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August 16, 1989

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

The economy, overall, evidently has continued to expand at a moderate rate. At the same time, declines in food and energy prices, the firmness of the dollar, and stability in wage trends have combined to yield an easing of inflationary pressures.

Labor demand appears to have remained solid through July. The rise in private nonfarm employment--204,000 (strike adjusted)--was in line with the average monthly gain in the second quarter, and the civilian unemployment rate remained at 5-1/4 percent. Although the rise in jobs at service establishments was off a bit compared with earlier in the year, hiring at construction sites rebounded. In manufacturing, employment held about steady after declining during the second quarter; much of the weakness in recent months is attributable to layoffs in the auto and electrical equipment industries, while employment elsewhere has changed little.

Industrial production was up 0.2 percent in July, in line with the average pace in the second quarter. Production of capital equipment posted another strong gain, and output of consumer goods (excluding motor vehicles) continued to rise at a moderate rate. Output of materials, which declined, on balance, over the first half of the year, rebounded last month. Nonetheless, capacity utilization in primary processing industries remains 2 percentage points below its January level. The operating rate for advanced processing, in contrast, has been about flat over the year.

Incoming data have depicted a stronger trend in consumer spending than was visible at the time of the July FOMC meeting. Retail sales in July at the "control" group of stores rose 0.4 percent from a substantially higher June level. Indeed, the revised May and June data imply an upward adjustment in second-quarter real PCE growth of a percentage point, to 2 percent (annual rate). In addition, motor vehicle sales rebounded in July, spurred by further enhancement of incentive programs.

The housing market also has strengthened somewhat. With mortgage rates having moved considerably lower since April, sales of new single-family homes picked up in June. In July, single-family starts rose to 1.04 million units, holding total starts above 1.4 million units despite a decline of multifamily construction.

Demand for business equipment appears to be moderating, however, after a sharp advance in shipments through the second quarter. Orders for nondefense capital goods (excluding aircraft) rose only a little in the second quarter, and anecdotal reports suggest that new bookings have been sluggish recently. The softening reportedly has occurred among both domestic and foreign customers. Aircraft remains an area of notable strength in orders. Here, domestic manufacturers are holding sizable inventories, some of which are reported to be destined for export in the next several months.

Business inventory investment slowed in June, and at the end of the second quarter the stock-sales ratio for all manufacturing and trade was unchanged, in current-cost terms, from its average over the past year. Manufacturers have managed to keep a tight rein on inventories, particularly of materials, as production has decelerated this year. At retailers,

stockbuilding picked up a bit in the second quarter, but inventory imbalances outside the auto sector appear to be limited.

Increases in consumer prices slowed markedly in June, and producer prices of finished goods declined, on average, in both June and July. Steep declines in the prices of petroleum products have had an important effect on these recent readings; and, with the softness in world oil markets, domestic energy prices are likely to drop further in coming months. Food prices also have had a moderating influence on inflation in recent months compared with their effect earlier in the year.

Apart from food and energy developments, recent reports on consumer prices show little change in trend compared with 1988. An important factor has been the damping effect of declining prices for imported goods. The easing of pressures on industrial capacity also has held down goods prices. Indeed, at the intermediate level, the PPI for materials (excluding food and energy) declined in June and July, and domestic spot commodity prices have eased as well.

Wage trends were stable as of midyear. The employment cost index for compensation remained 4-1/2 percent above year-earlier levels in June. The year-over-year rise in wages has been running slightly above 4 percent since late 1988; benefit costs, which accelerated sharply beginning early last year, have continued to rise relatively rapidly.

Outlook

The recent information on retail trade, employment, and industrial production suggests that the pace of economic expansion was somewhat stronger at midyear than the staff thought at the time of the July FOMC meeting. Although there are still gaps in the data, it appears that real

GNP growth in the second quarter could well be revised up to about 2-1/2 percent; our assessment is that the expansion is continuing at close to that pace in the current quarter. Much of the additional strength is expected to center on consumer spending. At the same time, inflation appears to be running somewhat lower now than we had anticipated previously, reflecting in large part weaker food and energy prices.

Looking ahead, the staff projection through the end of 1990 is influenced importantly by our assumptions regarding the outlook for financial markets and fiscal policy. First, in terms of monetary policy, the forecast assumes no significant change in money market conditions. Second, in foreign exchange markets, the dollar, which has risen in recent weeks, is assumed to again come under moderate downward pressure as progress toward reducing the current account deficit stalls. Finally, fiscal policy is projected to move noticeably further toward restraint over the next year.

Without appreciable changes in market rates of interest, monetary velocity would be expected to stabilize once the current adjustment to the earlier easing actions is complete; however, the outlook over the next few quarters is subject to unusual uncertainty because the behavior of velocity may depend in part on the strategies used to resolve troubled thrifts. M2 and M3 are expected to finish 1989 in the lower halves of their annual target ranges and then to grow in 1990 at rates in the middle to upper portions of the ranges.

The staff's budget projection has been revised to incorporate the recent thrift legislation as well as other technical information that became available with the Administration's mid-session review. For the current fiscal year, the deficit has been adjusted to allow for the \$20 billion that

is to be spent between now and the end of September under the new legislation to deal with insolvent thrifts; this brings our FY1989 estimate to \$168 billion. For FY1990, when the spending from the thrift legislation will be off-budget, the deficit is expected to drop to \$110 billion, little changed from the July Greenbook. That projection presumes that the Congress will fully enact the spending and revenue package in the bipartisan budget agreement.

Growth in real GNP now is expected to average a little more than 2 percent for the remainder of the year and then to decelerate to around 1-3/4 percent in 1990. Consumer demand is expected to be somewhat stronger in the near term than it was in the first half of this year; continued job growth and declining interest rates and rising stock prices have bolstered consumer sentiment. But while growth in consumer spending, overall, is projected to average 2-3/4 percent at an annual rate over the next three quarters, auto sales are expected to drift lower, with some scaling back of price incentives and with consumers resisting the higher sticker prices on 1990 models. At the current, lower level of interest rates, housing starts are expected to remain at the July pace, producing an upswing in residential construction expenditures through year-end. At the same time, with fears of near-term recession diminished, businesses are expected to follow through on most of their earlier plans for new plant and equipment; business fixed investment, while decelerating somewhat from the first-half pace, is projected to continue to outstrip growth of overall GNP by a considerable margin. The boost to domestic production from these sectors is offset somewhat, however, by relatively rapid growth in imports and a slowing of export demand brought on by the earlier appreciation of the dollar and the

slowing expansion abroad. Indeed, real net exports of goods and services are projected to decline, on balance, between now and next spring.

SELECTED COMPONENTS OF REAL GNP
(Percent change from previous period; compound annual rate)

	1989				1990			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	- - - - - projection - - - -							
Real GNP	3.7 ¹	1.7	2.2	2.1	1.8	1.7	1.7	1.8
Gross domestic purchases	1.8	1.4	2.6	1.8	2.7	1.7	1.4	1.3
Exports of goods & services	14.0	11.3	4.5	8.9 ²	.0	5.6	6.4	7.5
Imports of goods & services	-.4	8.7	7.1	6.3	5.8	5.4	4.5	3.7

1. On a drought-adjusted basis, 1.5 percent.

2. Includes sizable shipments of aircraft currently planned by domestic manufacturers.

As 1990 progresses, the stimulative effects of earlier declines in interest rates are projected to wane. Most notably, real residential investment is projected to flatten out. Growth in capital spending is expected to taper off, as weakness in profits provides impetus to corporate efforts to hold capacity expansion in line with sustainable sales trends. But, by midyear, the depreciation of the dollar is projected to contribute to a pickup in export growth; this, combined with the damping effects of slower growth in domestic demand on imports, yields a pickup in real net exports.

Given the pace of economic activity projected for the near term--just under its longer-run potential rate--the civilian unemployment rate is expected to remain near 5-1/4 percent through the end of 1989. In that environment, pressures by workers to catch up with the 5-1/4 percent rise in

are projected to accelerate slightly to just under a 5 percent rate in the first half of next year; the pickup in the overall CPI in early 1990 is greater because energy prices are expected to stop falling.

Beginning in mid-1990, the decline in the value of the dollar and the resultant pickup in import prices becomes an important factor boosting domestic inflation. This offsets the disinflationary benefits of emerging slack in the economy, and the projection shows no improvement in the underlying inflation trend through the end of the projection period. Looking further ahead, into 1991, in order for the FOMC to achieve its goal of a diminishing rate of inflation over time, it appears that economic growth would have to remain relatively subdued, particularly if the dollar were to continue to move significantly lower. The staff will be extending the forecast through 1991 in the next Greenbook.

August 16, 1989

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)		
	6/28/89	8/16/89	6/28/89	8/16/89	6/28/89	8/16/89	6/28/89	8/16/89	6/28/89	8/16/89	
Annual changes:											
1987	<1>	6.8	6.9	3.4	3.7	3.6	3.6	3.3	3.2	6.2	6.2
1988	<1>	7.5	7.9	3.9	4.4	4.2	4.2	3.4	3.3	5.5	5.5
1989		7.2	7.2	2.6	2.8	4.7	4.6	4.5	4.2	5.4	5.3
1990		5.7	6.0	1.4	1.9	4.4	4.3	4.2	4.1	5.9	5.6
Quarterly changes:											
1988	Q1 <1>	5.4	6.5	3.4	4.0	3.5	3.8	1.7	2.0	5.7	5.7
	Q2 <1>	8.7	8.6	3.0	3.7	5.0	4.8	5.5	4.8	5.5	5.5
	Q3 <1>	7.3	7.5	2.5	3.2	5.3	5.2	4.7	4.4	5.5	5.5
	Q4 <1>	7.6	7.5	2.4	2.7	4.2	4.3	5.3	4.7	5.3	5.3
1989	Q1 <1>	8.2	7.9	4.4	3.7	4.6	4.8	3.6	4.0	5.2	5.2
	Q2 <1>	7.4	6.6	1.7	1.7	5.6	5.2	5.4	4.9	5.3	5.3
	Q3	5.1	5.8	1.5	2.2	3.8	3.5	3.5	3.4	5.4	5.3
	Q4	5.1	5.9	1.3	2.1	3.9	3.8	3.8	3.7	5.6	5.3
1990	Q1	5.8	6.5	1.2	1.8	4.8	4.7	4.6	4.6	5.8	5.4
	Q2	5.7	5.9	1.4	1.7	4.4	4.3	4.3	4.2	5.9	5.5
	Q3	6.0	5.8	1.7	1.7	4.3	4.3	4.2	4.1	6.0	5.6
	Q4	6.3	5.8	2.0	1.8	4.1	4.3	4.2	3.9	6.1	5.7
Two-quarter changes: <2>											
1988	Q2 <1>	7.0	7.5	3.2	3.9	4.2	4.2	3.6	3.4	-.4	-.4
	Q4 <1>	7.4	7.5	2.4	2.9	4.8	4.8	5.0	4.5	-.2	-.2
1989	Q2 <1>	7.8	7.2	3.1	2.7	5.1	5.0	4.5	4.4	.0	.0
	Q4	5.1	5.8	1.4	2.1	3.9	3.6	3.6	3.5	.3	.0
1990	Q2	5.8	6.2	1.3	1.7	4.6	4.5	4.4	4.4	.3	.2
	Q4	6.1	5.8	1.9	1.7	4.2	4.3	4.2	4.0	.2	.2
Four-quarter changes: <3>											
1987	Q4 <1>	8.3	8.6	5.0	5.4	4.0	4.0	3.1	3.0	-.9	-.9
1988	Q4 <1>	7.2	7.5	2.8	3.4	4.5	4.5	4.3	4.0	-.6	-.6
1989	Q4	6.4	6.5	2.2	2.4	4.5	4.3	4.1	4.0	.3	.0
1990	Q4	6.0	6.0	1.6	1.7	4.4	4.4	4.3	4.2	.5	.4

<1> Actual.

<2> Percent change from two quarters earlier.

<3> Percent change from four quarters earlier.

August 16, 1989

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

	Units	1982	1983	1984	1985	1986	1987	1988	Projection	
									1989	1990
EXPENDITURES										

Nominal GNP	Billions of \$	3166.0	3405.7	3772.2	4014.9	4231.6	4524.3	4880.6	5229.9	5546.4
Real GNP	Billions of 82\$	3166.0	3279.1	3501.4	3618.7	3717.1	3853.7	4024.4	4136.3	4213.1
Real GNP	Percent change*	-1.9	6.5	5.1	3.6	1.9	5.4	3.4	2.4	1.7
Gross domestic product		-1.6	6.6	5.3	3.8	2.3	5.4	3.4	2.4	1.8
Gross domestic purchases		-.8	8.4	6.4	4.3	2.1	4.6	2.4	1.9	1.8
Final sales		.3	3.7	4.7	4.6	2.7	3.3	4.4	2.5	1.5
Private dom. final purchases		.8	7.7	5.6	4.6	2.9	2.7	3.8	2.5	1.8
Personal consumption expend.		2.9	5.4	4.1	4.6	3.8	2.2	3.8	2.2	1.9
Durables		9.0	14.7	10.8	7.0	11.5	-2.0	8.0	1.5	.5
Nondurables		1.8	4.4	2.3	3.3	2.9	1.1	2.1	.7	1.4
Services		2.3	3.9	3.5	5.0	2.1	4.4	3.6	3.4	2.5
Business fixed investment		-11.3	10.8	13.8	3.7	-5.5	8.5	4.2	5.7	1.9
Producers' durable equipment		-12.5	20.9	14.9	4.6	.4	11.1	7.0	8.4	3.2
Nonresidential structures		-9.1	-4.8	11.8	1.9	-17.7	1.9	-3.4	-2.4	-2.5
Residential structures		4.9	38.1	6.1	5.8	11.6	-4.2	3.2	-2.2	.2
Exports		-13.8	5.8	5.9	-2.4	10.6	19.1	13.9	9.6	4.8
Imports		-5.9	23.8	17.4	4.5	10.0	9.6	5.3	5.4	4.8
Government purchases		3.8	-2.7	7.9	8.6	3.1	2.1	1.8	-.1	.8
Federal		8.2	-8.1	13.0	13.3	.5	.7	-.3	-2.6	-.9
Defense		8.8	5.1	6.5	7.1	6.0	4.3	-1.9	-4.9	-2.9
State and local		.6	1.5	4.4	4.9	5.2	3.1	3.4	1.8	2.0
Change in business inventories	Billions of 82\$	-24.5	-6.4	62.3	9.1	5.6	23.7	27.9	20.1	23.8
Nonfarm	Billions of 82\$	-23.1	-.1	57.8	13.4	8.0	25.8	30.7	14.9	20.3
Net exports	Billions of 82\$	26.3	-19.9	-84.0	-104.3	-129.7	-115.7	-74.9	-54.8	-62.1
Nominal GNP	Percent change*	3.1	10.4	8.6	6.6	4.6	8.6	7.5	6.5	6.0
EMPLOYMENT AND PRODUCTION										

Nonfarm payroll employment	Millions	89.6	90.2	94.5	97.5	99.5	102.2	105.6	108.5	110.0
Unemployment rate	Percent	9.7	9.6	7.5	7.2	7.0	6.2	5.5	5.3	5.6
Industrial production index	Percent change*	-7.7	14.3	6.6	1.7	1.0	5.8	5.0	2.4	1.8
Capacity utilization rate-mfg.	Percent	70.3	73.9	80.5	80.1	79.7	81.1	83.5	84.1	83.1
Housing Starts	Millions	1.06	1.70	1.75	1.74	1.81	1.62	1.49	1.43	1.42
Auto sales	Millions	8.01	9.23	10.38	11.06	11.47	10.26	10.69	10.08	9.64
Domestic	Millions	5.78	6.82	7.92	8.22	8.22	7.06	7.55	7.18	6.90
Foreign	Millions	2.23	2.41	2.46	2.84	3.25	3.21	3.14	2.90	2.74
INCOME AND SAVING										

Nominal personal income	Percent change*	5.3	7.8	8.4	6.6	5.8	8.6	7.1	8.3	6.3
Real disposable income	Percent change*	1.0	5.1	4.3	2.7	3.3	3.0	4.0	3.2	1.5
Personal saving rate	Percent	6.8	5.4	6.1	4.4	4.1	3.2	4.2	5.5	5.5
Corp. profits with IVA & CCAdj	Percent change*	-19.1	70.1	7.4	9.2	-5.6	12.0	10.4	-11.9	-6.1
Profit share of GNP	Percent	4.7	6.3	7.1	7.0	6.7	6.6	6.7	5.9	5.1
Federal govt. surplus/deficit	Billions of \$	-145.9	-176.0	-169.6	-196.9	-206.9	-161.4	-145.8	-148.2	-125.6
State and local govt. surplus		35.1	47.5	64.6	65.1	62.8	51.3	49.7	49.7	54.3
Exc. social insurance funds		-1.7	4.4	19.8	13.8	5.6	-12.4	-21.4	-28.4	-29.9
PRICES AND COSTS										

GNP implicit deflator	Percent change*	5.2	3.6	3.4	2.9	2.6	3.0	4.0	4.0	4.2
GNP fixed-weight price index		5.0	3.9	3.7	3.3	2.6	4.0	4.5	4.3	4.4
Cons. & fixed invest. prices		4.4	3.3	3.3	3.4	2.5	4.7	4.2	4.5	4.5
CPI		4.4	3.2	4.2	3.5	1.3	4.4	4.3	4.6	4.5
Exc. food and energy		5.2	4.2	5.0	4.3	3.9	4.2	4.6	4.5	4.9
Nonfarm business sector										
Output per hour		.5	3.4	1.5	1.6	1.3	2.5	1.7	-.1	1.1
Compensation per hour		6.8	3.1	4.2	4.6	5.0	4.0	4.9	5.3	5.8
Unit labor costs		6.2	-.4	2.6	3.0	3.6	1.5	3.1	5.3	4.7

* Percent changes are from fourth quarter to fourth quarter.

August 16, 1989

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

	Units	Projection									
		1988		1989				1990			
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of \$	4926.9	5017.3	5113.1	5194.9	5268.2	5343.6	5428.6	5506.8	5585.5	5664.5
Real GNP	Billions of 82\$	4042.7	4069.4	4106.8	4123.9	4146.6	4167.9	4186.8	4204.1	4221.5	4240.1
Nominal GNP	Percent change	7.5	7.5	7.9	6.6	5.8	5.9	6.5	5.9	5.8	5.8
Real GNP		3.2	2.7	3.7	1.7	2.2	2.1	1.8	1.7	1.7	1.8
Gross domestic product		3.1	2.5	3.8	1.6	2.3	2.1	2.0	1.7	1.7	1.8
Gross domestic purchases		3.4	2.5	1.8	1.4	2.6	1.8	2.7	1.7	1.4	1.3
Final sales		1.6	4.7	3.1	1.9	2.7	2.2	1.4	1.4	1.3	1.9
Private dom. final purchases		3.1	1.7	2.3	1.1	3.9	2.5	2.5	1.6	1.4	1.5
Personal consumption expend.		3.3	3.0	2.0	1.1	3.8	1.9	2.6	1.5	1.6	1.7
Durables		-3.9	9.9	-1.1	4.4	6.6	-3.3	2.6	-9	-6	1.0
Nondurables		5.0	.7	1.3	-4.0	3.3	2.5	2.2	1.3	1.2	1.1
Services		4.5	2.6	3.6	3.7	3.3	3.2	2.8	2.5	2.5	2.4
Business fixed investment		2.6	-6.5	6.9	7.6	4.9	3.7	3.3	2.1	1.1	1.0
Producers' durable equipment		2.9	-6.9	9.6	13.6	5.6	5.0	5.0	3.5	2.2	2.0
Nonresidential structures		1.6	-5.1	-1.0	-9.9	2.6	-8	-2.3	-2.4	-2.8	-2.6
Residential structures		1.9	6.3	-5.0	-13.6	2.6	8.6	.2	.1	.1	.2
Exports		9.7	15.5	14.0	11.3	4.5	8.9	.0	5.6	6.4	7.5
Imports		10.2	12.6	-.4	8.7	7.1	6.3	5.8	5.4	4.5	3.7
Government purchases		-3.6	16.7	-3.3	4.0	-.3	-.5	1.4	1.2	-.4	.8
Federal		-9.5	33.7	-9.4	7.1	-3.4	-3.9	.7	.2	-3.7	-.8
Defense		-5.5	4.4	-10.6	2.7	-5.5	-5.6	-2.7	-2.7	-3.7	-2.4
State and local		.9	5.7	1.5	1.8	2.0	2.0	1.9	2.0	2.0	2.0
Change in business inventories	Billions of 82\$	37.5	18.3	24.5	22.0	17.7	16.3	20.3	22.7	26.8	25.4
Nonfarm	Billions of 82\$	37.2	31.9	16.9	19.6	12.3	10.9	16.4	19.0	23.4	22.5
Net exports	Billions of 82\$	-74.9	-73.8	-55.0	-52.6	-57.2	-54.6	-33.8	-64.5	-62.5	-57.4
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	106.0	106.8	107.7	108.3	108.9	109.2	109.6	110.1	110.1	110.3
Unemployment rate	Percent*	5.5	5.3	5.2	5.3	5.3	5.3	5.4	5.5	5.6	5.7
Industrial production index	Percent change	7.1	4.6	2.1	2.6	2.0	2.8	1.9	1.5	2.0	1.9
Capacity utilization rate-mfg.	Percent*	84.0	84.4	84.4	84.2	84.0	83.8	83.6	83.2	83.0	82.7
Housing Starts	Millions	1.47	1.56	1.52	1.35	1.43	1.43	1.42	1.41	1.42	1.42
Auto sales	Millions	10.32	11.00	9.72	10.31	10.48	9.82	9.90	9.70	9.50	9.45
Domestic	Millions	7.20	7.89	6.89	7.30	7.60	6.93	7.00	6.90	6.85	6.85
Foreign	Millions	3.12	3.11	2.82	3.01	2.88	2.88	2.90	2.80	2.65	2.60
INCOME AND SAVING											
Nominal personal income	Percent change	7.2	8.8	13.3	7.5	6.9	5.7	7.6	6.6	4.8	6.3
Real disposable income	Percent change	4.9	4.3	6.6	.4	4.4	1.4	3.8	1.2	-.3	1.2
Personal saving rate	Percent*	4.3	4.6	5.6	5.4	5.6	5.5	5.8	5.7	5.3	5.2
Corp. profits with IVA & CCAdj	Percent change	7.1	11.7	-25.3	-7.4	-13.9	1.1	-18.5	-8.4	13.6	-8.3
Profit share of GNP	Percent*	6.7	6.8	6.2	6.0	5.7	5.6	5.2	5.1	5.1	5.0
Federal govt. surplus/deficit	Billions of \$	-122.5	-167.6	-147.5	-146.7	-154.2	-144.3	-138.2	-133.2	-117.2	-113.8
State and local govt. surplus		49.8	45.7	48.8	47.9	50.8	51.2	50.8	54.0	55.7	56.8
Exc. social insurance funds		-22.3	-28.1	-26.6	-29.3	-28.2	-29.3	-31.2	-29.5	-29.3	-29.7
PRICES AND COSTS											
GNP implicit deflator	Percent change	4.4	4.7	4.0	4.9	3.4	3.7	4.6	4.2	4.1	3.9
GNP fixed-weight price index		5.2	4.3	4.8	5.2	3.5	3.8	4.7	4.3	4.3	4.3
Cons. & fixed invest. prices		4.4	4.7	4.8	6.0	3.5	3.8	4.2	4.5	4.6	4.6
I		4.5	4.4	5.4	6.4	3.0	3.6	4.2	4.5	4.7	4.7
Exc. food and energy		4.0	4.9	5.2	4.1	4.2	4.7	4.8	4.9	5.0	5.0
Nonfarm business sector											
Output per hour		3.4	1.9	-1.3	.2	.1	.8	1.0	1.0	1.2	1.2
Compensation per hour		5.5	5.9	4.8	5.5	5.4	5.5	7.0	5.5	5.5	5.4
Unit labor costs		2.0	3.9	6.2	5.2	5.3	4.7	5.9	4.5	4.2	4.2

* Not at an annual rate.

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

August 16, 1989

	Projection										Projection			
	1988		1989				1990				1987	1988	1989	1990
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	(fourth quarter to fourth quarter, net change)			
Real GNP	32.0	26.7	37.4	17.1	22.7	21.3	18.9	17.3	17.4	18.6	202.0	133.8	98.5	72.2
Gross domestic product	30.5	25.2	37.7	16.6	23.4	21.0	20.1	17.9	17.5	18.4	200.6	132.5	98.7	73.8
Gross domestic purchases	34.3	25.6	18.6	14.7	27.3	18.6	28.2	18.0	15.4	13.5	176.4	97.8	79.3	75.0
Final sales	16.0	45.8	31.3	19.6	27.0	22.7	14.9	14.9	13.3	20.0	124.6	172.0	100.6	63.1
Private dom. final purchases	25.4	14.2	19.2	9.3	32.2	21.2	21.4	13.2	12.0	13.2	82.9	121.7	81.9	59.8
Personal consumption expend.	21.3	19.6	13.3	7.2	24.8	12.5	17.1	10.3	10.6	11.8	54.5	95.4	57.9	49.7
Durables	-4.1	9.8	-1.2	4.5	6.8	-3.6	2.8	-1.0	-6	1.1	-8.1	31.1	6.5	2.2
Nondurables	11.1	1.7	3.0	-9.2	7.4	5.7	5.0	3.0	2.8	2.5	9.4	19.1	6.8	13.3
Services	14.2	8.2	11.5	11.8	10.7	10.5	9.3	8.4	8.4	8.1	53.2	45.2	44.6	34.2
Business fixed investment	3.2	-8.3	8.3	9.2	6.1	4.7	4.2	2.8	1.4	1.3	37.0	20.0	28.3	9.8
Producers' durable equipment	2.7	-6.7	8.6	12.3	5.4	4.9	4.9	3.5	2.2	2.1	34.7	24.3	31.2	12.7
Nonresidential structures	.5	-1.6	-.3	-3.1	.8	-.2	-.7	-.7	-.8	-.8	2.3	-4.3	-2.9	-3.0
Residential structures	.9	3.0	-2.5	-7.0	1.2	4.0	.1	.0	.0	.1	-8.4	6.2	-4.3	.3
Change in business inventories	16.0	-19.2	6.2	-2.5	-4.3	-1.4	4.0	2.4	4.1	-1.4	77.4	-38.3	-2.0	9.1
Nonfarm	11.8	-5.3	-15.0	2.7	-7.3	-1.4	5.5	2.6	4.4	-.9	66.5	-23.7	-21.0	11.6
Farm	4.3	-13.9	21.2	-5.2	3.0	.0	-1.5	-.2	-.3	-.5	10.9	-14.6	19.0	-2.5
Net exports	-2.3	1.1	18.8	2.4	-4.6	2.6	-9.3	-.7	2.0	5.1	25.6	36.0	19.2	-2.8
Exports	12.2	19.5	18.3	15.4	6.4	12.7	.0	8.2	9.5	11.4	77.6	67.3	52.8	29.1
Imports	14.6	18.3	-.6	13.1	11.0	10.0	9.3	8.9	7.5	6.2	52.0	31.3	33.6	31.9
Government purchases	-7.1	30.5	-6.7	7.9	-.7	-1.1	2.8	2.4	-.7	1.7	16.1	14.3	-.5	6.2
Federal	-8.1	24.1	-8.4	5.8	-3.0	-3.4	.6	.1	-3.1	-.7	2.5	-1.0	-8.9	-3.1
Defense	-3.7	2.8	-7.2	1.7	-3.6	-3.6	-1.7	-1.7	-2.3	-1.5	10.9	-5.1	-12.7	-7.2
Nondefense	-4.4	21.3	-1.2	4.0	.7	.2	2.3	1.8	-.8	.8	-8.4	4.1	3.8	4.1
State and local	1.0	6.4	1.7	2.1	2.3	2.3	2.2	2.3	2.4	2.4	13.6	15.3	8.4	9.3

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1988a	FY1989p			FY1990p			FRB Staff Projection								
		Admin ¹		FRB Staff	Admin ¹		FRB Staff	1988 IVa	Ia	1989		1990				
		CBO ²		CBO ²				IIa	III	IV	I	II	III	IV		
Not seasonally adjusted																
BUDGET																
Budget receipts ³	909	996	983	993	1080	1069	1069	222	220	308	244	228	248	329	265	249
Budget outlays ³	1064	1144	1142	1162	1179	1215	1179	289	280	285	306	295	297	298	290	314
Surplus/deficit (-) to be financed ³	-155	-148	-159	-168	-99	-146	-110	-68	-61	23	-63	-66	-49	31	-25	-64
(On-budget)	-194	-202	-215	-221	-164	-214	-176	-73	-77	0	-70	-76	-69	8	-40	-74
(Off-budget)	39	53	56	53	65	68	66	6	16	23	8	9	19	23	15	10
Means of financing:																
Borrowing	162	n.a.	n.a.	143	n.a.	n.a.	107	54	38	10	41	67	27	-1	15	62
Cash decrease	-8	n.a.	n.a.	13	n.a.	n.a.	-3	11	19	-29	12	4	12	-25	5	10
Other ⁴	1	n.a.	n.a.	13	n.a.	n.a.	6	3	4	-4	9	-5	10	-5	6	-8
Cash operating balance, end of period	44	n.a.	n.a.	32	n.a.	n.a.	35	34	15	44	32	27	15	40	35	25
Seasonally adjusted annual rates																
NIPA FEDERAL SECTOR																
Receipts	958	n.a.	1037	1034	n.a.	1133	1112	995	1036	1051	1055	1072	1107	1124	1145	1162
Expenditures	1103	n.a.	1177	1188	n.a.	1255	1245	1162	1184	1198	1209	1216	1245	1257	1262	1276
Purchases	377	n.a.	395	404	n.a.	416	413	406	399	404	407	405	415	418	416	417
Defense	297	n.a.	302	300	n.a.	311	300	301	299	302	300	297	301	301	300	299
Nondefense	80	n.a.	93	104	n.a.	105	114	106	100	102	107	108	113	117	116	117
Other expend.	726	n.a.	782	784	n.a.	839	831	756	785	794	802	811	830	839	846	859
Surplus/deficit	-145	n.a.	-140	-154	n.a.	-122	-133	-168	-148	-147	-154	-144	-138	-133	-117	-114
FISCAL INDICATOR ⁵																
Fiscal impetus measure (FI), percent	.2 *	n.a.	n.a.	-4.1 *	n.a.	n.a.	-7.3 *	1	-2.7	-.1	-.7	-3.1	-3.7	-.1	-1	-2

a--actual

p--projection

*--calendar year

n.a.--not available

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

1. The Administration figures are from the Mid-Session Review of the Budget (July 18, 1989), which incorporates the Bipartisan Budget Agreement but does not include on-budget RTC spending in FY1989.
2. The CBO figures are baseline budget estimates from An Analysis of President Reagan's Budgetary Proposals for Fiscal Year 1990 (February 1989). New CBO estimates will be released August 17, 1989.
3. Budget receipts, outlays, and surplus/deficit include social security (OASDI) receipts, outlays and surplus, respectively. The OASDI surplus is excluded from the "on-budget" deficit and shown separately as "off-budget", as classified under current law.
4. Other means of financing are checks issued less checks paid, accrued items and changes in other financial assets and liabilities.
5. FI is the weighted difference of discretionary federal spending and tax changes (in 1982 dollars), scaled by real federal purchases. For FI, (-) indicates restraint. Quarterly figures are not at annual rates.

Recent Developments

The federal funds rate fell about 1/2 percentage point over the intermeeting period, in two 1/4-point steps during July. However, most private short-term rates are now down only 1/4 point or less on net, and Treasury bill yields--under some supply pressure--have backed up about 1/4 point since the past FOMC meeting. At least some of the policy easing had been built into money market rates before that meeting. Still, short-term rates had retreated as much as 70 basis points before rebounding in early August when the release of stronger-than-anticipated economic data made market participants less sanguine about the prospects for near-term easing of policy.

Bond yields have edged up slightly on balance since the past FOMC meeting but stand about 15 to 40 basis points above the lows reached in late July. Stock prices, in contrast, are up 5 to 10 percent over the intermeeting period, with major stock indexes either at or near record highs.

The monetary aggregates surged in July. Growth in both M1 and M2 was propelled to double-digit rates of increase by rapid inflows to liquid deposits. Demand deposits appeared to be responding to a higher level of compensating balances induced by the second-quarter slide in interest rates. Households' liquid deposits also were buoyed by lower opportunity costs. In addition, the rapid growth of liquid household deposits may reflect a replenishment of accounts drained to meet the exceptionally large tax payments of last spring. M3 also posted a strong gain last month, though the pickup was less marked than that in M2. Ample inflows of core deposits

restrained the growth of managed liabilities, particularly at thrift institutions, where assets may have contracted again in July.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was signed into law on August 9. This legislation substantially revised the regulation of thrift institutions and empowered a new agency, the Resolution Trust Corporation (RTC), to deal with insolvent thrifts. The RTC is to receive \$18.8 billion from the Treasury before the end of this fiscal year, with the balance of its \$50 billion in total capital to be provided by a \$1.2 billion contribution from the Federal Home Loan Bank System, and by \$30 billion of bonds issued by an off-budget government sponsored agency, the Resolution Funding Corporation (REFCORP).

Business borrowing has been substantial since the past FOMC meeting, reflecting a surge in bank C&I loans. The outstanding commercial paper of nonfinancial firms was about unchanged last month, and gross issuance of investment-grade corporate bonds has faded a bit after a robust June pace. The high-yield bond market has continued to absorb new issues, albeit at wide rate spreads; this market has been troubled recently by prospects that FIRREA-mandated limitations on thrifts' portfolios could reduce investment demand for junk bonds and by investor apprehension about default rates in a slower-growing economy. Spurred by the runup in stock prices, new offerings of equity shares by nonfinancial firms has staged a modest recovery; nevertheless, net retirements of corporate equities appear to be very large in the current quarter because of several major acquisitions.

The federal deficit is likely to surge in the current quarter to \$63 billion, with RTC activity amplifying the seasonal upswing. The Treasury will meet some of this deficit by running down its cash balance. However,

net issuance of marketable securities will leap to some \$38 billion for the quarter, including about \$14 billion in bills.

Agency spreads have remained stable or narrowed a bit since the July FOMC meeting. REFCORP's planned issuance of bonds to finance the thrift bailout, perhaps beginning later this year, had been widely anticipated; and the amount, \$30 billion, was less than the initially proposed \$50 billion. Moreover, agency issuance has slumped of late, largely as a consequence of reduced borrowing by the Federal Home Loan Banks, whose funding needs have been trimmed by thrifts' repayments of advances.

Municipal bond issuance eased in July, to about its first-half pace, reflecting a falloff from June's strong volume of bonds issued for new capital. Refunding issuance tapered off as well, as municipal bond yields dipped only slightly below their June levels.

Lower mortgage rates may have fostered some pickup in home financing, in line with the rebound in single family starts and sales. Real estate lending was strong at banks in July. Mortgage originations and commitments at thrifts were weak in June, but this may at least partly reflect an increase in borrowers' selection of fixed-rate mortgages over the adjustable-rate loans that thrifts prefer to originate and hold. Spreads of most mortgage rates over Treasury yields have widened since earlier in the year; participants in the secondary markets continue to focus on the large supply of mortgage-backed securities held by insolvent and capital-deficient thrift institutions.

Consumer credit growth remained moderate through June. Its revolving credit component did pick up to a 20 percent annual rate of growth in that month. However, the overall expansion of consumer credit was held down by a

slight contraction in auto loans, as sales remained sluggish despite carmakers' incentive programs.

Outlook

The staff economic projection anticipates little change in money market conditions through the forecast period. There may be some tendency for intermediate- and longer-term rates to move up further, however, if, as projected, developments in the economy and policy continue to disappoint investors looking for additional easing in short-term rates.

Business borrowing is likely to slow modestly after the current quarter, though remaining well above its average pace of the first half of 1989. An expected decline in corporate profits relative to investment outlays implies a widening of the basic financing gap of nonfinancial corporations. However, this factor is expected to be offset to a degree by a reduced pace of net equity retirements. The weaker profit picture and more moderate economic growth could maintain the elevated risk premium in the high-yield market, increasing the cost of merger financing.

The current staff assumption is that the cost and availability of home mortgage credit will not suffer much further deterioration as the RTC goes forward with resolutions of insolvent thrift institutions and the thrift industry adapts to tighter capital requirements. The current wide spreads, which also reflect a recent pickup in ARM-to-FRM refinancings, are not anticipated to increase much more, and they should stay well below the peaks of 1986. With mortgage rates now projected to remain appreciably below their recent highs through the forecast horizon, households are expected to borrow somewhat more heavily in the mortgage market during the remainder of this year and next. Other consumer borrowing should about maintain its

recent pace, or edge down a little, in line with the projected moderate growth of consumption.

With FIRREA putting a portion of the cost of the thrift bailout onto the federal budget for this fiscal year, the federal deficit will bulge temporarily. However, growth of Treasury debt is expected to slow appreciably in 1990, as the rest of the bailout moves off budget and deficit-reduction initiatives take hold. Municipal borrowing will be supported by continued investment in infrastructure, though net issuance likely will recede in 1990 as the pace of retirements, associated with both maturing issues and the completion of advance refundings, trends up.

Overall, growth of debt of the domestic nonfinancial sectors is projected to run about 8-1/4 percent this year, reflecting an upward revision to federal borrowing, and to slow somewhat in 1990. The bulk of this slowing is accounted for by the pattern of federal borrowing, with private nonfinancial debt expected to expand at a nearly constant rate.

INTERNATIONAL DEVELOPMENTS

Recent developments

Foreign exchange markets have been relatively quiet during most of the period since the July FOMC meeting. The dollar moved lower on balance through July, along with dollar interest rates. In August, the dollar resumed climbing, in association with a reassessment of the prospects for U.S. economic activity and interest rates. On balance, the weighted average foreign exchange value of the dollar in terms of the other G-10 currencies has risen about 2-1/4 percent since the July FOMC meeting.

Foreign exchange market intervention has been light during most of the period since the July FOMC meeting, particularly when compared with the large scale of dollar sales in the previous intermeeting period. The Desk has sold \$850 million, mostly in mid-August and primarily against yen.

Interest rate differentials between assets denominated in dollars and assets denominated in yen or marks have shown a mixed pattern since the July FOMC meeting: short-term rate differentials generally have narrowed, while long-term rate differentials have widened.

Economic growth slowed significantly in the major foreign industrial countries in the second quarter, following exceptionally

rapid growth in the first quarter. Much of the pattern over the two quarters was attributable to special factors. Industrial production in the second quarter was flat in Japan and fell in Germany, largely because the anticipated April introduction of a sales tax in Japan and a mild winter in Europe had boosted first-quarter growth in Japan and Germany to unsustainable rates. Second-quarter growth in industrial production was sluggish in the United Kingdom and moderately strong in France, Canada, and Italy.

Inflation rates rose slightly on average in these foreign countries during the second quarter, but appear to have been leveling off by the end of the quarter. Some of the acceleration in inflation reflected currency depreciations against the dollar and increases in indirect taxes in Japan and Canada. The slowing at the end of the quarter partly reflected an easing in energy prices.

Recent developments in external accounts abroad have been mixed. Japan, Germany, and Canada recorded smaller trade surpluses in the second quarter, while France had a wider deficit. The trade deficits of the United Kingdom and Italy narrowed, but remained relatively high.

Mexico and its bank advisory committee reached agreement in principle on July 23 on a comprehensive financial package that provides each creditor bank options of principal reduction, interest reduction, and new money. Since the inauguration of President Carlos Menem on July 8, Argentina has begun to implement a stabilization program, including a large devaluation of the austral, hikes in public-sector prices, and a 90-day price freeze. Official reserves have risen in Mexico and Argentina, and short-term interest rates have fallen in those countries

and in Brazil as well. Colombia signed a \$1.65 billion new-money loan on August 10 with its commercial bank creditors; the commercial banks began their signing on July 23. The Philippines has reached substantive agreement with its bank advisory committee on the outlines of a financing package.

In May, the U.S. merchandise trade deficit was \$10.2 billion (seasonally adjusted, census basis, customs valuation), compared with \$8.3 billion (revised) in April. Data for June will be released on August 17 and will be discussed in the Greenbook supplement.

For April/May, the trade deficit was \$111 billion at an annual rate (balance of payments basis), little changed from the first quarter. Exports rose 3 percent in both value and volume in April/May, following strong growth in the final quarter of 1988 and the first quarter of this year. Both the value and volume of imports rose 2 percent in April/May, with the increase in value being accounted for entirely by a rise in the value of oil imports. The value of non-oil imports did not change in April/May, while volume increased about 1 percent. The oil import price averaged \$18.57 in the two-month period.

During the second quarter of 1989, prices of non-oil imports, as measured by the BLS, fell 3.1 percent (annual rate) on average, following increases of 2.2 percent in the first quarter and of nearly 4 percent in the second half of last year. For the year ending in the second quarter of 1989, prices of non-oil imports rose 1.4 percent. The prices of nonagricultural exports climbed 0.7 percent (annual rate) in the second quarter of 1989. For the year ending in the second quarter, the increase was 3.1 percent.

Capital inflows into the United States in the form of net private foreign purchases of U.S. bonds continued in the second quarter, but at a slower pace than in the first quarter. Net purchases of U.S. Treasury securities were less than \$2 billion in the second quarter, while net purchases of U.S. corporate and government agency bonds were more than \$6 billion. Net private foreign purchases of U.S. corporate stocks totaled nearly \$4 billion, mostly in June. Net U.S. purchases of foreign securities exceeded \$6 billion in the second quarter. There was a small inflow reported by banks in the second quarter. In addition, credit extended to U.S. residents by the foreign branches of U.S. banks continued to expand through July.

Official reserve assets in the United States declined substantially in the second quarter. Partial information from the Federal Reserve Bank of New York indicates little further change in foreign G-10 official holdings of dollar assets in July.

Outlook

The staff outlook for U.S. external balances incorporates a path for the dollar that is not much different from that assumed in the June Greenbook. The dollar is expected to decline at a moderate pace throughout the projection period, as progress in reducing the current account deficit stalls and interest rates move higher abroad.

The average U.S. oil import price in the second quarter is estimated to have been \$18.50 per barrel. The oil price is projected to decline to nearly \$17 per barrel in the final quarter of this year and to flatten out at \$17 per barrel during the four quarters of 1990.

World oil production is expected to be somewhat above first-quarter rates over the projection period.

The rates of economic growth and inflation in the major foreign industrial countries are projected to slow on average from their rates in the first half of 1989, but growth is expected to remain above, and inflation below, comparable U.S. rates. Growth in developing countries is expected to be in the range of 3 to 4 percent (annual rate) throughout the projection period, a modest acceleration from its pace in the first half of this year.

The U.S. merchandise trade deficit is projected to weaken over the six quarters ending in the fourth quarter of 1990, from a deficit of about \$110 billion (annual rate) in the first half of this year to a deficit of around \$125 billion in the final half of next year. The current account balance, excluding the influence of capital gains and losses, is expected to follow the course of the trade deficit, moving to nearly \$135 billion in the second half of 1990. Real net exports of goods and services change little on balance over the forecast period. However, with the projected decline in the dollar and slower growth in U.S. domestic demand in 1990, net exports strengthen marginally in the second half of that year.

August 16, 1989

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

	ANNUAL			1988		1989				1990			
	1988	1989-P	1990-P	Q3	Q4	Q1	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current \$, Net	-73.7	-53.8	-63.5	-66.2	-70.8	-54.0	-52.4	-56.5	-52.1	-62.5	-64.8	-64.8	-62.1
Exports of G+S	547.7	626.7	669.7	556.8	579.7	605.6	625.2	630.7	645.4	648.1	661.3	676.1	693.2
Imports of G+S	621.3	680.4	733.1	623.0	650.5	659.6	677.5	687.1	697.4	710.5	725.9	740.8	755.3
Constant 82 \$, Net	-74.9	-54.8	-62.1	-74.9	-73.8	-55.0	-52.6	-57.2	-54.6	-63.8	-64.5	-62.5	-57.4
Exports of G+S	530.1	587.6	618.0	531.9	551.4	569.7	585.1	591.5	604.2	604.2	612.4	622.0	633.3
Imports of G+S	605.0	642.5	680.1	606.9	625.2	624.6	637.7	648.7	658.8	668.1	677.0	684.5	690.7
2. Merchandise Trade Balance 2/	-127.2	-112.0	-125.1	-121.4	-128.1	-110.5	-110.7	-114.8	-111.8	-121.9	-125.4	-126.9	-126.1
Exports	319.3	364.7	386.1	322.4	334.9	354.0	364.6	365.1	375.2	373.9	380.9	389.5	400.2
Agricultural	38.1	41.5	40.7	39.7	39.2	43.5	43.8	39.7	39.1	39.7	40.5	41.0	41.7
Non-Agricultural	281.1	323.2	345.4	282.7	295.8	310.5	320.8	325.4	336.1	334.2	340.4	348.5	358.5
Imports	446.5	476.7	511.2	443.8	463.0	464.5	475.3	479.9	487.0	495.8	506.4	516.4	526.4
Petroleum and Products	39.3	50.6	52.6	39.1	36.9	43.3	54.4	52.9	51.8	52.0	52.5	52.8	53.1
Non-Petroleum	407.2	426.1	458.6	404.7	426.1	421.2	420.9	427.0	435.2	443.8	453.9	463.6	473.2
3. Other Current Account Transactions													
Capital Gains and Losses 3/	-1.0	-5.2	1.6	-11.4	15.8	-14.6	-6.9	0.0	0.8	1.6	1.6	1.6	1.6
Other D.I. Income, Net	32.5	33.4	34.7	33.6	34.3	34.1	31.6	32.9	34.8	34.1	34.0	34.7	35.8
Portfolio Income, Net	-29.3	-36.6	-46.5	-32.6	-32.2	-33.5	-34.3	-37.8	-40.9	-43.3	-45.4	-47.5	-49.6
Other Current Account, Net	-1.6	1.8	5.9	2.4	-4.6	1.8	2.1	2.8	0.4	4.4	6.1	7.4	5.5
4. U.S. Current Account Balance													
Including Capital G/L	-126.5	-118.6	-129.5	-129.4	-114.7	-122.7	-118.2	-116.9	-116.7	-125.1	-129.1	-130.8	-132.8
Excluding Capital G/L	-125.5	-113.4	-131.0	-118.0	-130.6	-108.1	-111.2	-116.9	-117.5	-126.7	-130.7	-132.4	-134.4
5. Foreign Outlook 4/													
Real GNP--Ten Industrial 5/	3.8	3.3	2.6	3.6	3.1	5.9	1.8	2.3	2.6	3.0	2.7	2.6	2.6
Real GNP--NonOPEC LDC 6/	3.6	2.9	3.5	3.2	2.8	2.6	2.8	3.2	3.5	3.7	3.7	3.6	3.5
Consumer Prices--Ten Ind. 5/	2.6	4.0	3.5	2.6	3.8	4.2	6.4	2.6	3.2	3.4	4.5	2.3	2.8

1/ National Income and Product Account data.

2/ International accounts basis.

3/ The net of gains (+) or losses (-) on foreign-currency denominated assets due to their revaluation at current exchange rates and other valuation adjustments.

4/ Percent change, annual rates.

5/ Weighted by multilateral trade-weights of G-10 countries plus Switzerland; prices are not seasonally adjusted.

6/ Weighted by share in NonOPEC LDC GNP.

P/ Projected