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June 27, 1990

## **SUMMARY AND OUTLOOK**

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Prepared for the Federal Open Market Committee

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

Overview

The available evidence portrays a rather lethargic economy at the moment, with production and employment growing more slowly than had been anticipated in the May Greenbook. Even so, labor markets remain quite tight, and though price increases have moderated in the aftermath of the winter burst, the underlying trend of inflation has not slowed. On the fiscal policy front, prospects continue to be unclear, but the staff's sense of the reports surrounding the budget summit is that participants are aiming for larger deficit-reduction packages than those previously included in our forecasts; consequently, the fiscal restraint built into the present projection is somewhat greater than that in May.

All told, our reassessment of the tendencies in aggregate demand and in the policy environment has led us to alter our interest rate outlook, and we now anticipate no significant changes in money market rates over the next eighteen months. Output growth is slower this year than in the last forecast, but faster next year, producing almost the same degree of slack by the end of 1991 as in the May Greenbook.

The uncertainties in this projection extend well beyond the fiscal sphere. Notably, the reduction in credit availability to some businesses and the weakening in real estate values in many parts of the country are restraining aggregate demand, but to a degree that is far from clear. Each of these developments has many dimensions, interrelated in complex ways. They include the response of depository institutions to more rigorous regulatory standards and to capital impairment resulting from loss

provisions and charge-offs. The security markets, too, have become less hospitable to the aggressive leveraging that was the hallmark of corporate finance in the 1980s. Beyond the direct effects these shifts have had on credit supply conditions, the persistent reports of financial problems cannot be a plus for household or business sentiment. Unfortunately, there is no way of translating the information on these phenomena into a comprehensive, quantitative measure of economic impact. The staff forecast implicitly incorporates a larger drag on activity than in the May Greenbook. However, that drag is still well short of what generally is connoted by talk of a "credit crunch," and it eases over the next year in part because borrowers find new credit sources and lenders regain their composure after the initial shock effect of losses and supervisory scrutiny.

#### Near-Term Developments

Data received since the May Greenbook generally have been weaker than expected. Although the unemployment rate has not changed significantly, growth in employment has slowed substantially in recent months. All of the increase in employment this spring was accounted for by temporary Census workers. Private payrolls have leveled off as the result of further declines in manufacturing, job losses in construction, and slower growth in the service-producing sector. Other indicators of production and spending have been correspondingly weak, and real GNP is projected to increase at a 1-1/4 percent annual rate in the second quarter--a downward revision of almost 1 percentage point from that in the May Greenbook. A rebound in auto and truck assemblies accounts for all of the projected growth.

Among the components of aggregate demand, the largest downward adjustment is to personal consumption expenditures, which now are expected

to rise only marginally in the second quarter. This shift primarily reflects the incorporation of the extraordinarily weak April-May retail sales data. To be sure, the statistical character of these data alone invites some skepticism about the latest figures. And although it is possible that a sudden wave of pessimism about employment prospects and personal finances could have induced a sharp cutback in purchases, such tendencies are not obvious outside New England. Moreover, a major retrenchment by consumers probably would have been reflected in other components of expenditure, such as new car sales. Consequently, we have discounted somewhat the latest retail sales figures in putting together our second-quarter consumption forecast, and we have carried through into future quarters only a portion of the recent surprise.

Indicators of business fixed investment have been mixed of late but suggest the likelihood of a small drop in real outlays in the second quarter. On the equipment side, shipments of nondefense capital goods have declined through May, and business purchases of motor vehicles have leveled off. However, orders point to some improvement in real outlays in the third quarter, centered on computers. Nonresidential construction put-in-place was surprisingly buoyant in April, but trends in contracts and permits have been deteriorating noticeably over the past year in response to excess capacity and the tightening of credit availability. Investment in nonresidential structures thus is expected to resume a downtrend in the second quarter, after a warm-weather surge this winter.

Residential construction also has contracted noticeably since the beginning of the year. Housing starts fell to just over 1.21 million units (annual rate) in April and May, the lowest level since the trough of the

1982 recession. Although a payback for the first-quarter spurt likely has been a factor, the recent weakness probably involves more fundamental forces as well. As the downtrend in sales of new and existing homes attests, housing demand has weakened progressively since late last year. Mortgage rates moved up through early May, and a slower pace of house price appreciation (or outright declines in some locales) further reduced the investment motivation for home purchase; difficulty in selling homes has hampered the "trade-up" market. In addition, builders clearly are finding credit harder to get--undoubtedly appropriately in many instances, but still a retardant on activity relative to the financial conditions prevailing previously. Reflecting these influences, real residential investment expenditures are expected to decline at a double-digit pace in both the second and third quarters of 1990, reducing overall GNP growth by more than 1/2 percentage point in each quarter.

The slackening in final demand has come at a time when inventories appear to be in good shape. In manufacturing and wholesale trade, stockbuilding was moderate through April, and inventory-sales ratios have edged down. At the retail level, auto dealers' stocks are relatively low, and though higher third-quarter production schedules may involve some insurance against a UAW strike, carmakers are likely to move quickly to adjust production or incentives if inventories begin to rise. Through April, inventories at other retail establishments generally seemed to be in line with sales. However, if it is not revised away, the decline in retail sales in May suggests that some combination of price reductions, domestic production adjustments, and cutbacks in orders for imported goods may be needed to prevent an inventory overhang. In the forecast, continued tight

control on stocks by businesses is expected to hold inventory investment at modest levels, but after a negative first quarter, stock accumulation adds somewhat to GNP in the second and third quarters.

As expected, consumer price inflation has moderated in the second quarter from the rapid pace early in the year. Food prices have leveled off, as a reversal of the first-quarter runup in vegetable prices was offset by somewhat higher meat prices. Declining prices of natural gas have held down energy prices, but the recent drop in world crude oil prices has been barely felt at the retail level: Shutdowns of refineries for maintenance have caused stocks of products to fall to low levels, and surveys indicate that gasoline prices actually rose appreciably in June. However, as refineries resume normal operations, energy prices are expected to decline in the second half.

The CPI excluding food and energy has decelerated since the first quarter, but the reversal of many early-1990 price hikes has yet to materialize. As a result, the twelve-month change in the CPI excluding food and energy was 4.8 percent in May--at the high end of the range that has prevailed for the past six years. For the next couple of months, increases in the CPI excluding food and energy are expected to average about 0.3 percent; however, somewhat larger increases are likely in August and September, when apparel prices are expected to rise sharply.

#### Longer-Term Outlook

The staff forecast continues to be shaped by the FOMC's stated goal of a reduction in price inflation over time. We continue to believe that, to achieve this objective, additional slack must be created and maintained in labor and product markets. In this projection, the economy is thought to be

somewhat weaker in the near term, in part because of apparently greater direct and indirect effects of the shift in credit conditions and the real estate slump. The likelihood of stronger deficit-reduction action in FY1991 also points to greater restraint on aggregate demand. In consequence, we have altered the assumption about monetary policy, and money market rates remain near current levels rather than rising through early 1991. However, as a result of the lower trajectory for interest rates, the trade-weighted foreign exchange value of the dollar remains near current levels over the forecast horizon rather than appreciating somewhat in the near term. This generates a bit more pressure on prices than in the May Greenbook, but it is not expected to be enough to prevent progress next year in reducing inflation.

Regarding the monetary aggregates, we have interpreted recent information as indicating that the ongoing restructuring of the thrift industry is likely to have a larger depressing effect on both M2 and M3 than previously thought. We now project that, even with the relatively stable interest-rate outlook embodied in our forecast, M2 is likely to remain in the lower portion of its annual range through the rest of the year, with moderate growth continuing in 1991. M3 probably will show only marginal growth over the next year and a half, ending this year well below the lower end of its annual range.

In this environment, real GNP is expected to increase at a 1-1/2 percent annual rate in the second half of 1990 and to grow 2-1/4 percent in 1991. Domestic private final purchases pick up gradually as the depressing effects of weak asset prices and credit constraints lose some of their force in impeding incremental growth. Government spending is restrained by



budgetary pressures, and with little improvement expected in the nation's competitive position, the external sector makes only a small net contribution to the increase in real GNP over the next year and a half. Inventory investment is projected to pick up over time from its recent very low levels--but only to moderate levels, as businesses keep a tight rein on stocks.

As a result of the greater weakness in economic activity in the near term, the unemployment rate now is projected to rise a bit faster in the second half of this year, reaching 5.8 percent by the fourth quarter. Owing to the change in monetary assumptions, output growth is much stronger in 1991 than in the May Greenbook; still, it remains below its potential rate, and the unemployment rate edges above 6 percent by year-end. Given the small changes in the paths of capacity utilization and the unemployment rate, the forecasts of hourly compensation and consumer prices have changed only a little. The consumer price index is projected to rise 4-1/2 percent next year, an improvement of about 1/4 percentage point from its expected performance in 1990.

Consumer spending. Real personal consumption expenditures are projected to rise at about a 1-3/4 percent annual rate in the second half of this year, somewhat less than in the May Greenbook. As suggested above, the downward revision reflects the view that adverse developments in the economy and the financial system probably are affecting consumer spending, but not to the extent that a literal reading of the retail sales data would indicate. Sales of cars and light trucks, absent a strike, are not expected to vary appreciably, but spending on goods other than motor vehicles is forecast to bounce back in the third quarter from its weak second-quarter

pace and then to grow slowly in the fourth quarter. Expenditures on consumer services are projected to continue posting moderate increases.

Consumer spending is expected to pick up slightly over the course of 1991. The increase of about 2 percent projected for next year still is relatively slow by recent historical standards, but it exceeds the modest growth projected in real disposable income. In effect, we are assuming that, as the worst fears of economic weakness and declining property values ebb, improving consumer confidence also will induce some retracing of the recent runup in the personal saving rate.

Business fixed investment. After declining in the second quarter, real business fixed investment is expected to grow at a 2 percent annual rate in the second half of this year. All of this small bounceback occurs in equipment spending, whereas nonresidential construction is projected to weaken further. Computers and aircraft appear likely to lead the gains in equipment, although purchases of heavy trucks may increase toward year-end as transport companies attempt to avoid 1991 emission standards. Office and other commercial structures should be the areas of greatest weakness in construction.

Business investment is projected to accelerate little over the course of 1991, owing to falling rates of capacity utilization and weak profitability. Computer purchases are expected to trend upward in real terms but at a relatively slow pace compared with recent years. Apart from computers, slow growth is expected in the other components of producers' durable equipment. The correction in nonresidential construction is projected to continue in 1991, as industrial building decelerates markedly, while the office and commercial sectors remain weak.

Housing. Residential construction is expected to remain at low levels in this forecast, below what probably would be consistent in the longer run with underlying demographic conditions. Slow income growth, rising unemployment, and high real borrowing costs (measured against weak trends in house prices) are likely to damp demand throughout most of the projection period. A modest improvement in construction is forecast for 1991, however, as some of the current excess supply is absorbed and homebuilders establish new credit sources to replace those lost because of FIRREA restrictions.<sup>1</sup>

Government spending. Fiscal policy is expected to be moderately restrictive over the forecast period. The staff now is assuming a \$35 billion deficit-reduction package in FY1991, \$5 billion more than in the May Greenbook. The assumed package consists of \$13 billion in additional revenues and \$22 billion in expenditure cuts. Real federal purchases are projected to decline at a 3-1/2 percent annual rate in the second half of this year and 2-1/4 percent in 1991; lower defense expenditures more than account for the drop.

On a unified basis, the federal deficit now is expected to rise to \$217 billion in the current fiscal year; about half the \$21 billion upward revision from the May Greenbook reflects higher spending by the Resolution Trust Corporation (RTC). The further rise in the deficit will necessitate

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1. The Office of Thrift Supervision this week announced plans to allow the best-capitalized thrifts until 1992 to achieve full compliance with the limits on loans to one borrower established by FIRREA. The approximately 1200 institutions, with \$215 billion in assets (17 percent of the industry total), that already meet the 1995 capital standards will be allowed to lend up to 60 percent of capital to one borrower this year, and 30 percent next year, before reaching FIRREA's 15 percent limit in 1992. While undoubtedly increasing the availability of construction credit to some builders, this narrowly targeted action is not expected to change overall market conditions significantly.

legislation to raise the federal debt ceiling in July or early August, and the Congress conceivably could use that opportunity to amend the Gramm-Rudman law. Whether then or later, it now seems clear that Gramm-Rudman ultimately will have to be revised. The assumption in this forecast is that, while the change may well be part of a multiyear budget plan, it will not lock in deficit reduction with such certainty that it prompts a major shift in bond-market expectations.

In the state and local sector, real expenditures are expected to grow at a 1-3/4 percent pace over the next year and a half. This projection anticipates that states and municipalities will continue to invest in infrastructure improvements, educational facilities, and prisons despite significant budgetary pressures. Taxes, mainly corporate and sales, are likely to be boosted, but the state and local budget deficit (excluding social insurance funds) still is expected to be about \$30 billion at an annual rate in the second half of 1991--versus \$45 billion in the first quarter of this year.

Exports and imports. The external sector is expected to make only a small net contribution to real GNP growth in the current forecast. Exports of nonagricultural goods are projected to grow substantially over the next year and a half, but growth in exports of agricultural commodities in 1991 is projected to be less than in 1990. Merchandise imports are expected to be weak in the near term as a result of the overall sluggishness of the economy, but they pick up as growth revives next year. A more detailed discussion of these trends can be found below in the International Developments section.

Labor costs and prices. The staff continues to expect that a widening margin of slack in the economy will induce a deceleration in wages and prices by 1991. In this forecast, manufacturing capacity utilization falls from 83 percent in May to 81-1/2 percent in the fourth quarter of next year. In the labor market, we have assumed that the recent flatness of the unemployment rate in the face of slow output and employment gains is a combination of statistical noise and normal, short-run labor-force and productivity variations. Thus, the jobless rate still is expected to reach 6 percent by the second half of 1991.

With such a path for the unemployment rate--and barring unforeseen shocks to prices--wage inflation should peak in the near term and begin to ease gradually in 1991. As measured by the employment cost index, hourly compensation is projected to increase about 5 percent this year before decelerating to a 4-3/4 percent pace in 1991.<sup>2</sup> With labor costs growing more slowly and prices of non-oil imports expected to decelerate, price pressure should ease in coming quarters. As noted previously, consumer prices are projected to decelerate 1/4 percentage point in 1991 and the same is true of fixed-weight GNP prices. Assuming that real GNP were to grow a bit below its potential rate in 1992, causing the unemployment rate to edge up to 6-1/4 percent, the underlying rate of inflation would be expected to fall roughly another 1/4 percentage point.

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2. Increases in employer contributions for social insurance and in the minimum wage add 0.2 percentage point to the rise in hourly compensation next year, after a 0.3 percentage point effect in 1990.

June 27, 1990

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## STAFF GNP PROJECTIONS

Percent changes, annual rate

		Nominal GNP		Real GNP		GNP fixed-weight price index		Consumer Price Index <1>		Unemployment rate (percent)	
		5/9/90	6/27/90	5/9/90	6/27/90	5/9/90	6/27/90	5/9/90	6/27/90	5/9/90	6/27/90
<b>Annual changes:</b>											
1987	<2>	6.9	6.9	3.7	3.7	3.6	3.6	3.7	3.7	6.2	6.2
1988	<2>	7.9	7.9	4.4	4.4	4.2	4.2	4.1	4.1	5.5	5.5
1989	<2>	7.2	7.2	3.0	3.0	4.5	4.5	4.8	4.8	5.3	5.3
1990		6.4	6.0	2.0	1.7	4.5	4.4	4.9	4.8	5.5	5.5
1991		5.9	6.1	1.6	1.9	4.2	4.1	4.3	4.3	6.0	5.9
<b>Quarterly changes:</b>											
1988	Q1 <2>	6.5	6.5	4.0	4.0	3.8	3.8	3.5	3.5	5.7	5.7
	Q2 <2>	8.6	8.6	3.7	3.7	4.8	4.8	4.2	4.2	5.5	5.5
	Q3 <2>	7.5	7.5	3.2	3.2	5.2	5.2	5.2	5.2	5.5	5.5
	Q4 <2>	7.5	7.5	2.7	2.7	4.3	4.3	4.1	4.1	5.3	5.3
	Q1 <2>	7.9	7.9	3.7	3.7	4.8	4.8	5.4	5.4	5.2	5.2
	Q2 <2>	7.1	7.1	2.5	2.5	5.0	5.0	6.0	6.0	5.3	5.3
	Q3 <2>	6.2	6.2	3.0	3.0	2.9	2.9	2.9	2.9	5.3	5.3
	Q4 <2>	4.6	4.6	1.1	1.1	3.6	3.6	3.9	3.9	5.3	5.3
1990	Q1 <2>	7.8	7.1	2.1	1.9	6.5	6.4	8.2	8.2	5.2	5.2
	Q2	6.8	5.8	2.2	1.3	4.3	4.2	3.3	3.3	5.4	5.4
	Q3	6.0	5.7	2.0	1.6	3.7	3.6	3.8	3.7	5.5	5.6
	Q4	6.1	5.3	1.8	1.6	4.1	3.8	4.3	4.1	5.6	5.8
1991	Q1	6.3	6.7	1.5	1.8	4.7	4.7	4.6	4.6	5.7	5.8
	Q2	5.2	6.4	1.1	2.1	4.1	4.2	4.4	4.5	5.9	5.9
	Q3	5.3	6.3	1.4	2.3	3.9	4.1	4.3	4.4	6.1	6.0
	Q4	5.5	6.2	1.7	2.4	3.9	4.0	4.3	4.4	6.2	6.1
<b>Two-quarter changes: &lt;3&gt;</b>											
1988	Q2 <2>	7.5	7.5	3.9	3.9	4.2	4.2	3.9	3.9	-.3	-.3
	Q4 <2>	7.5	7.5	2.9	2.9	4.8	4.8	4.6	4.6	-.2	-.2
1989	Q2 <2>	7.5	7.5	3.1	3.1	5.0	5.0	5.7	5.7	.0	.0
	Q4 <2>	5.4	5.4	2.0	2.0	3.3	3.3	3.4	3.4	.0	.0
1990	Q2	7.3	6.5	2.2	1.6	5.4	5.2	5.7	5.7	.1	.1
	Q4	6.0	5.5	1.9	1.6	3.9	3.7	4.1	3.9	.2	.4
1991	Q2	5.7	6.5	1.3	2.0	4.4	4.4	4.5	4.5	.3	.1
	Q4	5.4	6.2	1.6	2.4	3.9	4.0	4.3	4.4	.3	.2
<b>Four-quarter changes: &lt;4&gt;</b>											
1987	Q4 <2>	8.6	8.6	5.4	5.4	4.0	4.0	4.5	4.5	-1.0	-1.0
1988	Q4 <2>	7.5	7.5	3.4	3.4	4.5	4.5	4.3	4.3	-.5	-.5
	Q4 <2>	6.4	6.4	2.6	2.6	4.1	4.1	4.6	4.6	.0	.0
	Q4	6.7	6.0	2.1	1.6	4.6	4.4	4.9	4.8	.3	.5
	Q4	5.6	6.4	1.5	2.2	4.2	4.2	4.4	4.5	.6	.3

&lt;1&gt; For all urban consumers.

&lt;2&gt; Actual.

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

&lt;4&gt; Percent change from four quarters earlier.

June 27, 1990

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

	Units									Projection	
		1983	1984	1985	1986	1987	1988	1989	1990	1991	
<b>EXPENDITURES</b>											
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Nominal GNP	Billions of \$	3405.7	3772.2	4014.9	4231.6	4524.3	4880.6	5234.0	5547.5	5886.8	
Real GNP	Billions of 82\$	3279.1	3501.4	3618.7	3717.9	3853.7	4024.4	4144.1	4216.6	4295.8	
Real GNP	Percent change*	6.5	5.1	3.6	1.9	5.4	3.4	2.6	1.6	2.2	
Gross domestic purchases		8.4	6.4	4.3	2.1	4.6	2.4	1.9	1.0	1.9	
Final sales		3.7	4.7	4.6	2.7	3.3	4.4	2.5	1.9	1.9	
Private dom. final purchases		7.7	5.6	4.6	2.9	2.7	3.8	2.1	1.2	1.9	
Personal consumption expend.		5.4	4.1	4.6	3.8	2.2	3.8	2.5	1.5	1.9	
Durables		14.7	10.8	7.0	11.5	-2.0	8.0	.0	2.2	1.6	
Nondurables		4.4	2.3	3.3	2.9	1.1	2.1	1.0	-1.0	.6	
Services		3.9	3.5	5.0	2.1	4.4	3.6	4.4	2.9	2.9	
Business fixed investment		10.8	13.8	3.7	-5.5	8.5	4.2	3.7	2.3	1.8	
Producers' durable equipment		20.9	14.9	4.6	.4	11.1	7.0	5.2	3.4	3.8	
Nonresidential structures		-4.8	11.8	1.9	-17.7	1.9	-3.4	-.9	-1.4	-5.0	
Residential structures		38.1	6.1	5.8	11.6	-4.2	3.2	-7.0	-5.2	2.1	
Exports		5.8	5.9	-2.4	10.6	19.1	13.9	10.0	6.4	7.1	
Imports		23.8	17.4	4.5	10.0	9.6	5.3	4.6	1.9	5.1	
Government purchases		-2.7	7.9	8.6	3.1	2.1	1.8	.5	1.2	.2	
Federal		-8.1	13.0	13.3	.5	.7	-.3	-3.1	-.1	-2.2	
Defense		5.1	6.5	7.1	6.0	4.3	-1.9	-2.3	-4.0	-4.5	
State and local		1.5	4.4	4.9	5.2	3.1	3.4	3.1	2.1	1.8	
Change in business inventories	Billions of 82\$	-6.4	62.3	9.1	5.6	23.7	27.9	21.9	6.4	20.7	
Nonfarm	Billions of 82\$	-.1	57.8	13.4	8.0	25.8	30.7	17.7	3.7	18.6	
Net exports	Billions of 82\$	-19.9	-84.0	-104.3	-129.7	-115.7	-74.9	-52.6	-27.9	-15.3	
Nominal GNP	Percent change*	10.4	8.6	6.6	4.6	8.6	7.5	6.4	6.0	6.4	
<b>EMPLOYMENT AND PRODUCTION</b>											
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Nonfarm payroll employment	Millions	90.2	94.5	97.5	99.5	102.2	105.6	108.6	110.5	111.3	
Unemployment rate	Percent	9.6	7.5	7.2	7.0	6.2	5.5	5.3	5.5	5.9	
Industrial production index	Percent change*	11.3	4.7	1.9	1.4	6.5	4.5	1.1	2.0	2.2	
Capacity utilization rate-mfg.	Percent	74.9	80.4	79.5	79.0	81.4	83.9	83.9	82.6	81.6	
Housing starts	Millions	1.70	1.75	1.74	1.81	1.62	1.49	1.38	1.26	1.25	
Auto sales	Millions	9.19	10.35	11.03	11.45	10.23	10.65	9.89	9.54	9.28	
Domestic	Millions	6.82	7.92	8.22	8.22	7.06	7.55	7.06	6.82	6.80	
Foreign	Millions	2.37	2.43	2.82	3.23	3.18	3.10	2.83	2.71	2.48	
<b>INCOME AND SAVING</b>											
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Nominal personal income	Percent change*	7.8	8.4	6.6	5.8	8.6	7.1	8.4	6.7	6.7	
Real disposable income	Percent change*	5.1	4.3	2.7	3.3	3.0	4.0	3.6	1.4	1.6	
Personal saving rate	Percent	5.4	6.1	4.4	4.1	3.2	4.2	5.4	5.8	5.4	
Corp. profits with IVA & CCAdj	Percent change*	70.1	7.4	9.2	-5.6	12.0	10.4	-16.0	3.0	-2.6	
Profit share of GNP	Percent	6.3	7.1	7.0	6.7	6.6	6.7	5.8	5.3	5.0	
Federal govt. surplus/deficit	Billions of \$	-176.0	-169.6	-196.9	-206.9	-161.4	-145.8	-148.5	-153.0	-109.9	
State and local govt. surplus		47.5	64.6	65.1	62.8	51.3	49.7	44.0	40.7	55.9	
Exc. social insurance funds		4.4	19.8	13.8	5.6	-12.4	-21.4	-34.1	-43.9	-34.7	
<b>PRICES AND COSTS</b>											
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GNP implicit deflator	Percent change*	3.6	3.4	2.9	2.6	3.0	4.0	3.7	4.3	4.1	
GNP fixed-weight price index		3.9	3.7	3.3	2.6	4.0	4.5	4.1	4.4	4.2	
Cons. & fixed invest. prices		3.3	3.3	3.4	2.5	4.7	4.2	4.4	4.5	4.3	
CPI		3.2	4.2	3.5	1.3	4.5	4.3	4.6	4.8	4.5	
Exc. food and energy		4.2	5.0	4.3	3.9	4.3	4.5	4.3	5.0	4.5	
ECI hourly compensation		5.7	4.9	3.9	3.2	3.3	4.8	4.8	5.1	4.7	
Nonfarm business sector											
Output per hour		3.4	1.5	1.6	1.3	2.4	1.6	.7	.4	1.5	
Compensation per hour		3.1	4.2	4.6	5.0	4.0	4.8	5.5	5.2	4.7	
Unit labor costs		-.4	2.6	3.0	3.6	1.5	3.1	4.8	4.9	3.2	

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

June 27, 1990

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

	Units	Projection									
		1989		1990				1991			
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<b>EXPENDITURES</b>											
Nominal GNP	Billions of \$	5281.0	5340.2	5433.1	5510.5	5586.8	5659.7	5751.9	5841.8	5932.0	6021.5
Real GNP	Billions of \$2\$	4162.9	4174.1	4193.4	4207.2	4224.4	4241.4	4260.8	4282.7	4306.9	4332.8
Real GNP	Percent Change	3.0	1.1	1.9	1.3	1.6	1.6	1.8	2.1	2.3	2.4
Gross domestic purchases		3.5	.1	.5	1.0	1.3	1.0	1.7	2.0	1.8	1.9
Final sales		2.7	1.1	4.4	.3	1.2	1.6	1.4	1.5	2.2	2.3
Private dom. final purchases		4.7	-5	2.9	-5	1.2	1.4	1.6	1.8	2.1	2.1
Personal consumption expend.		5.6	.5	1.6	.6	2.0	1.7	1.7	1.9	2.0	2.1
Durables		11.3	-14.0	14.1	-4.6	-3	.5	.0	1.7	2.2	2.3
Nondurables		5.0	.1	-3.4	-2.9	2.0	.6	.6	.6	.6	.6
Services		4.3	5.9	1.3	4.8	2.6	2.9	2.9	2.9	2.8	3.0
Business fixed investment		5.2	-5.4	7.7	-2.1	2.5	1.4	1.5	1.5	2.0	2.0
Producers' durable equipment		4.6	-6.9	7.1	-1.7	5.0	3.5	3.5	3.5	4.0	4.0
Nonresidential structures		8.0	-3	9.6	-3.7	-5.3	-5.3	-5.1	-5.0	-4.9	-4.9
Residential structures		-9.2	-1.1	9.7	-11.7	-13.3	-3.8	1.0	.6	3.5	3.4
Exports		3.9	9.4	12.8	-1.2	6.5	8.1	6.8	6.5	7.5	7.6
Imports		7.4	2.2	3.0	-2.9	3.8	3.8	5.8	5.9	4.4	4.3
Government purchases		-2.4	2.6	3.4	2.2	-4	-6	.1	.1	.3	.2
Federal		-8.4	-3.3	2.3	4.8	-3.2	-4.0	-2.3	-2.5	-1.9	-2.1
Defense		6.9	-6.6	-1.9	-4.8	-4.5	-4.7	-4.3	-4.9	-4.4	-4.5
State and local		2.2	6.8	4.3	.5	1.7	1.8	1.8	1.8	1.8	1.8
Change in business inventories	Billions of \$2\$	21.9	22.2	-3.6	6.9	11.2	11.2	15.5	21.2	22.2	23.9
Nonfarm	Billions of \$2\$	16.2	18.0	-7.8	4.4	8.3	10.0	14.0	19.2	19.9	21.3
Net exports	Billions of \$2\$	-57.1	-47.2	-33.6	-30.6	-26.9	-20.6	-19.4	-18.7	-14.1	-8.8
Nominal GNP	Percent change	6.2	4.6	7.1	5.8	5.7	5.3	6.7	6.4	6.3	6.2
<b>EMPLOYMENT AND PRODUCTION</b>											
Nonfarm payroll employment	Millions	108.9	109.4	110.2	110.5	110.6	110.7	110.9	111.2	111.5	111.6
Unemployment rate	Percent*	5.3	5.3	5.2	5.4	5.6	5.8	5.8	5.9	6.0	6.1
Industrial production index	Percent change	-1.2	.2	.7	4.4	1.8	1.0	1.4	2.2	2.4	2.8
Capacity utilization rate-mfg.	Percent*	83.7	82.9	82.7	82.8	82.6	82.2	81.8	81.7	81.5	81.5
Housing starts	Millions	1.34	1.35	1.45	1.21	1.21	1.23	1.24	1.25	1.26	1.27
Auto sales	Millions	10.18	9.09	10.00	9.40	9.40	9.35	9.25	9.25	9.30	9.30
Domestic	Millions	7.36	6.56	7.11	6.68	6.75	6.75	6.75	6.75	6.85	6.85
Foreign	Millions	2.83	2.53	2.90	2.71	2.65	2.60	2.50	2.50	2.45	2.45
<b>INCOME AND SAVING</b>											
Nominal personal income	Percent change	5.2	7.3	9.4	5.8	5.0	6.5	7.5	6.3	6.0	7.1
Real disposable income	Percent change	4.4	2.4	2.5	1.6	.2	1.5	2.0	1.2	1.0	2.2
Personal saving rate	Percent*	5.1	5.6	5.8	6.0	5.6	5.6	5.7	5.5	5.3	5.3
Corp. profits with IVA & CCAdj	Percent change	-15.4	-12.0	5.4	11.1	5.1	-8.7	-1.6	-.3	-1.0	-7.3
Profit share of GNP	Percent*	5.6	5.4	5.3	5.4	5.4	5.2	5.1	5.0	4.9	4.8
Federal govt. surplus/deficit	Billions of \$	-144.7	-156.5	-170.9	-162.6	-142.3	-136.3	-125.2	-114.1	-99.3	-100.9
State and local govt. surplus		44.9	34.7	37.4	39.0	41.7	44.5	47.3	53.1	58.3	64.8
Exc. social insurance funds		-34.3	-45.7	-44.9	-44.8	-43.6	-42.3	-41.0	-36.7	-33.0	-28.0
<b>PRICES AND COSTS</b>											
GNP implicit deflator	Percent change	3.2	3.2	5.4	4.3	3.9	3.6	4.7	4.2	3.9	3.7
GNP fixed-weight price index		2.9	3.6	6.4	4.2	3.6	3.8	4.7	4.2	4.1	4.0
Cons. & fixed invest. prices		2.3	4.4	6.7	3.6	3.5	4.2	4.4	4.3	4.2	4.2
CPI		2.9	3.9	8.2	3.3	3.7	4.1	4.6	4.5	4.4	4.4
Exc. food and energy		3.8	4.4	6.2	4.7	4.7	4.4	4.6	4.6	4.5	4.4
ECI hourly compensation**		4.9	5.0	5.8	5.2	4.7	4.7	4.9	5.1	4.5	4.4
Nonfarm business sector											
Output per hour		2.4	.5	-2.7	1.1	1.4	1.4	1.5	1.5	1.5	1.4
Compensation per hour		5.3	6.0	4.1	5.9	5.2	5.6	3.5	5.6	4.6	5.0
Unit labor costs		2.8	5.5	7.0	4.7	3.7	4.1	2.0	4.0	3.1	3.6

\* Not at an annual rate.

\*\* Private industry workers; seasonally adjusted by Board staff.



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

June 27, 1990

	Projection										Projection			
	1989		1990				1991				1988	1989	1990	1991
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	(fourth quarter to fourth quarter, net change)			
Real GNP	30.4	11.2	19.3	13.8	17.2	17.0	19.4	22.0	24.2	25.9	133.8	104.7	67.3	91.4
Gross domestic purchases	36.3	1.3	5.7	10.8	13.5	10.7	18.3	21.2	19.5	20.7	97.8	78.1	40.6	79.7
Final sales	27.5	10.9	45.1	3.3	12.9	17.0	15.1	16.3	23.2	24.2	172.0	100.9	78.3	78.7
Private dom. final purchases	38.4	-4.1	24.6	-4.3	10.0	11.9	13.7	15.4	17.9	18.5	121.7	70.3	42.2	65.5
Personal consumption expend.	36.4	3.6	10.6	4.3	13.2	11.8	11.3	13.1	13.8	14.4	95.4	66.0	39.8	52.6
Durables	11.5	-16.1	14.1	-5.1	-.3	.6	.0	1.9	2.3	2.5	31.1	-.2	9.2	6.7
Nondurables	11.1	.3	-7.9	-6.7	4.5	1.4	1.3	1.4	1.5	1.5	19.1	9.1	-8.8	5.6
Services	13.9	19.3	4.5	16.1	9.0	9.8	10.0	9.9	10.0	10.4	45.2	57.0	39.4	40.3
Business fixed investment	6.5	-7.1	9.6	-2.7	3.2	1.8	1.9	2.0	2.6	2.7	20.0	18.1	11.9	9.3
Producers' durable equipment	4.4	-7.0	6.8	-1.7	4.8	3.5	3.5	3.5	4.1	4.1	24.3	19.3	13.4	15.2
Nonresidential structures	2.3	-.1	2.8	-1.2	-1.7	-1.6	-1.5	-1.5	-1.4	-1.4	-4.3	-1.1	-1.6	-5.9
Residential structures	-4.5	-.5	4.3	-5.8	-6.4	-1.7	.4	.3	1.5	1.5	6.2	-13.8	-9.6	3.7
Change in business inventories	2.8	.3	-25.8	10.5	4.3	.0	4.3	5.7	1.0	1.7	-38.3	3.9	-11.0	12.7
Nonfarm	-3.3	1.8	-25.8	12.2	3.9	1.7	4.0	5.2	.7	1.4	-23.7	-13.9	-8.0	11.3
Farm	6.1	-1.4	.0	-1.7	.4	-1.7	.3	.5	.3	.3	-14.6	17.8	-3.0	1.4
Net exports	-5.9	9.9	13.6	3.0	3.7	6.3	1.2	.7	4.6	5.2	36.0	26.6	26.6	11.7
Exports	5.6	13.5	18.5	-1.8	9.8	12.4	10.6	10.5	12.1	12.6	67.3	55.2	38.9	45.8
Imports	11.5	3.6	4.9	-4.8	6.1	6.1	9.5	9.7	7.5	7.4	31.3	28.6	12.3	34.1
Government purchases	-5.0	5.1	6.9	4.5	-.8	-1.2	.2	.1	.7	.5	14.3	4.0	9.4	1.5
Federal	-7.5	-2.8	1.9	3.9	-2.8	-3.4	-2.0	-2.1	-1.5	-1.8	-1.0	-10.6	-.4	-7.3
Defense	4.3	-4.4	-1.2	-3.1	-2.9	-3.0	-2.7	-3.0	-2.7	-2.7	-5.1	-5.9	-10.2	-11.1
Nondefense	-11.8	1.7	3.0	7.0	.1	-.4	.7	.9	1.2	.9	4.1	-4.6	9.7	3.8
State and local	2.5	7.8	5.1	.6	2.0	2.2	2.2	2.2	2.2	2.2	15.3	14.5	9.9	8.8

FEDERAL OR ACCOUNTS<sup>1</sup>  
(Billions of dollars)

	Fiscal years				1989				1990				1991			
	1988a	1989a	1990	1991	Ia	IIa	IIIa	IVa	Ia	II	III	IV	I	II	III	IV
<b>BUDGET</b>	Not seasonally adjusted															
Budget receipts <sup>2</sup>	908	991	1043	1132	219	308	242	229	230	322	263	246	258	345	282	264
Budget outlays <sup>2</sup>	1063	1143	1260	1318	280	285	288	299	310	339	312	346	329	324	320	344
Surplus/deficit (-) <sup>2</sup>	-155	-152	-217	-186	-61	23	-46	-71	-80	-17	-49	-99	-71	22	-37	-80
(On-budget)	-194	-204	-275	-259	-77	0	-54	-77	-94	-41	-63	-108	-92	-5	-55	-90
(Off-budget)	39	53	58	74	16	23	7	6	14	24	14	8	22	26	17	9
Surplus excluding RTC spending <sup>3</sup>	-155	-143	-157	-116	-61	23	-37	-65	-77	14	-29	-79	-52	38	-23	-68
<b>Means of financing:</b>																
Borrowing	166	140	243	175	38	10	39	63	90	40	49	81	52	13	29	73
Cash decrease	-8	3	-5	11	19	-29	3	14	8	-14	-14	26	5	-30	10	10
Other <sup>4</sup>	-3	8	-20	-1	4	-4	5	-7	-18	-10	14	-8	13	-4	-2	-2
Cash operating balance, end of period	44	41	46	35	15	44	41	27	19	32	46	20	15	45	35	25
<b>NIPA FEDERAL SECTOR</b>	Seasonally adjusted annual rates															
Receipts	958	1032	1093	1183	1036	1053	1043	1056	1085	1104	1126	1145	1178	1197	1213	1231
Expenditures	1103	1183	1251	1302	1184	1199	1188	1213	1256	1266	1268	1282	1303	1311	1313	1332
Purchases	377	404	415	423	399	406	403	405	414	421	419	418	424	424	425	425
Defense	297	302	305	303	299	301	308	301	309	307	305	303	306	303	302	300
Nondefense	80	101	109	119	100	105	95	104	105	114	115	115	119	121	123	125
Other expend.	726	780	836	879	785	793	785	808	842	846	849	864	879	886	888	908
Surplus/deficit	-145	-151	-158	-119	-148	-145	-145	-157	-171	-163	-142	-136	-125	-114	-99	-101
<b>FISCAL INDICATORS<sup>5</sup></b>																
High-employment (HEB) surplus/deficit (-)	-150	-167	-163	-103	-165	-162	-162	-168	-180	-165	-139	-127	-111	-96	-77	-76
Change in HEB, percent of potential GNP	.3	.4	-.1	-1.1	-.3	-.1	.0	.1	.2	-.3	-.5	-.2	-.3	-.3	-.3	.0
Fiscal impetus measure (FI), percent	.2 *	-3.4 *	-5.6 *	-5.2 *	-2.7	-.2	.5	-2.3	-2.3	-.7	-.9	-2.2	-2.1	-.5	-.5	-1.3

a--actual

\*--calendar year

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

- Staff projections. The FY1990 and FY1991 deficits in OMB's FY1991 Budget (January 1990) are \$124 billion and \$63 billion, respectively. These estimates incorporate approximately \$39 billion of cuts from the adjusted Gramm-Rudman-Hollings baseline in FY1991. CBO's FY1990 and FY1991 baseline deficits (June 1990) are \$195 billion and \$232 billion, respectively.
- 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. The Postal Service deficit is included in off-budget outlays beginning in FY1990.
- The Administration's deficit projections, excluding RTC spending, were \$121 billion and \$56 billion for FY1990 and FY1991, respectively. CBO's June deficit estimates, excluding RTC spending, were \$159 billion and \$162 billion in FY1990 and FY1991, respectively.
- Other means of financing are checks issued less checks paid, accrued items, and changes in other financial assets and liabilities.
- HEB is the NIPA measure in current dollars with cyclically-sensitive receipts and outlays adjusted to a 6 percent unemployment rate and 2.7% potential output growth. Quarterly figures for change in HEB and FI are not at annual rates. Change in HEB, as a percent of nominal potential GNP, is reversed in sign. FI is the weighted difference of discretionary federal spending and tax changes (in 1982 dollars), scaled by real federal purchases. For change in HEB and FI, (-) indicates restraint.

Recent Developments

The federal funds rate has remained in a narrow range around 8-1/4 percent since the May meeting of the FOMC. Other short-term rates are little changed, though Treasury bill rates have risen as issuance was increased to fund stepped-up activities of the Resolution Trust Corporation. Bond yields have fallen, more on private instruments than on Treasuries. Private credit demands evidently have moderated and traders apparently have become more sanguine about the prospects for markets as a consequence of weaker than anticipated economic indicators. In an environment of sluggish economic growth, weak profits, and slumping real estate markets, the problems of overextended borrowers have continued to mount. Asset quality difficulties have increasingly eroded bank capital and given rise to more cautious lending behavior. These shifts, coming on top of the contraction of the thrift industry, seem to be behind the reported "credit crunch."

These developments have left their mark on the monetary aggregates. All three money measures contracted in May; partial data indicate only a modest upturn in June. The decline of M2 in May, at a 2-3/4 percent rate, reflected a near cessation of growth in retail-type deposits and strong runoffs from demand deposits and MMMFs. Offering rates on retail deposits have been held back in recent months as the accelerating pace of thrift resolutions, in combination with weaker credit demands and greater caution in lending, has reduced depositories' needs for funds. Sluggish money growth reflects as well a slowing of income. Nonetheless, M2 growth is slower than the recent behavior of opportunity costs and estimated income

suggests. Relative to its fourth quarter 1989 base, M2 has expanded at a rate of just below 4 percent, in the lower half of its target range.

M3, which is affected more directly by the slower expansion of depository credit, declined in May at a 2-1/2 percent rate. From the fourth quarter of last year, it has expanded at only a 1-1/2 percent pace, well below the lower end of its target range.

Bank credit expanded at a 4 percent rate in May, and early evidence for June suggests some pickup, mainly owing to larger acquisitions of U.S. government securities. Bank credit growth in May also was paced by government securities, mainly mortgage-backed securities. Growth in bank loans remained subdued, particularly in the New England region. Survey information indicates that banks have tightened considerably their lending terms for merger-related activities and for commercial real estate projects--two types of lending that have been quite weak of late. Banks also have indicated that they have tightened somewhat their lending terms for mid-sized and smaller business customers, a development that is supported by data on loan pricing. The ability of some banks to lend has been curtailed by an erosion of their equity bases resulting from large loan charge-offs. This problem has been aggravated by the poor performance of bank shares and recent downgradings of their holding companies' debt. These capital pressures have encouraged banks to sell and securitize assets.

Business borrowing from banks has been weak of late and nonfinancial commercial paper, which contracted in May after several months of very rapid growth, increased only slightly in June. (The recent downgradings of two large financial issuers of commercial paper do not appear to have disrupted that market.) With long-term rates down from their recent peaks, bond

issuance by investment-grade nonfinancial corporations has picked up in June from its subdued pace in May. Yields on junk bonds generally fell a bit relative to those on Treasuries over the intermeeting period, in part because of actual and prospective retirements of this type of debt, including some outstanding issues of RJR-Nabisco.

The recent quickening in the pace of RTC activity has resulted in the resolution of 138 thrift institutions so far in the second quarter. These actions have increased the RTC's holdings of thrift assets to about \$20 billion. About 259 thrifts, with \$163 billion of assets--half of which is either nonperforming or not in conformance with underwriting standards of the secondary mortgage market--remain in conservatorship. Another 270 thrifts, holding \$170 billion in assets, are expected to be placed in conservatorship soon.

Household credit growth evidently continued to ebb in the second quarter. This weakness appears to reflect demand considerations as the behavior of rates on residential mortgages and on consumer loans provides no sign that lenders have cut back on their supply of credit to the household sector. Consumer installment credit expanded at only a 1 percent rate in April, after the slowest quarterly advance in three years; bank data through early June indicate a continuation of weak consumer lending. Mortgage lending at banks was strong in May, but that strength partly reflected the acquisition of a significant piece of Meritor Savings Bank by Mellon Bank (East). We estimate overall mortgage credit flows thus far in 1990 to have moderated appreciably from earlier years. Construction lending, suffering from deteriorating real estate markets and rising lender caution, probably has continued to bear a disproportionate share of this

slowing. However, softness in home sales likely is showing through to residential lending.

Federal government credit demands in the second quarter were boosted about \$30 billion by Treasury outlays for the RTC. Although net marketable borrowing by the Treasury during the last three months consequently was stronger than is typical during the tax season, growth of government debt still slowed on a seasonally adjusted basis as a result of unusually strong borrowing in the first quarter. The Federal Home Loan Banks have continued to pay down debt rapidly as advances to member institutions have contracted, helping to keep a narrow spread of yields on government sponsored credit agencies over Treasuries. Recent public discussion of the possible undercapitalization of these agencies does not appear to have affected this spread, perhaps because the market remains convinced that the government will support this debt.

The volume of long-term financing in the municipal market picked up a bit in May and June, buoyed most recently by an increase in refunding issuance as rates dropped. A \$4 billion offering by New York State caused short-term volume to surge in June. Downgradings of municipal credit ratings by Standard and Poor's, mainly reflecting economic conditions in the Northeast, exceeded upgradings in the first quarter.

#### Outlook

In the projected economic environment, credit quality problems are likely to continue surfacing. Risk premiums on private debt instruments may tend to increase and lending institutions probably will continue to experience pressures on their capital positions. Under these circumstances,

growth of the private debt aggregate is expected to remain on the slower growth path that has emerged over the past year.

In light of the reduced corporate restructuring activity of late and the continued limited availability of credit for highly leveraged transactions, we have shaded down further projections of net equity retirements. The pace expected for the next eighteen months is less than half that of the 1988-89 level. However, borrowing by nonfinancial corporations is expected to moderate by less, as the gap between investment outlays and internally generated funds widens. Cash flow is projected to tail off a bit between now and the end of 1991, causing interest coverage ratios to deteriorate further. Defaults will continue to occur, and downgradings of debt instruments likely will continue to exceed upgradings.

Household borrowing is anticipated to maintain its slower pace of the first part of this year, and the rate of borrowing for this year and next is anticipated to be markedly slower than in recent years. Consumer credit growth is expected to remain slow, consistent with the projected sluggishness in spending on consumer durables and with continued reaction to the loss of interest deductibility. Mortgage growth is likely to be moderate by the standards of recent years; a small pickup may occur over the coming year as real estate demand begins to firm and housing starts and resale activity perk up. Home equity loans will continue to contribute to mortgage credit expansion.

High borrowing costs, exacerbated by the recent downgradings, along with a gradual easing in spending, are expected to keep municipal debt growth for the rest of this year and through 1991 at a slow pace.

The staff assumes that the advanced pace of RTC activity will bring the growth rate of federal debt in 1990 to 9-1/2 percent. Excluding RTC-related borrowing, federal debt is projected to rise by roughly 6-1/2 percent this year. The growth of federal borrowing is expected to slow sharply in 1991, mainly owing to the assumed implementation of a deficit reduction package and also to an anticipated moderation in RTC needs.

Held up by higher federal borrowing, growth of the overall nonfinancial debt aggregate is projected to slow only a bit this year, to 7-1/4 percent, just above the midpoint of its monitoring range. This aggregate is expected to slow more noticeably in 1991, to 6-1/2 percent, as the federal component weakens.



Recent Developments

The trade-weighted foreign exchange value of the dollar against the other G-10 currencies has been about unchanged on balance since the May FOMC meeting. Increases against the EMS currencies and the yen were offset by a significant decline against the pound. Early in the intermeeting period the dollar was supported in part by perceptions of continued firmness in U.S. monetary policy, and in part by political developments in Europe and Japan. Toward the end of the period the dollar weakened on expectations of lower interest rates associated with improved prospects of a U.S. budget deficit reduction package. The pound strengthened on news that the United Kingdom may join the EMS later this year. Short-term interest rates in major foreign countries have fallen slightly on average over the intermeeting period: declines in several European countries were largely offset by moderate increases in Japan and France. Bond yields abroad also have declined slightly on average, though they rose in Japan and France.

The desk purchased nearly \$500 million against DM for the Treasury in a program to reduce foreign currency balances.

Growth in major foreign industrial countries on average was stronger than expected in the first quarter, although performance was uneven across countries. Growth in Japan and Germany was particularly strong, but in both cases special factors relating to favorable weather that are not likely to continue played important roles. In other major foreign industrial countries, growth appears to have been steady or to have slowed

somewhat. Preliminary indications suggest that the pace of activity abroad moderated in the second quarter.

Inflation in foreign industrial countries on average has remained little changed recently. In several continental European countries, earlier strength of the currencies helped to reduce upward pressure on import prices. A leading exception to this disinflationary trend is the United Kingdom, where the poll tax and increases in excise taxes pushed the twelve-month rate of inflation in retail prices to nearly 10 percent in May. Even absent these special factors, the underlying rate of inflation in the United Kingdom has moved up to around 7 percent.

Economic growth in Latin America slowed somewhat, early this year. Disinflation programs implemented by Argentina and Brazil depressed activity in those countries. Growth in Mexico slowed significantly in the first quarter from its moderate pace of last year, under the influence of somewhat tighter monetary and fiscal policies. In contrast, growth has picked up in some Asian countries, especially Korea and Singapore, though it remains slow in China and Hong Kong.

The nominal U.S. merchandise trade deficit narrowed significantly in the first quarter and substantially further in April. For the first four months of the year, the deficit was running at just under \$100 billion at an annual rate (Census basis), its lowest rate for a four-month period since 1984. Exports during January-April were 9 percent above their rate for the same period in 1989, while non-oil imports were running 2 percent above their year-earlier pace. The strength in exports in recent months has been broadly based: in aircraft (largely in response to the continued unwinding of the effects of the Boeing strike), other capital goods, industrial supplies, and consumer goods.

A runup in the price and quantity of oil imports earlier in the year was partially reversed in April-May. World crude oil prices have fallen recently as stocks have risen following expanded OPEC production and warmer than normal weather.

The U.S. current account deficit improved somewhat more than the trade deficit in the first quarter, falling to \$92 billion at an annual rate, as an improvement in net services and transfers was only partly offset by a decline in net investment income receipts.

### Outlook

Compared with the May forecast, the current staff projection incorporates a somewhat weaker outlook for the dollar and little change in growth abroad. The weaker dollar and, to a lesser extent, the slower projected pace of U.S. activity in the near term contribute to a net improvement in the outlook for the U.S. external balance over the projection period.

The Dollar. The foreign exchange value of the dollar against the other G-10 currencies on average is projected to remain unchanged over the forecast horizon. The path of the dollar is somewhat lower than that noted in the May Greenbook largely because of the lower assumed path for U.S. interest rates. The uncertainties about the dollar forecast are significant but seem about evenly balanced. On the one hand, either concern about the slower projected U.S. growth or renewed concern about the persistence of the U.S. external deficit could cause the dollar to fall. On the other hand, the possibility of intensified inflation pressures abroad could lead to an appreciation of the dollar, at least in nominal terms.

Against the currencies of eight major developing countries, the dollar is expected to appreciate slightly in real terms in 1990 and to depreciate slightly in 1991.

Foreign Industrial Countries. Real growth in foreign industrial countries is expected to moderate slightly this year, to an average rate of about 3 percent (Q4/Q4), reflecting the continuing effects of earlier monetary restraint in a number of countries. Growth is then projected to recover in 1991 to about last year's rate of 3-1/4 percent, with increases in growth in Germany, the United Kingdom, and Canada partly offset by some easing of growth in Japan and several other countries. This forecast is essentially the same as that made in May; small downward revisions to growth in several smaller countries have been offset by a slightly stronger projection for Germany.

German growth is projected to exceed 4-1/2 percent this year (Q4/Q4), buoyed by a very strong first quarter, and to rise to nearly 5 percent next year, reflecting the effects of German unification, liberalization of East European economies, and the approach of EC-1992. German interest rates are expected to move up gradually over the forecast period. Both the United Kingdom and Canada are expected to recover in 1991 from sharp slowdowns this year. U.K. activity will be helped by the lower interest rates that are likely to accompany slower inflation and that country's expected entry into the exchange rate mechanism of the EMS later this year. In contrast, Japanese growth is expected to taper off in 1991 as a result of recent monetary restraint and some expected further increases in short-term interest rates this year. The easing of growth in Japan is expected to allow Japanese short-term interest rates to edge down next year.

The inflation forecast for major industrial countries also is essentially unchanged from May. Average inflation in consumer prices in the

foreign G-10 countries is expected to be about 4-1/2 percent (Q4/Q4) in 1990 and to ease slightly to about 4-1/4 percent in 1991. Nevertheless, in light of continuing capacity pressures and relatively tight labor markets abroad, some risk remains that foreign inflation will be higher, particularly if demand generated in Eastern Europe is greater than anticipated.

Developing Countries. The outlook for developing countries is largely unchanged from the projections in the May Greenbook. Growth in developing countries on average is expected to recover slightly from last year's slowdown, to about 3-1/2 percent (yr/yr) this year. A further pickup in activity is projected in 1991, particularly in Latin America, because of recovery in Brazil and Argentina. Growth in Asia, however, is expected to be restrained by real effective appreciation of key Asian currencies, domestic developments in China, and by weakness in exports to the United States.

U.S. Merchandise Trade Quantities. The quantity of U.S. nonagricultural exports is projected to continue to expand at a rapid pace this year and next, stimulated by the expected continuation of fairly strong growth in most U.S. export markets, as well as by recent moderate gains in U.S. international price competitiveness. (See the table below.) The quantity of U.S. agricultural exports is expected to continue to grow much less rapidly than other exports, and to taper off in 1991 as Soviet purchases are expected to remain at about recent high levels. Relative to the May projection, the growth of total exports has strengthened somewhat, supported by gains in price competitiveness associated with the lower forecast for the dollar.

The quantity of non-oil imports is still projected to reverse its recent declines in the period-ahead. But relative to the May forecast, the pickup is projected to be somewhat weaker -- this year because of lower U.S.

growth and next year because of the projected lower level of the dollar. Oil imports are expected to decline in the current quarter from the unusually high rate in the first quarter, and to remain little changed for the balance of 1991 as stocks are reduced to more normal levels. Next year, oil imports are projected to expand considerably faster as domestic production of crude oil continues to decline.

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<u>Trade Quantities</u>	<u>1989</u>	<u>1990<sup>P</sup></u> (Q4/Q4 percent change)	<u>1991<sup>P</sup></u>
Nonagricultural Exports	10.1	9.2	10.7
Agricultural Exports	11.9	5.0	2.0
Non-Oil Imports	5.8	2.0	5.3
Oil Imports	1.7	-1.8	10.9

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On balance, total real net exports of goods are expected to improve significantly in the current quarter, and then to increase moderately through the end of 1991. Compared with the May forecast, the path of real net exports of goods rises somewhat faster in the second half of 1990, and is roughly \$10 billion higher on average during 1991 (annual rate). Most of this revision can be accounted for by the somewhat weaker outlook for the dollar. Slower U.S. growth in 1990 also is a factor, although much of its influence is reversed in 1991 as growth picks up again.

Merchandise Trade Prices. Fixed-weight prices of nonagricultural exports are expected to rise moderately this year and next, at about the projected rate of increase in domestic producer prices, shown in the table below. Non-oil import prices are projected to rise about in line with prices abroad. The revision in the outlook for the dollar has pushed up the projected rate of increase in the price of non-oil imports slightly.

The average price of oil imports is expected to fall to about \$16.50 per barrel in the second quarter and to about \$15.50 in the third quarter,

in line with recent declines in spot prices. Thereafter, the import price is projected to rise steadily to about \$18.25 per barrel in the fourth quarter of 1991, \$1.25 below the level in the May forecast. This forecast assumes that OPEC production will level off at about its current rate and that the recent bulge in world oil stocks will subside in the coming months.

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<u>Prices</u>	<u>1989</u>	<u>1990<sup>P</sup></u>	<u>1991<sup>P</sup></u>
	(Q4/Q4 percent change)		
PPI (export-share weighted)	3.0	2.1	2.3
Non-Oil Imports	-0.6	4.6	3.7
Oil Imports	36.8	-4.9	8.5

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Net Services and Nominal Balances. The merchandise trade balance is expected to decline significantly in the second quarter this year, and is then projected to fluctuate fairly narrowly around an annual rate of \$95 billion through the end of 1991. Net portfolio payments to foreigners are expected to grow significantly over the forecast period because of rising U.S. international indebtedness. This deterioration is somewhat less than that projected in the May forecast because lower expectations for dollar interest rates have reduced the projected rise in net portfolio payments. These rising net payments are now expected to be more than fully offset by increases in net services and transfers and net direct investment income receipts. As a result, the current account balance is projected to improve somewhat more than the trade balance over the forecast period, and to be less than \$80 billion in 1991.

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

	ANNUAL			1989		1990				1991			
	1989	1990-P	1991-P	-Q3	-Q4	Q1	-Q2-P	-Q3-P	-Q4-P	Q1-P	-Q2-P	-Q3-P	-Q4-P
<b>1. GNP Exports and Imports 1/</b>													
Current \$, Net	-47.1	-23.2	-13.0	-45.1	-38.8	-32.0	-23.5	-19.6	-17.9	-16.9	-15.7	-12.0	-7.7
Exports of G+S	625.9	679.0	738.2	628.5	643.5	664.7	669.1	682.9	699.2	714.6	729.3	745.9	762.9
Imports of G+S	673.0	702.1	751.1	673.6	682.3	696.6	692.4	702.4	717.1	731.4	744.9	757.7	770.4
Constant 82 \$, Net	-52.6	-27.9	-15.3	-57.1	-47.2	-33.6	-30.6	-26.9	-20.6	-19.4	-18.7	-14.1	-8.8
Exports of G+S	589.2	631.7	673.2	593.1	606.6	625.1	623.3	633.1	645.5	656.1	666.6	678.7	691.3
Imports of G+S	641.8	659.6	688.4	650.2	653.8	658.7	653.9	660.0	666.1	675.6	685.3	692.7	700.1
<b>2. Merchandise Trade Balance 2/</b>													
Exports	360.5	392.2	431.9	357.4	367.0	384.2	387.2	393.3	404.2	415.0	425.4	437.3	449.8
Agricultural	41.5	43.6	47.5	39.7	40.9	43.8	42.4	42.7	45.7	46.5	47.0	47.9	48.7
Non-Agricultural	319.0	348.6	384.3	317.7	326.1	340.4	344.8	350.7	358.5	368.5	378.4	389.4	401.1
Imports	475.3	489.3	526.7	476.6	481.9	489.7	480.4	487.5	499.8	511.6	522.1	531.7	541.5
Petroleum and Products	50.9	52.0	58.4	52.7	53.3	62.4	48.8	46.1	50.5	55.1	58.2	59.5	60.8
Non-Petroleum	424.4	437.4	468.3	423.9	428.6	427.2	431.6	441.4	449.3	456.5	463.9	472.3	480.7
<b>3. Other Current Account Transactions</b>													
Capital Gains and Losses 3/	-0.6	0.2	0.0	1.2	-1.2	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other D.I. Income, Net	40.3	43.8	46.9	38.9	45.4	43.1	41.3	44.9	46.1	46.7	46.7	47.1	47.4
Portfolio Income, Net	-40.5	-42.8	-46.1	-40.0	-41.9	-41.5	-42.5	-43.4	-44.0	-44.5	-45.4	-46.6	-47.8
Other Current Account, Net	5.7	11.0	15.9	8.8	6.0	11.3	10.8	11.7	10.3	14.7	16.0	17.3	15.6
<b>4. U.S. Current Account Balance</b>													
Including Capital G/L	-110.0	-84.8	-78.1	-110.4	-106.8	-91.8	-83.5	-81.0	-83.1	-79.8	-79.4	-76.8	-76.6
Excluding Capital G/L	-109.4	-85.0	-78.1	-111.6	-105.5	-92.6	-83.5	-81.0	-83.1	-79.8	-79.4	-76.8	-76.6
<b>5. Foreign Outlook 4/</b>													
Real GNP--Ten Industrial 5/	3.5	3.3	3.0	2.7	3.7	5.8	1.5	2.6	2.7	3.1	3.3	3.5	3.4
Real GNP--LDC 6/	3.2	3.4	4.1	3.0	3.1	3.3	3.5	3.8	4.1	4.3	4.3	4.2	4.1
Consumer Prices--Ten Ind. 5/	4.0	4.4	4.1	2.3	4.2	4.9	5.7	3.2	4.0	3.8	4.9	4.1	4.2

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 LDC GNP.

P/ Projected