05	3.47	3.44	3.08	3.20	3.25	3.25
INCOME AND SAVING											
Nominal personal income	Percent change	3.0	7.4	6.0	6.0	2.1	7.0	4.8	5.2	5.3	5.7
Real disposable income	Percent change	-4.0	2.6	6.5	7.1	-2.3	2.9	3.6	1.1	1.3	1.5
Personal saving rate	Percent*	4.2	4.4	5.0	5.1	3.0	4.6	4.8	4.4	4.2	4.0
Corp. profits with IVA & CCAdj	Percent change	36.2	-13.7	16.0	-4.4	9.2	-8.8	-2.1	5.5	8.1	9.5
Profit share of GNP	Percent*	7.4	7.0	7.1	7.0	7.1	6.8	6.7	6.7	6.8	6.8
Federal govt. surplus/deficit	Billions of $	-197.5	-217.6	-201.6	-238.1	-205.8	-195.3	-196.3	-184.5	-176.5	-169.2
State and local govt. surplus		59.5	62.5	70.0	59.0	64.3	52.0	55.2	55.7	57.9	60.8
PRICES AND COSTS											
GNP implicit deflator	Percent change	2.5	3.6	2.5	1.8	3.6	.8	2.8	2.7	2.6	2.6
GNP fixed-weight price index		2.8	4.0	2.5	1.7	2.4	2.1	3.0	3.0	2.8	2.8
Cons. & fixed invest. prices		2.7	4.3	1.6	.2	3.0	3.1	3.5	3.6	3.3	3.2
CPI		2.6	4.3	1.5	-1.7	2.6	3.2	3.9	3.8	3.6	3.5
Exc. food and energy		3.5	4.9	4.3	3.4	3.6	4.1	3.7	3.7	3.9	4.0
Nonfarm business sector											
Output per hour		2.2	-3.5	4.3	.5	.2	.8	1.0	1.0	1.2	1.2
Compensation per hour		3.2	3.7	3.1	2.3	2.3	2.8	3.0	3.2	3.3	3.4
Unit labor costs		1.0	7.4	-1.2	1.8	2.2	2.0	2.0	2.2	2.1	2.2

* Not at an annual rate.

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GROSS NATIONAL PRODUCT AND RELATED ITEMS
(seasonally adjusted; 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	3405.7	3765.0	3998.1	4212.0	4426.8
Real GNP	Billions of 82$	3192.4	3187.1	3248.8	3166.0	3279.1	3489.9	3585.2	3680.1	3777.2
Real GNP	Percent change*	.6	-.1	.6	-1.9	6.5	4.6	2.9	2.6	2.8
Gross domestic product		.2	.3	.3	-1.6	6.6	4.9	3.1	2.9	2.8
Gross domestic purchases		-.4	-1.1	.8	-.8	8.4	5.9	3.9	2.6	1.9
Final sales		2.2	-.2	.1	.3	3.7	4.4	4.0	1.9	2.7
Private dom. final purchases		1.3	-1.7	-.3	.8	7.7	5.3	4.2	2.1	2.2
Personal consumption expend.		1.4	-.1	.2	2.9	5.4	3.6	3.5	3.0	2.5
Durables		-3.8	-5.6	-3.3	9.0	14.7	8.8	6.2	3.6	2.4
Nondurables		.8	-1.4	.5	1.8	4.4	2.2	2.0	3.3	2.4
Services		3.5	2.4	.9	2.3	3.9	3.3	3.9	2.6	2.5
Business fixed investment		5.0	-4.8	5.6	-11.3	10.8	14.7	6.5	-4.7	1.3
Producers' durable equipment		1.6	-6.5	2.2	-12.5	20.9	16.0	8.1	-.8	3.1
Nonresidential structures		12.0	-1.8	11.7	-9.1	-4.8	12.1	3.3	-13.0	-3.0
Residential structures		-7.2	-14.2	-22.4	4.9	38.1	5.3	7.8	8.3	.6
Exports		13.7	.5	2.4	-13.8	5.8	5.5	-3.2	4.6	10.4
Imports		3.4	-8.8	4.9	-5.9	23.8	16.5	5.8	4.3	2.1
Government purchases		.1	1.0	2.9	3.8	-2.7	7.7	8.4	1.4	.7
Federal		-.3	3.1	9.5	8.2	-8.1	14.2	14.3	-2.9	-1.4
Defense		3.3	3.1	7.6	8.8	5.1	6.8	5.9	7.8	-.7
State and local		.4	-.3	-1.3	.6	1.5	3.1	3.7	5.1	2.3
Change in business inventories	Billions of 82$	15.0	-6.9	23.9	-24.5	-6.4	59.2	9.0	17.2	21.6
Nonfarm	Billions of 82$	10.4	-2.3	19.0	-23.1	-.1	54.3	10.9	15.1	22.1
Net exports	Billions of 82$	3.6	57.0	49.4	26.3	-19.9	-83.6	-108.2	-144.9	-119.7
Nominal GNP	Percent change*	9.5	9.9	9.3	3.1	10.4	8.5	6.3	4.8	5.5
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	89.8	90.4	91.2	89.6	90.2	94.5	97.6	100.2	102.2
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	.9	2.9
Capacity utilization rate-mfg.	Percent	84.6	79.3	78.3	70.3	74.0	80.5	80.1	79.7	79.8
Housing Starts	Millions	1.72	1.30	1.10	1.06	1.71	1.76	1.74	1.82	1.68
Auto sales	Millions	10.68	9.04	8.56	8.00	9.18	10.43	11.09	11.37	10.76
Domestic	Millions	8.36	6.62	6.24	5.77	6.77	7.97	8.24	8.18	7.57
Foreign	Millions	2.32	2.42	2.32	2.23	2.41	2.46	2.84	3.19	3.20
INCOME AND SAVING										
Nominal personal income	Percent change*	11.4	12.0	9.2	5.3	7.8	8.4	6.1	5.3	5.3
Real disposable income	Percent change*	.5	1.1	.7	1.0	5.1	4.2	1.9	3.5	1.9
Personal saving rate	Percent	6.8	7.1	7.5	6.8	5.4	6.3	5.1	4.4	4.3
Corp. profits with IVA & CCAdj	Percent change*	-10.7	-6.8	2.3	-19.1	70.1	6.6	7.8	2.5	5.1
Profit share of GNP	Percent	8.0	6.5	6.2	4.7	6.3	7.0	7.0	7.0	6.7
Federal govt. surplus/deficit	Billions of $	-16.1	-61.3	-63.8	-145.9	-176.0	-170.0	-198.0	-210.2	-181.6
State and local govt. surplus		27.6	26.8	34.1	35.1	47.5	68.5	61.7	61.3	57.4
PRICES AND COSTS										
GNP implicit deflator	Percent change*	8.9	9.9	8.7	5.2	3.6	3.6	3.3	2.2	2.7
GNP fixed-weight price index		8.8	9.8	8.5	5.0	3.9	3.9	3.6	2.2	2.9
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	1.4	3.7
Exc. food and energy		10.7	12.2	10.2	5.2	4.3	4.8	4.3	3.9	3.8
Nonfarm business sector										
Output per hour		-2.7	1.0	-.6	1.0	3.6	1.0	.2	1.4	1.1
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	1.2	2.1

* Percent changes are from fourth quarter to fourth quarter.

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1985*	Fiscal Year 1986*	FY1987e Admin[1]	FY1987e FRB Staff	CY 1985*	CY1986e FRB Staff	1985 IV*	1986 I*	1986 II*	1986 III*	FRB Staff Estimates 1986 IV	FRB Staff Estimates 1987 I	FRB Staff Estimates 1987 II	FRB Staff Estimates 1987 III
							Not seasonally adjusted							
Budget receipts[2]	734	769	831	824	745	779	177	180	215	198	187	196	237	204
Budget outlays[2]	946	990	975	1004	961	991	252	241	245	251	253	250	248	252
Surplus/deficit(-) to be financed[2]	-212	-221	-144	-180	-216	-212	-75	-61	-30	-54	-66	-54	-11	-48
Means of financing deficit:														
Borrowing from public	197	236	144	170	224	213	91	37	51	58	67	42	11	50
Cash balance decrease	13	-14	0	6	-13	1	-14	19	-12	-7	2	6	3	-5
Other[3]	1	-1	0	3	5	-2	-2	5	-8	3	-2	6	-3	3
Cash operating balance, end of period	17	31	20	25	31	30	31	12	25	31	30	23	20	25
Memo: Sponsored agency borrowing[4]	20	13	n. a.	15	20	9	5	-2	5	5	0	5	5	5
NIPA Federal Sector							Seasonally adjusted annual rates							
Receipts	771	810	890	860	787	822	806	800	808	826	852	849	863	877
Expenditures	963	1026	1033	1049	985	1032	1023	1002	1046	1032	1048	1045	1048	1054
Purchases	341	369	375	380	354	368	381	356	368	373	376	380	381	383
Defense	254	275	290	292	259	280	268	266	278	287	288	292	294	295
Nondefense	88	94	84	88	95	88	113	89	89	86	88	88	88	88
All other expend.	621	656	658	668	631	664	643	646	678	659	671	665	667	671
Surplus/deficit(-)	-191	-216	-143	-188	-198	-210	-218	-202	-238	-206	-195	-196	-185	-177
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-151	-179	n. a.	-152	-159	-173	-181	-168	-199	-169	-158	-159	-148	-142

*--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.

Recent developments. Short-term interest rates have risen somewhat since the last FOMC meeting, but pressures in these markets have not carried over to capital markets where longer-term yields have declined. The firmness of the money markets, where rates have risen around 1/8 to 1/4 of a percentage point on net, has reflected in part a tendency for federal funds to trade at 6 percent or more--even though measures of reserve availability have suggested no tightening of the System's stance. The reasons for the strength of the bond markets are not entirely clear, but it appears that some easing of inflation fears and of exchange market pressures on the dollar have been factors in the decline of long-term securities rates, which has measured as much as 1/4 percentage point. The bond market rally helped fuel a rise in the stock market in the face of the negative news of the Boesky scandal and the Iran-Contra affair. In the mortgage market, S&L commitment rates on fixed-rate loans have fallen more than 1/2 percentage point, to a 1986 low of 9.30 percent.

Growth rates of the monetary aggregates have diverged recently. Although M1 accelerated to around a 20 percent annual rate of increase in November, growth of the broader aggregates slowed. After increasing by about 7 and 6 percent, respectively, M2 and M3 were just below the tops of their annual target ranges. Within M1, both demand and other checkable deposits expanded rapidly last month. The nontransactions component of M2 grew little, despite continued brisk expansion of savings deposits. MMDA growth eased to the slowest rate since the first quarter of this year, small time deposits continued to run off at a rapid clip, and retail mutual fund balances fell, as offering rates on all of these instruments edged lower. The rush to buy U.S. savings bonds before their guaranteed minimum rate was lowered from 7-1/2 to 6 percent at the end of October may well have contributed to the slowing of M2. The non-M2 component of M3 posted a small increase in November, in part because depositories substituted term for overnight RPs and Eurodollars.

In the aggregate, debt of the nonfinancial sectors appears to have grown more in November than in October. Federal government borrowing through Treasury bills was stepped up in November after earlier debt ceiling constraints; otherwise, the Treasury has been maintaining normal marketable financing patterns. Corporate tax payments in December may be boosted a bit, owing to the additional 1986 tax liabilities imposed by the retroactive repeal of the investment tax credit, but the distribution of these extra payments between December and next March is uncertain. Tax-exempt bond issuance picked up in November as many states completed allocation among borrowers of new volume ceilings for previously delayed private-purpose bonds, and as further declines in interest rates prompted renewed advance refunding activity.

In the business sector, the soaring volume of share retirements associated with mergers, LBOs and share repurchases in advance of the year-end change of the tax law has been a major contributing factor to strong debt growth. Although there has been some paydown of merger-related commercial paper recently, this has been more than offset by the expansion in bank loans to businesses. Gross bond issuance also quickened slightly in November: the September-October pace had been restrained by the backup in long-term interest rates. Despite the concerns aroused by the insider-trading scandal, issuance of high-yield bonds to finance share retirements remained heavy. In the stock market, there was a sharp setback in prices, but the interruption was brief and some major indexes subsequently set records. The general upswing in the market has kept gross stock issuance, including initial public offerings, strong.

Residential mortgage borrowing appears to have maintained a fairly robust pace early in the current quarter, after picking up to a 13-1/2 percent annual rate of growth in the third quarter. Data on loan commitments at thrift institutions point to a continued high volume of originations, and mortgage bankers also report a strong demand for loans. Mortgage-backed securities continue to dominate the market, and federally related issues were at a near record pace in October and November. Commercial banks appear to be playing an important part in the demand for these instruments: the bulk of these banks' large acquisitions of U.S. government securities in the past several months evidently have been federally related mortgage securities.

Consumer credit growth in October receded only slightly to about 14 percent from the 16-1/4 percent pace in September. Both months received a boost from the concessionary auto finance programs that expired by mid-October. Growth in nonauto credit picked up some in October from a virtual standstill in September, but the trend in this component is clearly one of deceleration—especially so in the case of revolving installment credit.

<u>Outlook</u>. For the current quarter as a whole, growth of nonfinancial sector debt appears likely at least to match the third-quarter rate, paced by a pickup in merger-related financing in the business sector and continued strong home mortgage activity, which are more than offsetting

reduced net growth in consumer credit and state and local debt. Early next year, a distinct slowing in debt growth and further shifts in its composition are expected. The major tax bill enacted this year will be a factor in a number of these developments.

Tax reform will provide added federal revenue in fiscal 1987, with the gains concentrated early in the year, as corporations complete payments by March on added 1986 liabilities, and individuals pay taxes by April on additional capital gains realizations induced by the prospects of a higher capital gains tax rate. Coming on top of expenditure cuts, these additional receipts should ease federal credit demands somewhat in coming months, prior to the initiation of federal asset sales. Tax-exempt borrowing also is expected to slow somewhat further after the turn of the year, in response to the recently enacted constraints on private-purpose and advance refunding issues.

Both higher tax liabilites and the rush to consummate corporate financial restructurings prior to the tax law changes are contributing to a surge in nonfinancial corporate borrowing currently. This borrowing is likely to tail off early next year as the pace of financial restructuring ebbs and fixed investment picks up only gradually. Although the drain on corporate coffers to make tax payments may sustain short-term borrowing for a while, interest rates around current levels likely will continue to provide an incentive for corporations to lengthen the structure of their debt. Should the stock market remain reasonably buoyant, offerings of new shares can be expected to be heavy as well.

Households are expected to slow the growth of their total indebtedness somewhat further in coming months. Abstracting from the uneven pace of spending for new cars, consumer outlays are likely to slacken a bit early next year from the 1986 trend, while heavy installment debt repayments and the stresses reflected in high credit card loan delinquencies may be a deterrent to borrowing. In addition, investment in single family homes is expected to taper off, providing less impetus for household debt growth. Within this decelerating total, however, a noticeable shift away from consumer credit--particularly revolving credit--toward mortgage borrowing is expected. Households seem likely to increase their use of home equity loans in response to the new limitations on the tax deductibility of consumer interest and to the financial incentives for these loans now being offered by lenders.

Recent developments

The weighted-average foreign exchange value of the dollar against G-10 currencies has declined about 1-1/2 percent, on balance, since the November Committee meeting. Exchange rates have been fairly volatile, with markets very sensitive to news pertaining to the pace of economic activity, the process of external adjustment, and future monetary actions in the United States, Germany, and Japan. The dollar declined by a little over 2 percent against the mark and by about 3/4 percent against the yen. The strength of the mark has resulted in increasing pressures in the EMS, and France, Italy, and the Netherlands have responded with actions to increase short-term interest rates to support their currencies vis-a-vis the mark.

Recent data on third-quarter economic activity in foreign industrial countries present a mixed picture. Real GNP grew at annual rates of 2.9 percent in Germany and 2.6 percent in Japan. The relative configuration of domestic demand and GNP for the two countries was reversed from that of the second quarter. Total domestic demand in Germany was essentially flat in the third quarter. Excluding the accounting effects of gold purchases in the second quarter, total domestic demand grew at a surprising 8.7 percent annual rate in Japan, spurred by strong consumption and residential investment expenditures. Real GDP rose provisionally at a 4 percent rate in the United Kingdom but at only a 1.2 percent rate in Canada, while actually declining at a 3.2 percent rate in Italy. French GNP figures are not yet available, but industrial production in the third quarter rose at a rate of nearly 9 percent.

Economic activity in several Latin American debtor nations, notably Brazil, Argentina, and Peru, has been booming, contributing to deteriorating current account balances and difficulties in controlling inflation. Brazil acted during November to substantially tighten fiscal policy. Mexico secured the release of $1-1/4 billion in official financing, when it achieved agreement with commercial banks on a critical mass (90 percent) of its $7.7 billion new money commercial bank lending package; however, many smaller banks still have not agreed to participate in that package. Negotiations with several other countries concerning new financing arrangements are under way.

The third-quarter U.S. merchandise trade deficit is estimated at about $150 billion (s.a.a.r.) on a balance of payments basis, similar to the rates of deficit of the previous three quarters. Exports were essentially unchanged in the third quarter. The value of oil imports was about the same as in the second quarter, with price declines about offsetting volume increases. Non-oil import prices (fixed-weight) rose at a 4-1/2 percent rate in the third quarter; the volume of non-oil imports rose by less than 1 percent. The deficit in October was the smallest in recent months according to preliminary data. Exports rose somewhat, mostly accounted for by an increase in agricultural exports to Japan. Imports, both oil and non-oil, declined moderately.

Outlook

The staff continues to project a moderate decline in the dollar against G-10 currencies through 1987, but again notes the risk of a sharper fall if market participants are disappointed with the pace of adjustment of the U.S. current account deficit in nominal terms. The staff outlook for the current account is for little change throughout 1987, with the rate of deficit running at about a $150 billion annual rate. (An expected improvement in the nominal balance has been pushed back slightly, beyond the present forecast horizon.) Since import prices are forecast to rise considerably faster than export prices in 1987, the flat nominal balance masks a substantial rise in real net exports.

Strictly Confidential (FR)
Class II FOMC

December 10, 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	-102.6	-104.8	-83.7	-105.3	-93.7	-104.5	-108.2	-104.0	-106.2	-107.2	-104.3	-101.4
Exports of G+S	369.7	371.2	411.3	362.3	368.2	374.8	363.0	368.0	379.0	390.5	402.1	417.8	434.9
Imports of G+S	448.6	473.7	516.0	446.0	473.6	468.5	467.5	476.1	482.9	496.6	509.3	522.1	536.2
Constant 82 $, Net	-108.2	-145.0	-119.9	-113.8	-132.0	-125.9	-153.9	-163.6	-136.6	-130.2	-124.7	-116.4	-108.4
Exports of G+S	362.3	369.1	402.0	355.8	362.9	369.2	359.8	367.9	379.6	387.6	394.8	406.4	418.9
Imports of G+S	470.5	514.1	521.9	469.6	494.8	495.1	513.6	531.5	516.2	517.9	519.6	522.9	527.3
2. U.S. Merchandise Trade Balance 2/	-124.4	-146.8	-148.6	-126.7	-149.4	-145.8	-144.1	-150.0 P	-147.2	-150.1	-150.7	-148.2	-145.6
Exports	214.4	219.4	247.7	210.0	210.9	214.6	219.2	220.0 P	223.8	232.6	241.8	252.5	264.0
Agricultural	29.6	26.6	27.7	26.7	28.5	28.4	24.6	26.0 P	27.5	28.0	27.3	27.6	28.0
Non-Agricultural	184.8	192.8	220.0	183.3	182.4	186.2	194.5	194.0 P	196.3	204.6	214.5	224.9	236.0
Imports	338.9	366.2	396.3	336.7	360.3	360.5	363.3	370.0 P	371.0	382.7	392.5	400.7	409.6
Petroleum and Products	50.5	33.6	38.6	49.5	56.5	40.1	31.3	32.0 P	31.1	35.7	38.7	39.4	40.4
Non-Petroleum	288.3	332.6	357.8	287.2	303.8	320.4	331.9	338.0 P	339.9	347.0	353.8	361.3	369.1
3. U.S. Current Account Balance	-117.7	-144.2	-151.0	-113.8	-134.8	-136.2	-138.9	-149.7 P	-151.9	-151.5	-153.5	-150.8	-148.3
Of Which: Net Investment Income	25.2	18.0	9.1	33.0	37.0	26.1	21.2	14.3 P	10.6	9.1	8.7	9.2	9.2
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.8	2.5	2.4	2.9	2.5	-0.2	5.4	2.1	2.4	1.9	2.5	2.1	2.3
Real GNP--NonOPEC LDC 5/	3.6	3.7	3.8	3.4	3.7	3.9	3.9	3.8	3.8	3.8	3.8	3.9	4.0
Consumer Prices--Ten Ind. 4/	4.3	2.1	2.5	1.5	2.7	1.9	1.8	0.1	3.2	2.7	3.1	2.7	3.1

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