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Strictly Confidential (FR) Class II FOMC

March 25, 1987

SUMMARY AND OUTLOOK

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

Recent developments. Available data suggest that employment and production grew somewhat faster early this year. Final domestic demands apparently have declined, but activity has been supported by a rebuilding of inventories and a further improvement in the external sector. Prices have accelerated, in large part reflecting the passthrough of higher crude oil prices into prices of final energy products.

Payroll employment posted gains averaging about 325,000 in January and February, up from the 250,000 monthly pace in the fourth quarter of last year. Over the two-month period, sizable gains were reported in construction, trade, and services. Manufacturing employment also rose, on balance, over the period, although the increase reflected the return of striking workers rather than new hirings. Workweeks have lengthened in manufacturing and elsewhere, and total hours worked by production and nonsupervisory personnel have risen sharply from the fourth-quarter level. The civilian unemployment rate remained at 6.7 percent in February for the third consecutive month, as increases in the labor force matched the strong expansion in household employment.

The index of industrial production rose 0.5 percent in February to a level about 1 percent above its fourth-quarter average. Increased production of motor vehicles accounted for the bulk of the gains in both consumer goods and business equipment in February. Output of defense and space equipment, construction supplies, and nondurable materials posted further appreciable increases. Reflecting the recent strengthening in the industrial sector, the capacity utilization rate increased to 79.8 percent in February, up 3/4 percentage point from October.

Consumer spending apparently has fallen in the first quarter, pulled down by a decline in purchases of new autos. After a payback in January for the year-end surge in sales, domestic new car sales averaged 7-1/4 million units in February and the first 20 days in March; the recent sales pace is well below the 8-1/4 million unit rate of the fourth quarter. Automakers have trimmed assembly schedules and renewed sales incentive programs, but dealer inventories once again have begun to accumulate to uncomfortable levels. Consumer outlays excluding autos have advanced at a moderate rate, although, in real terms, the current pace of spending is likely slower than in the second half of last year.

Business investment spending dropped sharply over the first two months of this year. After the tax-related surge in equipment outlays at year-end, shipments of nondefense capital goods posted widespread declines in January that were only partially retraced in February. New orders have dropped more than 10 percent in the past two months, with most of the weakness attributable to a decline in aircraft orders from an exceptionally high fourth-quarter level. Excluding the volatile aircraft component, new bookings have been virtually flat thus far this year. Outlays for nonresidential construction fell further in January, maintaining the downtrend that commenced about a year ago; however, new commitments for construction have been surprisingly strong since last summer and may point to some temporary improvement in spending in the months ahead.

The large fluctuations in final sales that occurred around the turn of the year have been mirrored in changes in inventories: stocks rose sharply in January, after being drawn down late last year. Notable swings in inventories occurred for autos, machinery, and aircraft, where tax incentives may have had a greater effect on the timing of purchases than on production. In addition, some stockbuilding occurred early this year in manufacturing industries in which production has been relatively strong. Despite the sharp rebound in stocks, inventory-sales ratios for most major categories are within the ranges that prevailed over 1986.

Activity in the housing sector remained strong in January and February, with starts averaging more than 1.8 million units in both months. In particular, single-family starts have risen significantly over the past four months, reaching a three-year high in February. Although some of the strength thus far this year may be attributable to unusually good weather in the Midwest, data on permit issuance suggests that the recent gains have reflected, in part, a more fundamental improvement in underlying demand. In contrast to the vigor of single-family construction, multifamily starts have remained near the reduced fourth-quarter pace, held down by high vacancy rates and a less favorable tax environment for construction of rental units.

Inflation picked up early this year. Reflecting the rebound in crude oil prices, energy prices at the retail and wholesale level rose sharply in January. Although wholesale energy prices rose again in February, the increase moderated considerably from the previous month. Consumer food prices also picked up in January, but producer price developments at the finished and crude levels point to some slowing in food prices in the near term. Outside of food and energy, consumer prices rose 0.5 percent in January, with sizable increases for home electronics, apparel, and tobacco products. Producer prices for intermediate and crude materials other than food and energy also accelerated somewhat in January and February. Spot prices for industrial materials have leveled off somewhat in recent weeks after rising late last year.

Wage pressures remain subdued. The hourly earnings index rose 0.5 percent in February, after two months of little change. Moreover, available data suggest that wage increases in labor settlements reached thus far this year have continued to run in the neighborhood of 3 percent.

Outlook. The staff projects that real GNP will rise at about a 3-1/4 percent annual rate in the current quarter, with inventory investment and improvement in the external sector expected to more than offset the weakness in domestic final demands. The falloff in consumption spending anticipated in the current quarter largely reflects the decline in new car sales. However, the weakness in business fixed investment spending is expected to be more widespread; for many major categories of equipment, purchases were moved into the fourth quarter in response to tax advantages, and a substantial payback is projected in the first quarter. Outlays for nonresidential construction also are expected to decline in the current quarter.

In contrast to domestic final demands, exports are projected to continue to increase at a rapid rate, while oil imports should recede from an elevated fourth-quarter level. Moreover, nonfarm inventories are projected to accumulate at a brisk pace in the first quarter. Although auto dealers account for the bulk of the run-up, stockbuilding is likely to occur in a number of other sectors as well.

The policy assumptions underlying the projection have changed little since the last Greenbook. With regard to monetary assumptions, M2 and M3 are expected to grow somewhat below the midpoints of their ranges in 1987 and then to grow at similar rates in 1988. Interest rates are assumed to change little in the near term, but are projected to edge up later in the projection period. The staff continues to expect that Congress will enact deficit-reducing measures for fiscal year 1988 that are roughly comparable in magnitude to those enacted for fiscal year 1987, and as a result the high-employment deficit drops around $20 billion in both years. The federal budget deficit is projected to decline to about $180 billion and $150 billion in fiscal years 1987 and 1988, respectively.

Although the projected increase in activity in the first quarter has been revised upward, the staff continues to expect that real GNP growth will average 2-3/4 percent at an annual rate in both 1987 and 1988. The past and prospective depreciation of the dollar remains a critical element sustaining growth. In response to the enhanced competitive position of U.S. producers in international markets, growth in exports, which was considerable in the second half of last year, is expected to continue to boost demands on domestic production. Moreover, the rising relative prices of foreign goods are anticipated to slow the growth of imports. On balance, the improvement in our external position is projected to account for nearly 1-1/4 percentage point to real GNP growth in each of the next two years.

In contrast, gross domestic purchases are expected to rise at a sluggish 1-1/2 percent pace in both 1987 and 1988. The effects of fiscal restraint, the influence of rising import prices on income and consumption growth, and the overbuilding in the office and rental housing markets are the key factors causing the slowdown in domestic demand. Business equipment spending is projected to resume a moderate uptrend over the projection horizon, supported by continued cost-cutting pressures for modernization and a pickup in domestic production. Construction of single-family homes is expected to edge down from the current pace, but remain at a relatively high level through 1988.

The outloc: for inflation has changed little from the previous Greenbook. Inflation, as measured by the GNP fixed-weighted price index, is expected to move up to about a 3 percent annual rate in 1987 and then to increase to about a 3-3/4 percent pace in 1988. The pickup in inflation this year results from the effects of the recent rebound of crude oil prices, as well as the projected acceleration in import prices. Next year, continued sharp increases in import prices, as well as the lagged response to this year's acceleration, provide a further boost to inflation. The consumer price index, which directly includes imported goods and gives a higher weight to energy, is projected to rise 4 percent in 1987 and 4-1/4 percent in 1988. However, the remaining margin of slack in both product and labor m.rkets should act to limit overall inflationary pressures.

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)	
		2/4/87	3/25/87	2/4/87	3/25/87	2/4/87	3/25/87	2/4/87	3/25/87	2/4/87	3/25/87
Annual changes:											
1985	<1>	6.2	6.2	2.7	2.7	3.7	3.7	3.3	3.3	7.2	7.2
1986	<1>	5.3	5.2	2.5	2.5	2.8	2.8	2.7	2.7	7.0	7.0
1987		4.9	4.9	2.4	2.4	2.8	2.8	2.5	2.4	6.7	6.7
1988		6.2	5.9	2.8	2.7	3.5	3.5	3.3	3.1	6.5	6.6
Quarterly changes:											
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	7.1	7.1
	Q3 <1>	6.4	6.4	2.8	2.8	2.6	2.6	3.6	3.6	6.9	6.9
	Q4 <1>	2.6	1.7	1.7	1.1	2.6	2.7	1.0	.7	6.9	6.9
1987	Q1	5.0	6.0	2.2	3.2	2.9	3.1	2.6	2.8	6.7	6.7
	Q2	5.9	5.7	2.8	2.6	3.1	3.1	3.0	3.0	6.7	6.7
	Q3	6.1	5.7	2.9	2.6	3.1	3.1	3.0	3.0	6.6	6.7
	Q4	6.1	5.5	3.0	2.8	3.1	3.1	3.0	2.6	6.6	6.7
1988	Q1	6.4	6.0	2.7	2.6	4.0	3.8	3.5	3.3	6.6	6.
	Q2	6.2	6.0	2.6	2.6	3.7	3.7	3.4	3.3	6.6	6.
	Q3	6.0	6.3	2.6	2.8	3.7	3.7	3.3	3.4	6.5	6.5
	Q4	6.2	6.2	2.7	2.7	3.7	3.7	3.5	3.4	6.5	6.5
Two-quarter changes: <2>											
1986	Q2 <1>	4.3	4.3	2.2	2.2	2.1	2.1	2.1	2.1	.0	.0
	Q4 <1>	4.5	4.0	2.3	1.9	2.6	2.6	2.3	2.1	-.2	-.2
1987	Q2	5.4	5.9	2.5	2.9	3.0	3.1	2.8	2.9	-.2	-.2
	Q4	6.1	5.6	3.0	2.7	3.1	3.1	3.0	2.8	-.1	.0
1988	Q2	6.3	6.0	2.7	2.6	3.9	3.8	3.5	3.3	.0	-.1
	Q4	6.1	6.3	2.6	2.8	3.7	3.7	3.4	3.4	-.1	-.1
Four-quarter changes: <3>											
1985	Q4 <1>	6.3	6.3	2.9	2.9	3.6	3.6	3.3	3.3	-.2	-.2
1986	Q4 <1>	4.4	4.2	2.2	2.0	2.4	2.4	2.2	2.1	-.2	-.2
1987	Q4	5.8	5.7	2.8	2.8	3.1	3.1	2.9	2.9	-.3	-.2
1988	Q4	6.2	6.1	2.7	2.7	3.8	3.8	3.4	3.4	-.1	-.2

<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							
		1986		1987				1988			
	Units	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of $	4240.7	4258.7	4321.4	4381.8	4442.5	4502.0	4567.9	4635.3	4706.9	4778.2
Real GNP	Billions of 82$	3686.4	3696.1	3725.1	3748.9	3772.8	3799.4	3823.7	3848.3	3874.8	3901.0
Nominal GNP	Percent change	6.4	1.7	6.0	5.7	5.7	5.5	6.0	6.0	6.3	6.2
Real GNP		2.8	1.1	3.2	2.6	2.6	2.8	2.6	2.6	2.8	2.7
Gross domestic product		2.6	1.5	3.2	2.7	2.7	3.0	2.7	2.7	2.8	2.8
Gross domestic purchases		3.7	-.6	1.4	1.8	1.5	1.5	1.2	1.2	1.5	1.6
Final sales		4.5	4.2	-1.9	3.9	2.4	2.2	2.5	2.6	2.8	2.5
Private dom. final purchases		5.6	.5	-3.9	3.9	1.9	1.0	1.5	1.3	1.5	1.4
Personal consumption expend.		6.7	-.4	-1.8	3.7	1.5	.5	1.1	1.1	1.3	1.1
Durables		44.6	-11.0	-22.2	13.8	4.2	-4.3	.6	.7	2.0	.6
Nondurables		-.9	-.1	-1.9	1.9	1.1	1.1	1.1	1.1	1.1	1.1
Services		2.4	3.2	5.6	2.2	1.0	1.6	1.3	1.3	1.2	1.3
Business fixed investment		-2.1	3.0	-15.9	6.4	3.7	2.6	2.7	2.0	2.7	2.0
Producers' durable equipment		1.2	6.6	-18.0	7.7	5.0	4.0	4.5	3.5	4.5	3.5
Nonresidential structures		-9.8	-5.4	-10.4	3.0	.5	-1.1	-1.9	-2.0	-2.1	-2.0
Residential structures		9.7	5.2	.1	.4	2.1	2.8	2.7	1.8	1.8	3.2
Exports		13.3	16.7	10.1	8.6	11.7	12.9	13.4	13.0	13.4	11.6
Imports		17.3	-.5	-4.3	1.3	1.4	.4	1.0	.7	1.9	2.1
Government purchases		4.5	10.5	-1.2	-.2	-.6	.6	-.3	1.0	1.5	1.5
Federal		2.5	23.2	-4.6	-2.9	-4.4	-2.0	-3.6	-1.3	-.2	-.1
Defense		17.2	-10.2	7.0	4.0	-2.7	-2.6	-5.4	-2.2	-1.1	-.2
State and local		6.1	1.1	1.7	2.1	2.6	2.7	2.4	2.8	2.8	2.8
Change in business inventories	Billions of 82$	-.3	-28.5	18.1	6.3	7.5	13.1	14.3	14.0	13.7	15.8
Nonfarm	Billions of 82$	-8.6	-9.8	25.1	10.3	11.5	17.1	18.8	18.5	18.2	20.3
Net exports	Billions of 82$	-163.3	-148.0	-132.7	-126.2	-116.7	-104.5	-92.2	-79.3	-67.2	-57.0
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	100.3	101.1	101.8	102.4	102.8	103.3	103.7	104.2	104.6	105.1
Unemployment rate	Percent*	6.9	6.9	6.7	6.7	6.7	6.7	6.6	6.6	6.5	6.5
Industrial production index	Percent change	1.9	3.2	4.1	2.8	3.7	3.5	3.9	3.8	3.7	3.8
Capacity utilization rate-mfg.	Percent*	79.7	79.8	80.0	80.1	80.3	80.6	80.8	81.0	81.2	81.3
Housing Starts	Millions	1.76	1.70	1.78	1.70	1.72	1.72	1.73	1.74	1.74	1.74
Auto sales	Millions	12.91	11.32	9.32	10.76	11.35	10.85	10.85	10.90	11.00	11.00
Domestic	Millions	9.43	7.66	6.69	7.65	8.05	7.55	7.55	7.60	7.70	7.70
Foreign	Millions	3.47	3.66	2.63	3.11	3.30	3.30	3.30	3.30	3.30	3.30
INCOME AND SAVING											
Nominal personal income	Percent change	1.8	3.4	6.1	5.0	5.2	6.6	6.4	4.5	6.0	6.1
Real disposable income	Percent change	-3.1	-1.5	4.9	.8	.8	2.6	1.7	-.9	2.4	1.2
Personal saving rate	Percent*	2.8	2.5	4.1	3.4	3.2	3.7	3.8	3.3	3.5	3.5
Corp. profits with IVA & CCAdj	Percent change	12.7	11.6	14.5	-.4	6.5	7.2	-13.0	9.5	5.3	12.3
Profit share of GNP	Percent*	7.1	7.3	7.4	7.3	7.3	7.4	7.0	7.1	7.1	7.1
Federal govt. surplus/deficit	Billions of $	-197.4	-189.2	-203.4	-188.2	-174.1	-177.4	-169.3	-145.3	-146.1	-140.2
State and local govt. surplus		64.0	59.4	56.2	58.5	59.0	60.1	62.4	63.5	64.5	65.8
PRICES AND COSTS											
GNP implicit deflator	Percent change	3.6	.7	2.8	3.0	3.0	2.6	3.3	3.3	3.4	3.4
GNP fixed-weight price index		2.6	2.7	3.1	3.1	3.1	3.1	3.8	3.7	3.7	3.7
Cons. & fixed invest. prices		3.0	3.3	4.3	3.5	3.6	3.3	4.0	4.1	4.4	4.2
CPI		2.5	2.6	5.1	3.6	3.8	3.6	4.1	4.2	4.5	4.6
Exc. food and energy		3.7	3.8	4.1	3.5	4.2	4.2	4.5	4.7	4.9	5.0
Nonfarm business sector											
Output per hour		-.3	-2.2	-1.2	1.1	1.3	1.2	.9	1.2	1.2	1.0
Compensation per hour		2.3	2.7	2.0	3.0	3.1	3.2	4.8	3.5	3.8	4.1
Unit labor costs		2.6	5.1	3.2	1.9	1.8	2.0	3.9	2.3	2.6	3.1

Not at an annual rate.

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March 25, 1987

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

	Units	1980	1981	1982	1983	1984	1985	1986	Projection 1987	198
EXPENDITURES										
Nominal GNP	Billions of $	2732.0	3052.6	3166.0	3405.7	3765.0	3998.1	4206.1	4411.9	4672.1
Real GNP	Billions of 82$	3187.1	3248.8	3166.0	3279.1	3489.9	3585.2	3674.9	3761.6	3862.0
Real GNP	Percent change*	-.1	.6	-1.9	6.5	4.6	2.9	2.0	2.8	2.7
Gross domestic product		.3	.3	-1.6	6.6	4.9	3.1	2.3	2.9	2.7
Gross domestic purchases		-1.1	.8	-.8	8.4	5.9	3.9	2.4	1.6	1.4
Final sales		-.2	.1	.3	3.7	4.4	4.0	2.7	1.7	2.6
Private dom. final purchases		-1.7	-.3	.8	7.7	5.3	4.2	3.1	.7	1.4
Personal consumption expend.		-.1	.2	2.9	5.4	3.6	3.5	4.0	1.0	1.2
Durables		-5.6	-3.3	9.0	14.7	8.8	6.2	9.6	-3.1	1.0
Nondurables		-1.4	.5	1.8	4.4	2.2	2.0	3.3	.5	1.1
Services		2.4	.9	2.3	3.9	3.3	3.9	2.8	2.6	1.3
Business fixed investment		-4.8	5.6	-11.3	10.8	14.7	6.5	-4.0	-1.2	2.3
Producers' durable equipment		-6.5	2.2	-12.5	20.9	16.0	8.1	1.7	-.9	4.0
Nonresidential structures		-1.8	11.7	-9.1	-4.8	12.1	3.3	-16.2	-2.1	-2.0
Residential structures		-14.2	-22.4	4.9	38.1	5.3	7.8	10.0	1.3	2.4
Exports		.5	2.4	-13.8	5.8	5.5	-3.2	6.3	10.8	12.9
Imports		-8.8	4.9	-5.9	23.8	16.5	5.8	7.9	-.3	1.4
Government purchases		1.0	2.9	3.8	-2.7	7.7	8.4	2.7	-.3	.9
Federal		3.1	9.5	8.2	-8.1	14.2	14.3	.4	-3.5	-1.3
Defense		3.1	7.6	8.8	5.1	6.8	5.9	5.5	1.3	-2.2
State and local		-.3	-1.3	.6	1.5	3.1	3.7	4.6	2.3	2.7
Change in business inventories	Billions of 82$	-6.9	23.9	-24.5	-6.4	59.2	9.0	6.6	11.3	14.5
Nonfarm	Billions of 82$	-2.3	19.0	-23.1	-.1	54.3	10.9	7.4	16.0	18.9
Net exports	Billions of 82$	57.0	49.4	26.3	-19.9	-83.6	-108.2	-147.8	-120.0	-73.9
Nominal GNP	Percent change*	9.9	9.3	3.1	10.4	8.5	6.3	4.2	5.7	6.1
EMPLOYMENT AND PRODUCTION										
Nonfarm payroll employment	Millions	90.4	91.2	89.6	90.2	94.5	97.6	100.2	102.5	104.4
Unemployment rate	Percent	7.1	7.6	9.7	9.6	7.5	7.2	7.0	6.7	6.6
Industrial production index	Percent change*	-.8	-1.0	-7.7	14.3	6.6	1.7	1.0	3.5	3.8
Capacity utilization rate-mfg.	Percent	79.3	78.3	70.3	74.0	80.5	80.1	79.8	80.3	81.1
Housing Starts	Millions	1.30	1.10	1.06	1.71	1.77	1.74	1.82	1.73	1.74
Auto sales	Millions	9.04	8.56	8.00	9.18	10.43	11.09	11.52	10.57	10.94
Domestic	Millions	6.62	6.24	5.77	6.77	7.97	8.24	8.28	7.48	7.64
Foreign	Millions	2.42	2.32	2.23	2.41	2.46	2.84	3.25	3.09	3.30
INCOME AND SAVING										
Nominal personal income	Percent change*	12.0	9.2	5.3	7.8	8.4	6.1	4.3	5.8	5.8
Real disposable income	Percent change*	1.1	.7	1.0	5.1	4.2	1.9	2.2	2.3	1.1
Personal saving rate	Percent	7.1	7.5	6.8	5.4	6.3	5.1	3.8	3.6	3.5
Corp. profits with IVA & CCAdj	Percent change*	-6.8	2.3	-19.1	70.1	6.6	7.8	8.7	6.8	3.0
Profit share of GNP	Percent	6.5	6.2	4.7	6.3	7.0	7.0	7.1	7.4	7.1
Federal govt. surplus/deficit	Billions of $	-61.3	-63.8	-145.9	-176.0	-170.0	-198.0	-203.4	-185.8	-150.2
State and local govt. surplus		26.8	34.1	35.1	47.5	68.5	61.7	63.0	58.4	64.1
PRICES AND COSTS										
GNP implicit deflator	Percent change*	9.9	8.7	5.2	3.6	3.6	3.3	2.1	2.9	3.4
GNP fixed-weight price index		9.8	8.5	5.0	3.9	3.9	3.6	2.4	3.1	3.8
Cons. & fixed invest. prices		10.1	8.2	4.4	3.3	3.6	3.4	2.0	3.7	4.2
CPI		12.5	9.6	4.5	3.2	4.1	3.5	1.3	4.0	4.3
Exc. food and energy		12.2	10.2	5.2	4.2	4.7	4.3	3.9	4.0	4.8
Nonfarm business sector										
Output per hour		1.0	-.6	1.0	3.6	1.0	.2	.5	.6	1.1
Compensation per hour		10.9	8.3	7.3	3.3	4.3	3.9	2.6	2.8	4.0
Unit labor costs		9.8	9.0	6.2	-.3	3.2	3.7	2.1	2.2	2

* Percent changes are from fourth quarter to fourth quarter.

CONFIDENTIAL - FR
CLASS II FOMC

March 25, 1987

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

			Projection										Projection	
	1986		1987				1988				1985	1986	1987	1988
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	(fourth quarter to fourth quarter, net change)			
Real GNP	25.0	9.7	29.0	23.8	23.9	26.5	24.3	24.7	26.5	26.1	101.9	73.8	103.3	101.6
Gross domestic product	23.2	13.4	29.0	24.4	24.8	27.5	25.0	25.4	26.7	26.7	107.6	82.0	105.8	103.7
Gross domestic purchases	34.4	-5.6	13.8	17.3	14.4	14.3	12.0	11.8	14.4	15.9	141.2	89.8	59.7	54.1
Final sales	40.4	37.8	-17.5	35.6	22.7	20.9	23.1	25.0	26.8	24.0	141.1	97.0	61.8	98.9
Private dom. final purchases	41.6	3.6	-30.4	29.5	14.3	7.5	11.3	10.2	11.9	10.9	122.5	93.1	20.8	44.2
Personal consumption expend.	39.6	-2.2	-11.2	22.4	9.2	3.2	6.9	7.0	7.9	7.0	80.0	94.1	23.6	28.8
Durables	34.5	-11.2	-23.1	11.7	3.8	-4.0	.5	.6	1.8	.6	20.2	33.4	-11.7	3.5
Nondurables	-1.9	-.3	-4.1	4.1	2.4	2.4	2.4	2.4	2.4	2.4	16.7	27.9	4.7	9.7
Services	7.0	9.2	16.2	6.6	3.0	4.8	3.9	4.0	3.7	4.0	43.1	32.7	30.7	15.6
Business fixed investment	-2.4	3.4	-19.4	6.8	4.1	2.9	3.0	2.2	3.0	2.3	29.3	-19.1	-5.6	10.6
Producers' durable equipment	1.0	5.2	-15.9	5.9	3.9	3.2	3.6	2.9	3.7	2.9	24.4	5.6	-2.9	13.1
Nonresidential structures	-3.4	-1.8	-3.4	.9	.2	-.3	-.6	-.6	-.6	-.6	4.9	-24.7	-2.7	-2.5
Residential structures	4.5	2.5	.0	.2	1.0	1.4	1.4	.9	.9	1.6	13.2	18.2	2.7	4.9
Change in business inventories	-15.4	-28.2	46.6	-11.8	1.2	5.6	1.2	-.3	-.3	2.1	-39.1	-23.3	41.6	2.7
Nonfarm	-19.6	-1.2	34.9	-14.8	1.2	5.6	1.7	-.3	-.3	2.1	-17.8	-25.9	26.9	3.2
Farm	4.2	-27.0	11.7	3.0	.0	.0	-.5	.0	.0	.0	-21.3	2.6	14.7	-.5
Net exports	-9.4	15.3	15.3	6.5	9.5	12.2	12.3	12.8	12.1	10.2	-39.3	-16.0	43.5	47.5
Exports	11.4	14.6	9.4	8.2	11.3	12.8	13.7	13.7	14.6	13.0	-12.1	22.9	41.7	55.0
Imports	20.9	-.7	-5.9	1.7	1.8	.5	1.4	.9	2.5	2.8	27.1	39.0	-1.8	7.5
Government purchases	8.2	18.9	-2.3	-.3	-1.1	1.2	-.5	1.9	2.8	2.9	57.9	19.9	-2.6	7.2
Federal	2.0	17.7	-4.1	-2.5	-3.8	-1.7	-3.1	-1.1	-.2	-.1	43.4	1.4	-12.1	-4.4
Defense	10.1	-6.9	4.3	2.5	-1.8	-1.7	-3.5	-1.4	-.7	-.1	13.4	13.2	3.3	-5.7
Nondefense	-8.0	24.6	-8.4	-5.0	-2.0	.0	.4	.3	.5	.0	30.0	-11.8	-15.4	1.3
State and local	6.2	1.2	1.8	2.2	2.7	2.9	2.6	3.0	3.0	3.0	14.5	18.5	9.6	11.6

CONFIDENTIAL FR CLASS II March 25, 1987

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1986*	FY1987e Admin[1]	FY1987e FRB Staff	FY1988e Admin[1]	FY1988e FRB Staff	CY 1986*	CY1987e FRB Staff	1986 IV*	FRB Staff Estimates 1987 I	1987 II	1987 III	1987 IV	1988 I	1988 II	1988 III
								Not seasonally adjusted							
Budget receipts[2]	769	842	830	917	896	782	840	190	193	241	207	200	205	267	225
Budget outlays[2]	990	1016	1011	1024	1047	991	1017	253	253	250	254	259	261	259	268
Surplus/deficit(-) to be financed[2]	-221	-173	-181	-108	-151	-209	-177	-63	-60	-10	-47	-59	-56	8	-44
Means of financing:															
Borrowing from public	236	162	171	107	147	215	145	69	37	19	46	43	58	0	46
Cash balance decrease	-14	11	6	0	0	0	16	1	14	-7	-2	10	0	-5	-5
Other[3]	-1	0	5	1	4	-5	16	-5	10	-2	3	6	-2	-3	3
Cash operating balance, end of period	31	20	25	20	25	31	15	31	17	23	25	15	15	20	25
Memo: Sponsored agency borrowing[4]	14	n.a.	11	n.a.	20	13	12	4	-2	4	5	5	5	5	5
NIPA Federal Sector								Seasonally adjusted annual rates							
Receipts	815	875	868	968	933	827	880	854	859	872	886	901	928	948	953
Expenditures	1025	1061	1057	1089	1092	1030	1065	1043	1063	1060	1060	1078	1098	1094	1099
Purchases	368	385	379	395	387	366	382	372	379	383	383	384	387	388	390
Defense	275	291	287	301	293	278	291	279	287	292	292	292	293	293	294
Nondefense	94	94	92	94	94	89	92	93	93	91	91	92	94	95	95
All other expend.	657	676	677	694	705	664	683	671	683	677	677	695	711	706	710
Surplus/deficit(-)	-211	-186	-189	-121	-160	-203	-186	-189	-203	-188	-174	-177	-169	-145	-146
High-employment surplus/deficit(-) evaluated at 6 percent unemp.	-173	n.a.	-148	n.a.	-122	-165	-146	-147	-163	-148	-134	-139	-131	-107	-110

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

Note: Details may not add to totals due to rounding

1. Budget of the United States Government, Fiscal Year 1988 (January 1987). The Congressional Budget Office baseline estimates published in February indicated receipts of $834 and $901 billion, outlays of $1010 and $1071 billion, and deficits of $176 and $171 billion in FY1987 and FY1988, 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, 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 [illegible]e agencies is somewhat broader.

Recent Developments

Fixed-income markets have been tranquil in the weeks since the February FOMC meeting. The Chairman's remarks during his Humphrey-Hawkins appearance reassured the markets that the System had not altered its reserve stance. Since then federal funds generally have traded at a little above 6 percent. Private short-term rates are about unchanged, while Treasury bill rates are off roughly 25 basis points, reflecting a paydown of bills and some flight to quality in light of Brazilian debt developments. Long-term security yields have shown minor mixed changes. The recent calm in financial markets has been promoted by the tenor of incoming data, which were viewed as not portending a shift in Fed policy, and by a relatively steady dollar after the G-6 meeting in Paris.

The money stock estimates for January and February mask sharp intra-month swings. Both M1 and M2 were essentially unchanged in February when measured on a month-average basis. Demand deposits contracted even more rapidly in February than in January after the year-end rush of financial activity. However, these month-average estimates shroud what has been essentially an unchanged level of demand deposits since mid-January. Meanwhile, growth in other checkable deposits slowed in February to the lowest rate in the past year, suggesting that adjustments to the lower opportunity costs of these accounts may be winding down. In M2, the non-transactions component was flat in February; bond and equity mutual funds evidently continued to appeal to the public, and some individuals may have used M2 balances to pay down consumer debt. M3 edged up in February, buoyed by large inflows to term Eurodollars and RPs. Available data suggest subdued growth in the aggregates in March.

Overall borrowing by domestic nonfinancial sectors has dropped sharply since early January. The federal government has been the single largest source of this slowing, as the Treasury's unusually high cash balance at the beginning of the year has been tapped for some of the needed funds. Coupon issues have accounted for all of the new borrowing thus far this year. State and local government borrowing has been restrained by the tightened volume limits on private-purpose issues; advance refundings have accounted for an unusually large share of tax-exempt offerings. Total offerings of municipal securities did pick up in March, due in part to a rebound in taxable issues.

Net borrowing by businesses has backed off in the wake of the tax-related surge around year-end. The decline in credit demands for mergers and leveraged buyouts has more than offset the effects of large inventory restocking and temporarily high tax payments. Businesses have concentrated their borrowing in the long-term markets in response to the lowest bond rates in nine years. After a slow start early in the quarter, stock issuance now is responding vigorously to the 25 percent rise in share prices since the beginning of the year. New equity offerings will likely set a record in March.

In the household sector, mortgage borrowing apparently slowed a bit after the first of the year, judging from the deceleration of real estate lending at banks and at thrifts and from a reduction in issuance of mortgage pass-through securities. The recent tax changes had caused some real estate deals and their financing to be moved forward into 1986. Still, with housing construction up in January and February, mortgage debt growth probably has remained well above a 10 percent annual rate. In addition, some consumer borrowing has shifted into the mortgage category as home equity lines of credit have become more prevalent. This substitution, together with slower growth in consumer spending and expiration of most auto financing incentives, has resulted in a sharp reduction since last October in growth of consumer installment credit.

Outlook

Total debt growth in the nonfinancial sectors should continue the generally slower pace that has emerged recently. For the year as a whole, nonfinancial debt is projected to grow at just under 10 percent, which would be the slowest rate since 1982.

Most of the expected slackening in debt growth for the year arises from the government sectors. Reductions in the federal deficit should cut Treasury financing requirements by about $50 billion compared with calendar 1986. Borrowing will pick up from the recent very low level, however, because the Treasury has worked down its unusually large cash balances.

Among state and local governments, borrowing in the second quarter and through the rest of the year will remain well below the levels of 1985 and 1986. With interest rates not expected to change much, refunding activity is likely to tail off, while the more restrictive caps on private-purpose financings will continue to constrain offerings of these securities. Combining governments at all levels, their share of aggregate borrowing should decline again this year, to about 26 percent of total domestic nonfinancial debt growth--the smallest share since 1981.

Total business borrowing in the second quarter should rebound a bit from the relatively slow first quarter. But for the year as a whole, business credit growth should remain somewhat below the rate posted in 1986. The financing gap through the rest of the year, though rather small relative to capital outlays, will continue to be wider than last year. However, business borrowing to finance share retirements, including those stemming from mergers and buyouts, is expected to be less than in the past three years. Businesses probably will continue to lengthen maturities of their borrowing to lock in the relatively low rates now available.

Overall borrowing by households is expected to continue robust through 1987, largely because of strong mortgage demand for purchases of new and existing homes. Consumer installment credit, by contrast, is expected to grow at its slowest rate in five years. The projected sluggishness in consumer spending will hold down debt growth. The increasing prevalence of home equity borrowing is another significant element in the consumer credit outlook. Although unlikely to materially affect total household borrowing, this tax-preferred form of financing could shift much of the growth otherwise anticipated for consumer credit into the mortgage category.

Recent developments. After trading in a narrow range since the February Committee meeting, the dollar has come under strong downward pressure in recent days, particularly against the Japanese yen. This marked the first real test of the February 22 G-6 accord, which had indicated a desire on the part of monetary authorities to maintain exchange rates around then-current levels. A strong move of the yen/dollar rate below the 150 level brought forth massive intervention resistance

by the Desk, acting for the accounts of the System and the U.S. Treasury. The strengthening of the yen against the dollar seemed to be prompted by a heating-up of trade frictions between Japan and the United States and remarks by Secretary Baker that the U.S. government had no target rate for the dollar's exchange value.

In other exchange market developments, sterling rose sharply over the intermeeting period, rising by 6 percent against the dollar

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Sterling's strength appeared to result from an improved fiscal picture for the United Kingdom and brighter electoral prospects for the Conservative government. The Bank of England took the opportunity of sterling's strength to cut its official lending rates by a full percentage point in mid-March. Several other European countries also lowered official lending rates, taking advantage of a firming of their currencies against the mark after the G-6 meeting.

Over the period as a whole,

U.S. authorities purchased $793 million.

Economic activity in major foreign industrial countries remained generally weak in the fourth quarter, except in the United Kingdom, where growth was fairly strong. Real GNP declined in the fourth quarter in Germany and, although Japanese GNP showed a moderate increase, domestic demand growth was small. Japan's unemployment rate rose to an historic high in early 1987. Industrial production declined in Japan, Germany, and France in January, while it rose in the United Kingdom.

Debt-servicing problems again plagued several major developing countries. Brazil suspended interest payments to commercial banks on medium- and long-term debt on February 20, in the face of a sharp decline in its trade surplus over the course of 1986 and the general disarray of policymaking in that country. Following a catastrophic earthquake in March, Ecuador suspended most debt service payments for the rest of this year. Argentina responded to an upsurge of inflation by instituting a four-month wage and price freeze. On the brighter side, the Mexican commercial bank financing package was signed on March 20; efforts are continuing to obtain additional commitments from a number of smaller banks that withheld their participation. Chile and Venezuela reached debt rescheduling agreements with bank creditors, and further progress appears to have been made in the Philippines' debt rescheduling negotiations.

The U.S. merchandise trade deficit widened slightly further in the fourth quarter of 1986, to $154 billion (s.a.a.r.) on a revised balance of payments basis. For the year as a whole, the deficit was $148 billion. The value of exports rose by 9 percent from 1985QIV to

1986QIV, with the rise concentrated in consumer goods and some components of capital goods. Shipments to Western Europe rose by 13 percent and to Japan by 15 percent. Exports to developing countries rose only slightly. An almost 14 percent rise in the volume of nonagricultural exports from the fourth quarter of 1985 to the fourth quarter of 1986 provides some evidence of the effects of the improved U.S. competitive position. On the other hand, the value of imports rose by 6 percent (QIV/QIV), despite a sharp decline in the value of oil imports, with the volume of both oil and nonoil imports continuing to rise strongly.

The current account deficit for 1986 totalled $141 billion, with the fourth-quarter rate at $147 billion.

Outlook. The staff has revised slightly downward its forecast for economic activity in major foreign industrial countries. We now see GNP growth in this group of 10 countries at about 2 percent in 1987 and 1988. The outlook for the current account deficit is for little change from the 86QIV rate through 1987 and for a gradual reduction in 1988, though the small nominal improvement belies a substantial rise in real net exports, in spite of sluggish foreign growth. The staff continues to project a decline in the dollar at a moderate rate through 1988, though the February G-6 agreement may imply somewhat more near-term stability.

Strictly Confidential (FR)
Class II FOMC

March 25, 1987

Outlook for U.S. Net Exports and Related Items
(Billions of Dollars, Seasonally Adjusted Annual Rates)

	ANNUAL			1986		1987				1988			
	1986-	1987-P	1988-P	Q3-	Q4-	Q1-P	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current $, Net	-104.3	-111.5	-92.2	-108.9	-110.2	-115.2	-114.3	-110.8	-105.8	-101.7	-94.7	-89.0	-83.4
Exports of G+S	373.0	413.7	484.4	370.8	383.5	393.7	404.5	419.7	437.0	455.1	474.1	494.5	513.9
Imports of G+S	477.3	525.2	576.6	479.7	493.7	508.9	518.8	530.5	542.8	556.8	568.8	583.5	597.3
Constant 82 $, Net	-147.8	-120.0	-73.9	-163.3	-148.0	-132.7	-126.2	-116.7	-104.5	-92.2	-79.3	-67.2	-57.0
Exports of G+S	371.5	410.2	462.0	371.2	385.8	395.2	403.4	414.7	427.5	441.2	454.9	469.4	482.4
Imports of G+S	519.2	530.2	535.9	534.5	533.8	527.9	529.6	531.4	532.0	533.3	534.2	536.7	539.4
2. U.S. Merchandise Trade Balance 2/	-147.7	-153.2	-135.4	-148.6	-153.5	-157.3	-155.8	-152.4	-147.4	-143.8	-137.4	-132.7	-127.8
Exports	221.8	250.1	301.5	223.1	229.3	235.0	243.7	254.9	266.9	280.4	294.7	308.9	322.0
Agricultural	26.9	26.1	28.4	26.0	28.4	26.6	25.8	26.1	26.0	27.1	28.0	29.1	29.4
Non-Agricultural	194.8	224.0	273.1	197.0	200.9	208.4	217.9	228.8	240.9	253.4	266.7	279.8	292.6
Imports	369.5	403.3	436.9	371.7	382.8	392.3	399.5	407.3	414.2	424.3	432.1	441.6	449.8
Petroleum and Products	33.9	39.3	43.1	31.9	32.2	37.7	38.9	40.1	40.3	41.8	42.2	44.0	44.2
Non-Petroleum	335.6	364.1	393.9	339.7	350.6	354.5	360.6	367.2	373.9	382.5	389.8	397.6	405.6
3. U.S. Current Account Balance	-140.6	-148.9	-133.9	-141.2	-147.3	-147.1	-153.7	-149.2	-145.7	-141.9	-135.7	-130.9	-127.3
Of Which: Net Investment Income	22.9	16.1	9.3	24.6	19.6	22.0	14.6	14.7	13.1	11.2	9.7	8.8	7.4
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	2.3	1.9	1.9	2.3	1.2	1.2	1.9	2.0	2.0	1.8	1.8	1.8	1.8
Real GNP--NonOPEC LDC 5/	4.2	3.9	4.1	4.1	3.9	3.8	3.8	3.9	3.9	4.0	4.3	4.6	5.0
Consumer Prices--Ten Ind. 4/	2.0	2.3	2.8	0.1	2.1	2.8	3.0	2.4	2.6	2.8	3.2	2.9	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