

The U.S. Economy in 1986 and 1987

By J. A. Cacy, Glenn H. Miller, Jr., and Richard Roberts

The U.S. economy continued to grow in 1986 as the current business cycle expansion extended through its fourth year. Growth remained moderate, however, with a substantial part of internal demand growth again being met by imports. Household spending, for consumer goods and services and for housing, contributed heavily to total growth.

Interest rates declined substantially in 1986 as moderate economic growth held down the demand for credit. The sharp drop in oil prices also contributed to declining interest rates by lowering inflationary expectations. The Federal Reserve reduced its discount rate two percentage points during 1986 and maintained a generally accommodative policy during the year.

The economic expansion is expected to continue in 1987 as real GNP growth is likely to about equal that of 1986. The composition of growth is expected to change in 1987, however, as a smaller

portion of U.S. demand is met from imports and as export growth accelerates somewhat.

Nonetheless, uncertainty remains about the strength of domestic demand and the extent of improvement in U.S. net exports. This article summarizes economic and financial developments in 1986 and discusses the economic outlook for 1987.

The economy in 1986

The U.S. economy continued to grow moderately in 1986, despite strong growth in consumer spending and residential construction. Domestic demand grew more slowly than in 1985, and a worsening in net exports further reduced total growth. At the same time, 1986 was the best year for inflation performance in two decades. The improvement in inflation was due mainly to a fall in oil prices, but continued slack in the economy also contributed.

Economic growth

Economic growth in the first three quarters of 1986 slowed further from its moderate pace in

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TABLE 1

Real gross national product and components
(Percent change at seasonally adjusted annual rates)

	<u>1985^a</u>	<u>1986^b</u>
GNP	2.9	2.4
Final sales	4.1	2.2
Gross domestic demand	3.9	3.4
Personal consumption expenditures	3.5	5.5
Nonresidential fixed investment	6.5	-6.2
Residential fixed investment	7.8	11.7
Government purchases	8.4	0.0
Exports	-3.2	3.1
Imports	5.8	10.8
<u>Addenda</u>		
Inventory investment ^c	9.0 ^d	18.2 ^e
Net exports ^c	-108.2 ^d	-147.7 ^e
Personal saving rate ^f	5.1 ^d	4.3 ^e
^a 1985:Q4 compared with 1984:Q4		
^b 1986:Q3 compared with 1985:Q4		
^c Level, billions of 1982 dollars		
^d Annual average		
^e Average, first three quarters		
^f Personal saving as a percent of disposable personal income		

1985 (Table 1). This slowing occurred despite stronger growth in consumer spending and housing associated with sharp declines in oil prices and interest rates, and an increase in business inventory investment. Business capital spending declined in the first three quarters of 1986, and the growth in government purchases slowed markedly. Growth in domestic demand was slower than in 1985, and some of that growth was again diverted abroad. The U.S. net export position worsened considerably, despite the continuing decline in the value of the dollar and some evidence of increasing prices for imports. The

economy apparently grew moderately in the fourth quarter, and economic growth for the year was little changed from its 1985 pace.

Resource use and inflation

Slow output growth in 1986 brought little change in the underuse of resources. The civilian unemployment rate, which averaged 7.1 percent in the second half of 1985, averaged just over 7 percent for the first 11 months of 1986 and stood at that level in November. Nonfarm payroll employment increased in 1986, but manufacturing employment

TABLE 2
Consumer price index
 (Percent change at seasonally adjusted
 annual rates)

Period	All Items Less	
	All Items	Food and Energy
1982	3.9	6.0
1983	3.8	4.9
1984	4.0	4.7
1985	3.8	4.4
1986*	0.8	3.8

*First eleven months, annual rate

continued to slide. In addition, about one-fourth of the jobs in the oil and gas extraction industry was lost in 1986 as the industry adjusted to the sharp fall in oil prices. The rate of capacity use in industry drifted down through the year, indicating increased slack in the industrial sector of the economy.

Primarily because of the sharp decline in oil prices, 1986 was the best year for inflation in the United States since the mid-1960s. Oil prices fell about 50 percent from the end of 1985 before firming around midyear. Overall inflation as measured by the Consumer Price Index (CPI) responded by decelerating dramatically. The CPI increased at an annual rate of only 0.7 percent in the first ten months of 1986, compared with annual increases of about 4 percent in each of the four preceding years (Table 2). Improvement in inflation was not due solely to the decline in energy prices, however. The basic inflation rate, as indicated by the CPI less food and energy prices, also declined moderately in the first ten months of 1986, continuing a pattern of deceleration begun earlier in the decade (Table 2). Unit labor costs in the economy's nonfarm business sector also rose more slowly in the first three quarters of 1986 than in 1985, restraining the upward pressure of costs on

prices. The GNP deflator, the broadest general price index, increased at an annual rate of about 2.6 percent over the first three quarters of 1986, compared with a 3.3 percent increase for the year 1985.

Interest rates and the monetary aggregates in 1986

Interest rates declined substantially in 1986, as both short and long-term interest rates dropped to levels that had not been seen since 1977. The interest rate yield curve flattened during the first half of the year but steepened later. Long-term rates increased somewhat during the last half of the year but remained well below 1985 levels. In addition, real interest rates—nominal rates adjusted for inflation—decreased in 1986 but remained high by historical standards. Finally, both short and long-term U.S. interest rates generally declined more than their foreign counterparts.

Nominal interest rates

Short-term interest rates declined moderately through mid-April, rose slightly through mid-June, and then trended generally downward during the last half of the year (Chart 1). The decline in short-term rates mirrored a drop in the Federal Reserve's discount rate in 1986. The discount rate began the year at 7.5 percent and then was cut in a series of four one-half percentage point reductions to its current level of 5.5 percent.

Long-term interest rates declined sharply through mid-April but fluctuated in a narrow range slightly above their mid-April lows for the remainder of the year. For example, the 30-year U.S. Treasury constant maturity rate declined from around 9.3 percent in early January to around 7.2 percent in mid-April. After that, the 30-year Treasury rate increased to around 7.4 percent by early December (Chart 2).

CHART 1
Selected short-term interest rates

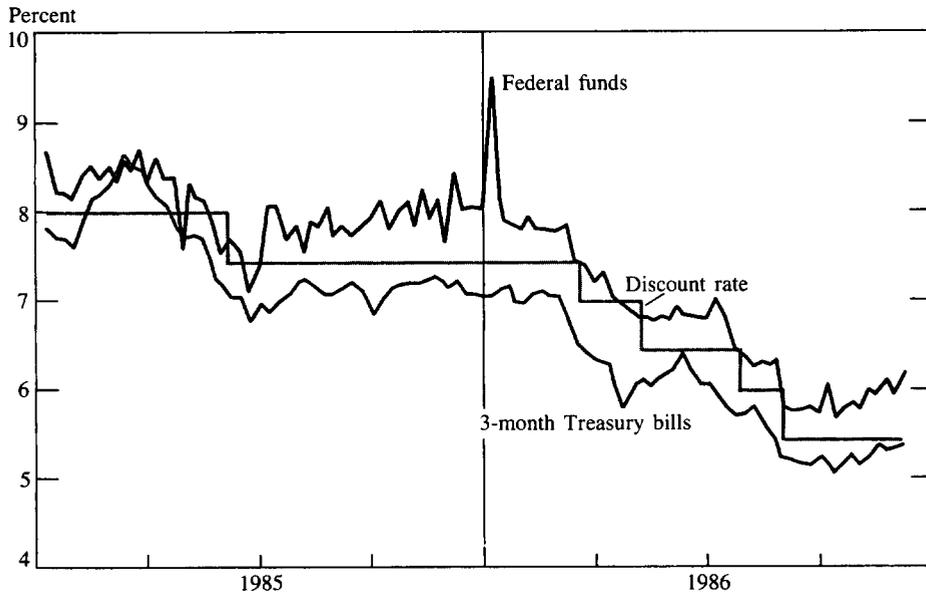


CHART 2
Selected long-term interest rates

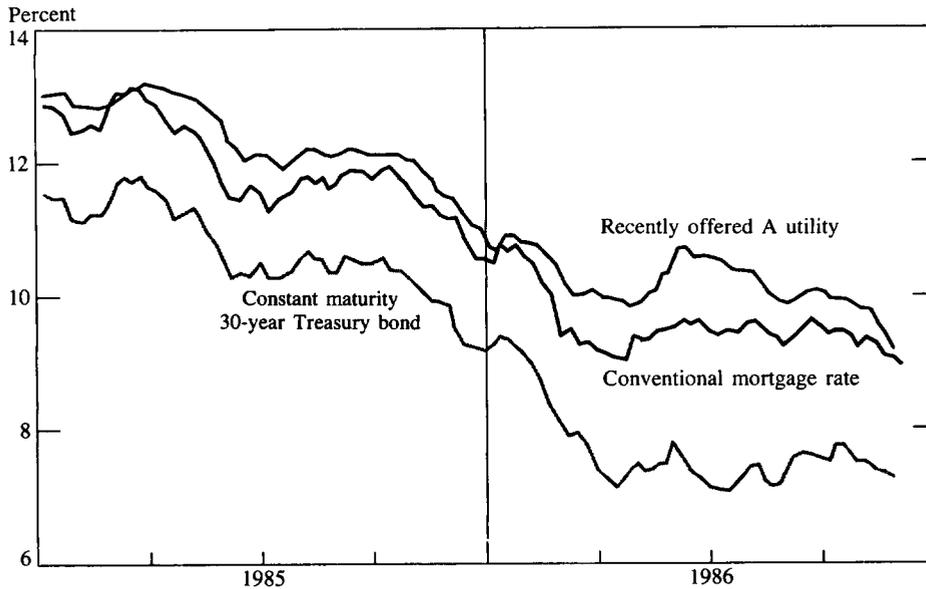
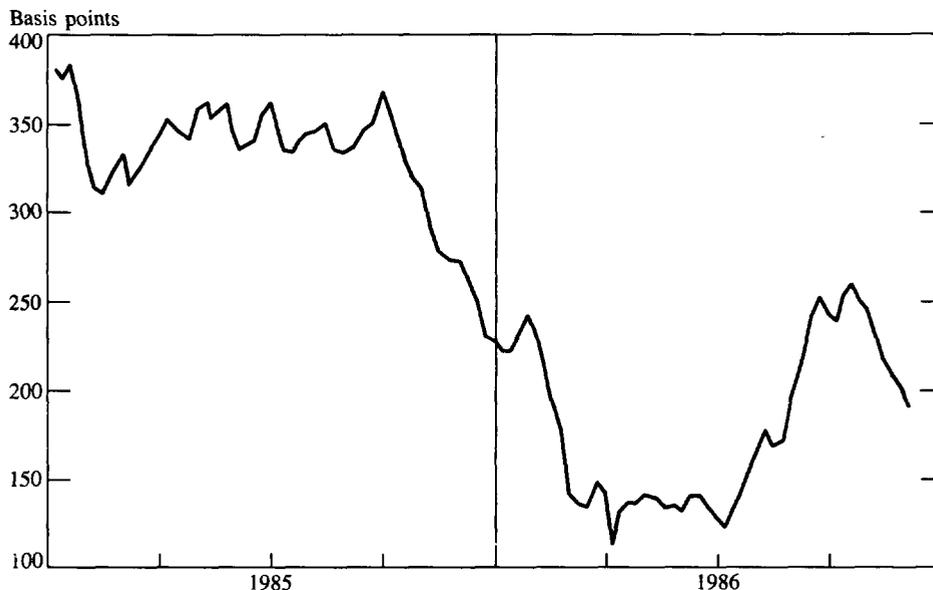


CHART 3
Yield on 30-year Treasury bonds
minus yield on 90-day Treasury bills



Yield curve

Chart 3 shows the yield spread between the 30-year Treasury bond and the 3-month Treasury bill, a measure of the slope of the yield curve. As shown, the yield spread fell sharply early in the year, resulting in a flattening of the yield curve. During the last half of the year, however, the yield curve steepened, as the spread between long and short-term interest rates increased. The interest rate yield curve is a smooth line drawn through several market interest rates, of varying times to maturity, observed at a particular time.

The dramatic flattening of the yield curve early in the year was due primarily to the sharp drop in oil prices. The sharp oil price decline, in turn, led to expectations of lower inflation that placed downward pressure on long-term rates. Short-term rates also declined moderately, due primarily to accommodative monetary policy.

There were several reasons for the steepening of the yield curve during the last half of the year. A bottoming out of oil prices, a runup in precious metals prices, and continued rapid monetary growth heightened concerns of future inflation. In addition, market expectations for the budget deficit apparently worsened after midyear. Finally, the decline in the value of the dollar may have caused foreign investors to reduce their participation in the U.S. bond market.

Real interest rates

Like nominal interest rates, measured real interest rates declined in 1986, but remained high by historical standards. The real 3-month Treasury bill rate averaged 3.2 percent for the year, lower than in 1985 but significantly higher than the -0.8 percent in the last half of the 1970s (Table 3). The tendency for real interest rates to persist at high

TABLE 3
Nominal and measured
real 3-month Treasury bill rate
 (Percent per year)

<u>Date</u>	<u>Nominal</u>	<u>Real</u>
1970-74	5.9	-0.9
1975-79	6.7	-0.8
1980-84	10.8	4.6
1985	7.5	4.2
1986	6.0	3.2
1986:Q1	6.9	4.4
Q2	6.1	4.3
Q3	5.5	1.9
Q4	5.3	1.7

Note: The measured real rate in this table is defined as the quarterly nominal 3-month Treasury bill rate minus the rate of inflation as measured by the percent change at an annual rate in the GNP deflator. Data for the fourth quarter assumes that the 3-month Treasury bill rate averaged 5.4 percent in December and that the inflation rate equaled that of the third quarter.

levels reflects, to an important extent, the impact of high budget deficits.

An additional indication of the decline in real interest rates in 1986 is shown in Chart 4. In this chart, the expected real interest rate is derived by subtracting the expected rate of inflation over the life of a security from the nominal yield of that security. By this measure, the real 1-year Treasury bill rate declined from 3.3 percent in December 1985 to 2.1 percent in November 1986. During the same period, the real 30-year bond rate declined from 3.9 percent to 2.0 percent.

Domestic rates relative to worldwide rates

The spread between U.S. and most foreign short-term rates declined in 1986, as domestic short-term rates generally fell more than their foreign counterparts. For example, from January

to early December, the rate on 3-month large certificates of deposit at U.S. banks declined over 2.0 percentage points, while comparable foreign short-term rates declined less than 1.5 percentage points.¹

U.S. long-term rates also declined more than their foreign counterparts. As shown in Chart 5, the spread between domestic and foreign long-term interest rates generally declined during the first six months or so, but after mid-year spreads over German rates stabilized, while the U.S.-Japanese spread rose.

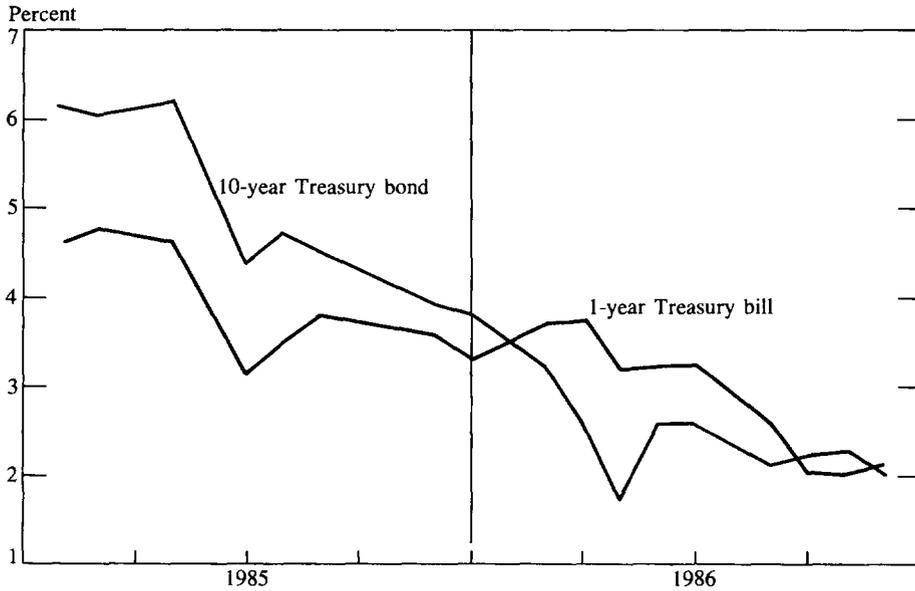
Monetary aggregates

Growth in the monetary aggregates in 1986 generally exceeded that of 1985. Through November 1986, the narrowly defined money supply, M1, grew at an annual rate of 15.0 percent, a pace considerably faster than in any recent year (Table 4). The more broadly defined money supply, M2, grew at an annual rate of 8.9 percent in 1986, about the same as in 1985. And M3, the most comprehensive money supply measure, grew at an annual rate of 8.7 percent, somewhat more than in 1985. In addition, domestic nonfinancial debt—the outstanding debt of all domestic government units, households, and nonfinancial businesses—grew at an annual rate of 12.6 percent in 1986, somewhat less than in 1985.

M1's turnover, or velocity, continued to decline sharply in 1986 as M1 grew much more rapidly than nominal GNP. The continued decline in velocity was due partly to the decline in interest rates, which induced the public to increase its holdings of liquid assets, including checkable deposits. Demand and other checkable deposits grew at an annual rate of 16.8 percent in the first three quarters of the year, compared with 13.7 percent in 1985.

¹ The foreign rates consist of a composite of G-10 (major west European countries, Canada, and Japan) and Swiss short-term rates. Source: Board of Governors of the Federal Reserve System.

CHART 4
Expected real interest rates



Source: Richard B. Hoey, *Decision-Makers Poll*, Drexel Burnham Lambert, Inc.

CHART 5
Long-term world interest rate differentials

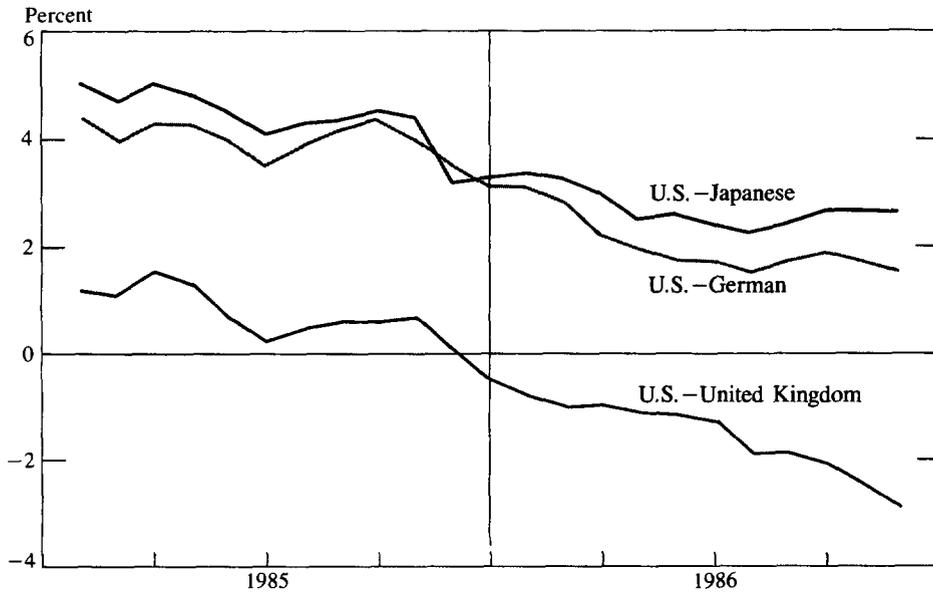


TABLE 4

Growth of the monetary aggregates: 1980-86
(Percent change at seasonally adjusted annual rates)

<u>Period</u>	<u>M1</u>	<u>M2</u>	<u>M3</u>	<u>Domestic Non-financial debt</u>
1980-85	8.1	9.4	10.0	14.8
1984	5.4	8.0	10.5	13.9
1985	11.9	8.7	7.7	13.3
1986: First 11 months*	15.0	8.9	8.7	12.6
1986: Q1	7.7	4.3	7.6	15.4
Q2	15.8	10.5	9.0	10.3
Q3	17.3	11.1	10.2	11.9

*Fourth-quarter 1985 through November 1986

The relationship between M1 velocity growth and short-term interest rates is illustrated in Chart 6. As shown, M1 velocity growth and the 3-month CD rate generally trended upward together from 1966 to 1980.² In recent years, however, M1 velocity trended downward, broadly mirroring the decline in the CD rate. Indeed, in recent years, velocity has become more sensitive to movements in market interest rates. This is partly due to the deregulation of interest rate ceilings and the rapid growth of M1's interest-bearing components.

Monetary policy in 1986

Monetary policy in 1986 continued to be guided by the need to bring about growth in the monetary

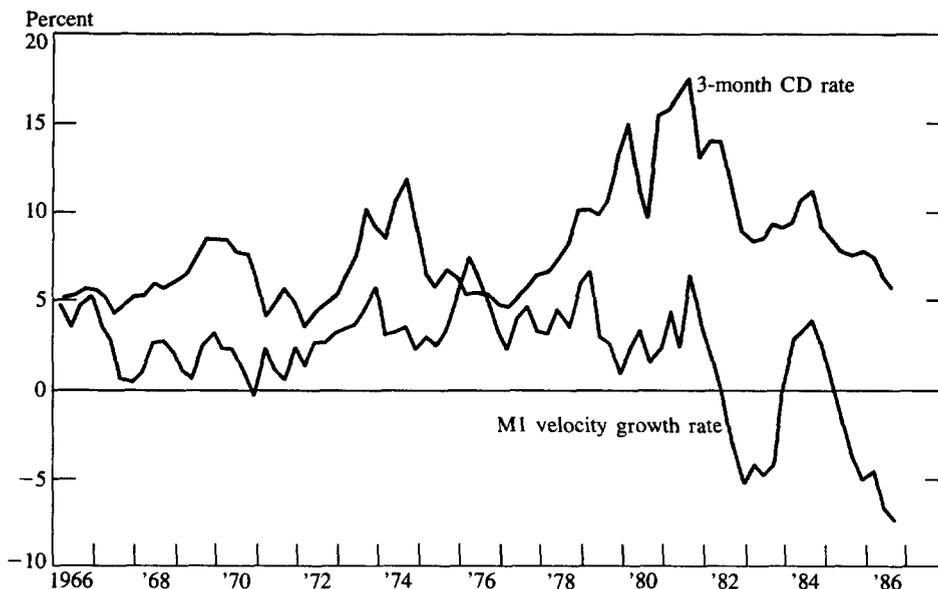
² The growth of velocity did not move upward with the CD rate in the early 1980s. This was due partly to the introduction of NOW accounts, which tended to reduce velocity by boosting M1 growth as the public transferred funds from non-M1 balances into NOW accounts.

aggregates consistent with sustainable economic growth in an environment of reasonable price stability over time.

In line with this objective, the Federal Reserve System's Federal Open Market Committee (FOMC) established growth rate ranges for the monetary and credit aggregates at its February 1986 meeting. M1's growth rate range for the period from the fourth quarter of 1985 to the fourth quarter of 1986 was established at 3 to 8 percent, while the ranges for M2 and M3 were both set at 6 to 9 percent. The range for total domestic nonfinancial debt was set at 8 to 11 percent.

Monetary growth in the broader aggregates was consistent with FOMC expectations and objectives during the first half of 1986. From the fourth quarter of 1985 to June 1986, M2 grew at an annual rate of 7.9 percent and M3 grew at an annual rate of 8.4 percent, both well within the 6 to 9 percent growth ranges established for these aggregates in February.

CHART 6
M1 velocity growth rate and 3-month CD rate



M1, however, grew much more rapidly than expected during the first half of 1986. The narrowly defined money supply increased at a 12.9 percent annual rate during the first half of the year, well above the earlier established 3 to 8 percent growth rate range.

Despite the rapid growth in M1, the Federal Reserve's monetary policy was generally accommodative in the first half of 1986. On March 7, the discount rate was cut from 7.5 percent to 7.0 percent, and on April 21, the discount rate was cut another one-half percentage point to 6.5 percent.

One consideration in the Federal Reserve's decision to lower the discount rate in the first half of 1986 was the desire to coordinate such action with other industrial nations. For example, the March 7 discount rate cut was taken "in the context of similar actions by other important industrial countries" such as Japan and Germany.³ The cut on

April 21 also was "consistent with international interest rate considerations."⁴ This action was shortly followed by a one-half percentage point cut in the Japanese discount rate. Acting in coordination with other industrial countries contributed to exchange rate stability and avoided undue deterioration in the value of the dollar. Furthermore, an overall reduction in the level of interest rates in other industrial countries was needed to stimulate their sluggish economies. The increase in the economic growth of industrial countries would, in turn, lead to an increase in the demand for U.S. exports and an improved U.S. trade deficit.

³ See press release, Board of Governors of the Federal Reserve System, March 7, 1986.

⁴ See press release, Board of Governors of the Federal Reserve System, April 18, 1986.

Several other factors also influenced the decision to maintain an accommodative monetary policy in the first half of 1986. Price pressures remained subdued, due in part to sharply lower oil prices. Also, growth in the broader monetary aggregates was moderate, with M2 and M3 remaining well within their growth rate ranges. In addition, economic growth was weaker than expected, and market interest rates generally declined throughout the period.

In accordance with the Full Employment and Balanced Growth Act of 1978, the 1986 target ranges for the aggregates were evaluated at the July FOMC meeting. At this meeting, the committee reaffirmed the 6 to 9 percent growth rate range set for M2 and M3 at its February meeting. The committee also reaffirmed the 8 to 11 percent growth rate range for domestic nonfinancial debt. Regarding M1, however, the committee noted that the demand for M1 balances had become increasingly sensitive to movements in market interest rates over the course of recent years. As a result, the committee felt that "it had become very difficult to assess or predict the implications of M1 growth for the future course of economic activity and the rate of inflation."⁵ Therefore, the committee stated that M1 growth in excess of the 3 to 8 percent range established earlier in the year would be acceptable. Chairman Volcker, in his testimony to Congress in July, stated that growth in M1 "could only be judged in the context of movements in the broader aggregates, and against the background of movements in interest rates and the economy generally."⁶

The posture of monetary policy generally remained accommodative during the second half

of the year. At its July and August meetings, the FOMC acted to reduce the restraint on bank reserve positions. On July 11 the discount rate was reduced one-half percentage point and a further reduction was made on August 21. These reductions were made in conjunction with declining market interest rates and against a background of slow economic growth, continued price stability, and moderate M2 and M3 growth.

For 1986 as a whole, the Federal Reserve was partly successful in achieving its growth objectives for the aggregates. Through November, the growth rates of M2 and M3 were at the upper end of their ranges. Due to the decline in velocity, M1's 11-month growth rate was well above the upper end of its range (Table 5).

Economic outlook for 1987

The current business cycle expansion is expected to continue through 1987 with the pace of economic growth likely to remain moderate. Real GNP growth is expected to be between 2.5 and 3 percent, compared with about 2.5 percent growth expected for 1986. Major uncertainties surrounding the outlook include the strength of consumer spending, the role of net exports in total output growth, and the impact of fiscal policy.

Consumer spending

Whether strong growth in consumer spending will continue to provide much of the motive power for total growth is an important question bearing on the performance of the economy in 1987. Consumer spending depends heavily on the growth of real disposable personal income and the behavior of the personal saving rate. Only modest real income growth is expected in 1987, as compensation grows only moderately and inflation accelerates slightly. The modest growth in real income expected in 1987 is thus related partly to an erosion of domestic purchasing power due to

⁵ Record of Policy Actions of the Federal Open Market Committee, meeting held on July 8, 1986.

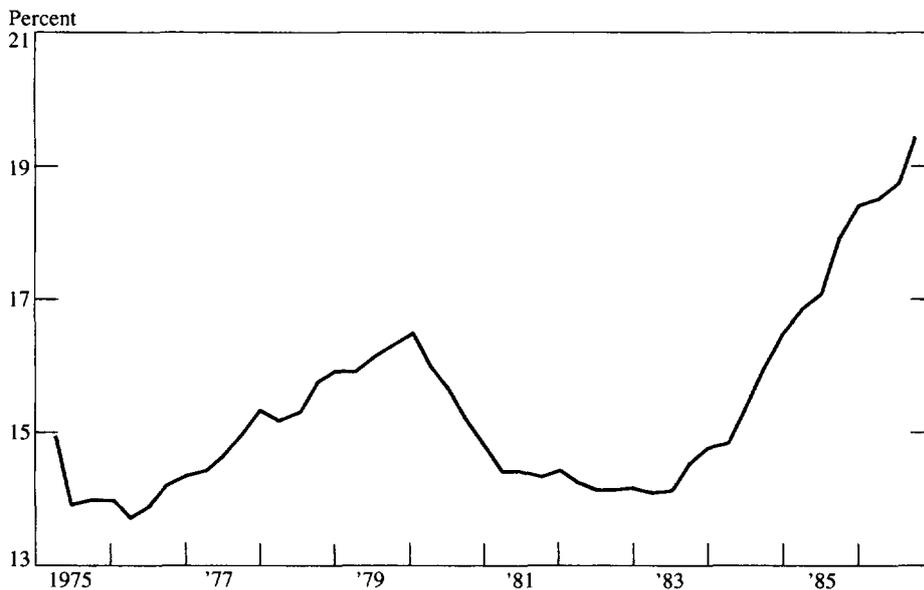
⁶ Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, *Monetary Policy Objectives for 1986*, Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 23, 1986.

TABLE 5
FOMC growth rate ranges
 (Percent change at seasonally adjusted annual rates)

<u>Period</u>	<u>M1</u>	<u>M2</u>	<u>M3</u>	<u>Domestic Non-financial Debt</u>
1986 actual*	15.0	8.9	8.7	12.6
1986 FOMC growth ranges	3-8	6-9	6-9	8-11
1987 FOMC tentative growth ranges	3-8†	5.5-8.5	5.5-8.5	8-11

*Growth rate from fourth-quarter 1985 through November 1986.
 †Indicative of likely range if more stable velocity behavior shows signs of reemerging.

CHART 7
Ratio of consumer installment credit outstanding to disposable personal income



rising import prices. Consumer spending growth is thus likely to be modest unless the slack from expected slower income growth is taken up by a further reduction in the personal saving rate.

Declines in the saving rate bolstered consumer spending in 1985 and 1986, but a repeat of that performance in 1987 is unlikely. The saving rate, which hovered around 7 percent in the late 1970s and early 1980s, fell from 6.3 percent in 1984 to an average just over 5 percent for 1985 and the first half of 1986 (Table 1). A further decline in the saving rate in the second half of 1986 was due partly to the low third-quarter rate associated with the incentive-induced surge in domestic new car sales. The saving rate may not increase much in 1987, but further significant declines are unlikely. Thus, a stable to rising saving rate is expected to join modest income growth in restraining the growth of consumer spending in 1987.

What happens to the saving rate in 1987 will depend partly on past and prospective changes in the extent of consumer credit use. Heavy use of credit in 1986 brought a sharp increase in the ratio of consumer installment credit outstanding to disposable personal income (Chart 7). The resulting increased debt burden can be expected to restrain consumer spending as households face increasing debt service expenses and become slow to add new debt. A similar analysis before 1986 was not borne out by consumer behavior, at least partly for some special reasons. Real personal disposable income growth benefited from the lower inflation rate as the decline in oil prices released income for increased purchases of other goods and services. Household net worth was maintained or increased as the value of household assets increased, acting as a counterbalance to the rising debt-income ratio. The sharp declines in interest rates, though depressing the growth in interest income, also served to strengthen consumer spending. The likelihood is low, however, of a similar set of positive influences coming together again in 1987.

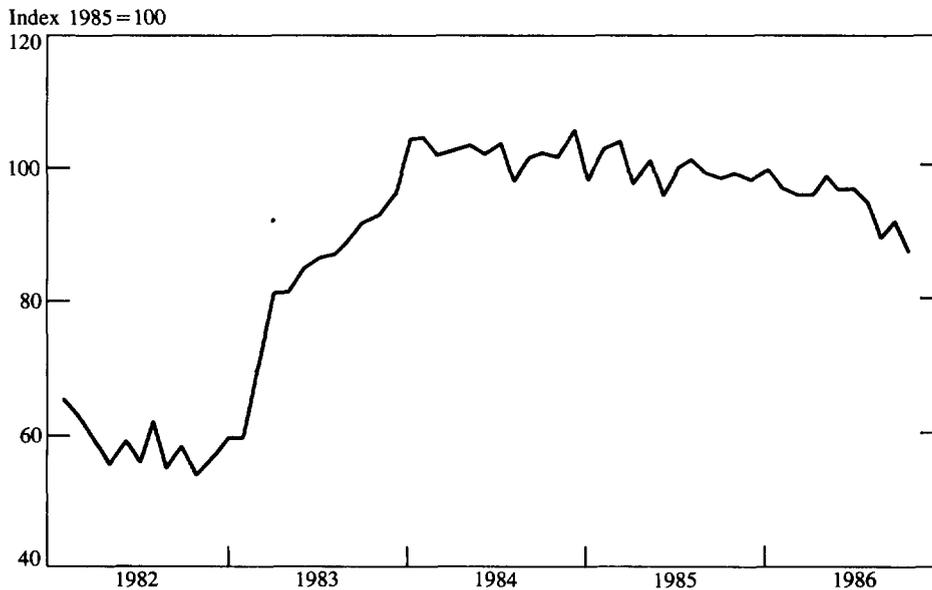
The ability of households to increase their purchases depends on such things as income growth, changes in the saving rate, and the burden of debt. But the ability to increase purchases does not alone determine the growth of consumer spending. Households must also be willing to increase their purchases, and that depends partly on their attitudes regarding their own future and the future of the economy. One measure of such attitudes is the Conference Board index of consumer confidence. That index, after drifting downward since early 1984, declined noticeably in the last half of 1986 (Chart 8).

For all these reasons, personal consumption expenditures are expected to grow more slowly in 1987 than in 1986. Modest income growth, no further decline in the saving rate, the burden of consumer debt, and lessened consumer confidence are likely to combine to prevent strong growth in consumer spending in 1987.

Other domestic spending sectors

Domestic final purchases other than personal consumption expenditures are not likely to contribute to economic growth in 1987. An exception is business fixed investment, which is expected to contribute slightly to growth in 1987 after being a drag on growth in 1986, especially in the first half of that year when the energy industry reduced its spending in response to the oil price declines. With most of that adjustment presumed to be over, some slight increase in capital spending is possible even though the capacity utilization rate remains low. Moderate growth in spending for producers' durable equipment may offset further declines in spending for new nonresidential structures. Residential construction, an important factor in 1986 growth, is expected to contribute little if anything to growth in 1987. Most of the effects of the early 1986 fall in mortgage rates have been felt, and high rental vacancy rates and reduced tax benefits are expected to restrain building of

CHART 8
Index of consumer confidence



Source: The Conference Board

multifamily structures. Government purchases are expected to increase at about their slow 1986 rate. Finally, inventory investment is expected to be a small but positive contributor to growth in 1987.

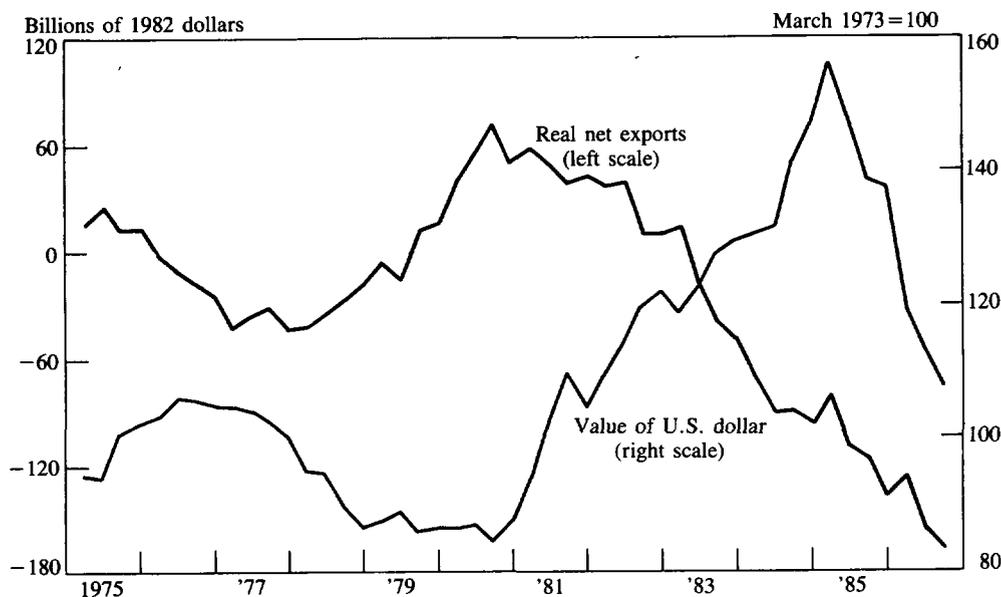
Net exports

The forecast of moderate growth in 1987 depends heavily on a significant turnaround in net exports. Improvement in the U.S. net exports position, in turn, depends partly on the relationship between the foreign exchange value of the dollar and net exports. Chart 9 shows the weighted average exchange value of the dollar and net exports moving regularly in opposite directions from 1975 to 1985. Expectations of an improvement in U.S. net exports in 1987 rest largely on a response to the decline in the dollar's value, which began in early 1985.

According to the measure shown, the dollar's value fell more than 30 percent from the first quarter of 1985 to the third quarter of 1986. The resulting higher prices for U.S. imports and lower prices for U.S. exports are expected to discourage imports and stimulate exports, thus improving the U.S. trade balance and making it a contributor to economic growth in 1987. Because much of the improvement is expected to be in traditional goods-producing industries, the U.S. economy would be strengthened and some of the imbalances of recent years would be corrected.

Many analysts expected the scenario just described to begin to be seen in 1986, but there is little evidence of its appearance yet. As Chart 9 shows, net exports continued to decline through the third quarter of 1986 despite the fall in the dollar's value. Several reasons have been given for an improvement in net exports not appearing

CHART 9
Real net exports and index of weighted-average
exchange value of U.S. dollar



after nearly two years of significant decline in the value of the dollar. One is that the lag between the beginning of dollar depreciation and a turnaround in real net exports is simply longer than estimated. A second is that foreign producers have not raised their prices in line with the appreciation of their currencies against the dollar, reflecting a strategy of accepting lower profit margins to hold market share.

Another reason suggested for the persistence of the trade gap is that the commonly cited indicators of change in the trade-weighted value of the dollar may not present a correct picture of the decline in the dollar. The dollar has not declined uniformly against the currencies of all our trading partners. It has declined most against the currencies of Japan and the European countries. However, it has declined little if any against the currencies of several other countries—including

Canada, Mexico, and several east Asian countries other than Japan—which account for a large part of our trade deficit.

Relatively slow growth in the economies of some of our major trading partners has also limited the growth of foreign demand for U.S. goods. Table 6 shows that real GNP growth was slower in Japan and west Europe after the 1980-82 recession years than in the late 1970s. Growth strengthened in Canada and in west Europe in the first half of 1986, but slowed down in Japan. Recent economic policy moves in Japan, including the third discount rate reduction of 1986 and a proposal for tax reform to take effect in 1987, should provide some stimulus to demand growth there. Increased growth in demand for U.S. exports resulting from faster growth in foreign economies would help improve the U.S. trade balance.

TABLE 6

**Real gross national product, United States
and selected major trading partners**
(Percent change, annual rate)

	<u>1976-79</u>	<u>1980-82</u>	<u>1983-85</u>	<u>1986*</u>
United States	4.3	-0.3	4.2	2.2
Canada	3.6	0.6	4.2	4.7
Japan	5.2	3.7	4.3	1.9
West Europe†	3.6	0.5	2.2	3.5 ^e
*First half				
†Germany, United Kingdom, France, Italy				
^e Estimated				

These four factors also account for the uncertainty about the extent and timing of an improvement in U.S. net exports and its contribution to economic growth in 1987. Without a significant improvement in net exports, economic growth in 1987 will be slower than suggested earlier.

Monetary and fiscal policy in 1987

The FOMC established tentative 1987 growth rate ranges for the monetary and credit aggregates in mid-1986. The tentative ranges for M2 and M3 were both set at 5.5 to 8.5 percent, slightly less than their 1986 ranges. The M1 range for 1987 was tentatively set at the 1986 range of 3 to 8 percent, assuming that more stable velocity behavior reemerges. The tentative domestic nonfinancial debt range was set at the 1986 range of 8 to 11 percent. These tentative ranges will be reconsidered when the FOMC meets early in 1987.

The fiscal policy stimulus of recent years is likely to be reduced in 1987. The actual budget deficit set a record of \$220.7 billion in fiscal year

1986. Budget legislation enacted by Congress and signed by the President produced an estimated deficit of \$151 billion for fiscal 1987. While above the Gramm-Rudman-Hollings target of \$144 billion, the estimated deficit was within the \$10 billion leeway granted by the law. Private observers and some congressional leaders have suggested that the 1987 deficit is more likely to be near \$180 billion. But even at that level, a sizable decline in the deficit from its 1986 record level would be achieved.

The estimated decline in the actual deficit would be accompanied by a significant decline in the structural, or high employment, budget deficit. This measure, which estimates how big the deficit would be at a high level of resource use, is an indicator of the thrust of fiscal policy. A smaller high employment deficit in fiscal 1987 indicates a lessening in fiscal stimulus that would be a restrictive influence on economic growth. A decrease in the structural deficit would thus weigh in on the side of only modest economic growth in 1987.

Resource use and inflation

There are reasons for expecting some acceleration in inflation from its slow rate in 1986. The end of the sharp decline in the price of oil, and the firming that followed, will contribute to a higher inflation rate. In addition, the weakening dollar has brought some increases in import prices and higher import prices have the potential for reducing pressure on prices of U.S. goods competing with imports. The weaker dollar, then, is also a potential source of accelerating inflation in this country.

While these factors will mean a higher rate of inflation than in 1986, the expected moderate rate of economic growth and continued slack in the economy will keep inflation moderate in 1987. With the civilian unemployment rate and the rate

of industrial capacity use likely to change little in 1987, moderate labor cost increases are expected to put little upward pressure on prices.

Conclusion

Neither recession nor exceptional strength is expected for the U.S. economy in 1987. Moderate growth in real GNP is expected to rely on a significant turnaround in U.S. net exports and continued but slower growth in personal consumption expenditures. Other major spending sectors are likely to contribute little to total growth. The rate of resource use is not likely to change much in such an environment. But inflation will probably accelerate somewhat from its very low rate in 1986, due to the effects of the dollar depreciation and the end of the sharp fall in oil prices.