

# The U.S. Economy in 1985 and 1986

By J. A. Cacy, Glenn H. Miller, Jr., and Dan H. Hoxworth

The U.S. economy continued on an upward path in 1985, but its upward momentum slowed considerably in the first half of the year. While economic growth was supported by a healthy growth in the demand for goods and services, domestic production grew sluggishly because the demand was met in part by imports from abroad. The economy grew more rapidly in the second half of the year, leading to improved expectations for continued expansion in 1986. However, uncertainties are numerous as the economy moves into its fourth year of expansion. This article summarizes the economic and financial developments in 1985, and then discusses some of the uncertainties and the economic outlook for 1986.

## The economy in 1985

### *A slow first half*

Economic growth was sluggish in the first half of 1985, with real gross national product (GNP) growing at a rate of only 1 percent after growing at a 3 percent rate in the last

half of 1984 (Table 1). A decline in inventory investment and a further worsening of the nation's net export position in the first half of 1985 largely offset a moderately strong increase in domestic final purchases of goods and services, which includes personal consumption expenditures, business fixed investment, residential construction, and government purchases. U.S. households provided most of the strength in final purchases, due to strong growth in consumption and an increase in residential construction spending. Business capital spending also rose in the first half of 1985 and government purchases showed a small increase.

### *Faster growth after midyear*

Economic growth quickened after midyear, with real GNP growing at a 4.3 percent rate in

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**TABLE 1**  
**Real gross national product and components**  
 (percent change at seasonally adjusted annual rates)

|                                   | 1984       |             | 1985       |               |
|-----------------------------------|------------|-------------|------------|---------------|
|                                   | First Half | Second Half | First Half | Third Quarter |
| GNP                               | 8.6        | 3.0         | 1.1        | 4.3           |
| Final sales                       | 7.0        | 3.5         | 2.2        | 5.7           |
| Domestic final purchases          | 8.7        | 3.6         | 4.6        | 6.6           |
| Personal consumption expenditures | 6.3        | 2.2         | 5.0        | 5.4           |
| Nonresidential fixed investment   | 21.0       | 11.1        | 6.5        | -3.7          |
| Residential fixed investment      | 11.3       | -5.1        | 5.9        | 11.5          |
| Government purchases              | 9.8        | 5.7         | 2.0        | 19.0          |
| <b>Addendum*</b>                  |            |             |            |               |
| GNP                               | 66.1       | 23.6        | 8.9        | 17.6          |
| Inventory investment              | 13.1       | -2.5        | -8.5       | -5.8          |
| Final sales                       | 53.1       | 27.1        | 17.4       | 23.4          |
| Domestic final purchases          | 66.5       | 28.9        | 37.9       | 28.0          |
| Net exports                       | -13.4      | -2.0        | -20.4      | -4.6          |

\*Change from preceding period, seasonally adjusted annual rates, billions of 1972 dollars

the third quarter. Domestic final purchases grew even faster in the third quarter than in the first half of the year and net exports declined less. Inventory investment declined somewhat more rapidly than in the first half, largely because of a sharp rundown in new domestic automobile stocks.

The third-quarter strength in domestic final purchases was due partly to a sharp rise in government purchases of goods and services. Federal purchases rose because of increased use of Commodity Credit Corporation loans by farmers and a large increase in defense purchases. Residential fixed investment also rose

in the third quarter while nonresidential fixed investment declined. Personal consumption expenditures again grew strongly in the third quarter.

The economy apparently continued to grow at a moderate pace in the fourth quarter of 1985. As a result, economic growth for all of 1985, likely to be no more than 2.5 percent, was considerably below that of 1984. Growth in domestic final purchases was relatively strong all year, due in large measure to the strength of personal consumption expenditures. There was less drag on real GNP from worsening net exports in the second half of the

year, but the negative impact of decreasing inventory investment continued past midyear.

### *Resource use and inflation*

Output growth in 1985 was not strong enough to significantly reduce the underuse of resources. The civilian unemployment rate fell slightly, from 7.2 percent in December 1984 to 7.0 percent in November 1985. Nonfarm payroll jobs increased moderately but manufacturing employment declined. Another measure of resource use—the rate of capacity utilization in industry—declined about one percentage point, reflecting the greater slack present in the industrial sector than in the total economy.

The U.S. inflation rate was kept in check by the slack in the economy combined with the impact of the strong dollar on prices of imports and import-competing goods. Unit labor costs rose at a moderate rate, and favorable performances of food and energy prices also contributed to relatively mild inflation in 1985. The GNP deflator, the broadest general price index, increased at a 3.75 percent annual rate over the first three quarters of 1985. The index of prices of finished goods sold at wholesale was about 1.5 percent higher in November 1985 than a year earlier, as food prices declined significantly and energy prices dropped slightly. Consumer price inflation also continued to be restrained. The Consumer Price Index, benefiting from moderate growth in food prices, was only 3.6 percent higher in November 1985 than a year earlier.

### *Summary*

The year 1985 saw moderate U.S. demand growth changed into sluggish output growth by a worsening in net exports and a reduction in inventory investment. Sluggish output

growth kept the amount of idle resources relatively large. The slack in the economy, along with the direct influences of the strong dollar and weak food and energy prices, kept price inflation restrained.

## **Financial developments in 1985**

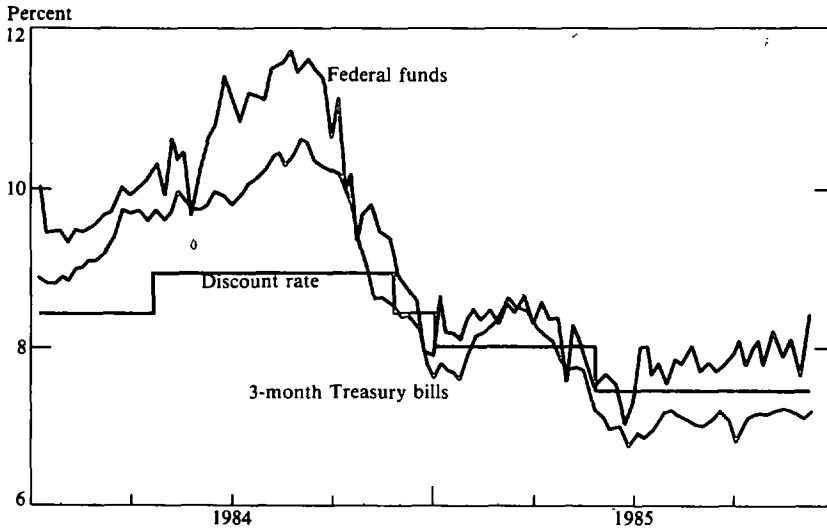
### *Interest rates*

Interest rates were lower and more stable in 1985 than in other recent years. Short-term interest rates were their lowest since 1978, while long-term rates declined to levels that had not been seen since 1980. Short-term interest rates were more stable than in any year except one since 1978, while long-term interest rates also fluctuated less than in most recent years. Real interest rates—nominal rates adjusted for inflation—were also lower in 1985 than in recent years, although they remained very high by historical standards.

Interest rates fluctuated some during the year. From late January to early March, both short and long-term interest rates rose moderately to yearly highs, due in part to strong demand for business credit and the ending of a period during which the Federal Reserve eased pressures on bank reserve positions. After peaking in March, interest rates declined in April and June. The weak performance of the economy and a corresponding sharp drop in the demand for business loans were factors in the rate decline. A cut in the Federal Reserve's discount rate also contributed to the second-quarter drop in interest rates.

After midyear, short-term rates fluctuated in a narrow range slightly above their June lows. By early December, the 3-month U.S. Treasury bill rate was 7.10 percent, about one percentage point less than at the end of 1984 (Chart 1). Long-term interest rates also fluctuated in a narrow range in the third quarter, but

**CHART 1**  
**Selected short-term interest rates**



**CHART 2**  
**Selected long-term interest rates**

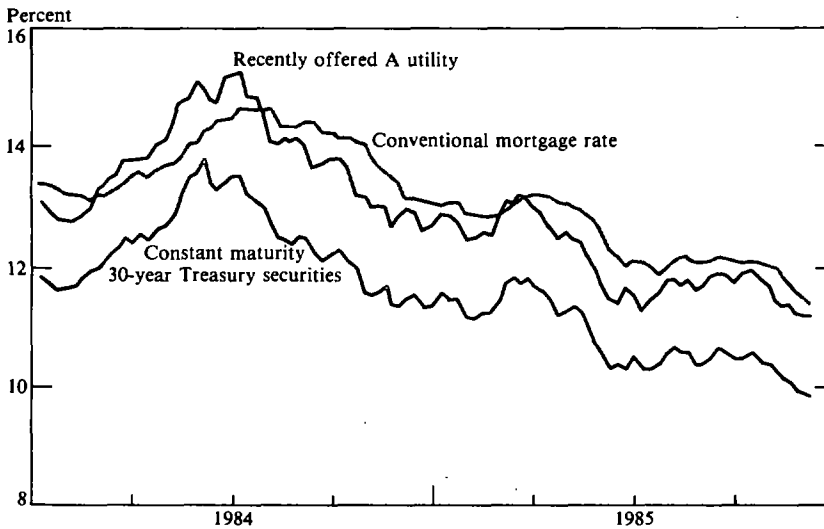


TABLE 2

## Selected interest rates: yearly highs, lows, and averages

| <u>Period*</u> | <u>Federal Funds</u> | <u>3-Month Treasury Bills</u> | <u>U.S. Government 30-Year</u> |
|----------------|----------------------|-------------------------------|--------------------------------|
| 1980 High      | 18.90                | 15.49                         | 12.40                          |
| Low            | 9.03                 | 7.07                          | 9.81                           |
| Average        | 13.36                | 11.43                         | 11.30                          |
| 1981 High      | 19.10                | 16.30                         | 14.68                          |
| Low            | 12.37                | 10.85                         | 12.14                          |
| Average        | 16.38                | 14.03                         | 13.44                          |
| 1982 High      | 14.94                | 13.48                         | 14.22                          |
| Low            | 8.95                 | 7.71                          | 10.54                          |
| Average        | 12.26                | 10.61                         | 12.76                          |
| 1983 High      | 9.56                 | 9.34                          | 11.88                          |
| Low            | 8.51                 | 7.86                          | 10.48                          |
| Average        | 9.05                 | 8.58                          | 11.18                          |
| 1984 High      | 11.64                | 10.47                         | 13.44                          |
| Low            | 8.38                 | 8.06                          | 11.52                          |
| Average        | 10.22                | 9.52                          | 12.39                          |
| 1985 High      | 8.58                 | 8.52                          | 11.81                          |
| Low            | 7.53                 | 6.95                          | 10.06                          |
| Average        | 8.09                 | 7.51                          | 10.91                          |

\*Calculations are based on monthly average rates for each calendar year. 1985 calculations are based on data through November.

then dropped rapidly in late October. By early December, the yield on 30-year U.S. Treasury securities had dropped to 9.61 percent, almost two percentage points lower than at the end of 1984 (Chart 2). Contributing to the drop in long-term rates was continued low inflation, signs that the economy would remain sluggish, and indications that monetary policy would not tighten. Also, progress toward a congressional budget resolution intended to reduce the federal budget deficit placed downward pressure on long-term rates.

Interest rates in 1985 were more stable than in most recent years. Short-term interest rates

fluctuated within a narrow range of one and one-half percentage points during the year, compared with three percentage points in 1984 and considerably less than in any year except one during the 1980-84 period (Table 2). Long-term rates were also relatively stable in 1985, fluctuating in a relatively narrow range of less than two percentage points.

Like nominal interest rates, real interest rates declined in 1985 but remained high by historical standards. The real prime rate averaged 6.3 percent for the year, lower than in 1984 and during the 1981-84 period, but significantly above the average of only 1.8 per-

**TABLE 3**  
**Nominal and measured real prime rate**

| <b>Date</b> | <b>Nominal</b> | <b>Real</b> |
|-------------|----------------|-------------|
| 1970-74     | 7.5            | 1.5         |
| 1975-79     | 8.6            | 1.8         |
| 1980-84     | 14.4           | 8.4         |
| 1984        | 12.0           | 8.4         |
| 1985        | 9.9            | 6.3         |
| 1985:Q1     | 10.5           | 5.2         |
| Q2          | 10.2           | 7.6         |
| Q3          | 9.5            | 6.2         |
| Q4          | 9.5            | 6.2         |

Note: The measured real prime rate is defined in this table as the quarterly nominal prime rate minus the rate of inflation as measured by the percentage change at an annual rate in the GNP deflator. Data for 1985 assume that the prime rate averaged 9.5 percent in the fourth quarter and that the inflation rate equaled that of the third quarter.

cent in the last half of the 1970s (Table 3). Real interest rates remained at historically high levels because of the large federal budget deficit and continuing investor concerns that the deficit may eventually lead to inflationary growth in the supply of money and credit.

### *Growth of the monetary aggregates in 1985*

Growth in the monetary aggregates in 1985 generally exceeded that of 1984. M1 grew considerably faster than in any recent year and M2 rose faster than in 1984. The growth rate of M3, however, was less in 1985 than in 1984.

M1, the narrowly defined money supply, grew at an annual rate of 11.6 percent in the first 11 months of 1985, more than twice 1984's growth rate (Table 4). This rapid growth stemmed from the resurgence of the growth in demand deposits and a rebound in

the growth of other checkable deposits. After exhibiting little growth on balance in the past five years, demand deposits grew at an annual rate of 8.0 percent in the first 11 months of 1985. Other checkable deposits, which include interest-bearing NOW and Super NOW accounts, grew at an annual rate of 22.1 percent during the same period, almost twice that of 1984.

M1's turnover, or velocity, declined sharply in 1985, as M1 grew much more rapidly than nominal GNP. During the first three quarters of the year, M1's velocity declined at an annual rate of 6.2 percent (Table 5). In contrast, velocity rose in 1984 and during the 1980-84 period as a whole. The decline in M1's velocity was due in part to the drop in interest rates that occurred in late 1984 and 1985. The decline in interest rates reduced the yield on alternative investments and made it less costly for the public to hold its assets in M1 balances. Concern over the stability of the financial system and the economy also may have encouraged the public to place more of its funds in M1 balances.

M2 grew at an annual rate of 8.6 percent in the first 11 months of 1985, somewhat more than in 1984 (Table 4). In contrast with M1 growth, M2 growth in 1985 was in line with its average growth during the 1980-84 period.

In addition to M1, several of the other components of M2 grew more rapidly in 1985 than in 1984. Savings deposits increased in 1985 after contracting in 1984. MMDA's also grew more rapidly in 1985 than in 1984. Some of the 1985 growth of both MMDA's and savings deposits may have come at the expense of small time deposits (certificates of deposit under \$100,000). Small time deposits declined sharply in 1985, compared with sharp growth in 1984.

In contrast with M1 and M2, growth of M3 slowed sharply in 1985. M3 grew at an annual

**TABLE 4**  
**Growth of the monetary aggregates: 1980-85**  
 (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> |
|---------------------------|-----------|-----------|-----------|------------------------------------|
| 1980-84                   | 8.5       | 11.5      | 12.9      | 13.1                               |
| 1983                      | 10.4      | 12.2      | 10.0      | 11.2                               |
| 1984                      | 5.2       | 7.7       | 10.4      | 14.1                               |
| 1985: First<br>11 months* | 11.6      | 8.6       | 7.8       | 12.8                               |
| 1985:Q1                   | 10.6      | 12.1      | 10.7      | 13.6                               |
| Q2                        | 10.2      | 5.3       | 5.2       | 11.8                               |
| Q3                        | 15.0      | 10.2      | 8.1       | 12.2                               |
| 1985:July                 | 9.3       | 8.6       | 4.8       | 12.6                               |
| Aug.                      | 20.3      | 11.3      | 9.7       | 12.0                               |
| Sept.                     | 11.9      | 7.1       | 10.1      | 11.0                               |
| Oct.                      | -1.6      | 2.1       | 3.9       | 11.6                               |
| Nov.                      | 13.0      | 6.6       | 5.0       | 16.1                               |

\*Fourth-quarter 1984 through November 1985

Note: Annual rates of growth are based on quarterly average data. M1 is the sum of currency held by the public, plus travelers' checks, demand deposits, and other checkable deposits, including negotiable order of withdrawal (NOW and Super NOW) accounts, automatic transfer service (ATS) accounts, and credit union share draft accounts.

M2 is M1 plus savings and small-denomination time deposits, plus money market deposit accounts, shares in money market mutual funds (other than those restricted to institutional investors), overnight repurchase agreements, and certain Eurodollar deposits.

M3 is M2 plus large time deposits, large-denomination term repurchase agreements, shares in money market mutual funds restricted to institutional investors, and term Eurodollar deposits.

Domestic nonfinancial sector debt is outstanding debt of domestic government units (federal, state, and local), households, and nonfinancial businesses.

rate of 7.8 percent in the first 11 months of 1985, considerably less than in any recent year. This slower growth was largely due to a sharp drop in the growth of large-denomination time deposits. Growth of term repurchase agreements and institution-only money market funds also slowed considerably in 1985.

Growth of domestic nonfinancial debt also slowed in the first 11 months of 1985, growing at a rate of 12.8 percent, moderately less than in 1984. Domestic nonfinancial debt consists of the outstanding debt of all domestic government units (federal, state, and local), households, and nonfinancial businesses.

**TABLE 5**  
**Growth of nominal GNP, M1, and velocity of M1 and M2**  
 (percent change at seasonally adjusted annual rates)

| <u>Period</u>                 | <u>GNP</u> | <u>Money Supply</u> |           | <u>Velocity</u> |           |
|-------------------------------|------------|---------------------|-----------|-----------------|-----------|
|                               |            | <u>M1</u>           | <u>M2</u> | <u>M1</u>       | <u>M2</u> |
| 1970-79                       | 16.0       | 8.9                 | 15.4      | 3.8             | 0.2       |
| 1980-84                       | 10.0       | 8.5                 | 11.4      | 1.0             | -0.9      |
| 1984                          | 9.5        | 5.2                 | 7.7       | 4.1             | 1.7       |
| 1985: First<br>three quarters | 5.6        | 12.3                | 9.4       | -6.2            | -3.5      |
| 1985:Q1                       | 5.6        | 10.6                | 12.0      | -4.9            | -6.3      |
| Q2                            | 4.5        | 10.2                | 5.3       | -5.6            | -0.8      |
| Q3                            | 6.7        | 15.0                | 10.2      | -8.2            | -3.5      |

**TABLE 6**  
**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> |
|--------------------------------------|-----------|-----------|--------------------|------------------------------------|
| 1985 actual                          | 12.0      | 8.6       | 7.8                | 12.8                               |
| 1984 FOMC<br>growth ranges           | 4-8       | 6-9       | 6-9                | 8-11                               |
| 1985 FOMC<br>growth ranges           | 3-8       | 6-9       | 6-9 <sup>1/2</sup> | 9-12                               |
| 1986 FOMC tentative<br>growth ranges | 4-8       | 6-9       | 6-9                | 8-11                               |

Note: The fourth quarter of the previous year normally serves as the base period for the targeted ranges. M1 was rebased in 1985 from the fourth-quarter base of 1984 to the second quarter of 1985. The 1985 actual growth rates are calculated from the base period through November 1985.

### *Monetary policy in 1985*

Monetary policy in 1985 continued to be directed toward providing adequate growth in the monetary aggregates needed to promote

sustained economic growth in a noninflationary environment. Consistent with this objective, the Federal Reserve System's Federal Open Market Committee (FOMC), at its meeting in February, established growth rate



ranges for the monetary and credit aggregates for 1985. The growth rate range for M1, for the period from the fourth quarter of 1984 to the fourth quarter of 1985, was set at 4 to 7 percent, compared with 4 to 8 percent in 1984 (Table 6). M2's growth rate range was left unchanged from 1984 at 6 to 9 percent, while the 1985 range for M3 was set at 6 to 9 1/2 percent, compared with 6 to 9 percent in 1984. The range for domestic nonfinancial debt was set at 9 to 12 percent, higher than its 1984 range. Even with the increases in their ranges, the growth rates targeted for M3 and the debt aggregate were considerably below their actual growth in 1984.

The 1985 target ranges for the aggregates were evaluated at the July FOMC meeting. The ranges remained unchanged for all aggregates, except M1. The Committee decided, in light of M1's rapid first-half growth, to rebase M1's growth rate range to the second quarter of 1985 and to widen the range to 3 to 8 percent. These changes were made because the Committee found the decline in M1's velocity and the associated rapid first-half M1 growth to be an aberration. In establishing a new range, the Committee expected M1 velocity to behave more in line with past experience during the last half of 1985. The M1 growth range was widened, however, due to uncertainties surrounding the possible behavior of velocity.

In implementing monetary policy on a day-to-day basis in 1985, the Federal Reserve considered several factors in addition to the behavior of the monetary aggregates. These factors included the state of the economy, the behavior of inflation, movements in the exchange value of the dollar, and conditions in domestic financial markets. With inflation remaining moderate throughout the year, responses to incoming information on monetary growth were tempered by the need to sup-

port a sluggish economy and by concerns about the adverse effects of an overly strong dollar. Thus, despite M1 growth above its targeted range, pressures on bank reserve positions remained relatively unchanged throughout 1985. As a result, adjustment plus seasonal borrowing from the Federal Reserve—a measure of reserve pressures—moved within a relatively narrow range. Borrowing fluctuated between a daily average of about \$450 million in the first quarter and about \$600 million in the second quarter. Also, the federal funds rate fluctuated within a relatively narrow range, remaining on a monthly average basis between a low of about 7.5 percent in June and a high of about 8.6 percent in March.

Some adjustments were made during 1985 in the pressures on reserve positions. In light of slow economic growth and the continued strength of the dollar in foreign exchange markets, policy was directed toward easing reserve conditions in late 1984 and early 1985. But, due in part to rapid growth of the monetary aggregates, the easing ended by early February and bank reserves were provided somewhat more cautiously. The sluggish growth of the economy, strains in financial markets, and declining market interest rates prompted the Federal Reserve to reduce the discount rate one-half percentage point to 7 1/2 percent on May 20. In late summer, reserve conditions were tightened somewhat in response to rapid growth in M1 and M2 and in light of evidence of stronger economic growth and a decline in the dollar's foreign exchange value.

For 1985 as a whole, the Federal Reserve was successful in achieving its monetary growth objectives for M2 and M3. From the fourth quarter of 1984 through November 1985, M2 rose at an 8.6 percent annual rate, within its targeted range of 6 to 9 percent

(Table 6). M3's growth rate of 7.8 percent in the first 11 months also fell within its 6 to 9½ percent range. Due to the continued decline of M1's velocity, M1 growth in the last half of the year exceeded its rebased range of 3 to 8 percent, expanding at a 12.0 percent annual rate from the second quarter of 1984 through November 1985.

## **Economic outlook for 1986**

With economic weakness in the first half of 1985 giving way to faster growth later in the year, expectations have improved for continued business expansion in 1986. But substantial uncertainties remain as the economy moves into its fourth year of cyclical expansion. These uncertainties include the strength of consumer spending, the declining dollar's effect on production and inflation, the direction of inventory investment, and the course of the federal government's fiscal policy.

### *Consumer spending*

Strong growth in personal consumption expenditures in the first three quarters of 1985 undergirded a generally weak economy. And consumption growth will again be particularly important for the performance of the economy in 1986.

Consumer spending will depend on income growth and the behavior of the personal saving rate, as influenced by consumer attitudes and the use of consumer credit. With household income expected to grow only moderately in 1986 (though faster than in 1985), consumer spending may also be expected to grow only moderately. But the performance of personal saving is more likely to restrain the growth of consumer spending in 1986 than to enhance it as occurred in 1985. In particular, the personal saving rate in 1986 may be higher than

in the second half of 1985, when it was held down by the very low third-quarter rate associated with the surge in purchases of durable goods, especially new automobiles.

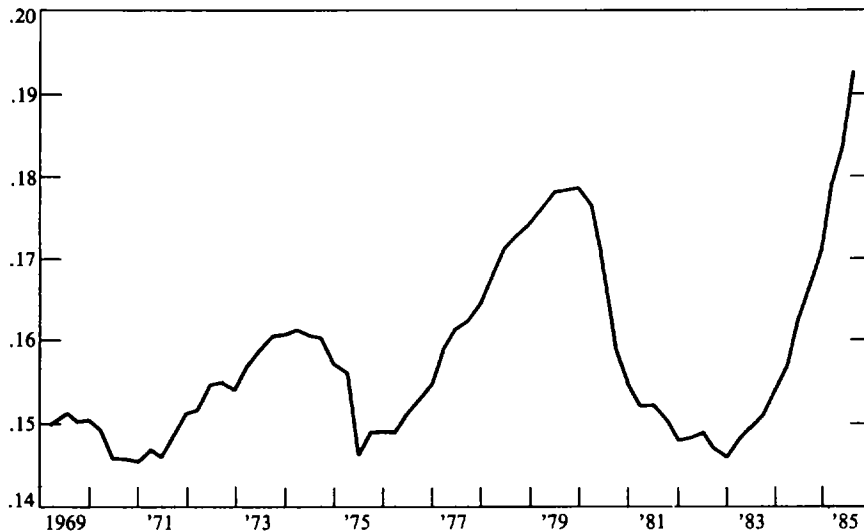
The magnitude of the rise in the saving rate will depend in part on whether consumers decide to cut back on the use of credit. Consumer credit outstanding continued to grow rapidly in 1985. As a result, the ratio of consumer installment credit outstanding to disposable personal income reached a new high in 1985, rising above the former peak attained in 1979 (Chart 3). Because of the high debt-income ratio, consumers will no doubt be more cautious about taking on new debt and will be using more income for debt repayment, both factors that would raise the saving rate in 1986.

The consumer debt burden may appear larger and more likely to restrict consumption growth than it really is, however. Part of the increase in consumer credit outstanding reflects an expanding use of credit cards as a convenient payment substitute for cash or checks, as charges are paid in full each month. Since this is not consumer borrowing, strictly speaking, it should not be included in a measure of debt burden. There has also recently been a lengthening of maturities for some loans, such as for purchases of new cars. By lessening monthly repayment sizes, maturity lengthening tends to reduce the burden of debt on consumers for a given amount of credit outstanding.

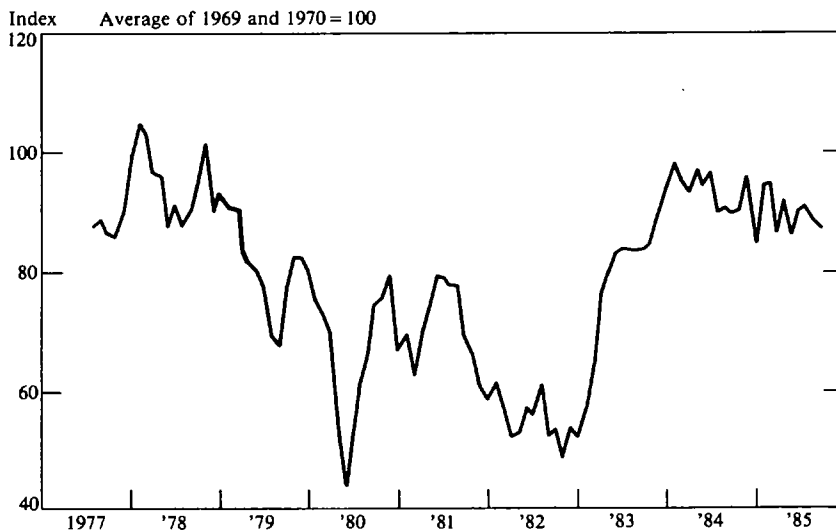
While the influence of these special factors might reduce concerns about the high ratio of consumer credit to income, the rise in the ratio to a level above its previous peak cannot be easily dismissed. Thus, efforts by consumers to prevent their debt burden from rising or to reduce it are likely to lead to a rise in the saving rate in 1986.

The burden of debt outstanding may be only

**CHART 3**  
**Ratio of consumer installment credit outstanding**  
**to disposable personal income**



**CHART 4**  
**Index of consumer confidence**



Source: Conference Board

one of several factors affecting the proportion of income consumers want to save in 1986. For example, consumer confidence appears to be waning. The Conference Board index of consumer confidence, while still high, has been edging downward since early 1984 (Chart 4).

On balance, major determinants of consumer spending seem to point toward slower growth in real personal consumption expenditures in 1986 than in 1985. Income growth, while slow, may be slightly faster in 1986 than in 1985. But the increase in income is likely to be more than offset by a rise in the saving rate, due to the high ratio of consumer debt to income and waning consumer confidence. Personal consumption expenditures will rise at a moderate rate in 1986, but will not be the engine for expansion to the extent that they were in 1985.

#### *Other final purchases*

Other spending sectors are unlikely to take up enough of the slack left by slower growth of personal consumption expenditures to bring total growth in domestic final purchases to the rate attained in 1985. In fact, domestic final purchases other than personal consumption expenditures on balance are expected to contribute little to economic growth in 1986. Low rates of utilization and high real interest rates will keep business fixed investment spending growth in check, a conclusion supported by the results of early surveys of capital spending plans for 1986. Commercial and office construction activity is also expected to slacken. Nor is residential construction expected to contribute much to total output growth. Multifamily starts are likely to weaken in the face of high vacancy rates in existing structures. Only slight improvement is expected in single-family starts, because of slower income

growth, tighter mortgage loan standards, and little further reduction in mortgage rates. Government purchases of goods and services are likely to grow modestly and contribute only slightly to GNP growth.

#### *Inventory investment*

Reductions in inventory investment were a drag on real GNP growth in 1985, and the ratio of inventories to sales reached a low level during the year. But businesses are not expected to engage in much inventory building in 1986, as economic growth and sales increases are expected to be modest. Although the inventory-sales ratio is historically low, there appears to be little desire to see it rise much, with carrying costs high and commodity inflation expectations low. Thus, increased inventory investment is not likely to boost GNP growth much in 1986.

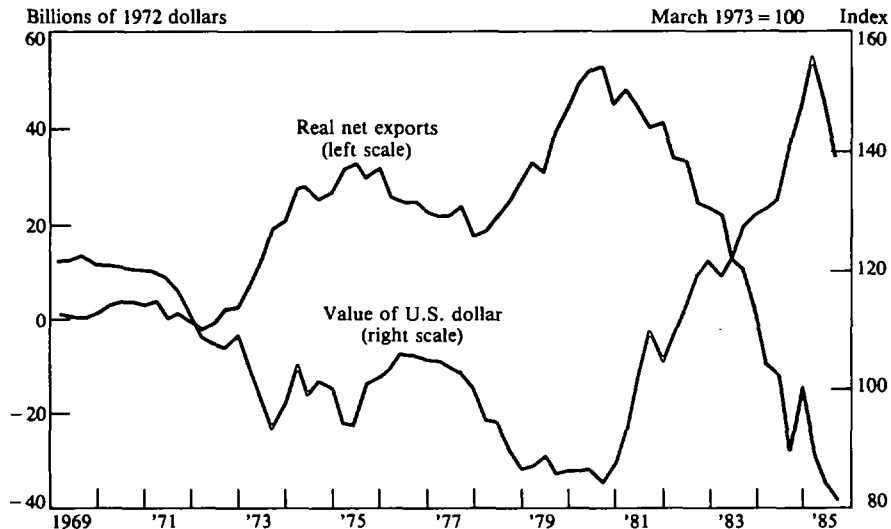
#### *Net exports*

U.S. net exports in 1986 will depend heavily on the strength of the dollar in foreign exchange markets, as well as on the impact of the decline in the dollar that has already occurred.

There has been a close relationship in the past between the value of the dollar and net exports. The value of the dollar declined in the 1970s and real net exports increased (Chart 5). But from its low in mid-1980, the dollar's value increased more than 80 percent to a peak in early 1985. Over that period, U.S. real net exports fell from about \$53 billion to about -\$28 billion.

The five-year uptrend in the value of the dollar was reversed in early 1985, partly because of lower U.S. interest rates and greater uncertainty about prospects for the U.S. economy. More recently, after the meet-

**CHART 5**  
**Real net exports vs. index**  
**of weighted-average exchange value of U.S. dollar**



ing of the Group of Five countries—the United States, Japan, Germany, France, and the United Kingdom—foreign exchange market intervention by some of these countries has also contributed to downward pressures on the dollar's value. As a result, the dollar's value in the third quarter of 1985 was about 11 percent below its first-quarter peak. However, even after this recent decline, the dollar is still strong compared with the past decade and a half. And the dollar's fall has not yet reversed the worsening in U.S. real net exports. This is not surprising since improvement in U.S. net exports can be expected to follow a weakening of the dollar only with a lag of up to a year.

Considerable uncertainty still exists about future movements in the value of the dollar relative to foreign currencies. The large and sustained increase in the value of the dollar since 1980 is mainly attributable to a substantial difference between U.S. interest rates and

rates elsewhere in the world. Relatively high U.S. interest rates are themselves due importantly to large federal budget deficits and the associated large federal demand for credit. Future movements in the value of the dollar are closely linked to efforts to reduce the budget deficit.

On balance, given the recent decline in the dollar's value, some improvement in net exports and in their contribution to GNP growth may be anticipated some time in 1986. Thus, for 1986 as a whole, net exports will be a source of economic growth, stimulating U.S. production and strengthening the U.S. economy, especially its goods-producing industries.

#### *Monetary and fiscal policy in 1986*

In 1986, the task for monetary policy will again be to provide adequate growth in the

**TABLE 7**  
**Congressional Budget Office projections**  
**of federal deficit, billions of dollars**  
 (fiscal year, including off-budget entities)

|  | <u>1985*</u> | <u>1986</u> | <u>1987</u> | <u>1988</u> | <u>1989</u> | <u>1990</u> | <u>1991</u> |
|--|--------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Baseline projections   | 212          | 212         | 229         | 243         | 264         | 285         | —           |
| Budget resolution†   | 212          | 175         | 163         | 143         | 132         | 120         | —           |
| Gramm-Rudman Targets   | 212          | 172         | 144         | 108         | 72          | 36          | 0           |
| *Actual  |              |             |             |             |             |             |             |
| †Congressional Budget Office estimate  |              |             |             |             |             |             |             |
| Source: Congressional Budget Office, "The Economic and Budget Outlook: An Update," August 15, 1985 |              |             |             |             |             |             |             |

monetary aggregates to support balanced economic expansion and progress over time toward price stability. To achieve these objectives, the FOMC has established tentative 1986 growth rate ranges for the monetary and credit aggregates. The tentative ranges for M2 and M3 for 1986 were set at 6 to 9 percent, while the monitoring range for domestic nonfinancial debt was set at 8 to 11 percent. The tentative M1 range for 1986 was established at 4 to 7 percent.

Fiscal policy has been highly stimulative in recent years as the structural, or high employment, budget deficit has increased rapidly. This measure of the deficit, which estimates its level at an assumed high level of resource use, is regarded as a good indicator of the thrust of fiscal policy. Because the structural deficit is expected to show little change in 1986, little change is expected in fiscal stimulus—another reason for anticipating only moderate economic growth.

The actual federal budget deficit of \$212 billion for fiscal year 1985 was \$27 billion, or 15 percent larger than the 1984 deficit (Table

7). The congressional budget resolution for fiscal year 1986 sets the projected 1986 deficit at \$175 billion. Deficit reductions resulting from the resolution's spending cuts would extend through the rest of the decade, slowing the growth of the federal debt and reducing the government's share of total credit demand. Furthermore, the Gramm-Rudman bill requires larger annual deficit reductions designed to bring the budget into balance by 1991.

#### *Resource use and inflation*

Given the outlook for only moderate real GNP growth in 1986, it is unlikely that there will be much, if any, reduction during the year in the relatively large amount of slack in the economy. Neither the overall unemployment rate nor the rate of capacity utilization in industry will show much change from 1985. Labor compensation increases should continue to be moderate in such an environment, as should unit labor cost increases. Food price increases are not expected to raise inflation much in 1986, while oil price changes could

put downward pressure on the inflation rate. All of these factors should continue to keep inflation subdued in 1986.

At the same time, however, a falling dollar is likely to increase U.S. inflation. As the dollar's value increases, cheaper imports contribute to disinflation in the United States, both directly and indirectly by restricting the freedom of domestic producers to raise prices on import-competing goods. Thus, depreciation in the dollar's foreign exchange value would reduce downward pressures on the U.S. inflation rate. This impact would be lessened to the extent that foreign sellers were willing to accept smaller profit margins rather than increase prices in an effort to maintain market share. Nevertheless, the falling dollar is the factor most likely to cause a significant rise in the inflation rate in 1986.

## **Conclusion**

The U.S. economy will continue to grow in 1986, but the growth of GNP is not likely to greatly exceed its estimated long-run trend rate of 3 percent. Domestic final purchases are expected to grow moderately. Consumer spending is likely to be an important contributor to growth, but less so than in 1985. Among the remaining major sectors, residential construction appears likely to make the most significant contribution to a growing economy. Inventory investment may increase, and if net exports cease to worsen and improve—as expected—they will no longer be a drag on GNP growth but a contributor to it. Inflation should continue to be moderate in 1986, and the rate of resource use is not likely to change much.