

February 1, 1989

SUMMARY AND OUTLOOK

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

the other hand, homebuilding is expected to be damped by less favorable mortgage conditions.²

REAL GNP AND THE DROUGHT

(Percent change, annual rate)

	1988				1989				1990	
	Q1	Q2	Q3	Q4	Q1	Q2	H2	H1	H2	
	----- actual -----				----- projected -----					
Real GNP	3.4	3.0	2.5	2.0	5.0	2.8	2.2	.8	1.5	
Real GNP, excluding effects of the drought	3.4	3.9	3.0	3.1	2.4	2.6	2.0	.8	1.5	

Beyond the current quarter, a continuing updrift in interest rates is expected to result in a gradual decline in residential construction activity well into 1990. Gains in real net exports are likely to be smaller over coming months than the average in 1988, given the relatively flat path of the dollar over last year or so. The negative effects of rising interest rates, including those on asset values, also are likely to damp consumer spending. And, with less impetus to production from these sources, employment and income growth will tend to slow. In this environment, business fixed capital spending may fall somewhat short of current plans, even though those plans do not seem to be founded on an especially strong business outlook. Thus, excluding drought effects, real output growth over the four quarters of 1989 is expected to slow to about 2-1/4 percent from

2. Warmer than normal weather over much of the country in January may have caused some shifting forward of construction activity, but the extent of its effect overall on first-quarter home building is problematic. The staff has not built a significant net effect into its forecast.

Greenbook. After rising faster than overall inflation in 1988 in response to the drought, food prices now are projected to increase at a rate of about 3-3/4 percent this year and next, a bit less than the broad inflation measures.

With labor markets remaining tight over the year, compensation per hour is expected to accelerate a little further in 1987. In the first quarter of 1990, an increase in social security payroll taxes will boost labor costs about 1 percent at an annual rate. Subsequently, however, as a higher unemployment rate relieves pressures in labor markets, growth in compensation is projected to begin to recede.³ Inflation, as measured by the broad price indexes should stabilize, setting the stage for a deceleration in 1991, if some slack is maintained in labor and product markets.

STAFF INFLATION PROJECTION
(Percent change, annual rate)

	<u>1988</u>		<u>1989</u>		<u>1990</u>	
	H2	H1	H2	H1	H2	
GNP fixed-weight price index	4.8	4.5	4.4	4.9	4.5	
Consumer price index	4.5	4.8	4.9	5.2	5.1	
Excl. food and energy	4.3	5.0	5.5	5.7	5.6	
Compensation per hour	5.5	5.3	5.4	6.0	5.3	

3. The projection does not incorporate an increase in the minimum wage, but if increases were to be incorporated of about the size proposed by some members of Congress last year, the rate of inflation would be raised by about 0.2 percentage point.

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CLASS II FOMC

STAFF GNP PROJECTIONS

Percent changes, annual rate

	Nominal GNP		Real GNP		GNP fixed-weighted price index		GNP deflator		Unemployment rate (percent)			
	12/7/88	2/1/89	12/7/88	2/1/89	12/7/88	2/1/89	12/7/88	2/1/89	12/7/88	2/1/89		
Annual changes:												
1987	<1>	6.8	6.8	3.4	3.4	3.6	3.6	3.3	3.3	6.2	6.2	
1988	<1>	7.4	7.4	3.9	3.8	4.1	4.2	3.4	3.4	5.5	5.5	
1989		7.4	7.5	3.3	3.0	4.5	4.5	4.0	4.3	5.4	5.4	
1990		5.7	5.8	1.5	1.5	4.4	4.7	4.2	4.3	5.9	5.9	
Quarterly changes:												
1988	Q1	5.4	5.4	3.4	3.4	3.5	3.5	1.7	1.7	5.7	5.7	
	Q2	8.7	8.7	3.0	3.0	5.0	5.0	5.5	5.5	5.5	5.5	
	Q3	7.3	7.3	2.6	2.5	5.1	5.3	4.7	4.7	5.5	5.5	
	Q4	7.0	6.8	2.2	2.0	4.3	4.0	4.6	4.7	5.3	5.3	
1989	Q1	8.8	8.9	5.8	5.0	4.3	4.3	2.9	3.9	5.3	5.3	
	Q2	7.0	7.3	2.7	2.8	4.3	4.6	4.1	4.4	5.3	5.3	
	Q3	6.2	6.1	2.4	2.4	4.2	4.3	3.7	3.7	5.4	5.4	
	Q4	5.9	6.0	2.0	2.0	4.2	4.5	3.8	4.0	5.5	5.5	
19	1	5.9	5.7	.9	.9	4.9	5.2	4.9	4.8	5.7	5.7	
	2	4.7	5.1	.8	.8	4.4	4.6	3.9	4.3	5.9	5.9	
	Q3	5.6	5.7	1.3	1.3	4.3	4.5	4.2	4.3	6.0	6.0	
	Q4	5.7	5.9	1.4	1.6	4.3	4.5	4.2	4.3	6.1	6.1	
Two-quarter changes: <2>												
1988	Q2	<1>	7.0	7.0	3.2	3.2	4.2	4.2	3.6	3.6	-.4	-.4
	Q4	<1>	7.1	7.0	2.4	2.2	4.8	4.8	4.7	4.7	-.2	-.2
1989	Q2		7.9	8.1	4.2	3.9	4.3	4.5	3.5	4.1	.0	.0
	Q4		6.1	6.1	2.2	2.2	4.2	4.4	3.8	3.8	.2	.2
1990	Q2		5.3	5.4	.9	.8	4.6	4.9	4.4	4.5	.4	.4
	Q4		5.6	5.8	1.3	1.5	4.3	4.5	4.2	4.3	.2	.2
Four-quarter changes: <3>												
1987	Q4	<1>	8.3	8.3	5.0	5.0	4.0	4.0	3.1	3.1	-.9	-.9
1988	Q4	<1>	7.1	7.0	2.8	2.7	4.5	4.5	4.1	4.1	-.6	-.6
1989	Q4		7.0	7.1	3.2	3.0	4.3	4.4	3.6	4.0	.2	.2
1990	Q4		5.5	5.6	1.1	1.1	4.5	4.7	4.3	4.4	.6	.6

<1> Actual.

<2> Percent change from two quarters earlier.

<3> Percent change from four quarters earlier.

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

	Units	Projection									
		1988		1989				1990			
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXPENDITURES											
Nominal GNP	Billions of \$	4909.0	4989.9	5097.9	5188.3	5266.3	5343.7	5418.0	5485.9	5562.6	5643.2
Real GNP	Billions of 82\$	4009.4	4029.2	4078.8	4106.6	4130.7	4150.9	4160.1	4167.9	4181.6	4198.0
Nominal GNP	Percent change	7.3	6.8	8.9	7.3	6.1	6.0	5.7	5.1	5.7	5.9
Real GNP		2.5	2.0	5.0	2.8	2.4	2.0	.9	.8	1.3	1.6
Gross domestic product		2.0	2.1	5.2	2.6	2.3	2.0	.9	.7	1.3	1.6
Gross domestic purchases		2.5	2.6	4.4	2.4	1.7	1.2	.0	.0	.3	.6
Final sales		2.0	3.1	3.2	3.1	3.0	2.3	1.6	1.2	1.6	1.7
Private dom. final purchases		3.9	2.4	3.3	3.0	2.3	1.7	.8	.4	.5	.8
Personal consumption expend.		3.9	2.8	3.5	3.0	2.2	1.6	.8	.5	.6	.9
Durables		-.2	2.1	5.5	3.9	.5	-.5	-2.9	-2.1	-1.8	.0
Nondurables		5.0	1.9	2.6	2.1	1.8	1.3	1.0	.5	.5	.5
Services		4.5	3.7	3.6	3.3	3.1	2.4	1.8	1.4	1.4	1.4
Business fixed investment		4.0	-3.7	2.5	5.4	4.2	3.4	2.4	1.0	.8	.2
Producers' durable equipment		4.6	-3.0	3.7	7.5	6.0	5.0	4.0	3.0	3.0	2.5
Nonresidential structures		2.6	-5.6	-.7	-.7	-1.2	-1.3	-2.7	-5.1	-6.1	-7.1
Residential structures		4.3	12.7	2.1	-3.1	-1.2	-1.4	-3.1	-3.7	-.9	1.4
Exports		14.5	2.8	13.2	12.3	11.4	10.8	9.2	8.8	9.0	7.5
Imports		13.1	7.0	7.7	8.3	5.3	4.6	2.4	3.0	1.5	.9
Government purchases		-5.2	9.3	.1	1.6	2.1	1.3	.5	.6	.7	.7
Federal		-13.2	17.0	-2.7	.8	2.2	.2	-1.6	-1.6	-1.4	-1.2
Defense		-10.5	4.9	-5.1	-1.9	-1.2	-5.4	-3.0	-2.9	-3.0	-2.9
State and local		1.1	4.1	2.1	2.1	2.0	2.1	2.1	2.1	2.1	2.0
Change in business inventories	Billions of 82\$	39.5	29.2	46.9	44.2	38.3	34.7	27.2	23.0	20.3	18.7
Nonfarm	Billions of 82\$	40.4	36.6	37.2	35.4	31.4	30.4	24.3	20.7	18.3	17.2
Net exports	Billions of 82\$	-93.9	-100.7	-95.9	-92.9	-86.3	-78.9	-69.9	-62.2	-51.7	-41.9
EMPLOYMENT AND PRODUCTION											
Unemployment rate	Millions	106.5	107.3	108.0	108.5	108.9	109.2	109.4	109.5	109.8	110.0
	Percent*	5.5	5.3	5.3	5.3	5.4	5.5	5.7	5.9	6.0	6.1
Industrial production index	Percent change	7.1	4.2	3.7	3.1	2.4	2.2	.6	.6	1.6	2.5
Capacity utilization rate-mfg.	Percent*	84.0	84.4	84.4	84.4	84.2	83.9	83.4	82.8	82.5	82.4
Housing Starts	Millions	1.47	1.54	1.50	1.47	1.46	1.43	1.41	1.39	1.39	1.39
Auto sales	Millions	10.53	10.53	10.07	10.31	10.22	10.05	9.75	9.52	9.32	9.32
Domestic	Millions	7.41	7.42	7.04	7.31	7.22	7.10	6.85	6.70	6.55	6.55
Foreign	Millions	3.12	3.11	3.03	3.00	3.00	2.95	2.90	2.82	2.77	2.77
INCOME AND SAVING											
Nominal personal income	Percent change	7.3	9.2	10.0	6.4	6.1	7.3	7.5	6.3	6.2	6.5
Real disposable income	Percent change	5.6	4.7	5.2	.7	1.1	1.7	2.0	.5	.5	.8
Personal saving rate	Percent*	4.2	4.6	5.0	4.4	4.2	4.2	4.5	4.4	4.4	4.4
Corp. profits with IVA & CCAdj	Percent change	4.4	1.8	7.0	12.7	-1.7	-11.0	-26.5	-15.4	-10.0	-6.5
Profit share of GNP	Percent*	6.7	6.6	6.6	6.7	6.6	6.3	5.7	5.4	5.2	5.1
Federal govt. surplus/deficit	Billions of \$	-123.5	-152.1	-152.1	-141.2	-137.2	-138.8	-131.1	-128.8	-119.7	-117.1
State and local govt. surplus		56.0	49.7	59.8	64.4	66.8	68.4	68.0	68.1	68.6	71.1
Exc. social insurance funds		-13.3	-21.2	-12.1	-8.4	-6.9	-6.1	-7.3	-8.0	-8.3	-6.6
PRICES AND COSTS											
GNP implicit deflator	Percent change	4.7	4.7	3.9	4.4	3.7	4.0	4.8	4.3	4.3	4.3
GNP fixed-weight price index		5.3	4.0	4.3	4.6	4.3	4.5	5.2	4.6	4.5	4.5
Cons. & fixed invest. prices		4.5	4.2	4.1	4.7	4.5	4.8	4.9	5.0	4.9	4.9
CPI		4.8	4.1	4.7	4.9	4.7	5.1	5.1	5.2	5.1	5.1
Exc. food and energy		4.0	4.6	4.8	5.2	5.3	5.6	5.7	5.7	5.6	5.6
Nonfarm business sector		1.9	.2	.7	.8	.8	.8	.6	.6	1.0	1.2
Output per hour		5.6	5.4	5.3	5.2	5.3	5.4	6.5	5.4	5.3	5.3
Compensation per hour		3.7	5.2	4.6	4.4	4.5	4.6	5.9	4.8	4.3	4.1
Unit labor costs											

* t an annual rate.

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4SS II FOMCGROSS NATIONAL PRODUCT AND RELATED ITEMS
(Seasonally adjusted; annual rate)

February 1, 1989

	Units	Projection								
		1982	1983	1984	1985	1986	1987	1988	1989	1990
EXPENDITURES										
Nominal GNP	Billions of \$	3166.0	3405.7	3772.2	4014.9	4240.3	4526.7	4861.8	5224.0	5527.4
Real GNP	Billions of 82\$	3166.0	3279.1	3501.4	3618.7	3721.7	3847.0	3995.0	4116.8	4176.9
Real GNP	Percent change*	-1.9	6.5	5.1	3.6	2.0	5.0	2.7	3.0	1.1
Gross domestic product		-1.6	6.6	5.3	3.8	2.3	5.1	2.9	3.0	1.1
Gross domestic purchases		-.8	8.4	6.4	4.3	2.4	4.4	2.0	2.4	.2
Final sales		.3	3.7	4.7	4.6	2.5	3.0	3.7	2.9	1.5
Private dom. final purchases		.8	7.7	5.6	4.6	2.8	2.4	3.8	2.6	.6
Personal consumption expend.		2.9	5.4	4.1	4.6	4.2	1.8	3.6	2.6	.7
Durables		9.0	14.7	10.8	7.0	11.5	-2.4	6.4	2.3	-1.7
Nondurables		1.8	4.4	2.3	3.3	3.1	.6	2.0	1.9	.6
Services		2.3	3.9	3.5	5.0	2.7	4.2	3.8	3.1	4.5
Business fixed investment		-11.3	10.8	13.8	3.7	-7.3	8.8	5.5	3.9	1.1
Producers' durable equipment		-12.5	20.9	14.9	4.6	-2.4	9.6	10.1	5.5	3.1
Nonresidential structures		-9.1	-4.8	11.8	1.9	-17.4	6.7	-6.1	-1.0	-5.3
Residential structures		4.9	38.1	6.1	5.8	11.3	-3.5	2.4	-.9	-1.6
Exports		-13.8	5.8	5.9	-2.4	5.6	18.4	12.7	11.9	8.6
Imports		-5.9	23.8	17.4	4.5	7.6	10.4	5.7	6.5	1.9
Government purchases		3.8	-2.7	7.9	8.6	2.9	2.3	-.2	1.2	.6
Federal		8.2	-8.1	13.0	13.3	.0	2.1	-4.3	.1	-1.4
Defense		8.8	5.1	6.5	7.1	4.8	6.0	-3.2	-3.4	-3.0
State and local		.6	1.5	4.4	4.9	5.3	2.5	2.9	2.1	2.1
Change in business inventories	Billions of 82\$	-24.5	-6.4	62.3	9.1	15.4	34.4	42.5	41.0	22.3
Nonfarm exports	Billions of 82\$	-23.1	-.1	57.8	13.4	17.9	36.9	39.7	33.6	20.1
Billions of 82\$		26.3	-19.9	-84.0	-104.3	-137.5	-128.9	-99.1	-88.5	-56.4
I GNP	Percent change*	3.1	10.4	8.6	6.6	4.8	8.3	7.0	7.1	5.6
AND PRODUCTION										
Nonfarm payroll employment	Millions	89.6	90.2	94.5	97.5	99.5	102.3	106.0	108.6	109.7
Unemployment rate	Percent	9.7	9.6	7.5	7.2	7.0	6.2	5.5	5.4	5.9
Industrial production index	Percent change*	-7.7	14.3	6.6	1.7	1.0	5.8	5.0	2.8	1.3
Capacity utilization rate-mfg.	Percent	70.3	73.9	80.5	80.1	79.7	81.0	83.6	84.2	82.8
Housing Starts	Millions	1.06	1.71	1.77	1.74	1.81	1.63	1.49	1.46	1.40
Auto sales	Millions	8.00	9.18	10.43	11.09	11.52	10.34	10.66	10.16	9.48
Domestic	Millions	5.77	6.77	7.97	8.24	8.28	7.14	7.51	7.17	6.66
Foreign	Millions	2.23	2.41	2.46	2.84	3.25	3.21	3.14	2.99	2.81
INCOME AND SAVING										
Nominal personal income	Percent change*	5.3	7.8	8.4	6.6	5.9	8.5	7.1	7.4	6.6
Real disposable income	Percent change*	1.0	5.1	4.3	2.7	3.4	3.0	3.8	2.2	.9
Personal saving rate	Percent	6.8	5.4	6.1	4.4	4.0	3.2	4.2	4.4	4.4
Corp. profits with IVA & CCAdj	Percent change*	-19.1	70.1	7.4	9.2	.9	7.6	4.9	1.3	-14.9
Profit share of GNP	Percent	4.7	6.3	7.1	7.0	7.0	6.9	6.7	6.5	5.4
Federal govt. surplus/deficit	Billions of \$	-145.9	-176.0	-169.6	-196.9	-205.6	-157.8	-141.9	-142.3	-124.2
State and local govt. surplus		35.1	47.5	64.6	65.1	61.2	52.9	53.9	64.8	69.0
Exc. social insurance funds		-1.7	4.4	19.8	13.8	5.0	-9.2	-14.5	-8.4	-7.5
PRICES AND COSTS										
GNP implicit deflator	Percent change*	5.2	3.6	3.4	2.9	2.8	3.1	4.1	4.0	4.4
GNP fixed-weight price index		5.0	3.9	3.7	3.3	2.7	4.0	4.5	4.4	4.7
Cons. & fixed invest. prices		4.4	3.3	3.3	3.4	2.5	4.7	4.0	4.5	4.9
CPI		4.4	3.2	4.1	3.5	1.3	4.4	4.3	4.9	5.1
Exc. food and energy		5.2	4.2	4.8	4.3	3.9	4.3	4.5	5.2	5.7
w business sector		1.0	3.6	1.5	1.5	1.2	1.9	.8	.8	.8
it per hour		7.3	3.3	4.2	4.5	4.2	4.1	4.7	5.3	5.6
ensation per hour		6.2	-.3	2.6	2.9	3.0	2.1	4.0	4.5	4.7
unit labor costs										

* Percent changes are from fourth quarter to fourth quarter.

CONFIDENTIAL - FR
CLASS II FOMC

February 1, 1989

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

	Projection										Projection			
	1988		1989				1990				1987	1988	1989	1990
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Real GNP	24.2	19.8	49.6	27.8	24.2	20.2	9.1	7.8	13.8	16.4	188.3	106.2	121.8	47.1
Gross domestic product	20.0	21.0	50.9	26.3	23.5	20.8	9.3	7.4	13.1	16.8	188.3	111.7	121.5	46.5
Gross domestic purchases	25.5	26.6	44.8	24.8	17.5	12.9	.2	.1	3.2	6.6	171.9	80.9	100.0	10.0
Final sales	20.0	30.1	31.9	30.5	30.1	23.8	16.6	12.0	16.5	18.0	110.7	144.1	116.2	63.1
Private dom. final purchases	31.6	19.5	27.0	24.4	19.3	13.9	6.6	3.1	4.6	6.8	76.2	120.5	84.6	21.1
Personal consumption expend.	24.8	18.1	23.0	19.4	14.7	10.3	5.2	3.6	3.9	5.9	45.5	90.2	67.4	18.6
Durables	-.2	2.1	5.5	4.0	.5	-.6	-3.1	-2.2	-1.9	.0	-9.7	24.9	9.4	-7.3
Nondurables	10.9	4.2	5.8	4.8	4.1	3.0	2.3	1.2	1.2	1.2	5.2	18.2	17.7	5.8
Services	14.1	11.8	11.6	10.7	10.1	7.9	6.0	4.7	4.7	4.7	50.0	47.1	40.3	20.1
Business fixed investment	4.8	-4.6	3.1	6.5	5.1	4.3	3.0	1.3	1.1	.3	37.5	25.6	19.0	5.6
Producers' durable equipment	4.1	-2.8	3.3	6.7	5.5	4.7	3.8	2.9	2.9	2.5	29.2	33.7	20.3	12.1
Nonresidential structures	.8	-1.8	-.2	-.2	-.4	-.4	-.8	-1.6	-1.9	-2.2	8.3	-8.1	-1.2	-6.5
Residential structures	2.0	5.8	1.0	-1.5	-.6	-.7	-1.6	-1.8	-.4	.7	-7.0	4.7	-1.8	-3.1
Change in business inventories	4.2	-10.3	17.7	-2.7	-5.9	-3.6	-7.5	-4.2	-2.7	-1.6	77.6	-37.9	5.5	-16.0
Nonfarm	10.3	-3.8	.6	-1.8	-4.0	-1.0	-6.1	-3.6	-2.4	-1.1	67.0	-31.6	-6.2	-13.2
Farm	-6.1	-6.6	17.1	-.9	-1.9	-2.6	-1.4	-.6	-.3	-.5	10.6	-6.3	11.7	-2.8
Net exports	-1.3	-6.8	4.8	3.0	6.7	7.4	9.0	7.7	10.5	9.8	16.4	25.3	21.8	37.0
Exports	17.1	3.6	16.3	15.7	15.1	14.7	12.8	12.6	13.1	11.3	71.4	58.4	61.8	49.8
Imports	18.4	10.4	11.6	12.7	8.4	7.3	3.9	4.9	2.6	1.5	55.0	33.1	40.0	12.8
Government purchases	-10.3	17.4	.1	3.1	4.1	2.5	1.0	1.2	1.4	1.3	18.1	-1.7	9.9	4.9
Federal	-11.5	12.8	-2.3	.7	1.8	.1	-1.4	-1.3	-1.1	-1.0	7.2	-14.8	.4	-4.8
Defense	-7.2	3.1	-3.4	-1.2	-.8	-3.5	-1.9	-1.8	-1.9	-1.8	15.1	-8.7	-8.9	-7.4
Nondefense	-4.2	9.8	1.0	1.9	2.6	3.6	.5	.5	.8	.8	-7.9	-6.0	9.2	2.6
State and local	1.2	4.6	2.4	2.4	2.3	2.4	2.4	2.5	2.5	2.3	10.9	13.1	9.5	9.7

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February 1, 1989

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1988a	FY1989p				FY1990p				FRB Staff Projection												
		Admin ¹		CBO ²		FRB Staff		Admin ¹		CBO ²		FRB Staff		1988 IVa	I	II	1989 III	IV	I	II	1990 III	IV
		Not seasonally adjusted								Seasonally adjusted annual rates												
BUDGET																						
Budget receipts ³	909	976	983	979	1059	1069	1068	222	224	285	249	236	253	313	265	254						
Budget outlays ³	1064	1137	1138	1139	1152	1209	1195	289	286	284	279	303	299	301	292	307						
Surplus/deficit(-)	-155	-161	-144	-159	-93	-136	-127	-68	-62	1	-30	-66	-46	12	-26	-53						
to be financed ³	-194	-218	-211	-209	-161	-209	-192	-73	-77	-17	-42	-74	-64	-10	-43	-67						
(On-budget)	39	56	56	49	69	68	65	6	15	18	11	8	18	22	17	13						
(Off-budget)																						
Means of financing:																						
Borrowing	162	144	140	139	91	141	121	54	32	28	26	46	35	16	23	39						
Cash decrease	-8	14	n.a.	4	0	n.a.	0	11	25	-24	-7	22	3	-20	-5	22						
Other ⁴	1	3	n.a.	16	2	n.a.	6	3	6	-5	12	-2	8	-8	8	-8						
Cash operating balance, end of period	44	30	n.a.	40	30	n.a.	40	34	9	33	40	18	15	35	40	18						
NIPA FEDERAL SECTOR																						
Receipts	964	1029	1037	1030	1133	1133	1117	991	1020	1045	1062	1079	1113	1128	1146	1166						
Expenditures	1107	1174	1177	1175	1213	1255	1246	1143	1172	1187	1199	1217	1244	1257	1266	1283						
Purchases	380	398	395	397	413	416	409	393	394	398	401	403	410	411	412	413						
Defense	298	298	302	301	305	311	303	298	300	301	303	300	305	304	304	304						
Nondefense	82	100	93	96	108	105	106	95	94	97	99	102	105	107	108	109						
Other expend.	727	776	782	779	800	839	837	750	778	789	798	815	834	846	854	871						
Surplus/deficit	-143	-145	-140	-146	-77	-122	-130	-152	-152	-141	-137	-139	-131	-129	-120	-117						
FISCAL INDICATORS ⁵																						
High-employment (HEB) surplus/deficit(-)	-151	n.a.	n.a.	-164	n.a.	n.a.	-137	-163	-172	-162	-158	-157	-142	-132	-116	-109						
Change in HEB, percent of potential GNP	.2	n.a.	n.a.	.3	n.a.	n.a.	-.5	.6	.2	-.2	-.1	0	-.3	-.2	-.3	-.1						
Fiscal impetus measure (FI), percent	.1 *	n.a.	n.a.	-4.1 *	n.a.	n.a.	-6.9 *	.9	-2	-.4	-.4	-2.9	-3.8	-.5	-.5	-.4						

a--actual

p--projection

*--calendar year

n.a.--not available

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

1. The Budget of the United States Government, Fiscal Year 1990 (January 1989). Budget estimates include policy proposals.
2. Baseline budget estimates from The Economic and Budget Outlook: Fiscal Years 1990-1994 (January 1989).
3. Includes 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. Checks issued less checks paid, accrued items and changes in other financial assets and liabilities.
5. HEB is the NIPA measure in current dollars with cyclically-sensitive receipts and outlays adjusted to a 6 percent unemployment rate. 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.

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

	ANNUAL			1988		1989				1990			
	1988-P	1989-P	1990-P	Q3-	Q4-	Q1-P	Q2-P	Q3-P	Q4-P	Q1-P	Q2-P	Q3-P	Q4-P
1. GNP Exports and Imports 1/													
Current \$, Net	-93.2	-85.6	-57.5	-80.0	-90.3	-92.3	-88.0	-83.8	-78.2	-69.5	-62.7	-53.2	-44.6
Exports of G+S	518.7	599.4	680.6	536.1	543.8	566.3	589.4	610.5	631.4	651.6	671.3	691.0	708.3
Imports of G+S	611.9	685.0	738.1	616.0	634.1	658.6	677.5	694.3	709.6	721.1	734.0	744.3	752.9
Constant 82 \$, Net	-99.0	-88.5	-56.4	-93.9	-100.7	-95.9	-92.9	-86.3	-78.9	-69.9	-62.2	-51.7	-41.9
Exports of G+S	503.7	556.9	611.0	514.0	517.6	533.9	549.7	564.7	579.4	592.2	604.8	617.9	629.2
Imports of G+S	602.7	645.5	667.5	607.9	618.3	629.9	642.6	651.0	658.3	662.2	667.1	669.6	671.1
2. U.S. Merchandise Trade Balance 2/	-125.0	-122.3	-98.4	-114.1	-124.4 ^P	-126.0	-124.4	-122.0	-116.8	-109.1	-101.9	-95.0	-87.6
Exports	320.0	361.9	409.1	329.2	331.2 ^P	345.2	357.0	366.8	378.6	391.1	402.7	414.6	427.9
Agricultural	38.5	43.7	50.7	41.6	37.8 ^P	41.6	43.4	43.9	46.0	48.7	50.4	51.3	52.5
Non-Agricultural	281.5	318.2	358.3	287.6	293.4 ^P	303.7	313.6	323.0	332.6	342.4	352.3	363.2	375.4
Imports	445.0	484.2	507.5	443.4	455.7 ^P	471.2	481.4	488.8	495.4	500.2	504.6	509.6	515.5
Petroleum and Products	39.1	42.4	43.9	39.5	36.2 ^P	40.9	42.7	42.9	43.1	43.3	43.7	44.0	44.5
Non-Petroleum	405.8	441.8	463.6	403.9	419.4 ^P	430.3	438.7	445.9	452.2	456.9	460.9	465.5	471.0
3. U.S. Current Account Balance	-133.4	-131.2	-110.1	-123.6	-127.1 ^P	-138.2	-129.9	-128.3	-128.4	-119.6	-112.7	-105.7	-102.2
Of Which: Net Investment Income	1.2	-1.5	-8.5	-1.3	9.1 ^P	-4.4	1.6	0.0	-3.2	-6.0	-7.8	-9.0	-11.4
4. Foreign Outlook 3/													
Real GNP--Ten Industrial 4/	3.8	3.0	2.4	5.0	3.3 ^P	2.9	2.8	2.3	2.1	2.5	2.6	2.7	2.7
Real GNP--NonOPEC LDC 5/	3.4	3.7	3.9	3.5	3.6 ^P	3.7	3.7	3.7	3.7	3.7	3.9	4.2	4.5
Consumer Prices--Ten Ind. 4/	2.6	3.4	3.1	2.5	3.8 ^P	2.9	4.5	3.1	3.0	2.7	4.0	2.4	2.8

1/ National Income and Product Account data.

2/ International accounts basis.

3/ Percent change, annual rates.

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

5/ Weighted by share in NonOPEC LDC GNP.

P/ Projected

February 1, 1989

RECENT DEVELOPMENTS

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

APPENDIX

FEDERAL BUDGET ESTIMATES FOR 1990 AND THE LONGER-RUN BUDGET OUTLOOK

President Reagan's FY1990 Budget was submitted to the Congress on January 9, as required by law. President Bush is expected to indicate his own budget priorities in an address on February 9.¹ Alternative projections that may be used by the Congress as the base for its deliberations are contained in CBO's January 24 report on the economic and budget outlook. Hearings are now under way and the congressional target is a budget resolution by mid-April.

The Reagan budget proposes to reduce the federal deficit to \$93 billion in FY90 and to achieve a surplus by FY94 (line 3 of table 1). Even without enactment of the Reagan program, the OMB projects that the deficit would decline over the next five years, from \$127 billion in FY90 to near balance by FY94 (line 1 of the table). This "current services" estimate assumes that budget authority is held constant in real terms for all discretionary programs including defense, that programs for entitlements and other mandatory spending continue to operate as specified in current laws, and that the tax law is unchanged. In contrast, CBO projects that the deficit in FY90 will be \$141 billion under current spending and tax policies (line 4) and would decrease merely to \$122 billion by 1994.

Table 1

ESTIMATED BUDGET SURPLUS/DEFICIT (-)
(Billions of dollars, fiscal years)

	1989	1990	1991	1992	1993	1994
Administration						
1. Current services	-160	-127	-102	-70	-37	-9
2. Effect of proposals	-2	34	35	37	39	42
3. Policy budget	-162	-93	-67	-32	2	33
4. CBO baseline	-155	-141	-140	-135	-129	-122
Memo:						
5. Gramm-Rudman target	-136	-100	-64	-28	0	n.a.
6. Gramm-Rudman trigger		-110	-74	-38	0	n.a.

n.a.--not applicable.

1. Press reports have indicated that the National Economic Commission, which is charged with making specific recommendations to reduce the budget deficit, will report on March 1, as required by law.

CBO's baseline estimates differ from the administration's current services figures mainly because their economic assumptions are more pessimistic. Aggregate receipts in the two sets of budget projections, shown in table 2, are quite close, as the higher inflation in CBO's economic outlook roughly offsets the effects of their slower assumed growth of real income.² On the spending side of the budget, however, the administration's more optimistic projections of inflation and nominal interest rates lower their projections of outlays. Differences in technical assumptions, such as those for FSLIC spending, also affect the budget figures.

Both OMB and CBO raised their estimates of the deficit from levels forecast last summer. The administration's projections contain slightly higher estimates of receipts for both FY89 and FY90 than in the August Mid-Session Review but substantially higher outlays (almost \$28 billion for FY89 and \$16 billion for FY90). The continued surge in deposit insurance outlays and higher interest costs account for close to two-thirds of the rise in 1989 outlays; the upward revisions in OMB's estimates of outlays for 1990 are considerably more widespread, though the increase of \$10 billion in interest outlays looms large. CBO's deficit projections were revised up by lesser amounts--\$7 billion in FY89 and \$5 billion in FY90. In CBO's estimates, upward revisions of outlays, largely for interest and deposit insurance, outweighed the increase since last July in their estimates for receipts.

The focus of the Reagan budget initiatives remains essentially the same as it has for the last several years (see table 3). The budget does not call for any major changes in tax law. In the near term, the projected growth of receipts averages 8 percent over FY89 and FY90, mainly reflecting the assumed expansion of nominal income and employment. However, current law also provides a boost in payroll taxes in January 1990, when the combined employer-employee Social Security tax rate rises 0.27 percentage point.

On the outlay side, relatively small increases in spending--totaling \$5.1 billion in FY90--are slated for defense, international affairs, science, and a few other programs deemed to have a high priority. Outlay reductions--in almost all cases requests similar to those in earlier Reagan budgets--are proposed for some entitlements (Medicare, Medicaid, civil

2. Particularly in the near term, CBO appears to be slightly more optimistic than the Treasury about the volume of receipts associated with a given amount of income (particularly personal income).

3. The administration's economic assumptions are indicated as being premised broadly on the policies put forth in the budget, including the contour of deficit reduction. Thus, they might argue that failure to achieve the roughly \$40 billion deficit reduction in their proposals for the 1992-1994 period would imply higher interest rates than in their projections.

4. Unlike past years, there appear to be few definitional differences between the administration's current services and CBO baseline concepts, and they are relatively insignificant.

II-A-3
Table 2

COMPARISON OF ADMINISTRATION CURRENT SERVICES AND CBO BASELINE ESTIMATES
(Billions of dollars)

	Fiscal years					
	1989	1990	1991	1992	1993	1994
Receipts						
Administration	976	1058	1137	1209	1278	1342
CBO	983	1069	1140	1209	1280	1359
Outlays						
Administration	1136	1185	1238	1278	1315	1350
CBO	1138	1209	1280	1344	1410	1480
Deficit						
Administration	160	127	102	70	37	9
CBO	155	141	140	135	129	122

COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS

	Calendar years					
	1989	1990	1991	1992	1993	1994
-----Percent change, year-to-year-----						
Nominal GNP						
Administration	7.3	6.9	6.6	6.0	5.5	4.9
CBO	7.2	6.4	6.5	6.4	6.4	6.5
Real GNP						
Administration	3.2	3.2	3.3	3.2	3.2	3.2
CBO	2.9	2.1	2.2	2.2	2.3	2.3
GNP deflator						
Administration	3.9	3.6	3.2	2.7	2.2	1.7
CBO	4.2	4.2	4.2	4.1	4.1	4.1
-----Percent, annual average-----						
Civilian unemployment rate						
Administration	5.3	5.2	5.0	5.0	5.0	5.0
CBO	5.5	5.5	5.5	5.6	5.6	5.6
Three-month Treasury bill rate						
Administration	6.3	5.5	4.5	4.0	3.5	3.0
CBO	7.9	7.1	6.7	6.4	6.1	5.9

II-A-4
Table 3

COMPOSITION OF ADMINISTRATION BUDGET PROPOSALS: CHANGE FROM CURRENT SERVICES¹
(Billions of dollars)

	Fiscal years					
	1989	1990	1991	1992	1993	1994
Outlays:						
National defense		2.1	5.5	7.5	11.0	14.9
International affairs, space and science, and justice	*	2.6	3.6	5.3	6.1	6.7
Human resources ²	0.4	-15.4	-20.4	-24.2	-28.0	-32.0
Net interest	0.1	-1.2	-2.9	-4.5	-5.8	-6.9
Other domestic programs	1.0	-20.7	-16.8	-18.0	-19.3	-21.6
Subtotal, outlays	-1.5	-32.6	-31.0	-33.8	-36.0	-38.8
Receipts ³	*	-1.8	-3.8	-3.6	-3.3	-3.2
TOTAL EFFECT ON DEFICIT:	1.5	-34.4	-34.8	-37.4	-39.3	-42.0

Source: OMB, The Budget of the United States Government, Fiscal Year 1990, January 1989.

Note: Estimates exclude the effect of the administration's credit reform proposal.

---\$50 million or less.

1. Current services assumes that budget authority is held constant in real terms for all discretionary programs including defense, that programs for entitlements and other mandatory spending continue to operate as specified in current laws, and that tax law is unchanged.
2. Education, training, employment, and social services; Health; Medicare; Income security; Social security; and Veterans functions.
3. Receipt increases are shown as a negative because they reduce the deficit.

Table 4

REVENUE IMPACT OF RECENT TAX LEGISLATION BY ACT
 (Unified receipts basis, billions of dollars)

	Fiscal years				
	1988	1989	1990	1991	1992
Economic Recovery Tax Act of 1981	-264.4	-290.9	-322.8	-357.7	-397.6
Tax Equity and Fiscal Responsibility Act of 1982	57.3	55.7	57.2	61.2	64.7
Highway Revenue Act of 1982	4.9	5.1	5.1	5.1	5.1
Social Security Amendments of 1983	24.6	30.9	23.4	23.8	25.2
Other legislation enacted in 1983 ¹	-.6	-.9	-1.4	-1.7	-1.9
Deficit Reduction Act of 1984	25.4	27.7	31.0	33.8	37.9
Consolidated Omnibus Budget Reconciliation Act of 1985	2.9	3.0	3.0	3.2	3.5
Tax Reform Act of 1986 ²	-8.9	-24.4	-20.3	-16.4	-20.9
Other legislation enacted in 1986 ³	5.8	5.6	4.1	3.1	4.0
Legislation enacted in 1987 ⁴	10.6	16.6	18.7	18.1	14.9
Legislation enacted in 1988 ⁵	--	.3	6.7	7.6	6.9
Total enacted since 1981	-142.6	-171.3	-195.3	-219.8	-258.3

Source: OMB, The Budget of the United States Government, Fiscal Year 1990, January 1989.

1. Interest and Dividends Tax Compliance Act of 1983 and Railroad Retirement Revenue Act of 1983.
 2. Estimates include increases in the earned income credit, which is scored as an outlay in the unified budget.
 3. Includes Federal Employees' Retirement System Act, the Omnibus Budget Reconciliation Act, Superfund Amendments and Reauthorization Act, and the Continuing Resolution for 1987.
 4. Omnibus Budget Reconciliation Act of 1987 and Continuing Resolution for 1988.
 5. Includes Medicare Catastrophic Coverage Act of 1988, Family Support Act of 1988, and the Technical Corrections and Miscellaneous Revenue Act of 1988.
- Note: Details may not add to totals due to rounding.

TREASURY AND AGENCY FINANCING¹
(Total for period; billions of dollars)

	<u>1988</u>	<u>1989</u>	<u>1989</u>		
	Q4	Q1 ^e	Dec.	Jan. ^e	Feb. ^p
<u>Treasury financing</u>					
Total surplus/deficit (-)	-67.6	-62.1	-11.6	2.8	-26.3
Means of financing deficit:					
Net cash borrowing from the public	53.7	31.5	12.0	5.5	13.2
Marketable borrowings/ repayments (-)	36.9	28.7	1.8	5.6	11.9
Bills	15.5	3.7	-6.0	1.9	-.7
Coupons	21.4	25.1	7.7	3.7	12.6
Nonmarketable	6.3	2.8	1.1	.0	1.2
Other borrowing ²	10.5	.0	9.1	.0	.0
Decrease in the cash balance	10.8	24.7	-12.3	-10.1	20.1
Memo: Cash balance at end of period	33.7	8.9	33.7	43.7	23.6
Other ³	3.1	5.9	11.9	1.7	-7.0
<u>Federally sponsored credit agencies, net cash borrowing⁴</u>					
FHLBs	9.0 ^e	--	4.4 ^e	--	--
FNMA	-.5	--	.1	--	--
Farm Credit Banks	-.6	--	-.3	--	--
FAC ⁵	.2	--	.0	.0	--
FHLMC	.4 ^e	--	.2 ^e	--	--
FICO	2.1	--	1.4	.0	--
SLMA	2.0	--	.7	--	--

1. Data reported on a not seasonally adjusted, payment basis.

2. Securities issued by federal agencies under special financing authorities (primarily FSLIC).

3. Includes checks issued less checks paid, accrued items and other transactions.

4. Excludes mortgage pass-through securities issued by FNMA and FHLMC.

5. Financial Assistance Corporation, an institution within Farm Credit System, was created in January 1988 by Congress to provide financial assistance to Farm Credit Banks. It first issued bonds in July 1988.

e--staff estimate.

p--preliminary.

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

The 40 basis point decline in yields on long-term municipal securities over the intermeeting period has reduced the ratio of tax-exempt to taxable yields to its lowest level in five years. This sharp decline has occurred despite possible future downgradings of bonds issued by New York State, Connecticut, and New Jersey, each of which has suffered a significant revenue shortfall.

GROSS OFFERINGS OF MUNICIPAL SECURITIES
(Monthly rates, not seasonally adjusted, billions of dollars)

	<u>1987</u>	<u>1988</u>	<u>1988</u>			<u>1988</u>		<u>1989</u>
	Year	Year ^P	Q2	Q3	Q4 ^P	Nov.	Dec. ^P	Jan. ^f
Total offerings ¹	10.44	10.78	11.73	11.55	11.17	10.52	11.56	--
Total tax-exempt	10.05	10.54	11.41	11.32	10.99	10.14	11.43	10.50
Long-term	8.53	8.96	9.20	8.80	9.91	8.55	10.71	9.50
Refundings ²	3.80	2.73	3.18	1.87	2.83	2.72	2.27	--
New capital	4.73	6.23	6.02	6.93	7.08	5.83	8.44	--
Short-term ³	1.52	1.58	2.21	2.52	1.08	1.59	.72	1.00
Total taxable	.39	.24	.32	.23	.18	.38	.13	--

1. Includes issues for public and private purposes; also includes taxable issues.

2. Includes all refunding bonds, not just advance refundings.

3. Does not include tax-exempt commercial paper.

p--preliminary. f--forecast.

Mortgage Markets

Contract interest rates on commitments for conventional fixed-rate home loans and for adjustable-rate mortgages (ARMs) declined a bit most recently, but are a little higher than in the week preceding the last FOMC meeting. Lenders have continued to offer sizable initial rate discounts on ARMs, in order to gain or retain market share and loan-origination fees. The FHLBB's December survey of conventional home mortgage loans closed show that an estimated 60 percent of ARMs closed in the first five working days of the month carried initial discounts, with an average discount in excess of 200

CONFIDENTIAL (FR)
CLASS III - FOMC

February 3, 1989

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

CONFIDENTIAL FR CLASS II

February 2, 1989

FEDERAL SECTOR ACCOUNTS
(Billions of dollars)

	Fiscal Year 1988a	FY1989p				FY1990p				FRB Staff Projection										
		Admin ¹		CBO ²	FRB Staff	Admin ¹		CBO ²	FRB Staff	1988 IVa		I	II	1989 III	IV	1990 I		II	III	IV
		Not seasonally adjusted				Seasonally adjusted annual rates														
BUDGET																				
Budget receipts ³	909	976	983	979		1059	1069	1068		222	224	285	249	236	253	313	265	254		
Budget outlays ³	1064	1137	1138	1139		1152	1209	1195		289	286	284	279	303	299	301	292	307		
Surplus/deficit(-)	-155	-161	-155	-159		-93	-141	-127		-68	-62	1	-30	-66	-46	12	-26	-53		
to be financed ³	-194	-218	-211	-209		-161	-209	-192		-73	-77	-17	-42	-74	-64	-10	-43	-67		
(On-budget)	39	56	56	49		69	68	65		6	15	18	11	8	18	22	17	13		
(Off-budget)																				
Means of financing:																				
Borrowing	162	144	140	139		91	141	121		54	32	28	26	46	35	16	23	39		
Cash decrease	-8	14	n.a.	4		0	n.a.	0		11	25	-24	-7	22	3	-20	-5	22		
Other ⁴	1	3	n.a.	16		2	n.a.	6		3	6	-5	12	-2	8	-8	8	-8		
Cash operating balance, end of period	44	30	n.a.	40		30	n.a.	40		34	9	33	40	18	15	35	40	18		
NIPA FEDERAL SECTOR																				
Receipts	964	1029	1037	1030		1133	1133	1117		991	1020	1045	1062	1079	1113	1128	1146	1166		
Expenditures	1107	1174	1177	1175		1213	1255	1246		1143	1172	1187	1199	1217	1244	1257	1266	1283		
Purchases	380	398	395	397		413	416	409		393	394	398	401	403	410	411	412	413		
Defense	298	298	302	301		305	311	303		298	300	301	303	300	305	304	304	304		
Nondefense	82	100	93	96		108	105	106		95	94	97	99	102	105	107	108	109		
Other expend.	727	776	782	779		800	839	837		750	778	789	798	815	834	846	854	871		
Surplus/deficit	-143	-145	-140	-146		-77	-122	-130		-152	-152	-141	-137	-139	-131	-129	-120	-117		
FISCAL INDICATORS⁵																				
High-employment (HEB) surplus/deficit(-)	-151	n.a.	n.a.	-164		n.a.	n.a.	-137		-163	-172	-162	-158	-157	-142	-132	-116	-109		
Change in HEB, percent of potential GNP	.2	n.a.	n.a.	.3		n.a.	n.a.	-.5		.6	.2	-.2	-.1	0	-.3	-.2	-.3	-.1		
Fiscal impetus measure (FI), percent	.1 *	n.a.	n.a.	-4.1 *		n.a.	n.a.	-6.9 *		.9	-2	-.4	-.4	-2.9	-3.8	-.5	-.5	-.4		

a--actual

p--projection

**calendar year

n.a.--not available

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

1. The Budget of the United States Government, Fiscal Year 1990 (January 1989). Budget estimates include policy proposals.
2. Baseline budget estimates from The Economic and Budget Outlook: Fiscal Years 1990-1994 (January 1989).
3. Includes 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. Checks issued less checks paid, accrued items and changes in other financial assets and liabilities.
5. HEB is the NIPA measure in current dollars with cyclically-sensitive receipts and outlays adjusted to a 6 percent unemployment rate. 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.