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FORECAST

1986 · 1987

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First Interstate Offices Around the World

About the Cover

The message is stimulus to demand in most major countries. The top economic policy-makers in the U.S., France, Germany, Japan, and Great Britain (the Group of Five or G-5) have set a goal of achieving a faster pace of economic expansion in 1986. Such an effort at coordinated stimulus by major countries has been dubbed the "locomotive" approach to economic policies. The near-term results will be more output and employment. The longer-term results will be rising inflation and increased risk of recession.

"Let's liven up the party" is now the near-term objective of large-country policymakers. Further reduction of inflation offers no political payoff. "Austerity" provides no more benefit in reducing the burden of international debts. For at least the next year, achieving faster growth worldwide is the new "number one economic policy priority." As a result of the new emphasis on expansion, the U.S. economy will enter a "second phase" in the recovery, while other industrialized countries will finally emerge from the protracted period of stagnation they have suffered in recent years. Less developed countries will have better markets for their exports and will find it easier to service their debts.

An Overview

The U.S. economy enjoyed a robust recovery from early 1983 to mid 1984, before a pause occurred. From mid 1984 to mid 1985, real output rose only 2%, even though spending by consumers and businesses was reasonably good. Renewed vigor surfaced during the past summer as the lagged effects of extremely rapid monetary growth began to be reflected in increased production.

Even as the largest industrial economies began to gain some momentum, economic policymakers began formulating plans to engage in additional pump priming to ensure rapid expansion in 1986. Late in September, 1985, the top economic policy officials of the five largest countries (the G-5) -- France, Germany, Japan, the United Kingdom and the United States -- agreed to coordinate their efforts to drive down the value of the U.S. dollar and to achieve higher levels of domestic spending in each of their countries.

Our reading of the policymakers' mood is that they will use whatever economic policy tools are available for as long as necessary to achieve results. Their determination to increase growth of output and employment is as strong now as was the determination a few years ago to reduce inflation.

Lead Locomotive - U.S.A.

In the United States, the motivations for this new policy come from the threat of protectionism, stagnation of employment in some manufacturing industries, concerns over the real estate, agriculture and energy sectors, and the continuing burden of the international loans of large banks.

Our view for several months has been that enough already has been done to ensure faster growth in the U.S. for the next few quarters. The risk is that the economy will be overstimulated, and worries about recession will not resurface until 1987.

Monetary growth has been extremely rapid in the past year, and the new policy objective of driving down the international value of the dollar implies continued rapid monetary growth well into 1986. Meanwhile, the growth of government spending has been stimulative and will continue to be expansive, since Congress is more likely to add to the budget than cut it. Consequently, large fiscal deficits will persist.

Interest rates and inflation will both increase in the year ahead, but will not reach levels that threaten the expansion. By sometime in 1987, we expect that rising inflation will dominate the attention of policymakers again, so a tilt towards less stimulus will start to cool the pace of growth.

Employment in the U.S. will rise by another 3 million in 1986, adding to the 10 million jobs that have been created since the recovery began three years ago.

Policymakers will use whatever tools are available for as long as necessary to achieve results. Their determination to increase growth of output and employment is as strong now as was the determination a few years ago to reduce inflation.

Personal and business incomes are expected to rise more rapidly in the next year than in 1985, so the feeling of prosperity and well-being should be stronger.

Foreign Economies Will Hook Up

In Europe, the last few years have been characterized by the longest and deepest economic stagnation since the 1930s. The European policymakers have been wanting to stimulate their domestic economies, but the persistent weakness of their currencies against the U.S. dollar prevented the adoption of more expansionary policies.

Interest rates and inflation will both increase in the year ahead, but will not reach levels that threaten the expansion. By 1987, however, we expect rising inflation to dominate the attention of policymakers again.

Export demand provided what growth there has been for the past three years, and policymakers are anxious to stimulate domestic demand as their currencies strengthen against the U.S. dollar. This year, most European economies started to experience some recovery of consumer spending, and 1986 should be the most prosperous year so far in the decade.

In Japan, the threat of protectionist legislation by the U.S. Congress is taken seriously, and the policymakers acknowledge that domestic demand has been stagnant. Yet, they maintained restrictive domestic policies through midyear. The G-5 policy announcement in September suggests that Japan will adopt more stimulatve domestic policies as the yen appreciates on world markets.

Japan's overall growth rate is expected to be somewhat slower, but domestic consumption is forecast to strengthen as export growth slows. The Japanese current account surplus will still rise next year, but by a smaller amount than in the recent past.

Efforts to drive down the value of the dollar will be hampered by more vigorous economic performance in 1986, but the dollar is still expected to finish next year lower than current levels.

Highlights of 1986-1987

The First Interstate Economics forecast for the next two years includes:

- faster growth of output and employment in all large countries;
- rising trend of U.S. inflation and interest rates;
- world oil prices drifting lower, but some firming in other internationally traded commodity prices;
- efforts to drive down the value of the dollar will be hampered by the more vigorous economic performance as 1986 gets under way; nevertheless, the dollar is expected to finish next year lower than current levels;
- stronger growth of U.S. exports, smaller increase of imports, and a smaller rise in the U.S. trade and current-account deficits;
- gradual improvement in the problems posed by the international debt burdens of many less-developed countries in 1986, but potentially more serious problems building as rising interest rates and slowing of export growth in 1987 start to dominate;
- some lessening of the strains on the U.S. financial system in 1986, but serious longer-term concerns posed by the rising trend of inflation and interest rates;
- a marked slowing in commercial construction activity in this country;
- another reasonably good year for residential construction in 1986, but not sustained in 1987;
- no dramatic worsening of the plight of the agriculture and energy sectors, but no marked improvement, either;
- modest improvement in the outlook for "high-tech" industries;
- good year for banking, communications, health, recreation, and retail;
- major risks to the expansion in 1986 include a sharper drop in the value of the dollar, protectionist legislation, anti-business tax legislation, and a financial "shock"arising from the international debts of developing countries.

—November 18, 1985

Because of a stronger U.S. economy and the new initiatives, growth in both industrial and developing countries will accelerate in 1986. Developing countries should be able to better their financial positions. Things that could derail the locomotive effort, aside from inflation, include protectionism, rising interest rates, and obstacles to economic reform in developing countries. In any case, by late 1987 a noticeable slowdown should be evident. A return of the "locomotive" approach to stimulating the global economy was signalled this fall by initiatives on the dollar, international trade, and developing-country debt.

Industrial-Country Growth to Accelerate

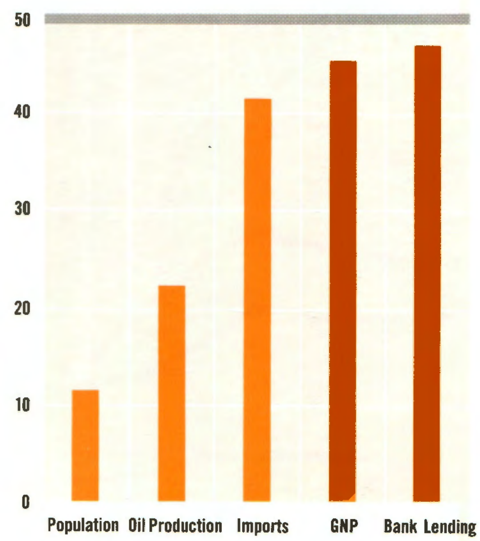
During 1984, the two countries clearly coupled to the American train were Canada and Japan, the two largest trading partners of the United States. Real economic activity in these countries accelerated significantly as a result of strong U.S. import demand. Although growth also increased in Europe, it remained below levels that would alleviate the high unemployment found in the region. Europe failed to join the U.S. locomotive because of internal structural difficulties and the rising value of the dollar, which limited the monetary stimulus the Europeans could undertake without risking higher inflation.

During 1985, with U.S. growth slowing, both Canada and Japan also slowed. Although growth in Europe accelerated somewhat, if the global economy is to avoid being sidetracked by either a trade war or a financial crisis, policymakers in the United States and Europe concluded that hooking Europe up to the locomotive was essential.

The most important initiative in this direction was that in late September to drive down the value of the dollar. Essentially, this policy allows countries in Europe to increase their money growth without risking currency depreciation. More expansive monetary policies should, in turn, stimulate domestic demand and, it is hoped, imports. In the mirror image of what is occurring in the United States, European economies are seeing the relative importance of their export sectors decline as those sectors that respond to domestic demand expand.

As indicated in the accompanying table, we are forecasting a pickup in growth in most major European economies during 1986. Monetary stimulus can be effective as long as U.S. money-supply growth rate exceeds that of the European countries. As we expect U.S. monetary growth to be relatively vigorous in coming quarters, there is considerable room for expansive policies in Europe, particularly in view of lower oil prices in domestic currency terms due to the lower value of the dollar. As in the United States, however, the increased monetary stimulus, if it persists, would eventually lead to a revival of inflation. This danger, together with a slowing in U.S. growth, should lead to a slowdown in Europe and other industrial countries in 1987.

Japan has announced an increase in government expenditure during 1986 in order to offset some of the slower growth in exports that will follow the yen's recent appreciation. It is unlikely that the Japanese will join the other industrial countries in implementing a more expansionary monetary policy. We expect that the effects of slower export growth will outweigh the fiscal stimulus and that, as a result, growth in Japan will decelerate somewhat in the coming two



Locomotive Power: G-5 Countries as a Percentage of World Totals

In the mirror image of the United States, European economies are seeing the relative importance of the export sectors decline as those sectors that respond to domestic demand expand.

Industrial Country Indicators

	Real Growth (% Change, GNP or GDP)				Inflation (% Change, CPI)				Current Account Balance ($U.S. Billions)			
	1984	1985e	1986f	1987f	1984	1985e	1986f	1987f	1984	1985e	1986f	1987f
Japan	5.8	4.8	4.3	4.0	2.3	2.4	2.6	2.7	35.0	40.6	44.5	46.0
Germany	2.6	2.8	3.4	2.7	2.4	2.4	2.7	3.2	6.1	8.0	8.5	8.0
France	1.6	1.1	2.0	1.8	7.4	6.4	6.2	6.8	0.0	0.4	0.7	−0.2
U.K.	1.6	3.0	2.6	1.9	5.0	6.4	5.8	6.1	0.7	−1.2	−1.0	−1.5
Italy	2.6	2.3	2.8	1.0	10.8	9.4	8.8	8.7	−2.9	−4.0	−1.2	−0.3
Canada	4.7	4.1	4.2	2.5	4.3	3.9	5.5	6.1	1.9	1.6	2.8	1.6
Total, above countries	3.4	3.1	3.3	2.6	4.6	4.5	4.6	4.9	40.8	45.4	54.3	53.6
Total, incl. U.S.	5.1	2.9	4.1	2.6	4.4	4.0	4.4	5.5	−60.7	−83.0	−84.2	−97.7

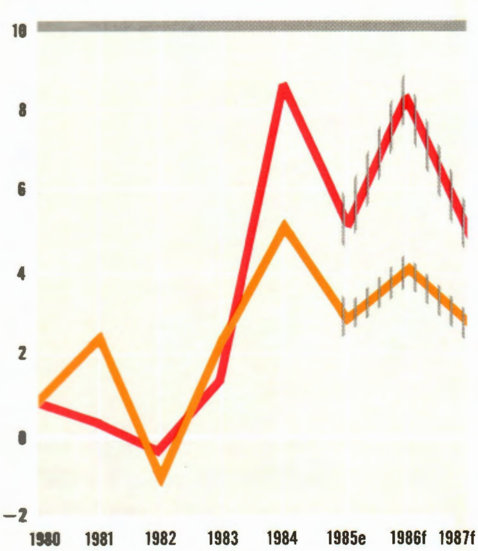
e = estimate; f = forecast

years. Import growth could still rise, but slower economic growth in Japan is likely to keep the rise to a level less than desired by some of Japan's trading partners. Japan's current-account surplus, therefore, should continue to rise.

World Trade Rebounds in '86 After Slowdown in '85

The decision by the major industrial countries to scrap their anti-inflation programs and promote pro-growth policies in late 1985 and in 1986 should be reflected in more vigorous growth of world trade in 1986. In 1985, the continuing expansion of the Western industrial economies has translated directly into a further growth in world trade, but like the growth in the industrial countries, it is sluggish, as the data in the table indicate. Collectively, the major industrial economies' real economic growth fell from over 5% in 1984, to just under 3% in 1985, and the growth of world imports is being cut sharply.

The consensus among the major industrial countries to institute pro-growth economic policies, however, should reverse this slowdown. Stimulative economic policies will provide the steam to revitalize the world economy, at least temporarily, which will be reflected in stronger growth of world trade in 1986, in both volume and nominal terms. Stronger growth in the industrial countries will be transmitted to the developing world via increased import demand by the industrial countries. In 1987, the declining rates of growth for world trade follow directly from the lower growth of the world economy as the pro-growth economic policies prove impossible to sustain.



Growth in Volume of World Trade Reflects Real Economic Growth in Industrial Countries

(Percent change)

*U.S., Japan, Germany, France, U.K., Italy, & Canada

World Trade

(Imports, percent change)

	1984	1985e	1986f	1987f
Volume	8.6	5.2	8.2	5.8
Nominal	6.1	3.6	10.5	7.8

e = estimate; f = forecast

For 1986 and 1987, we expect nominal world trade to increase more rapidly than volume, in comparison to the previous five years when the opposite took place as import prices declined. Rising prices are a major objective of the more stimulative economic policies being adopted by the major industrial economies.

In 1986, we expect commodity prices generally to begin to increase, instead of falling as they did in 1985. For the first two thirds of 1985, the IMF's price index for "all commodities" (excluding petroleum) fell 12.8% from year-earlier levels. In 1986, we expect commodity prices to increase 6% and in 1987, a weaker 4%. We anticipate that prices for petroleum and related products will fall in both 1986 and 1987. Finally, inflation will generally increase in most countries as domestic austerity policies are jettisoned.

The looming threat of protectionism is a major risk to the above forecast. If substantial protectionist measures are instituted by one country and other countries then retaliate, as is likely, world trade would grow more slowly or actually shrink, which would increase the difficulties confronting most countries. Our forecast assumes that no major barriers to trade will be imposed. The likelihood of such a development, however, has jumped sharply in the past year.

The increased expansion of world trade is good news in the short run for both the developed and developing worlds, as it implies, for example, a lessening of the external debt-servicing burden. Over the longer run, we will probably see that any improvement will have been temporary. World trade can grow only as fast as the sustainable rate of real economic growth in the world and the lack of barriers permit.

Developing Countries: Short-Term Relief

The developing countries, some of which constitute the caboose on the global economic train, have seen a substantial decline in export growth during 1985, following a healthy increase in 1984. (This increase helped reduce the ratio of foreign debt to exports for many developing countries, as illustrated in the accompanying graph.) The decline in export growth in 1985--which resulted from slower growth in the United States, lower commodity prices, and, perhaps, protectionism in industrial countries--brought about some deterioration in the balance-of-payments positions of a number of countries.

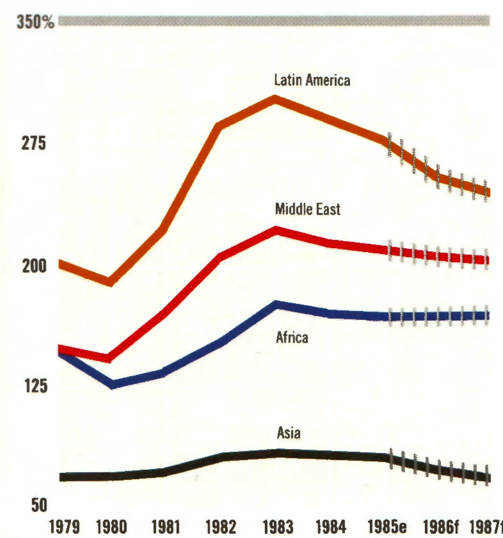
Additionally, although some of the largest debtors began to show a recovery in their economies in 1984 and 1985, a number of export-dependent countries showed falling economic growth rates in 1985. This deterioration in both exports and growth, and the continuing difficulties of a number of heavily-indebted countries in reducing their budget deficits and inflation, led to a questioning of the framework that had evolved for handling the debt problem.

By mid 1985, difficulties had surfaced in the debt framework. In particular, Brazil, the largest debtor, had effectively suspended negotiations over a new IMF program, while Mexico, the second largest debtor, failed to meet its IMF targets for midyear. Moreover, the IMF's role in the debt problem was under attack by the president and prime minister of Peru.

Given these difficulties and the apparent need for continued financial inflows if international lenders are to continue to receive interest payments, the U.S. Treasury Secretary announced a new plan to deal with the debt problem. It involved increased lending from commercial banks and multilateral institutions and extensive economic reforms in the developing countries. A number of questions remain concerning the plan, centering on the willingness of the countries to undertake further reform, banks' willingness to lend more, and the attitude of regulatory authorities in creditor countries.

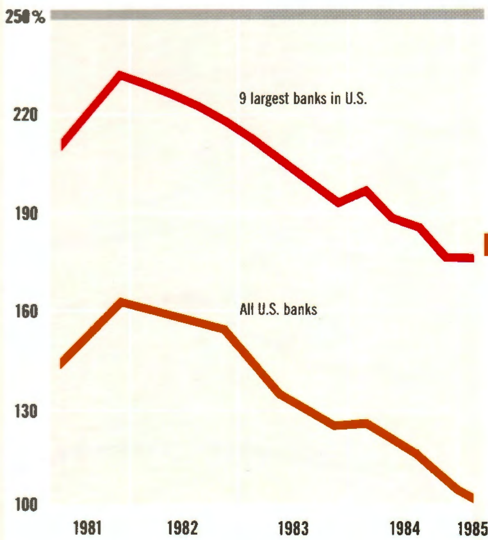
The locomotive approach to the world economy should have a significant effect in the coming few quarters by boosting developing-country exports. Also, some increase in commodity prices and only modest increases in dollar interest rates are positive factors for the developing countries. Thus, in 1986 developing countries will be able to continue the reform process begun during the past few years, while maintaining acceptable levels of real economic growth.

For 1986 and 1987, we expect nominal world trade to increase more rapidly than volume, in comparison to the previous five years when the opposite occurred as import prices declined.

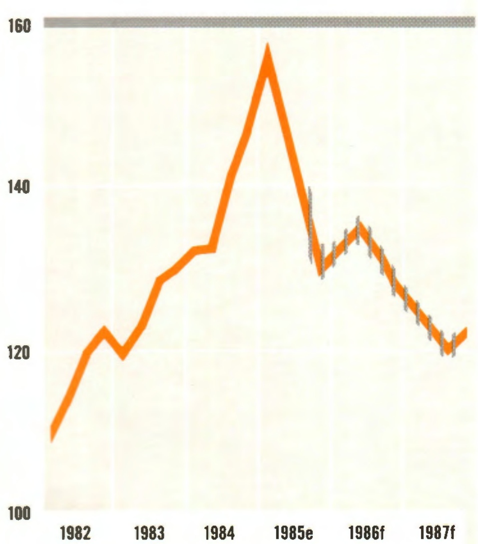


Ratio of External Debt to Exports Still High
(Non-oil developing countries)

There should be some downward pressure on the dollar until late 1987, when rising interest-rate differentials between the United States and elsewhere provide support.



Bank Exposure to Developing Countries Declining
(Ratio of loans to 15 countries*/Capital)
*Countries included in the Treasury's plan for developing-country debt.



U.S. Dollar Declines Hesitantly
(Trade-weighted index: March 1973 = 100)

However, the outlook for 1987, when interest rates are expected to rise and growth in the industrial countries is expected to slow, holds the potential for further problems in the debt arena.

The impact of such problems on the American (and international) banking system could be substantial. However, the potential impact has been diminishing over time, as illustrated in the accompanying graph. The ratio of developing-country loans to the capital of U.S. banks has been declining since late 1981 and should decline further during the coming two years.

The U.S. Dollar to Fall, But...

The financial leaders of the Group of Five announced on September 22 that they were united in their resolve to drive the U.S. dollar down on the foreign-exchange markets. The markets wait to be convinced.

Part of the motivation for this G-5 policy is to derail the protectionist sentiment that was rapidly gathering strength in the U.S. Congress. If a decline in the value of the dollar could not be engineered, little remained that could be done about the large, growing U.S. trade and current-account deficits, which resulted in the United States becoming a net debtor for the first time in decades.

The decline in the dollar that we forecast one year ago took place, but it began about three months later than expected. The dollar peaked in February 1985 and then declined, on a monthly average basis, through August. On balance, the dollar fell 13.2% against the currencies of ten leading industrial countries, on a trade-weighted basis. Then the dollar began to rise, as we expected, which turned out to be politically unacceptable.

Since September 22, the dollar has been driven down about 7.5%, on a trade-weighted basis, almost solely as a result of foreign-exchange intervention by the G-5 central banks. Whenever the central banks fail to intervene, the foreign-exchange markets begin to bid up the dollar. The markets believe that the dollar is the currency to hold.

Our forecast calls for the dollar to depreciate 8.2% in 1986, and an additional 7.1% in 1987. The forecast, however, is not for a steady decline, as the chart shows.

During first half 1986, we expect the dollar to rise, despite interventionist policies. U.S. inflation will remain low, and the differential between U.S. real economic growth and that of the other major industrial countries is forecast to increase. In second half 1986, the real growth differential is expected to shrink rapidly and even become negative in 1987. In addition, the trade and current-account deficits will rise, although very modestly. Consequently, there should be some downward pressure on the dollar until late 1987, when rising interest-rate differentials between the United States and elsewhere provide support.

Generally, we expect the G-5 dollar policy to fail. The central banks by intervention can keep the dollar from rising as much as it would when the markets want the dollar to rise, such as during first half 1986. The central banks would probably be forced to clobber the market occasionally. Success of the G-5 policy would require that U.S. inflation be higher on a sustained basis than in other industrial countries. The markets' perception of that development would take a while to occur. Ultimately, it is the market, not the G-5 policy, that will lower the value of the dollar.

U.S. Balance of Payments: 1983-1987
(Billions of Dollars—f.a.s. basis)

	1983	1984	1985e	1986f	1987f
Merchandise-Trade Balance	−62.0	−108.3	−131.3	−132.3	−136.8
Exports	200.7	220.3	215.0	249.3	281.8
Imports	−262.7	−328.6	−346.3	−381.6	−418.6
Services, net	30.1	18.2	15.0	7.0	0.0
Exports	132.9	142.6	142.0	147.0	155.0
Imports	−102.8	−124.4	−127.0	−140.0	−155.0
Transfers, net	−8.9	−11.4	−12.1	−13.2	−14.5
Private	−6.3	−8.4	−8.9	−9.7	−10.5
Official	−2.6	−3.0	−3.2	−3.5	−4.0
Current-Account Balance	−40.8	−101.5	−128.4	−138.5	−151.3

e = estimate; f = forecast

Rise in U.S. Current-Account Deficit Slows

Both the U.S. trade and current-account deficits have been growing rapidly in recent years, but as the data in the table show, we are looking for that growth to decrease sharply during the 1986-1987 period. The two most important explanations for the slower growth in the U.S. trade deficit in 1986-1987 are the diminished differential between U.S. real growth and that elsewhere in comparison to the 1983-1984 period and the lower international value of the U.S. dollar. A third is the possibility of a slightly better export market in the Third World.

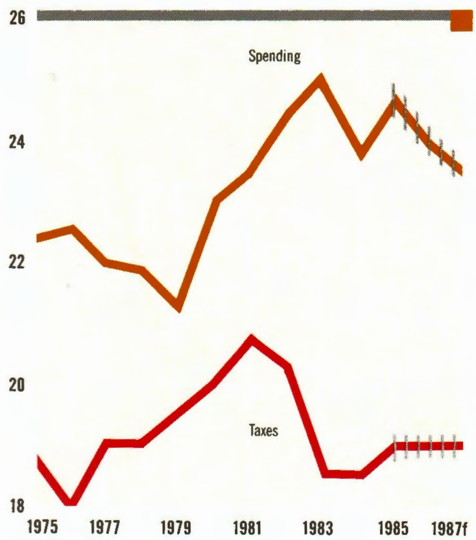
In the 1983-1984 recovery, the U.S. economy grew much more vigorously than other industrial countries collectively. Partially because of this, U.S. imports increased more rapidly than exports. Now, with all the major industrial countries instituting more expansionary economic policies at the same time, these economies should grow more equally, and U.S. export performance should be better in comparison with that in 1983-1984.

Simultaneously, the lower international value of the U.S. dollar will discourage U.S. imports while promoting exports. Finally, the encouragement that the Third World is being given to modify their austerity programs and cease trying to cut imports should improve the U.S. export market somewhat. As a result, we expect U.S. exports to grow more rapidly during the 1986-1987 period than imports.

One startling development we foresee is the disappearance of the traditional net-services surplus by 1987. The large U.S. current-account deficits over the past several years have required net capital inflows to offset them. In 1985, the United States became a net debtor, which implies that it will now be paying out more than it receives on its net capital position. Since we foresee large current-account deficits for some time, U.S. net indebtedness will continue to rise as will the net outflow of funds to service this position.

The current-account deficits that we are forecasting for 1986-1987 are the equivalent of just over 3% of GNP. On balance, these large deficits should be a negative factor for the value of the dollar. Since these deficits have to be offset by capital inflows, interest rates will have to rise sufficiently to encourage foreign investors to buy U.S. assets, in order to compensate for any decline in the international value of the dollar.

We expect the new emphasis of fiscal and monetary policies to produce a year of strong economic activity in 1986, with rising sales, employment, and profits. The cost, however, will be an acceleration in inflation, especially in 1987. Because little progress is expected in curbing the growth of government spending, deficits are likely to be close to $200 billion in each of the next two fiscal years. We believe Federal Reserve policies will remain expansive in 1986 and then tilt towards restraint in response to rising inflation by 1987. Our forecast includes a rising trend of interest rates over the next two years. A flattening of the yield curve should occur, as short-term rates rise faster than long-term rates.



Federal Spending–Little Discipline
(Federal spending and taxes as a percent of GNP)

With three years remaining in the Administration's second term, the chances of a lasting revolution in economic policymaking have diminished.

Economic Policy—The Reagan Program

The election of Ronald Reagan in November, 1980 raised the possibility of a major change in the role of government and fiscal policy. The initial goals included increased economic growth. Tax rates were reduced to provide incentives for saving and investment. Government spending was to be curbed to release resources to the private sector, while government regulation was to be replaced by discipline of the market. Finally, monetary policy was to achieve a stable, non-inflationary environment through a gradual slowing of money growth.

Results vs. Objectives

With three years remaining in the Administration's second term, the chances of a lasting revolution in economic policymaking have diminished. Various troubled parts of society, ranging from the textile industry to agriculture to savings and loan institutions, have turned to government for assistance. These groups focus their demands on power points of decision making and often justify them by pointing to past mistakes of government policy. The public frequently sympathizes with the problems of these groups and rarely organizes any opposition since the costs that corrective policies may impose are unknown.

One result of this response to special interests has been that federal spending currently stands at more than 24% of total GNP, close to a record high. The Reagan Administration originally planned to reduce the share of both taxes and spending to 19% of GNP, but only on the tax side has it been successful. It is true that concern about the size of deficits has prevented the spawning of new programs. However, many programs have only been restrained, and this may prove to be temporary.

New Priorities

In 1985, the Reagan Administration has emphasized tax reform and economic growth. Strong opposition from various groups and lack of public support appear to have scuttled prospects for any major tax reform legislation.

However, the commitment to promoting growth at home and abroad is likely to strengthen. Faster growth will help in the short run to offset the inability to make major cuts in federal outlays. Better economic performance will reduce the growth of certain benefit programs, while bolstering the increase in revenues. Although federal spending growth will be slower, outlays are still likely to amount to more than 23% of GNP by fiscal 1987. We expect the deficit to remain close to $200 billion in both fiscal 1986 and 1987, representing a slightly smaller share of a larger GNP.

Federal Budget Remains Intractable
(Billions of dollars, fiscal years ending September 30)

	Receipts	Outlays*	Deficit
1981	$599.3	$ 678.2	$ 78.9
1982	617.8	745.7	127.9
1983	600.6	808.3	207.7
1984	666.5	851.8	185.3
1985	734.0	945.9	211.9
1986f	**795.0**	**995.0**	**200.0**
1987f	**867.0**	**1065.0**	**198.0**

*Including off-budget spending

Solution to the Deficit Problem

Efforts to reflate out of the deficit problem cannot be successful in the long run. To the extent that anti-inflationary policies are ultimately adopted, rising expenditures and falling revenues will push the deficit higher than ever. There is no lasting solution to the deficit problem other than a binding limitation on federal spending.

Monetary Policy—Reflating

We have long contended that the Federal Reserve has two speeds in terms of monetary growth--too fast and too slow. The first three years of the current economic expansion have proved to be no exception. The growth of money (M1) declined from over 10% in 1983 to slightly over 5% in 1984. Not surprisingly, this sharp deceleration produced a slowdown in economic growth. To counter this slowdown, the Federal Reserve aggressively supplied reserves in 1985. This is likely to yield an M1 growth of close to 11.5% this year.

Policy Incentives

The Federal Reserve believes it is responsible for monitoring and influencing a number of different variables. These include economic growth, inflation, exchange rates, and the health of the financial system. Moreover, while it maintains long-run policy objectives, it has always responded to the most pressing issues of the time. The most immediate concerns come from the potential credit problems in various sectors in the U.S. and the developing nations. Other serious concerns are economic growth, especially in manufacturing, and the rise of protectionism. Inflation is not considered a problem; on the contrary, many would like to see a faster rise in the price of the goods they produce or of the real assets they hold. In this setting, the Federal Reserve has decided to tilt towards an expansive policy.

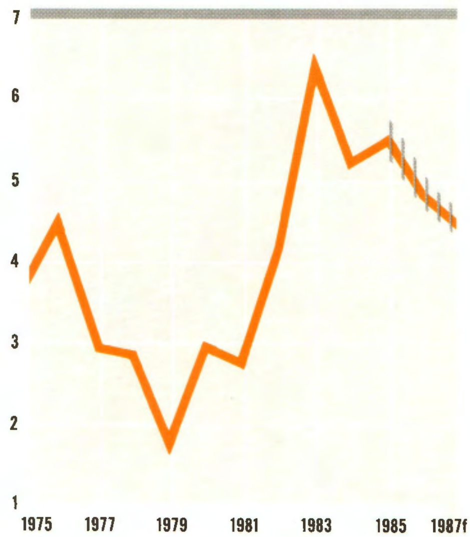
"Go-Stop" vs. "Go-Go"

We believe that the Federal Reserve will adhere to a policy of monetary stimulus in 1986, with M1 growth of about 8%. The effort to weaken the dollar under the G-5 agreement of the major central banks will induce the Federal Reserve to attempt to hold interest rates below market levels. This effort will further stimulate loan demand and hence monetary growth. Evidence of a rebound in economic growth in 1986 and a visible speedup in inflation by year-end can be expected to cause the Federal Reserve to slow monetary growth in 1987 to below 5%.

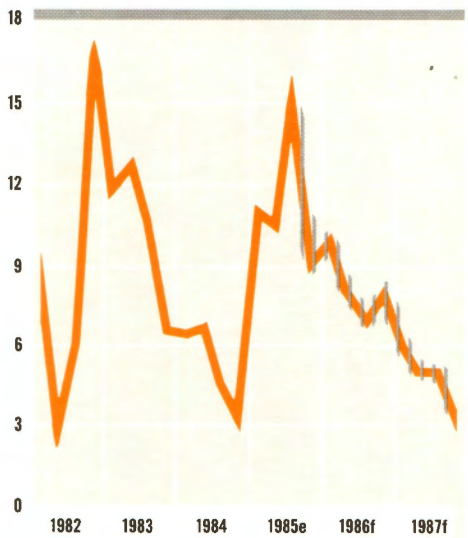
The Risks

Because the Federal Reserve is highly responsive to current conditions, future policy actions are difficult to predict. A major risk to our forecast is that if economic growth turns out to be very strong in the next two quarters, the Federal Reserve might shift more sharply towards monetary restraint than we now expect. The alternative scenario, with a lesser probability, would be that the Federal Reserve would continue to foster rapid monetary growth through 1987 in an effort to prolong the period of sizable economic expansion.

Some do not consider inflation a problem; many would like to see a faster rise in the price of goods or assets. The Federal Reserve has decided to tilt towards an expansive policy.

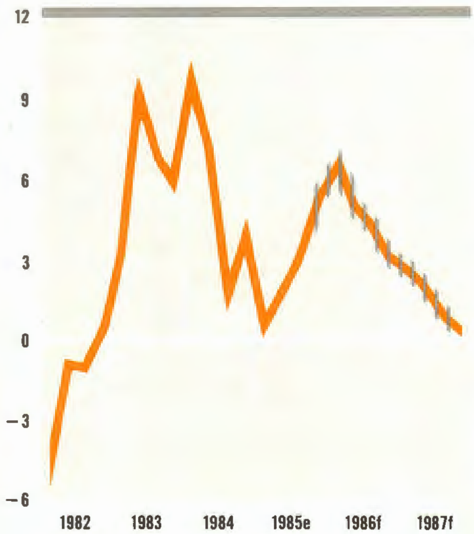


Federal Deficit–Effort to Reflate Out of the Problem
(Federal deficit as a percent of GNP)

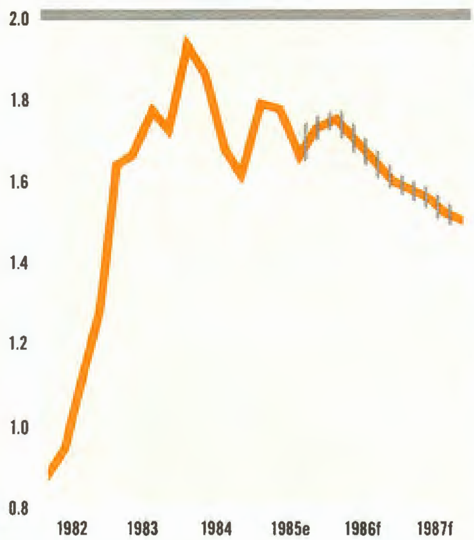


Monetary Growth (M1) Rapid in '85 and '86, Cutback in '87
(Percent change from prior quarter, annual rate)

We expect consumer borrowing to grow more moderately in 1986 than in 1985, but consumer spending will still be a major factor in the economic expansion.



Real GNP to Rebound in '86, Slow in '87
(Percent change from prior quarter, annual rate)



Housing Starts Remain Sizable, Then Fall
(Millions of units, seasonally adjusted annual rate)

Growth—Strong in 1986, Weaker in 1987

We look for a further pickup in economic activity in the first part of 1986, following a strong final quarter of 1985. Three major factors will be responsible for this acceleration: (1) a delayed response to rapid monetary expansion in 1985; (2) a swing from inventory liquidation in the third quarter of 1985 to a rebuilding of stocks; and (3) a leveling off of net exports in real terms, helped especially by a pickup in exports.

Our forecast is real GNP growth of about 5.5% in the fourth quarter of 1985 and 6.5% during the first quarter of 1986. For all of 1986, we expect real GNP to advance 4.7% (on a fourth-quarter to fourth-quarter basis), in contrast to an estimated rise of 2.7% in 1985. We then expect a substantial slowdown in economic activity in 1987 in response to more restrictive monetary policy, with real GNP up only 1.4%.

Consumers—Overextended?

By early fall, 1985, concern had mounted that consumers had accumulated too much debt and therefore would retrench from borrowing and spending. Since consumer spending accounts for about two-thirds of total outlays in the economy, this led to many predictions of a continued sluggish pace of business activity.

Several forces have contributed to the rise in consumer debt and should mitigate alarm about its climb. First, the rapid growth in credit in late summer and early fall reflected the attractiveness of low interest rates on auto loans. Consumers took advantage of these in order to reduce their expected future car payments from those that would have been required if they had waited to purchase.

Second, many individuals use credit cards as a substitute for cash and pay off balances without incurring any debt expense. Third, part of the rise in the total debt-to-income ratio reflects growth in the population segment aged 25-44. This is typically the age group that borrows substantially.

Finally, households have increased their holdings of financial assets. The rapid expansion of monetary reserves has not only produced a sizable climb in borrowing, but also a significant growth in assets. The rise in stock prices has also increased the value of those assets. Consequently, the ratio of households' total financial liabilities (including mortgage debt) to their assets is much below the peak of 1979.

On balance, we expect consumer borrowing to grow more moderately in 1986 than in 1985, but consumer spending will still be a major factor in the economic expansion.

Housing and Capital Spending

We expect housing starts to remain sizable into the first part of 1986, with a gradual downward trend in the second half of the year in response to higher interest rates. For all of 1986, we forecast housing starts of 1.68 million units, off about 4% from the 1.74 million units estimated for 1985. The shift towards monetary restraint, which we assume will occur in 1987, would then push housing starts down 8% in that year.

Businesses should increase outlays for plant and equipment by approximately 11% in nominal terms during 1986, amounting to real growth of about 7%. Although nonresidential building will advance modestly, principally to complete projects begun in 1985, most of the gain will represent equipment purchases to improve productivity.

Plant and Equipment—Improving Productivity

	Total	Percent Change	
	(Billions)	(Nominal)	(Real)
1981	$353.9	14.6%	5.5%
1982	349.6	−1.2	−4.6
1983	352.9	0.9	2.5
1984	425.7	20.6	19.8
1985e	464.5	9.1	6.1
1986f	**518.0**	**11.5**	**7.3**
1987f	**560.0**	**8.1**	**2.1**

e = estimate; f = forecast

Computer purchases should rebound and orders for new aircraft should also be sizable. Uncertainty about tax reform, which caused some projects to be accelerated and others to be deferred in 1985, should diminish as few changes are actually legislated in 1986.

A general slowing in orders and sales in 1987 is likely to hold the growth of

Money and the Economy—The Velocity Issue

The rapid growth of the money supply during 1985, accompanied by only a sluggish rise in GNP during much of the year, again focused attention on the linkage between money and economic activity. We estimate that velocity, the ratio of current dollar GNP divided by the money supply (M1), will decline by approximately 4.5% in 1985. This contrasts with a historical trend since 1965 of a positive growth rate of slightly over 2.5%.

What is Behind Velocity Swings?

Three major sets of factors are responsible for the behavior of velocity: (1) changes in the public's demand for money, (2) the impact of money on spending vs. production, and (3) the time required to restore the balance between desired and actual money holdings.

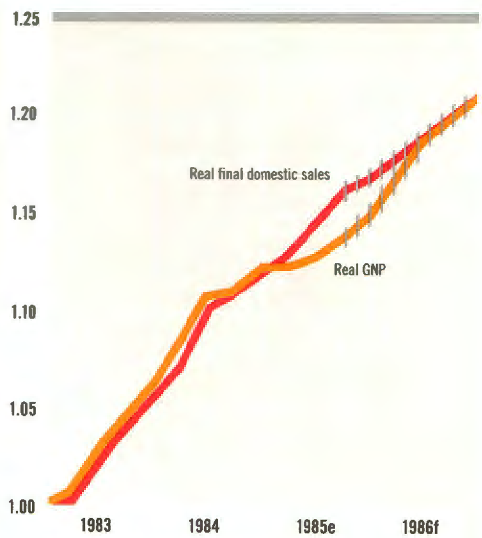
Business cycle forces, economic uncertainty, and the level of interest rates, including the expected rate of inflation, can each affect the amounts of cash balances people desire to hold relative to income (raise or lower velocity). Changes in the definition of money, such as to include greater savings components, can also influence measured velocity. These elements played some role in depressing velocity in 1985.

Another key factor in the velocity picture is the distinction between spending and production. As typically measured, velocity relates the value of GNP to the money supply. This might be valid in a closed economy, but not where foreign trade is significant. Fluctuations in inventory investment can also affect production. In 1985, a sizable gap developed between the growth of domestic demand (real final domestic sales) and production. The relation between money and final demand (including spending on imports) has been more stable or predictable than the relation between money and production (GNP).

The third major argument in the money-income issue involves the difference between desired and actual velocity. One can think of desired velocity as the amount of money that people wish to hold relative to income. If the actual amount of money in existence is greater or less than desired by the public, this will trigger changes in spending, income, prices, and interest rates until equality of desired and actual cash balances is restored. The adjustment process, however, is not immediate. This means that observed changes in velocity can be either due to changes in the public's demand for money or to changes in the amount of money supplied by the Federal Reserve. Consequently, the large drop in reported velocity in 1985, in sizable part, can be attributed to the sudden jumps in monetary growth and the time necessary to adjust to those changes.

Velocity in 1986 and 1987

We believe that the velocity of money will resume an upward trend in 1986, with a fourth-quarter to fourth-quarter increase of about 1.5%. This represents a reversal of the forces operating in 1985. We look for a slower increase in money demand relative to income, a faster growth in GNP than spending, and the adjustment of desired to actual money balances. Our forecast shows an increase in velocity of about 3.4% in 1987. This largely reflects our assumption of a significant cutback in monetary growth in that year and the time required for adjustment.

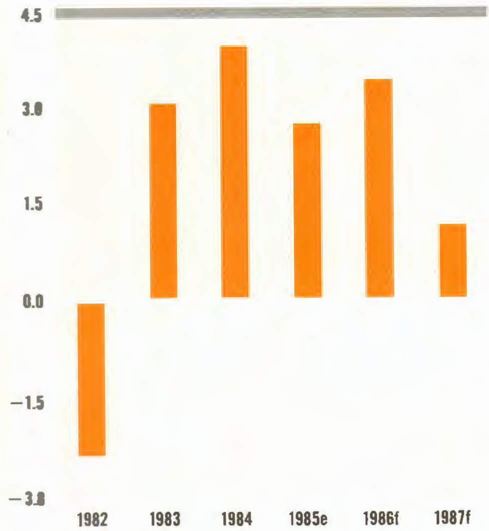


Gap between Demand and Production to Narrow
(Cumulative change from 4th quarter 1982, Index = 1.0)

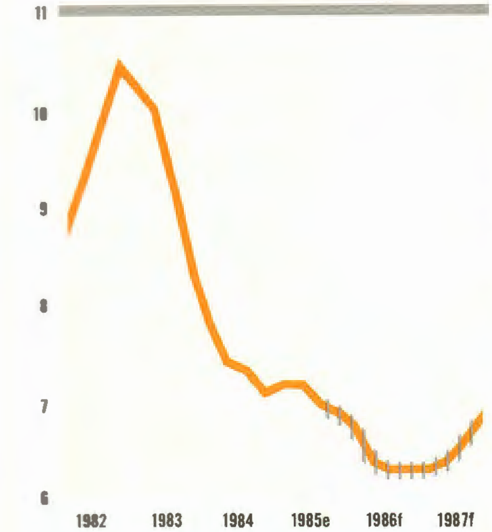
Major Economic Indicators

	1985 I	1985 II	1985 III	1985 IV	1986 I	1986 II	1986 III	1986 IV
	Actual			Forecast (Quarterly)				
Gross National Product (Billions of $, annual rate)	3810.6	3853.1	3916.1	4006.1	4111.7	4209.3	4308.0	4401.6
% Change, annual rate	5.6	4.5	6.7	9.5	11.0	9.8	9.7	9.0
Money Supply (M1) (Billions of $, annual rate)	568.1	582.6	604.5	617.7	632.6	644.8	655.8	668.6
% Change, annual rate	11.0	10.6	15.9	9.0	10.0	8.0	7.0	8.0
Velocity (GNP/M1)	6.71	6.61	6.48	6.49	6.50	6.53	6.57	6.58
% Change, annual rate	−4.8	−5.5	−7.9	0.5	0.9	1.7	2.5	0.9
Real GNP (Billions of 1972 $, annual rate)	1663.5	1671.3	1684.8	1707.5	1734.6	1755.9	1774.0	1787.2
% Change, annual rate	0.3	1.9	3.3	5.5	6.5	5.0	4.2	3.0
Real Final Sales (Billions of 1972 $, annual rate)	1644.4	1663.0	1686.9	1698.5	1716.6	1731.9	1748.0	1762.2
% Change, annual rate	−0.3	4.6	5.9	2.8	4.3	3.6	3.8	3.3
Real Change in Inventories (Billions of 1972 $, annual rate)	19.1	8.3	−2.1	9.0	18.0	24.0	26.0	25.0
GNP Deflator (1972 = 100)	229.1	230.6	232.4	234.6	237.0	239.7	242.8	246.3
% Change, annual rate	5.4	2.6	3.3	3.8	4.2	4.6	5.3	5.8
Consumer Price Index (1967 = 100)	317.8	321.1	323.0	326.2	329.6	333.4	337.8	342.6
% Change, annual rate	3.2	4.2	2.4	4.0	4.3	4.7	5.3	5.8
Auto Sales (Millions, annual rate)	10.8	10.9	12.5	10.0	10.8	11.0	11.2	11.0
Housing Starts (Millions, annual rate)	1.80	1.77	1.66	1.73	1.75	1.70	1.65	1.60
Industrial Production (1977 = 100)	123.8	124.2	124.5	125.9	127.9	129.5	130.7	131.8
% Change, annual rate	2.3	1.3	1.0	4.7	6.3	5.2	3.8	3.5
Nonfarm Employment (Millions)	96.6	97.3	97.9	98.6	99.5	100.5	101.4	102.1
Unemployment Rate (Percent)	7.2	7.2	7.0	6.9	6.7	6.4	6.3	6.3
Corporate Operating Profits (Billions of $, annual rate)	292.3	298.5	312.0e	325.0	346.0	363.0	378.0	390.8
% Change over year ago	5.4	2.5	15.4	11.5	18.4	21.6	21.2	20.0
Cash Flow After Dividends (Billions of $, annual rate)	379.0	388.4	402.0e	420.0	443.0	462.0	480.0	495.0
% Change over year ago	5.2	5.9	8.0	11.9	16.9	18.9	19.4	17.9

NOTE: All quarterly series are seasonally adjusted; % Change, annual rate calculated from prior quarter; e = estimate; Calculations based on unrounded data:



Employment Gains Strengthen in '86, Weaken in '87
(Change in payroll employment in millions, 4th quarter to 4th quarter)



Jobless Rate Down in '86, Up in '87
(Unemployment as a percent of total labor force, quarterly averages)

total capital outlays to 8% in dollar terms, representing a real gain of only 2%. The surplus in office space will produce an actual decline in nonresidential construction in 1987.

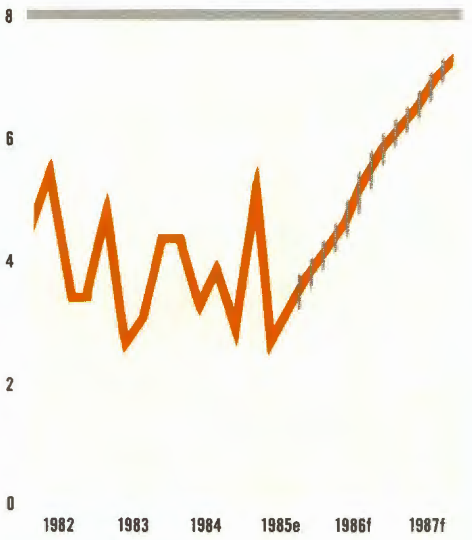
Job Picture Brightens

The rebound in economic growth that we forecast for 1986 should yield stronger gains in employment and a gradually falling unemployment rate. We expect 3.5 million jobs to be added to nonfarm payrolls between the end of 1985 and the end of 1986. This will bring the increase in employment since the end of the last recession in 1982 to nearly 13.5 million. A relatively small additional increase of 1.2 million jobs can then be expected in 1987.

We believe economic growth will be strong enough next year to drive the unemployment rate down to an average of about 6.3% in the second half of 1986 from a level of slightly over 7% during much of 1985. Meanwhile, the proportion of the working-age population holding jobs should continue to advance, moving past 61% to a new all-time high in 1986. Our forecast of a slowing economy in 1987 is likely to reverse the decline in the jobless rate, pushing it back towards the 7% level by the end of that year.

1987				4th Quarter					
I	II	III	IV	1985	% Change '85/'84	1986	% Change '86/'85	1987	% Change '87/'86
				Estimate		Forecast			
4498.2	4592.2	4681.0	4767.7	4006.1	6.6	4401.6	9.9	4767.7	8.3
9.1	8.6	8.0	7.6						
678.4	686.7	695.2	700.3	617.7	11.6	668.6	8.2	700.3	4.7
6.0	5.0	5.0	3.0						
6.63	6.69	6.73	6.81	6.49	−4.5	6.58	1.5	6.81	3.4
2.9	3.5	2.8	4.5						
1799.1	1808.1	1812.1	1813.0	1707.5	2.7	1787.2	4.7	1813.0	1.4
2.7	2.0	0.9	0.2						
1772.1	1776.1	1782.1	1788.0	1698.5	3.2	1762.2	3.8	1788.0	1.5
2.3	0.9	1.4	1.3						
27.0	32.0	30.0	25.0	9.0	N/A	25.0	N/A	25.0	N/A
250.0	254.0	258.3	263.0	234.6	3.8	246.3	5.0	263.0	6.8
6.2	6.5	7.0	7.4						
347.8	353.3	359.3	365.8	326.2	3.5	342.6	5.0	365.8	6.8
6.2	6.5	7.0	7.4						
10.8	10.6	10.2	9.8	11.1*	6.3	11.0*	−0.4	10.4*	−6.0
1.58	1.56	1.52	1.50	1.74*	−0.6	1.68*	−3.7	1.54*	−8.1
132.5	132.9	132.9	132.3	125.9	2.3	131.8	4.7	132.3	0.3
2.0	1.2	0.0	−1.8						
102.6	103.0	103.3	103.3	98.6	2.9	102.1	3.5	103.3	1.2
6.3	6.4	6.6	6.9	6.9	N/A	6.3	N/A	6.9	N/A
400.0	410.0	416.0	419.0	325.0	11.5	390.0	20.0	419.0	7.4
15.6	12.9	10.1	7.4						
507.0	520.0	528.0	534.0	420.0	11.9	495.0	17.9	534.0	7.9
14.4	12.6	10.0	7.9						

*Annual average; N/A = Not applicable.



Inflation to Accelerate
(Percent change from prior quarter in GNP implicit price deflator, annual rate)

Corporate Profits Respond

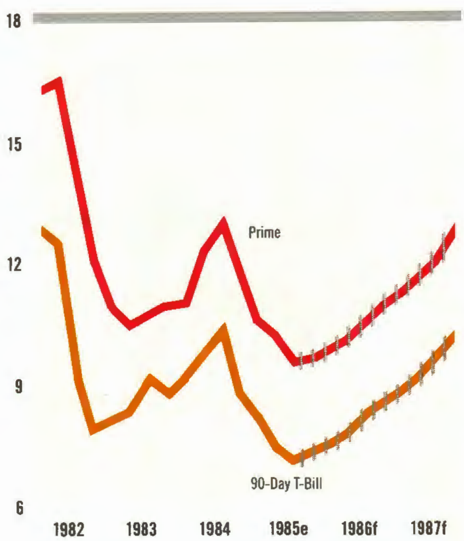
With an improvement in sales volume, the efforts to improve productivity and reduce costs will rapidly flow to the bottom line in 1986. We expect pretax operating profits (excluding inventory profits and valuing depreciation on a replacement cost basis) to jump by about 20% in 1986. Net cash flow (retained earnings plus depreciation) should also advance by a healthy 18% in the coming year. The growth in operating profits and net cash flow would then be constrained to the 7-8% range in 1987.

Inflation Concerns Subside, Reemerge

As the third year of economic expansion ends, inflation has remained subdued. By year-end, we estimate that consumer prices for 1985 will have risen 3.5%. This will be similar to the inflation rates of the previous two years. While this is below the pace of the second half of the 1970s, it is still high compared to the expansion of the 1960s.

Confusion persists regarding the basic causes of inflation and, hence, its future course. Part of this confusion involves the distinction that should be made between changes in relative prices and changes in the general price level. The rest relates to the distinction between

Interest rates will continue to rise in 1987 despite a slowing in economic growth.



90-Day T-Bill and Prime Rates to Move Upward
(Percent, quarterly averages)

transitory effects on prices and the trend of ongoing inflation. For example, declines in oil and food prices may only represent reductions in relative prices; prices of all other goods and services could be rising. In addition, price shocks, such as a jump in the dollar's value or deregulation, may drive various prices lower, but this will represent a one-time impact.

Inflation is the rate of increase in the general price level. Rapid money supply growth is necessary for sustained inflation, although it takes about two years before the major effects of changes in money supply occur. Certain factors, such as oil prices, food prices, and the dollar's value, because of their significant influence on most price indexes, may affect temporarily the reported rate of inflation, but the impact will not be permanent.

These distinctions are important to understanding the recent course of inflation and its probable path. The dollar soared by nearly 70% from the end of 1980 to the end of 1984. This appears to have been the key element in preventing inflation from reflecting the rapid money growth of 1982 and 1983. We estimate that a ten percent change in the dollar's value has about a 1.1% effect on the reported inflation rate when time is allowed for the total impact.

Dollar Reversal

This analysis also means, however, that since the dollar has stopped rising, inflation will be higher. Our research indicates that much of the impact of changes in the exchange rate on prices does not occur until after two years, although some effect can take place after two quarters.

As other elements in our inflation forecast, we look for only a modest rise in food prices through 1987 and a gradual

Two Inflation Measures
(Percent change, 4th quarter to 4th quarter)

	Consumer Prices*	GNP Deflator
1976	5.0%	4.7%
1977	6.6	6.1
1978	9.0	8.5
1979	12.7	8.2
1980	12.6	10.2
1981	9.6	9.0
1982	4.5	4.3
1983	3.3	3.8
1984	4.1	3.6
1985e	3.5	3.8
1986f	**5.0**	**5.0**
1987f	**6.8**	**6.8**

*All urban e = estimate; f = forecast

decline in the price of oil. However, we expect that the rapid acceleration in monetary growth in 1985 and the dollar's decline will produce a notable acceleration in inflation by the end of 1986 and a further climb in 1987. On a fourth-quarter to fourth-quarter basis, we expect consumer prices to increase 5% in 1986 and 6.8% in 1987.

Although the year-end inflation rate by 1987 will still be much less than its peak at the end of the 1970s, it will represent a disturbing doubling of inflation in only two years. The commitment among policymakers and the general public to sustaining the gains achieved against inflation has now dissipated and set the stage for this development.

Interest Rate Outlook

We believe that interest rates will rise in 1986 for several reasons. First, a rebound in economic growth will cause the Federal Reserve to be reluctant to supply reserves so liberally and will convince financial markets that a cyclical rise in interest rates has resumed. Second, continued rapid money growth, combined with a recovery in economic activity, will cause financial markets to anticipate Fed actions to slow money

Forecast of Interest Rates
1986-1987

	1985				1986				1987			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Short-Term	Actual			Forecast								
Fed Funds (Overnight)	8.48	7.92	7.90	8.10	8.30	8.45	8.95	9.30	9.65	10.00	10.45	11.10
Treasury Bills (90-day)[1]	8.18	7.46	7.11	7.30	7.55	7.75	8.25	8.60	8.85	9.15	9.60	10.20
CDs (90-day, Secondary)	8.62	7.95	7.79	8.10	8.35	8.50	9.05	9.45	9.75	10.10	10.55	11.20
Eurodollar (90-day)	8.92	8.16	8.01	8.25	8.55	8.75	9.35	9.75	10.10	10.45	10.95	11.60
Prime Rate	10.54	10.20	9.50	9.60	9.90	10.10	10.55	11.05	11.30	11.70	12.10	12.70
Long-Term												
U.S. Government Bonds (20 yrs)[2]	11.78	11.15	10.74	10.90	11.05	11.15	11.30	11.50	11.60	11.75	11.90	12.10
Corporate Aaa (Moody's)	12.26	11.63	11.03	11.15	11.30	11.45	11.65	11.85	11.95	12.10	12.25	12.45
Mortgage Rate (Fixed)[3]	13.07	12.78	12.14	12.30	12.45	12.60	12.75	13.00	13.10	13.30	13.50	13.75

(1) Bank Discount Basis. (2) Yields adjusted to constant maturities. (3) Contract rates on first mortgages, conventional market.

growth or more inflation if the Fed fails to act. Third, government borrowing requirements will continue to be large, while business loan demand expands with faster economic growth.

The Federal Reserve is likely to try to temper the rise in interest rates as long as the policy to push the dollar lower persists. Efforts to carry out this policy may well weaken by the second half of 1986. The most important factor affecting interest rates in the immediate period ahead will be the strength of the economy. A surge in economic growth could push rates up more quickly than indicated in our forecast.

We believe that interest rates will continue to rise in 1987 despite a slowing in economic growth for two major reasons. First, concern about inflation will be rising and, second, the cutback in monetary growth may produce some liquidity effect, pushing interest rates higher in the short run.

How Large a Rise?

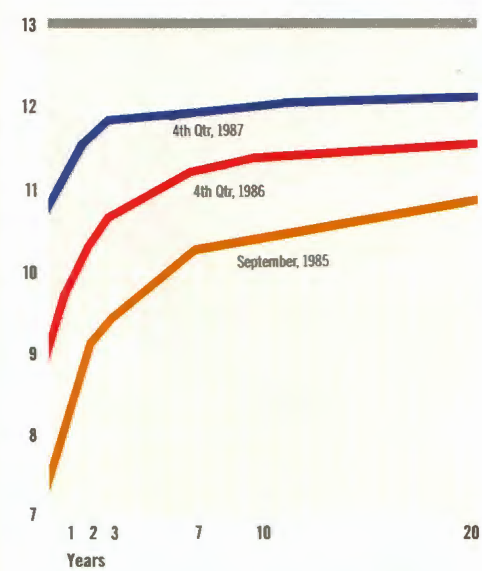
We forecast that the yield on 3-month Treasury bills will move from an average of 7.3% towards the end of 1985 to 8.6% late in 1986 and 10.2% at the end of 1987. Changes in the prime rate lag changes in money market rates, whether interest rates are rising or falling. Consistent with our forecast of 90-day CD rates, we expect the prime rate to move from an estimated average of about 9.6% in the fourth quarter of 1985 to about 11% by the end of 1986 and 12.7% at the end of 1987.

The rise in long-term rates should be substantially less than that for short-term rates. This is because long-term rates already include a sizable component reflecting expectations of future inflation, as well as a risk premium for uncertainty about the future course of economic policy. Unfortunately, some of these inflation concerns are likely to be realized.

We expect the yield on 20-year government bonds to rise from an average of about 10.9% in the fourth quarter of 1985 to 11.5% by the end of 1986 and over 12% in the final part of 1987. Mortgage rates on 30-year fixed-rate loans will increase from an estimated average of 12.3% in late 1985 to 13% by the end of 1986 and 13.75% by year-end 1987. This rise in fixed rates will again trigger a greater use of adjustable-rate mortgage loans.

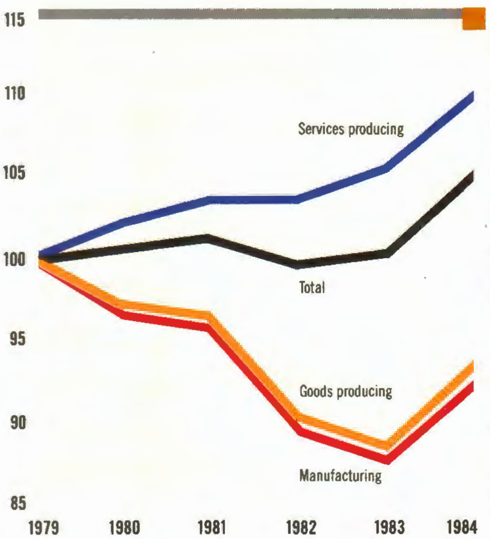
An anomaly of this expansion has been the steepness of the yield curve three years into the recovery. This may partly reflect a liquidity effect, with rapid money growth temporarily pushing short-term interest rates down, while concerns persist about inflation over the longer-run. The faster rise in short-term rates than long-term rates over the next two years should finally produce some flattening in the yield curve.

20-Year Government Bond and Mortgage Rates – Anticipating Higher Inflation
(Percent, quarterly averages)

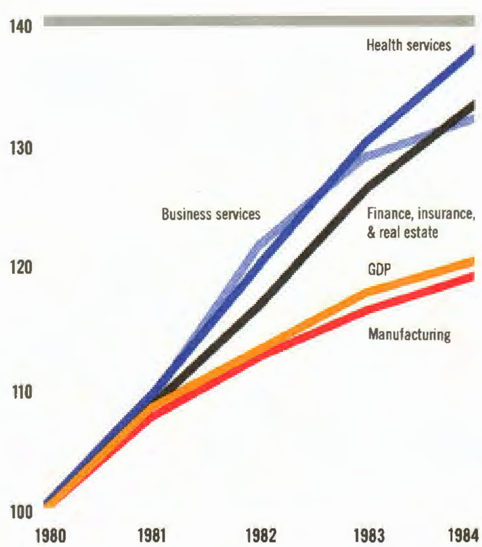


Yield Curve of Government Securities to Flatten
(Percent, monthly and quarterly averages)

Growth in service sectors will continue to outpace goods sectors over the next two years. Despite a further decline in the dollar's exchange value, manufacturers will remain challenged by import competition. Strong business activity in next year's first half should not be interpreted as a sign of a sustainable increase in the rate of economic growth. Manufacturing employment will continue recovering, but, after an initial spurt, its growth will also settle back to a sluggish pace. Rising inflation will be focused in the health, financial and business services sectors.



Will Employment Recovery in Goods Sector Last?
(Index of employment, 1979 = 100)



Services Escape General Inflation Slowdown
(Gross product deflators, Index 1980 = 100)

Manufacturing

Hope for revitalization of the manufacturing sector that was sparked by the 8% increase in manufacturing production in 1983 was dampened by the past year's performance. Although the production index gained more than 12% in 1984, the increase was concentrated in the first half. Once the stimulus of rapid M1 growth was removed, output gains slowed considerably, but even the strong monetary stimulus in the first half of this year has not been able yet to revive production growth near the rates that were induced in the early stages of the recovery.

Employment in manufacturing is off 1% since last year at this time, in contrast to a more than 5% average increase in 1984 vs. 1983. Our forecast for accelerating output beginning this quarter through mid-1986 should produce a spurt of employment growth in the manufacturing sector. We expect, however, that the response of production to monetary stimulus will be considerably less than in 1983. Growth of production jobs will thus be less and will slow in next year's second half. Factory jobs could start to decline again in 1987 as output growth slows to rates comparable with those seen earlier this year.

Wage increases in major collective-bargaining agreements in manufacturing slowed in the first half of this year to a 1.9% rate over the contract life from 3% in the same 1984 period. Nonmanufacturing wage settlements, in contrast, averaged 3.2% in 1985's first half, almost the same as 1984's increase of 3.1%. The sharp pickup in production in the early quarters of the forecast period should encourage demands for larger settlements in manufacturing, but these will be faced with the reality of slowing output growth later on.

Prices of manufactured goods have been growing at virtually the same rate as those for all output (see chart), having been held in check by competition from imports due to the strong dollar. Service prices, however, are insulated from import competition, so substantial inflation has been experienced in the service sectors, even though the recent overall rate of inflation is considered low. Despite the further decline that we are forecasting for the dollar's exchange value, we expect that imports will remain a significant challenge to U.S. manufacturers. A falling dollar will allow part of the inflation that we are forecasting to be felt in goods prices, but service prices will continue to outpace them by a wide margin.

Industrial Production

The chart shows a selection of industries that we expect to most outperform and to most underperform the growth of the overall production index in the next two years. The aerospace industry leads the

New Construction Spending
(Billions)

	Total*	% Annual Change	Residential	% Annual Change	Commercial	% Annual Change	Industrial	% Annual Change	Public	% Annual Change
1983	$268.7	13.4	$121.3	50.5	$35.8	−4.0	$12.9	−25.4	$50.7	−0.2
1984	313.0	16.5	145.1	19.6	48.1	34.6	13.7	6.2	55.2	8.9
1985e	338.3	8.1	146.9	1.2	59.2	23.1	15.7	14.6	61.5	11.4
1986f	**355.6**	**5.1**	**148.3**	**1.0**	**67.7**	**14.4**	**16.1**	**2.5**	**65.7**	**6.8**
1987f	**359.0**	**0.9**	**144.4**	**−2.6**	**71.3**	**5.3**	**16.7**	**4.0**	**68.2**	**3.8**

*Includes categories not shown.
e = estimate; f = forecast

list of strong performers. Both increased government outlays as the production phase of the defense buildup progresses and healthy orders for commercial aircraft to supply fleet expansion and upgrade technology will continue.

Whereas aerospace output is fairly independent of cyclical fluctuations in production, the remaining leaders historically reflect the national business cycle. Since we expect the current acceleration of business activity to last only through mid-1986, with growth slowing thereafter, growth of the leaders will be initially stronger than shown but will then be inhibited by slowing growth of demand.

We expect an upswing in the semiconductor industry to contribute to the relatively strong gain shown for electrical machinery. The sluggish rate of growth of the economy since mid-1984 obscures the devastating recession that has struck this industry since then. It has been particularly vulnerable to economic fluctuations because of its short product cycles. Investment in capacity for new circuit technologies has frequently been postponed during recessions, allowing its primary competitor, the Japanese semiconductor industry, gradually to gain technological competitive advantages in production over the course of several business cycles. The recovery in semiconductors is likely to be short-lived, however, because of the slowdown in the latter part of our forecast.

Agriculture

As the U.S. farm economy enters a new marketing year, there is widespread skepticism about whether much progress can be made in solving its problems. Reports of bountiful harvests and depressed livestock and crop prices have been sprinkled with announcements of farm failures, foreclosures, and depressed conditions at agribusiness firms. Exports have dropped to a level not seen in this decade. As a consequence, carryover stocks continue to mount, and no early market recovery is in sight.

The depressed export situation is a major concern, since it may signal the demise of the U.S. as the principal supplier of farm commodities to overseas markets. The decline in wheat exports, for example, is quite dramatic, plummeting over 30% from the 1982 peak. In the last ten years, cotton exports have dropped 40%. The U.S. share of the world soybean trade has slipped from 90% to under 75% recently. Although strength in the dollar has played a role, a major factor in depressing exports is the rapid buildup of agriculture production and trading capabilities by other nations. Indeed, there is a worldwide agricultural surplus today that may tend to keep pressure on farm commodity prices for some years to come.

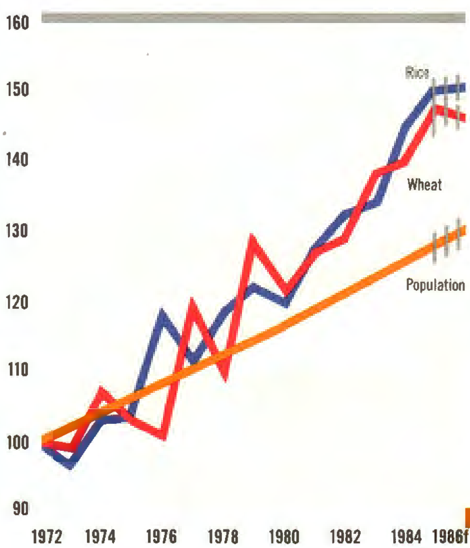
Transportation

The revival of the manufacturing sector in the early part of the forecast period

Growth in Manufacturing Output —Leaders & Laggers, 1986-1987
(Two-year percent increase of industrial production indexes)

The depressed export situation is a major concern, since it may signal the demise of the U.S. as the principal supplier of farm commodities to overseas markets.

What financial institutions and their customers need most in order to work out of the credit problems that developed in the 1970s and early 1980s is a long period of strong economic growth with low inflation rates.



World Grain Production Outpaces Population Growth
(Index, 1972 = 100)

1985e: USDA estimate of grain production
1986f: USDA projection of grain production

deposits that were still subject to Regulation Q ceilings. Consequently, there was a transfer of real wealth from net creditors, such as the depositors and shareholders of banks and thrifts, to people who borrowed in order to buy land and commodities.

When inflation slowed down, the flows of real wealth went into reverse. Prices of land and commodities fell faster than interest rates. Depositors and shareholders of banks and thrifts began to recoup. Small savers, in particular, enjoyed a rise in real interest income.

Unfortunately for the banks and thrifts, however, some of the people who borrowed from them in the 1970s at home and abroad proved unable to repay the principal or to maintain their interest payments on schedule in the 1980s. Lenders recovered only part of what they had unintentionally given up earlier.

Inflation Confuses People

Borrowers and lenders may confuse changes in prices of individual commodities or assets that are caused by changes in inflation rates with changes in real demands and supplies. During the 1970s, for example, inflation and a falling dollar boosted prices of farm products and farm land in the United States (See charts on accompanying pages.)

Many U.S. farmers and their creditors interpreted these changes in prices as evidence of a lasting rise in world demand for U.S. farm products. Meanwhile, as can be seen on the chart, world production of wheat and rice, two of the world's main food staples, was growing rapidly. Production of these and other grains has been growing faster than the world population of potential consumers. Like Saudi Arabia, with its oil, U.S. farmers and their creditors eventually must face the problem of adjusting to a world market that is growing more slowly than they thought it would in the 1970s.

Reflation and Reregulation are Not Solutions

Inflation could make the problems of financial institutions worse, rather than better, by confusing borrowers and lenders as it did before. However, they are unlikely to fall into the same traps again. Interest rates are unlikely to lag so far behind inflation in a future flareup of inflation, so there should be less temptation to borrow or lend on proposals that would not make sense in real terms. And we should not again see the fear of running out of energy, food, and other resources that misled so many investors in the 1970s.

Misconceptions about the causes of failures in financial institutions during the 1920s and 1930s led the U.S. Congress to impose a blanket of financial regulations. These regulations severely hampered the ability of banks and thrifts to adjust to the problems caused by inflation in the 1970s. Financial deregulation since 1980 has considerably improved their ability to adjust in the future. That will help.

What financial institutions and their customers need most in order to work out of the credit problems that developed in the 1970s and early 1980s is a long period of strong economic growth with low inflation rates. Such economic conditions would provide opportunities for supplementing declining businesses with new businesses and for financing both old and new businesses securely.

Part of that prescription is in place. From the end of the last recession in 1982, through 1987, the world economy will grow more in real terms than it did in the 1970s. Banks and thrifts and their customers will benefit from that growth. But they must be wary of being carried away again with the misplaced confidence that inflation could bring.

Financial Deregulation and Reregulation

Congress took major steps towards deregulation of the financial services sector in 1980, with the Monetary Control Act, and in 1982, with the Garn-St. Germain Act. However, the liberalization process reached an impasse in early 1984, with the near failure and subsequent federal rescue of Continental Illinois Bank.

In 1985, a series of financial crises escalated concerns of Congress and financial regulators over the difficulties which financial institutions are experiencing in adjusting to a less restricted market environment. Supporting these concerns have been: the Ohio thrift crisis, the problems of the Federal Farm Credit Banks, the large number of bank and thrift failures, and the exposure of large banks to the debt of less developed nations. Consequently, reregulation of certain areas of the financial markets has become a strong possibility.

Interstate banking legislation is not likely to be enacted by Congress in 1986. The urgency has been reduced in the view of some observers because financial institutions have found several avenues through which branching across state lines is being accomplished. Others, including the Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation (FDIC), and some Treasury officials, advocate early action by Congress. Their concern is that the proliferation of regional compacts and other actions by state governments to allow interstate banking will Balkanize the American financial landscape, creating a patchwork quilt of non-uniform laws. In addition, although the Supreme Court upheld the legality of regional compacts in June 1985, these arrangements discriminate against large money center banks. Beyond 1986, federal legislation may be passed.

Deposit insurance reform will continue to receive the close attention of legislators and regulators. This issue came to the forefront in 1985 with the failure of a state-insured savings and loan association in Ohio, which triggered a financial crisis. In addition, savings and loan failures reached a record high of 252 in 1982, and were still high in 1983-1985. Bank failures reached a record of 79 in 1984 and are already past this mark in 1985. These levels even exceed the previous record of 77 failed banks in 1937, during the Great Depression. Concerns have mounted over the exposure of the funds of the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) to additional failures of large institutions.

A more immediate measure being contemplated to protect the integrity of the federal deposit insurance funds is to reduce the insurance coverage of individual depositor accounts from the current $100,000. Consumer groups are against such a measure, for fear of losses in the event of institutions failing. Some financial industry leaders are also apprehensive about the possibility of substantial withdrawals of savings funds from their institutions.

Tighter regulation is likely in a few areas as the U.S. financial system seems more vulnerable to shocks, whose disruptive effects are very costly in terms of loss of confidence and monetary policy responses.

Sources of Long-Term Business Capital
(Annual flows – billions of dollars)
*1st half 1985

Business demand for credit is expected to increase from the relatively slow 1985 as the economy picks up steam.

Interest rate ceilings (Regulation Q) on regular savings accounts at banks and thrift institutions will be removed on April 1, 1986. Some concern has been expressed about the effects of this final phase of interest rate deregulation. It is very unlikely that there will be a headlong rush by banks and thrifts to raise the present 5-1/2% rate paid for these funds. If, for example, the rate on the $300 billion of savings deposits is raised to levels close to those paid on Money Market Deposit Accounts (MMDAs), this would raise the cost of money to depository institutions by several billion dollars.

Given the narrow profit margins of some institutions, this additional expense would be difficult to absorb in the short run. Moreover, there is a great deal of inertia associated with savings accounts, as illustrated in a recent study, which estimates that a 2% increase in the interest rate paid would induce less than 30% of depositors to shift their funds to another financial institution.

Tighter regulation is likely in a few areas as the U.S. financial system seems more vulnerable to shocks, whose disruptive effects are very costly in terms of loss of confidence and monetary policy responses. Congress enacted legislation in late 1985 to regulate 200 government securities dealers. This is intended to minimize failure resulting from fraudulent activities, such as occurred in two cases in 1985 and which had severe repercussions on the financial markets. Capital and reporting requirements will be imposed on these institutions with the hope of minimizing the risk of future shocks.

Higher capital adequacy requirements may be imposed on banks to increase their ability to withstand future losses and to enhance market confidence in the stability of the system. If the high incidence of failures of institutions continues in 1986, there could be a groundswell of support for this measure.

U.S. Credit Market Conditions

During the first half of 1985, although the total demand for credit has declined slightly from the explosion of 1984, the structure of the holdings of debt has begun to change. The demand for credit is a function of the level and direction of interest rates, the pace of economic activity, and expections for inflation.

With declining interest rates through mid-1985, corporations shifted their debt structure to longer maturities. In 1984, when interest rates were generally rising, almost 35% of corporations' total debt was in the form of bonds, and 36% in the form of bank loans.

By the second quarter of 1985, while interest rates were declining and economic growth was slack, their bonds comprised 37% of corporate debt while bank loans fell to 33.3%. Commercial paper grew to 5% of the total in the second quarter of 1985 from only 4.3% in 1984.

On the other hand, corporations continued to liquidate equities as the recent trend of mergers and acquisitions forced the buy-back of record amounts of stock. Rising interest rates and stronger economic growth in 1986 and 1987 will push up the demand for credit, principally bank loans and commercial paper.

The composition of the issuers of net new debt (issued by non-financial entities) has changed as well. In 1979, the government accounted for only 14% of the total, increasing to nearly 48% in 1982 and falling to 32% in 1984. For the first half of 1985, the government accounted for just over 35% of the total new debt. Households incurred 46.5% of the total new debt in 1979, 33% in 1984, before climbing to 38.5% in the first half of 1985.

Corporate business issuance of new debt declined to 26.3% of the total in the first half of 1985, compared with 39.3% in 1979, and 35% in 1984. (See chart). These changes have occurred because government use of credit generally is greater during a recession, while consumers and businesses tend to reduce their needs during recessions and borrow during expansionary times, when they feel fairly confident that they can pay back the debt.

In 1984, businesses issued the majority of the total new debt--since it was the second year of the expansion and they invested heavily in inventories and plant and equipment. The decline of the business share of new debt so far in 1985 reflects the cautious attitude businesses have taken during the slow economic growth that occurred in the first part of 1985.

Over the next two years, we expect government borrowings to remain strong, but the government proportion of total debt is not expected to rise, as a recession is not likely. Business demand for credit is expected to increase from the relatively slow 1985 as the economy picks up steam.

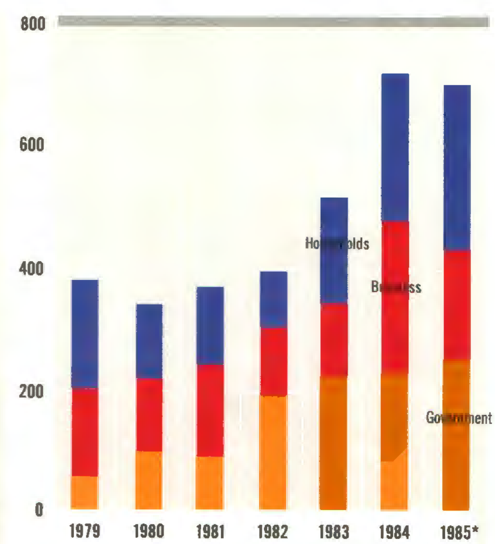
Households incurred the major proportion of new debt in the first half of 1985 as consumer installment credit grew $99.7 billion at an annual rate compared to $76.8 billion in 1984. With a lower projected level of both auto sales and housing starts in 1986 and 1987 compared with 1985 levels, additions to household debt should moderate relative to the other sectors, although it will still be substantial.

Business loan demand in the first half of 1985 was weak compared to 1984 when loans grew a rapid 19.2%. Loan growth is very cyclical and tends to pick up when the economy is strong. The current expansion is entering its fourth year, and since we expect the pace of economic growth to be quite strong in 1986 it is likely that loan growth will increase as well. Business demand for credit will increase due to the expected inventory buildup along with the need to finance plant and equipment expenditures.

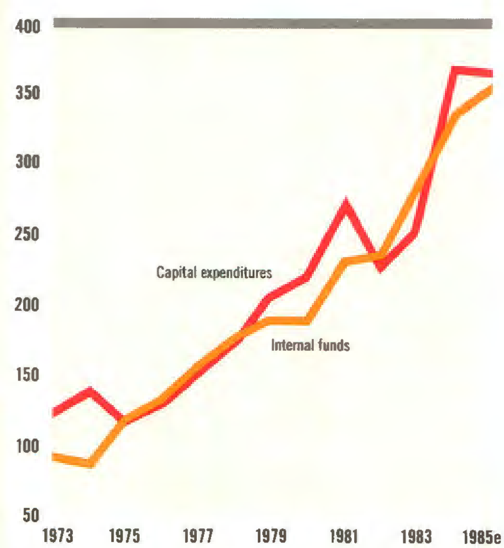
As the accompanying chart shows, in most periods capital expenditures are greater than internal funds, making it necessary for corporations to rely on external financing. This financing gap has narrowed to only $11 billion in the first half of 1985 from $33 billion in 1984 as capital expeditures have leveled off. With internal cash flow increasing, corporations have had less need to borrow, and this has been reinforced by a weak economy, which encouraged corporations to postpone expansion plans.

Strong economic growth in the next several quarters should boost capital expenditures faster than the rise of internal cash flow in 1986 causing the gap to widen. Concern over rising inflation, interest rates, and slackening economic growth should result in some narrowing of the gap in 1987 as capital expenditures slow.

The liquidity of U.S. credit markets will be bolstered by corporate savings, which grew by almost $428 billion in 1984 and by $453 billion at an annual rate in the first half of 1985. This has been very strong since the tax changes of 1981 resulted in added incentives for companies to save. At the same time, there has been much concern over the fact that households have recorded their



Changing Mix of Total Net Borrowing by Domestic Non-Financial Sectors
(Annual flows–billions of dollars)
*1st half 1985



Corporate Financing Gap Narrows
(Annual rates–billions of dollars)

Short-Term Business Credit Demand
(Change over prior year, billions of $)

	Bank Loans		Non-Financial Commercial Paper	
	Amount	Percent	Amount	Percent
1980	$26.6	9.8%	$ 3.5	14.3%
1981	42.7	14.3	14.7	52.5
1982	41.1	12.0	−6.1	−14.3
1983	18.9	4.9	−0.8	−2.2
1984	77.2	19.2	21.7	60.6
1985*	24.2	5.1	10.5	18.3

*First half at an annual rate.

lowest saving rate in recent history. Household savings increased $587.6 billion at an annual rate for the first half of 1985, falling from an increase of $605.8 billion in 1984.

As long as the tax code is biased toward the consumer going into debt, this situation will continue. If tax revisions are made to take away the incentives for corporations to save, it will result in a big decline in the supply of available funds. Another source, the foreign inflow of funds into the U.S., has increased in the first half of 1985 by $75.6 billion at an annual rate. We expect this source of funds to continue growing by substantial amounts in the forecast period as the U.S. will remain an attractive investment market.

Role of Financial "Shocks"

Recently, we have seen potentially destabilizing developments in the financial system. Failures or near failures of financial institutions create some anxiety on the part of the public. Usually, the press commentary at the time of one of these "crises" is that there may have to be a "bail out", and that the actions to alleviate the situation are potentially inflationary.

Actually, financial "crises" are more likely to be deflationary than inflationary. At the time the news breaks that some major institution or group of institutions are in serious trouble, financial market participants become more uncertain about the near-term outlook. They expect the Federal Reserve or other Federal authorities to "do something", but they do not know what, when, or what the effects will be. Consequently, portfolio managers naturally tend to prefer shorter-term, highly liquid assets while "waiting for the smoke to clear." The collective actions of a large number of market participants to increase their own "liquidity" tends to steepen the yield curve. In other words, they pay a premium in terms of foregone yield on longer-term and less liquid assets they could have held.

If the Federal Reserve is attempting to stabilize interest rates during this period of uncertainty, open market operations may drain reserves from the banking system in order to put a floor under short-term interest rates. In past periods of financial crisis -- such as Chrysler, Penn Central, Franklin National, New York City, Penn-Square, and Continental Illinois -- the yield curve has tended to steepen while reserve growth has slowed or bank reserves actually fell, and a deceleration of money growth followed. The end result was a "pause" or "plateau" in the economic expansion, or an actual recession.

The warning here is that the vigorous pace of economic expansion we have projected for 1986 could be aborted if a "financial crisis" occurs and the Fed responds in the same way as in the past.

During this past year, First Interstate extended its territory eastward to include banks in Iowa and Wisconsin. Therefore, we have expanded our state economic forecasts from the 13 Western states to 15. In nearly every state in First Interstate Territory the upturn expected for the nation as a whole will result in stronger real growth than in 1985. In the first two years of the current economic expansion, the Territory grew in employment, income, and housing at annual rates exceeding those of the nation; in 1985 that pattern was reversed. In the forecast period, 1986-87, we expect the differential advantage of the Territory to persist, but to be somewhat narrower than it was in the 1970s and early 1980s.

Overview

The outlook for employment and personal income growth in the states in First Interstate Territory over the next two years is essentially the same as that for the nation. The high-tech, aerospace, tourism, and services industries will continue at above-average growth rates, while the natural-resource-based industries still must overcome accumulated economic problems. Since the importance of each of these sectors varies widely across the states, there are important differences among the states' economic outlooks over the next two years.

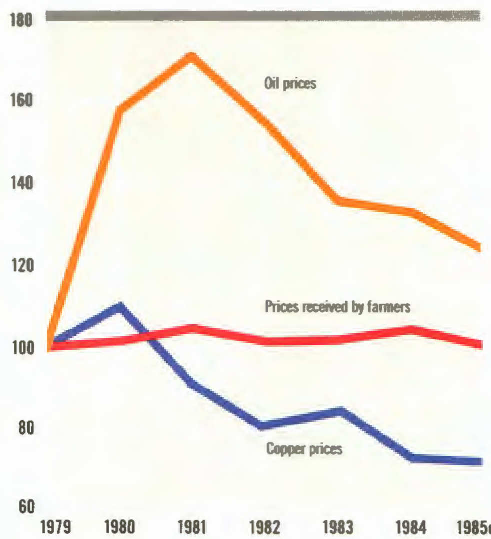
Most western states benefitted in the late 1970s and into the 1980s from rising prices for energy, agricultural products, land, and some minerals and by the continuing growth of the high-tech and aerospace industries. Now the picture is mixed.

The states that are most dependent on energy production, agriculture, and lumber face the greatest difficulty, for example, Wyoming and Oregon, while states dependent more on high-tech and tourism, for example, Arizona and Nevada, are experiencing well-above-average growth. Inclusion of Iowa and Wisconsin to the Territory adds more agriculture and heavy industry, so the Territory is now more like the rest of the nation.

The problems of agriculture in Iowa and Wisconsin are the same as elsewhere: accumulation and over-leveraging of farm assets during the inflationary period of the late 1970s followed by generally unforseen cooling of inflation after 1982. The states east of the Rockies are more dependent on federal agricultural policies and support programs than most of the states in the West.

Although high-tech manufacturing in such centers as Santa Clara County, California, and Phoenix and Tucson, Arizona, has cooled considerably this past year, we expect growth to revive during the next year, although certainly not at the explosive rates of 1983 and 1984. In Southern California and Seattle, Washington, the greater demands for military aerospace hardware and commercial aircraft have been strong offsets to other problems.

Brief commentaries and the outlook for each state, and tables for nonfarm payroll employment, personal income, and housing unit permits for each state follow.

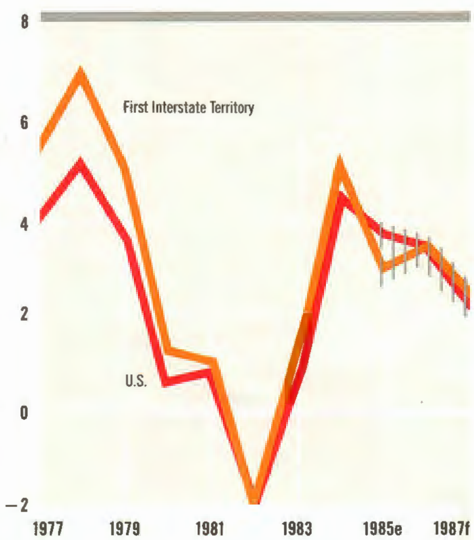


Recent Trends in Oil and Commodity Prices
(Index: 1979 = 100)

Alaska

Alaska continues to outpace the national average in employment growth, but by the smallest margin since 1978, the year after the completion of the Trans-Alaskan Pipeline. Alaska's particularly heavy dependence on the oil industry has been a mixed blessing to the

Arizona's economy should remain one of the strongest in the First Interstate Territory, with the greatest growth being in manufacturing, services, and retail trade. The latter two will be driven partly by increased tourism.



Total Nonfarm Employment Growth—First Interstate Territory vs. U.S.
(Percent change from year ago)

state since 1979. The state's general fund revenues rose from $765 million in fiscal year 1978 to $3.4 billion in 1984, while nonfarm employment and population increased by almost a third between 1980 and 1984.

This sudden spurt of fortune resulted in strong employment growth in construction and other industries, particularly the trade, services, finance, and transportation sectors. However, the continued weakness in oil and lumber prices has begun to filter its way through the Alaskan economy to bring on slower employment and income growth.

Construction is the key to employment forecasts for Alaska as large state expenditures are filtered into the economy through infra-structure expenditures on roads, schools, government buildings, and housing subsidies. The significant surplus of residential and commercial space in Alaska's three major communities (Anchorage, Fairbanks, and Juneau) and our forecast of rising interest rates does not bode well for new construction employment over the next two years.

Although we do not expect to see declines in the state's total nonfarm employment within the next two years, significantly slower gains are expected: 3.3% in 1986 and 2.9% in 1987.

Arizona

Although less rapid growth is expected, Arizona's economy should remain one of the strongest in the First Interstate Territory. By year end 1986, the state's population is expected to total 3,365,000, a gain of 112,000 or 3.4% over 1985. After an expected 6.1% gain in nonfarm employment in 1985, a somewhat slower 4.5% gain is expected in 1986.

The sectors adding the greatest strength to the state's job growth will continue to be manufacturing, services, and retail trade, the latter two driven in part by increased tourism. The heavily high-tech oriented manufacturing sector should improve in 1986 (especially semiconductors and electronic components) as the national economy rebounds, adding to the growth in other manufacturing industries.

The outlook for the mining and construction sectors is less positive. Copper prices have shown no sign of strengthening as over-production by foreign countries, relative to demand, continues. The copper mining sector in Arizona, which produces about 90% of the nation's copper, will remain depressed.

California

After a decade when California's nonfarm employment growth rate matched or exceeded the national growth rate, employment gains in the state in 1985 have not kept pace with the nation; the growth rate for the nation is estimated at 3.6% while that for California is 3.2%.

Several sectors were especially hard hit by the sluggish U.S. economy and international competition including high-tech manufacturing (especially micro-computers and semiconductors) and agriculture. We expect that the state's employment growth will return to a level slightly above that of the nation in 1986 and 1987.

When energy prices rose dramatically in 1974 and 1979, California gained compared with the northern states, including some additional income directly from energy production. The reversal of the rising trend in energy prices takes away some of that advantage.

One problem facing at least the

southern coastal part of the state, which contains nearly 60% of the population, is that in early 1986 Arizona will begin to take a greater share of Colorado River water for the Central Arizona Project. This likely will put pressures on the South's development and on the North and Central Valley to find ways of sending more water to the larger and more rapidly growing part of the state, not a happy prospect for farmers and environmentalist groups.

Colorado

Following a substantial advance in 1984, Colorado's economy in 1985 was less robust. Manufacturing and construction employment remained flat, mining was down, and job gains in the broad services categories were below average. For the first time in well over a decade, growth of the Colorado economy slipped below the national average.

For 1986, the performance of the state's economy will reflect national developments. As U.S. GNP growth strengthens, economic activity in Colorado will improve, with employment growth reaching 3% in 1986 before slowing to 2.5% in 1987.

The recent performance of Colorado's economy reveals the strengths as well as the weaknesses of the state's economy. The slowdown was partly related to falling world energy prices and the high-valued dollar's effect on minerals and agriculture. While none of these industries is dominant, together they have a significant impact on the Colorado economy. The slowdown in the state also reflected the worldwide slump in the electronics industry and its effect on companies along Colorado's Front Range.

The winding down of a construction boom in Colorado, which produced 125,000 new housing units and 73 million square feet of commercial space between 1982 and 1984, contributed to the slowdown. With a large backlog of unsold new and existing houses and with prospects for another year of below-average employment growth, new housing starts in 1985 are likely to fall nearly 20% below 1984. In 1986, totals will be off another 10 to 15%.

Hawaii

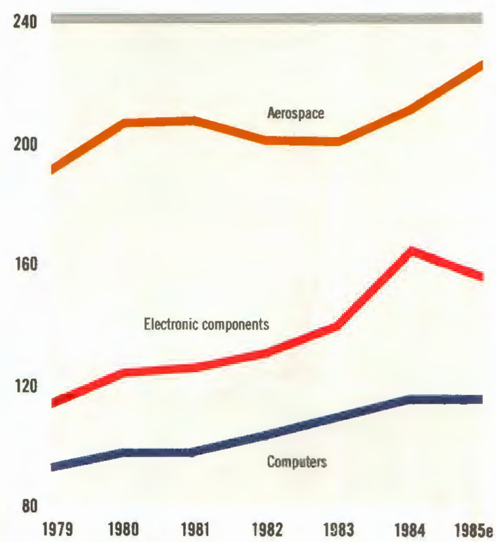
Hawaii's economy has been relatively stable since 1983 despite construction worker strikes in 1984, an airline strike during the prime tourist season in 1985, and continuing problems in the pineapple and sugar industries. Although the airline strike reduced tourist traffic in the first half of 1985, a robust second half is expected to make up for some of these losses.

Total nonfarm employment is expected to advance about 1.5% in both 1986 and 1987, matching the state's rate of growth in 1984 and 1985. Housing construction should also remain relatively stable at about 5,700 authorized units in 1986 and 5,500 units in 1987.

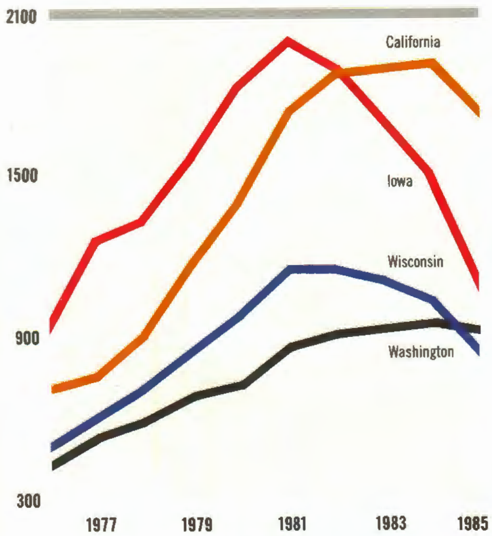
Although tourism and military outlays are important to the Hawaiian economy, the state has experienced growth in smaller industries such as diversified agriculture (macadamia nuts, flowers, and papayas), textiles, noodle factories, and motion pictures. Growth in these industries is an encouraging sign of an entrepreneurial spirit building within the state.

Idaho

In 1984, Idaho experienced its strongest employment growth in 6 years. Unfortunately, 1985 will be a return to lower levels of growth as problems in silver mining, food processing, and high-tech



California Employment in High-Tech Industries
(Number of jobs in thousands)



Farm Real Estate Values Decline
(Average dollar value per acre)

manufacturing emerge again. Total nonfarm employment growth will be about 1.5% in 1985, half the rate of growth in 1984. On the positive side, nonfarm employment is forecast to reach 338,000 in 1986, a level equal to the 1979 pre-recessionary figure.

Drought, grasshoppers, Army worms, aphids, weevils, hail, a strong dollar, lower commodity prices, and over-production played havoc with Idaho farming in 1985. Prospects for the largest harvest since 1974 have pushed potato prices down almost 35% from 1984. Wheat prices have also been lower than year-ago levels with little relief in sight as inventories continue to grow. Prices for Idaho feed cattle have been the lowest since 1973.

The prospects for Idaho farmers in 1986 are not particularly bright, although, a resurging national economy combined with a lower-valued dollar should help farmers next year. The non-agriculture sectors are expected to help make up for some of the difficulties in agriculture.

Iowa

After a rocky period in the early 1980s, Iowa nonfarm employment began to expand in 1984 and continued in 1985. In line with the faster national growth, the state's economy should recover further in 1986.

Although the state's fundamental problems are based on its relatively heavy direct dependence on agriculture, its manufacturing sector also is based significantly on products that are related to agriculture, such as food processing and farm implements. Iowa leads the nation in hog production, its top agricultural product; the next most important agricultural products are, respectively, cattle and calves, soybeans, and corn.

Positive economic factors that will help the Iowa economy are declining energy prices and a declining value of the dollar. On the political side, although debate is continuing in the Congress, it appears that farm support programs will not be cut as much as the Administration initially requested and may even expand somewhat. Over the longer run, the state must continue efforts to diversify the economy.

Montana

After a promising expansion in 1984 and early 1985, Montana recently experienced a period of slower economic activity. The slowdown, which was initiated by cutbacks in basic industries such as lumber products, mining, petroleum and transportation, has spread to service industries as well. Growth in employment for 1985 is estimated at 1.5%, with prospects for 1.7% and 1.0% increases in 1986 and 1987, respectively.

For the most part, Montana's problems are the consequence of a resource-based economy with few immediate prospects for diversification. A sharp increase in the nation's housing starts boosted the state's lumber and wood products industry in 1983 and 1984. Increasingly, however, Montana's lumber products faced stiff competition from Canadian lumber as well as from synthetic building products.

The state continued to be adversely affected by lower prices for oil and gas and from declining oil and gas exploration activity. Production in the important coal industry is expected to show only modest increases over the next several years. Problems for the state's large and productive agricultural sector have been exacerbated by a severe drought now in its fourth year. On the brighter side, tourism was up in 1985 with estimated tourism expenditures in excess of $800 million a year.

Nevada

Nevada's economy experienced a strong rebound in 1984, which continued into 1985, after four years of sluggish growth. Nevada's outlook for 1986 is promising as both the nation and California (the major source of Nevada visitors) are expected to experience a stronger and continued rebound in growth. Nonfarm employment growth of 6.5% is expected in Nevada for 1986 followed by a 4% gain in 1987 as tourism, retail and wholesale trade, and the services sector (mainly hotel and gaming services) continue strong.

Gaming revenues in the first half of 1985 increased 10.2% from the same period a year earlier, the best performance since 1980. However, the wealth was not spread evenly over the state. Reno experienced essentially no gains in gaming revenues in 1985 over 1984 while Las Vegas experienced almost 15% gains, again the best year since 1980. Las Vegas led the state in 1985 and can be expected to be the leader again in 1986 with employment gains of about 6.5%.

Overall, Nevada will be the fastest growing state in First Interstate Territory, as measured by employment growth, regaining the number one position it lost in 1980.

New Mexico

With an increasingly diversified economic base, the New Mexico economy achieved a solid advance of nonfarm employment in 1984. As with other Rocky Mountain states, however, economic growth in 1985 has been weaker.

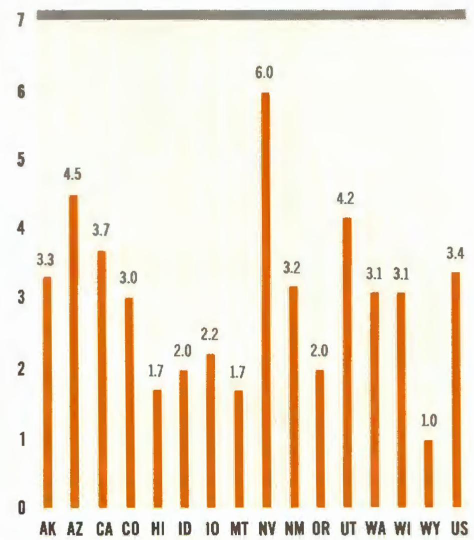
Unemployment rates in New Mexico are up--from the 7% range in mid 1984 to the 9% range in mid 1985. The state's mining and petroleum industries have experienced further job losses. Layoffs in New Mexico's substantial electronic equipment industry caused manufacturing employment to remain flat. Construction employment was off slightly after a boom year in 1984. Service employment advances in 1985 were considerably weaker than in 1984.

Areas of strength include transportation equipment manufacturing employment, which recently was up by 7% over year-ago levels, and defense and space-related activity. Tourism continues to rise -- prospects for another year of expansion in the national economy mean consumer expenditures on travel should be sustained through 1986. Air travel at Albuquerque's airport was up over 15% in 1985; this hub airport is undergoing reconstruction that by 1989 will double its capacity. With a pickup in the national economy, the outlook for New Mexico is for employment gains of 3.2% in 1986, falling to 2.5% growth in 1987.

Oregon

The Oregon economy's growth rate dropped sharply in 1985 from the recovery pace of the prior year. Nonfarm employment growth slowed to 2.2% from a 3.9% rate in 1984. Personal income increased only 4.6% in 1985, down from 8.8% in 1984.

Employment growth in Oregon is forecast to hold steady in 1986 and 1987 at 2% and 2.2%, respectively. Little change is expected in the current near-zero growth rate in manufacturing employment until 1987, when several new high-tech plants, primarily representing Japanese investment, are expected to be in production.



Varied Employment Growth Expected Throughout First Interstate Territory in 1986
(Percent change from year ago)

Nevada's outlook for 1986 is promising, as both the nation and California (the major source of Nevada visitors) are expected to experience a stronger and continued rebound in growth.

A better performance of employment growth hinges on improvement in interest and dollar exchange rate levels, which have adversely affected important Oregon agricultural, wood products and electronics sectors. Specifically, a lower dollar would improve export markets and prices for Oregon soft white wheat, ease import competition from Japan on high-tech products, and lessen price competition of Canadian lumber in traditional western markets. Output of wood products is particularly sensitive to the interest rate/housing start relationship.

The construction sector has been slowing in activity during 1985 compared to 1984's strong levels. We expect housing permit activity to be off about 11% to 13,200 units in 1985 followed by declines of about 13% in both 1986 and 1987. Rising mortgage rates over our forecast horizon and overbuilding of multi-family units in the last 18 months are causal factors.

Utah

Utah began to show signs of weakness in the second half of 1985 as a result of slower growth in three of its basic industries--mining, construction, and manufacturing. Mining's problems are linked, like Arizona's, to the copper sector and little improvement is expected for this sector through 1987.

Employment activity in the manufacturing sector has not shown losses, but has also shown no gains in the latter half of 1985. This trend should begin to turn around in 1986. The state's other high-tech-related businesses should rejoin the defense-related manufacturers in adding to payrolls in 1986.

In addition, some new non-durable manufacturing jobs should be coming on-line soon. Continued strength in the services sector, particularly personal business and medical services, as well as the retail trade sector will result in overall employment in Utah advancing 4.2% in 1986 following a 4.0% gain in 1985. However, slower job growth is expected for Utah in 1987 as the national economy slows markedly.

Washington

Modest growth in the midst of continued dramatic shifts is the forecast for 1986. Total employment is expected to rise by about 3.1%. However, most new jobs will be in non-manufacturing sectors, which pay lower wages than some of the industrial jobs that are being phased out.

Several risks confront the state, however. One is the threat of protectionist legislation from Congress. Washington state has a major stake in international trade activity and would pay a high price if national decisions were made to help certain industries largely based in other parts of the country.

A second risk is the prospect of substantial changes in the way that the Bonneville Power Administration prices its electricity. Periodic attempts have been made by members of Congress to make the BPA pay higher interest rates on its outstanding debt or otherwise raise the relatively low cost of electricity enjoyed by the Northwest.

Such a shift would adversely impact the industrial base built around the existence of inexpensive power. However, the prospect of such a change in pricing arrangements remains modest. Fortunately, the state is aggressively dealing with the need to reduce further its dependence on lumber, shipbuilding, metals, and agriculture.

Greater emphasis on economic development has produced significant gains. Major new plants to produce helicopters, plate glass, and advanced electronics components represent the range of new businesses attracted to modest land and housing costs, a relatively well-educated labor force, absence of a personal income tax, and slowly improving land use arrangements.

Strengths in the outlook include a bright future at Boeing, whose 10,000 new jobs to be generated between early 1985 and late 1986 will help offset the loss of about 4,000 jobs in the lumber industry over the same period. Major changes in the aerospace industry will keep the future for Boeing quite favorable through the early 1990s. In addition, the volume of international trade shipped through Washington increased 21% in 1984 and is estimated to rise about 18% further in both 1985 and 1986, barring major protectionist legislation.

Wisconsin

A state with a relatively diversified economic base, Wisconsin has been subject to many of the difficulties affecting the entire North Central region, the slowest growing section of the country since 1980. The major problem is strong international competition in both manufactured and agricultural goods due in part to the relatively high value of the dollar.

Yet, with a well-educated workforce and a public university system that enjoys the highest levels of support relative to income in the country, the state has weathered some of the competitive and deflationary storms better than many of its neighbors. For example, nonfarm employment growth rates in the state in 1984 and 1985 at 4.1% and 2.8%, respectively, were just below the U.S. averages.

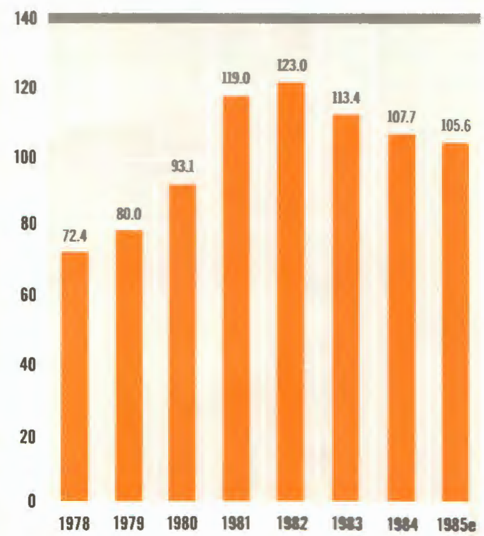
With a renewed national expansion in 1986 and slowdown in 1987 forecast, nonfarm employment is expected to grow 3.1% in 1986 and 1.7% in 1987, again just below the forecasts for national growth. At the same time, housing construction should continue to slow throughout the period in response to rising interest rates and economic uncertainty.

Wyoming

The problems that beset agriculture, minerals, and petroleum across the country seem to bear down especially hard on Wyoming. With little in the way of manufacturing, and with heavy concentration of the state's jobs in the natural resources and in resource-related financial and construction services, Wyoming employment has only recently begun to bottom out from the long downward slide that began in 1982.

Employment in 1985 is estimated to be down 1.8% on average from 1984. However, unemployment rates also are trending down, with only one county still showing a double-digit jobless rate, as out-migration matched the job shrinkage. The basic forecast for the next two years is for only slight nonfarm employment growth: 1.0% in 1986 and 0% in 1987.

An important boost for the Wyoming economy is being provided by several large construction projects in the southwest part of the state. In the rest of the state, the pattern of economic activity is little changed over the past year. Casper, which is the center of the state's oil and gas development, continued to suffer employment losses. Cheyenne experienced a small upturn in the first half of 1985, but a slowdown in construction restrained the city's employment gains.



Oil and Gas Employment Continues Downward
(Number of jobs in thousands)
(Based on data for Alaska, California, Colorado, New Mexico & Wyoming)

Nonfarm Employment	1984		Estimate 1985		Forecast 1986		Forecast 1987	
	Thous.	% Change	Thous.	% Change	Thous.	% Change	Thous.	% Change
Alaska	225	5.0	233	3.5	241	3.3	248	2.9
Arizona	1,181	9.6	1,253	6.1	1,309	4.5	1,362	4.0
California	10,553	5.9	10,891	3.2	11,294	3.7	11,599	2.7
Colorado	1,385	4.3	1,415	2.2	1,458	3.0	1,494	2.5
Hawaii	413	1.6	420	1.7	427	1.7	432	1.3
Idaho	326	2.9	331	1.6	338	2.0	341	1.0
Iowa	1,062	2.1	1,067	0.5	1,091	2.2	1,104	1.2
Montana	281	1.8	285	1.5	290	1.7	293	1.0
Nevada	427	6.0	451	5.5	478	6.0	497	4.0
New Mexico	503	4.9	518	2.9	534	3.2	548	2.5
Oregon	1,004	3.9	1,026	2.2	1,047	2.0	1,070	2.2
Utah	601	6.0	625	4.0	652	4.2	670	2.8
Washington	1,636	3.4	1,685	3.0	1,737	3.1	1,782	2.6
Wisconsin	1,941	4.1	1,995	2.8	2,057	3.1	2,092	1.7
Wyoming	199	−2.2	196	−1.5	198	1.0	198	0.0
First Interstate Territory	21,736	5.1	22,391	3.0	23,149	3.4	23,728	2.5
U.S.	94,164	4.5	97,554	3.6	100,871	3.4	103.090	2.2

Personal Income	1984		Estimate 1985		Forecast 1986		Forecast 1987	
	Millions	% Change	Millions	% Change	Millions	% Change	Millions	% Change
Alaska	$ 8,739	4.6	$ 9,193	5.2	$ 9,791	6.5	$ 10,506	7.3
Arizona	36,151	13.3	39,368	8.9	43,463	10.4	47,809	10.0
California	371,202	11.0	401,641	8.2	436,985	8.8	478,499	9.5
Colorado	44,004	9.5	46,996	6.8	50,756	8.0	55,324	9.0
Hawaii	13,547	7.8	14,495	7.0	15,698	8.3	17,064	8.7
Idaho	10,099	8.3	10,705	6.0	11,551	7.9	12,532	8.5
Iowa	35,121	13.0	36,210	3.1	38,129	5.3	40,378	5.9
Montana	8,690	6.0	9,125	5.0	9,718	6.5	10,398	7.0
Nevada	12,132	9.6	13,078	7.8	14,177	8.4	15,382	8.5
New Mexico	14,610	8.4	15,633	7.0	16,961	8.5	18,488	9.0
Oregon	31,052	8.8	32,791	5.6	34,562	5.4	36,843	6.6
Utah	16,074	10.1	17,247	7.3	18,782	8.9	20,473	9.0
Washington	55,633	6.8	58,693	5.5	63,271	7.8	68,649	8.5
Wisconsin	58,511	9.0	62,139	6.2	67,234	8.2	72,882	8.4
Wyoming	6,252	4.1	6,565	5.0	6,958	6.0	7,432	6.8
First Interstate Territory	721,817	10.1	773,879	7.2	838,036	8.3	912,658	8.9
U.S.	3,020,259	10.4	3,204,495	6.1	3,467,263	8.2	3,779,317	9.0

Housing Permits	1984		Estimate 1985		Forecast 1986		Forecast 1987	
	Number	% Change	Number	% Change	Number	% Change	Number	% Change
Alaska	7,087	−38.2	4,500	−36.5	4,200	−6.7	4,000	−4.8
Arizona	79,409	12.8	70,000	−11.8	65,000	−7.1	62,000	−4.6
California	218,007	29.5	222,000	1.8	211,000	−5.0	195,000	−7.6
Colorado	43,267	−13.3	36,000	−16.8	31,000	−13.9	30,000	−3.2
Hawaii	5,519	3.4	5,900	6.9	5,700	−3.4	5,500	−3.5
Idaho	5,067	−0.6	4,500	−11.2	4,300	−4.4	4,000	−7.0
Iowa	7,106	−0.9	5,700	−19.8	5,500	−3.5	5,100	−7.3
Montana	4,702	−8.7	3,900	−17.1	3,700	−5.1	3,200	−13.5
Nevada	14,484	−22.4	11,400	−21.3	11,000	−3.5	10,600	−3.6
New Mexico	12,989	17.2	13,000	0.1	12,000	−7.7	11,500	−4.2
Oregon	7,880	7.4	10,100	28.2	8,300	−17.8	8,500	2.4
Utah	14,839	7.6	13,200	−11.0	11,500	−12.9	10,000	−13.0
Washington	31,381	12.4	32,000	2.0	30,000	−6.3	25,000	−16.7
Wisconsin	17,382	2.5	16,800	−3.3	16,100	−4.2	14,600	−9.3
Wyoming	2,484	−28.2	2,100	−15.5	2,000	−4.8	1,800	−10.0
First Interstate Territory	471,603	11.5	451,100	−4.3	421,300	−6.6	390,800	−7.2
U.S.	1,639,000	3.1	1,620,000	−1.2	1,560,000	−3.7	1,430,000	−8.3

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The following speech was delivered today at the 25th annual Business Forecast Luncheon, sponsored by the University of Chicago Graduate School of Business and Executive Program Club. More than 1,500 business professionals attended the luncheon in the International Ballroom of the Chicago Hilton and Towers.

THE ECONOMY GETS ITS SECOND WIND

Outlook 1986

by

Walter D. Fackler

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and Director of Management Programs
University of Chicago
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This year, 1985, has been somewhat disappointing in many ways. Real growth in the economy has been lower than we forecast last November. After a good start in the first quarter, the second quarter was a letdown, but the third quarter improved (up 4.3% at an annual rate), and there is much mumbling and grumbling about the current quarter. Automobile sales are down from their autumn discount levels; the trade deficit still constitutes a drag on the statistics (but not on the consumer); even with bumper crops the farmers are still in financial difficulties, and their friendly bankers aren't so friendly anymore; real per capita personal after-tax income has leveled off, and there are doubts about the consumer's ability to finance growing purchases by drawing down savings (the rate is awfully low at 2.5) and piling up debts; capital-spending surveys reveal that businessmen are very cautious about plant and equipment purchases; some basic industries are still troubled -- the litany goes on. Many forecasters are writing off this recovery and are arguing that we will have stagnation, if not recession, in the coming year. I dissent. Business hasn't been all that bad. When the Commerce Department gets through revising the numbers, real growth will be estimated at about 3.0% (last year I forecast 3.6%) for 1985. Total employment increased by 1.27 million in the first nine months of this year. Not bad in the third year of an expansion. Like sex, business is still good even when it is not great.

I think the economy is poised for a new thrust. This recovery is stronger than it looks. Hence, I have entitled my talk today, "The Economy Gets Its Second Wind." I think 1986 may turn out to be a much better year than the forecasters who are now running for cover would have us believe. I remain cautiously optimistic. Here's why.

1) Monetary policy has been quite expansive over the past twelve months. From October of last year until October of this year, the Federal Reserve pulled hard on the monetary string. For the first three quarters of this year the monetary base has increased 8.5% (annual rate), and the nominal money supply (M1), 13% (annual rate) -- well above Fed targets. The broader monetary aggregate M2 in real terms (in

1972 dollars) has risen at a 6% annual rate over the past six months. This recovery won't be choked off by monetary restraint -- at least for the next six to nine months. The economic engine has already been fueled.

2) The foreign exchange value of the dollar has declined, on a trade-weighted basis, by about 20% from its peak. This will not cause a dramatic increase in exports and a decrease in imports in 1986, but it will help some in both the industrial and farm sectors.

3) The leading indicators of economic activity (strongly affected by the stock market to be sure) are still rising. No threat of recession here. Investors, at least, seem pretty confident about the future. If they were expecting a recession and dismal earnings, the Dow, as Joel Stern would say, would now be heading south.

4) The consumer is in better shape than the debt figures and low savings rate would indicate. Consumers have also increased their financial assets at a faster rate than they have gone into debt. Consumer liquidity is good. Some of our thrift institutions wish they had such a good match of assets and liabilities.

5) Government purchases of goods and services will continue to rise in real terms. From the 4th quarter of 1984 to the 3rd quarter of 1985, federal purchases rose by 10.2% in real terms. Rising deliveries of defense products in 1986 will be a real plus in growth rate next year.

6) Inventory accumulation has been very modest this year, zero in the third quarter and only about $17 billion for the year as a whole. There is no imbalance here. Indeed, a pick up in final demand would have manufacturers and distributors scrambling.

I could go on. What I am saying is simply this: amid the gloom of night there are some very strong positive forces at work which are likely to make tomorrow much brighter.

To make a forecast one has to settle on certain assumptions that the user can then accept or discard as he or she chooses. At minimum we have to make some assumptions about monetary policy, fiscal policy, and our response to the international economic situation.

1. On monetary policy, I expect the Federal Reserve to be accommodating. In the past two months, the Fed has stopped adding to the monetary base -- temporarily, I trust. But even if they sit on their hands for six months as they did in 1984, the effects would be felt late in the year or in 1987. I am making the rather arbitrary assumption that the Fed will behave in a halfway sensible manner and add to the monetary base at a 7.5 to 8% rate next year.
2. Fiscal policy on the expenditure side will be quite stimulative; but on the tax side only God and President Reagan know, and neither will tell. Will we get a tax bill? And if so, what kind? If we do get a tax bill, it won't be reform and we probably won't like it. The House bill which has come out of the Ways and Means Committee is a real hodge-podge, but it is also an anti-investment bill that eliminates the investment tax credit, lengthens depreciation schedules, and increases capital gains rates. In order to keep some popular individual tax deductions, and at the same time lower marginal personal rates, it was necessary to hit business. In its present form it would probably raise the tax on capital by about 4%. (For you who are entertaining business clients and customers at this dog and pony show, it would mean that you would be able to write off only 80% of the cost.) This is not the place to go

into the complexities of the proposed "reform". Your friendly CPA will be delighted to brief you on the ramifications. I think it is still an open question whether we will get major tax legislation this year. Obviously, Secretary of the Treasury Baker and Congressman Rostenkowski have a lot of personal involvement at stake, but the Regan-Reagan axis will decide whether to push or not. And politicians understand, probably better than a lot of businessmen, that sunk costs are sunk. The problem is that even if the House bill should pass and go to the Senate, the same constituent pressures would prevail, and the President would not likely be able to get rid of the objectionable features he opposes in principle and on the record. I think it is only a 60-40 chance that we will get tax legislation next year. But whether we get tax legislation or not will not have a material effect on the short run outlook -- although it could have substantial cumulative impact over the next five years.

3. The decline of the foreign exchange value of the dollar is a positive sign, but the foreign trade deficit will persist and that means that pleas and plans for protection will remain rampant. I think the Administration will resist the more blatant protectionist moves -- as the President did in the shoe case. Protectionism destroys more jobs than it saves, and the outlook for employment will be better if the President continues his firm resolve -- and I believe he will.

So here we go. I have fasted and prayed. I have played with the numbers. I have played with my personal computer. And here are the results:

Table I

	Real GNP (Billion of 1972 Dollars)	Implicit Price Deflator (1972 = 100)	Nominal GNP (Billions of Current Dollars)
Estimated:			
1985 Year	1,681	231.7	3,895
1985 (4th Quarter)	1,705	234.5	3,998
Forecast:			
1986 Year	1,750	240.8	4,215
1986 (4th Quarter)	1,777	245.0	4,354
Change:			
1986-85	+69(+4.1%)	4.0%	+320(8.2%)
1986-(4)-1985(4)	+72(+4.2%)	4.5%	+356(8.9%)

I have given you the base, the levels, and the percentage changes. Predicting the current dollar or market value of output is much easier than predicting how that aggregate demand will divide itself between real change in output and price level change. I think it will be a pretty even horse race next year with a 4.1% real increase in GNP and a 4% rate of inflation (as measured by the Implicit Price Deflator of the National Income Accounts). But I do think the rate of inflation will rise to 5% in the fourth quarter of 1986, which will make the price level 4.5% higher at the end of next year than it is currently. Real output, year-end to year-end, will increase by 4.2%. For you that want to keep a scorecard, the components add up as follows.

Table II

	Billions of Current Dollars		
	1985*	1986	Percentage Change
Gross National Product	3,895	4,215	8.2
Consumer Purchases	2,513	2,703	7.7
Durables	348	376	8.0
Nondurables	891	944	5.9
Services	1,274	1,383	8.6
Gross Private Investment	640	691	7.8
Fixed nonresidential	465	495	6.5
Structures	167	178	6.6
Producer durables	298	317	6.2
Residential	160	171	6.9
Inventory change	15	25	--
Net Exports	-86	-76	--
Government Purchases	827	897	8.5
Federal	335	365	9.0
Defense	246	269	9.4
Nondefense	89	96	7.9
State and local	492	532	8.5
Real GNP	1,681	1,750	4.1
Implicit Price Deflator (1972=100)	231.7	240.8	4.0

*Estimated, based on the actual figures for first three quarters and guesses about the fourth quarter.

The consumer will be a sustaining force. Housing and inventories will provide some thrust in the investment sector. The government will be an expansive force, both at the federal and at the state and local levels. And net exports will continue to be negative, but less so. Unemployment will finally dip below 7% of the labor force to a 6.8 or 6.9% average for the year.

I am supposed to say something about gross private domestic investment, and I am pleased to do so. Business investment in plant and equipment has been very strong in this expansion -- up 35% in the first 36 months as compared with a 36-month average of 20% for all postwar expansions. The Economic Recovery Tax Act of 1981 played a major role. But investment spending is tapering off. According to the McGraw-Hill autumn survey, business plans to spend 1% less next year on plants and equipment, with most of the cutbacks in the nonmanufacturing sector. I would gross up the McGraw-Hill numbers a bit. As the year unfolds, businessmen will outspend their expectations. Construction still looks good, although some cities have a surplus of office space, and office construction may have peaked for the time being. Construction awards reached a new high in October, according to F. W. Dodge. Orders for industrial structures remain solid; and if housing construction stays high, as I expect it will, commercial construction such as warehouses and shopping centers will provide some modest thrust. Demand for producers' durable equipment, especially in the high-tech area, will be up, but only modestly. In other words, some components of investment will be up and others down, but overall business investment will be sufficiently strong to help sustain the recovery.

I will say little about the federal deficit -- except that it will continue to plague us. I talked about it last year at some length and have pontificated about it in other forums. I disagree with Milton Friedman and others that the deficit doesn't really matter all that much. Milton and others are quite right when they say the real charge on the economy is the level of government expenditures that represents the diversion of resources from private to public use. How those expenditures are financed -- whether by compulsory taxes or voluntary lending -- they argue, is incidental. I demur. I think the method of financing makes a whale of a difference for two reasons. 1) Deficit finance is likely to be highly inflationary down the road. 2) When people have to pay taxes for government services, they are more likely to worry about how their taxes are spent; but when expenditures are financed by government borrowing, it appears that someone else is paying. The notion that deficits don't matter promotes the idea that somehow there is a "free lunch", and Milton Friedman, of all people, knows that is simply not true.

Let me sum up. The economy is getting its second wind. Income, output, and employment will be rising. The rising tide certainly will not lift all boats, but it will lift a lot of them. The profit picture is good if not rosy. There will be neither recession nor stagnation -- after all, 4% real growth is nothing to be sneezed at. And gloom-sayers are betting on the wrong averages. One final word of warning. The precise numbers presented here will surely turn out to be wrong. The Commerce Department is in the process of making some major revisions in the national income accounts which we do not have as yet, so we are shooting at a moving statistical target. What we are really trying to forecast are first differences, so look at the percentage changes when you call us to account. For the purists, and that set obviously includes all my former students, I am about .78 confident that the year will unfold as I have suggested.

November 27, 1985

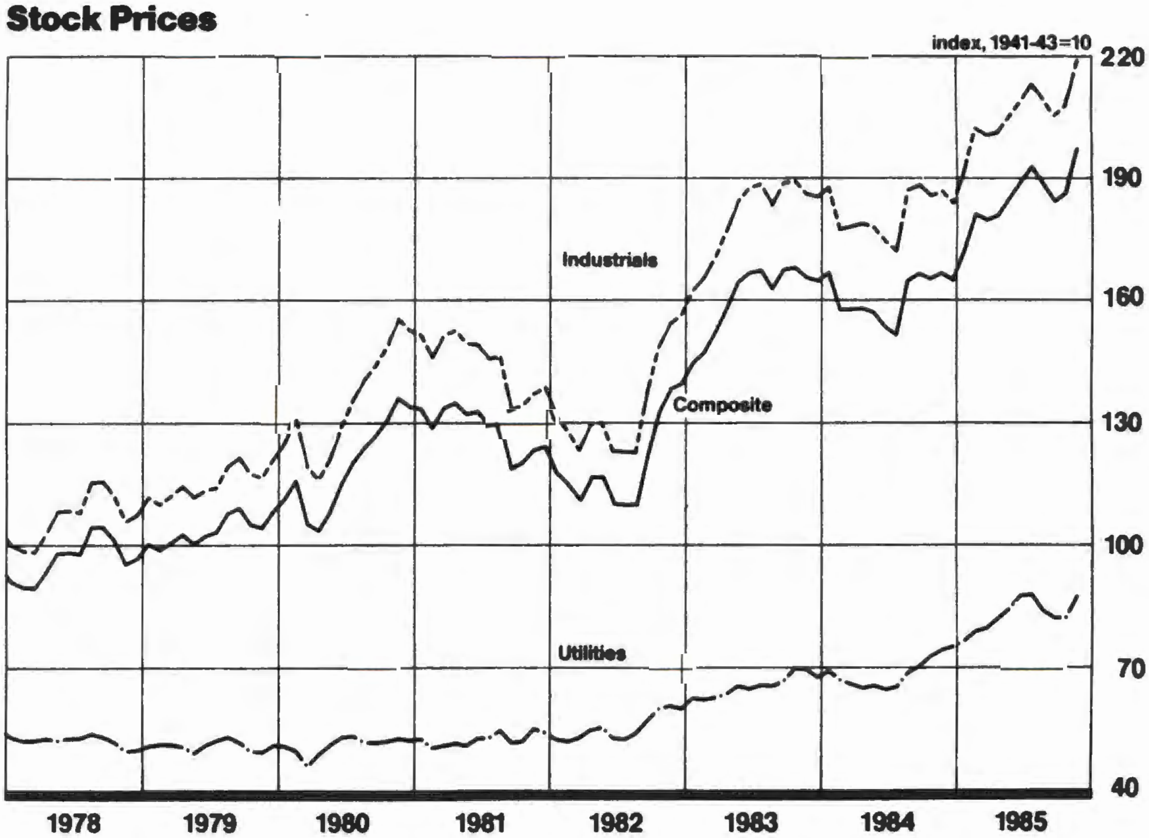
ECONOMIC PROSPECTS THROUGH 1987

Business activity is moving deceptively higher while a less expansive monetary policy is increasing the chances that interest rates will go lower. Meanwhile, profits have improved, stocks have soared, Reagan and Gorbachev are talking peace and Congress is seriously considering proposals to limit government spending. In the midst of all this good news the House Ways and Means Committee has come up with a real turkey for tax reform. If it flies, the economy will not.

Stocks Soar

A combination of favorable developments have lifted stock prices to new highs. At current prices the market is anticipating either significant double-digit earnings gains for many years or a sharp decline in interest rates from present levels. While such favorable developments are possible, any deviation from this course would bring about a serious downward correction.

Stock Prices



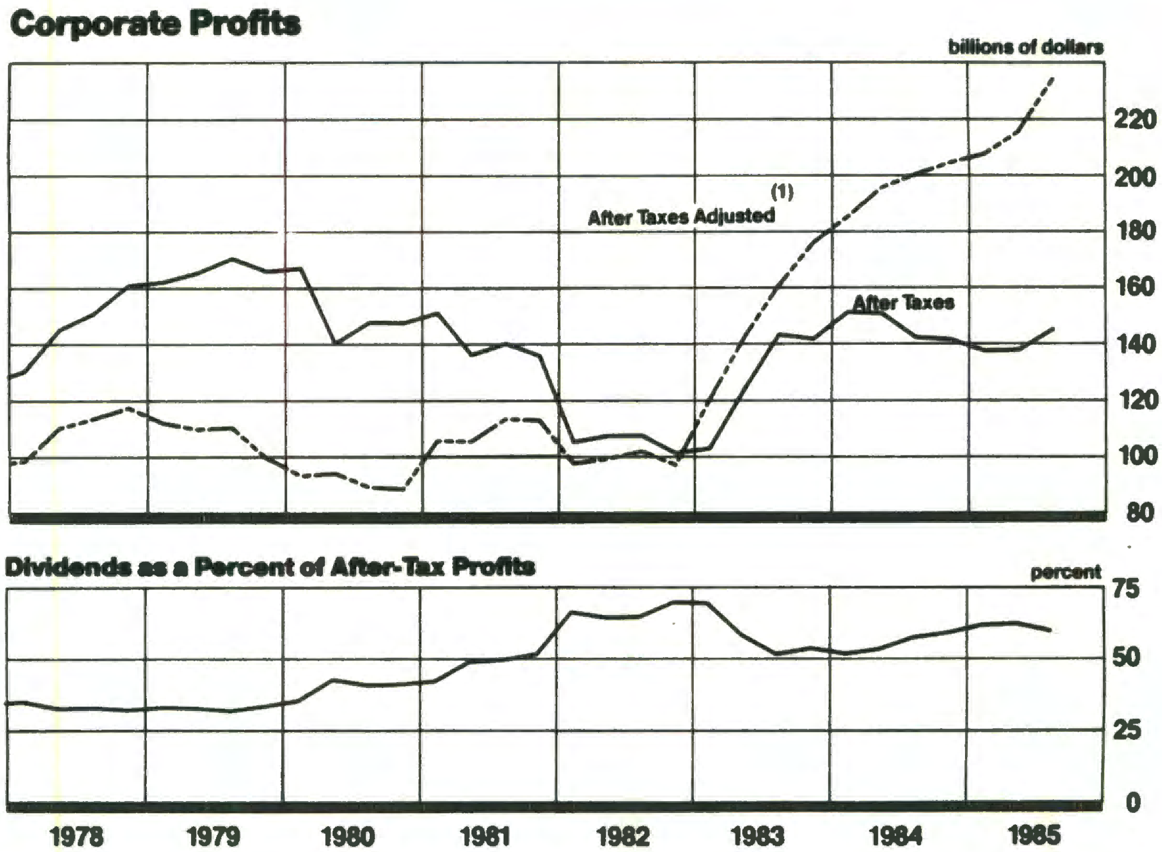
Source: Standard & Poor's Corporation

The Deceptive Recovery

Although real growth for the third quarter was revised upward to an annual rate of more than 4 percent, questions regarding the near-term strength of the economy remain. Nominal spending for the third quarter was up 6.7 percent at an annual rate and personal income rose at an annual rate of only 4 1/2 percent in September and October. During this latter period industrial production was virtually flat. While these numbers may suggest a weak economy, it is important to remember that the present recovery is a deceptive one.

Over the past year employment increased by more than 2 million and operating profits rose 17 percent (and remember, this was a bad year). More recently the personal income figures had the wind knocked out of them by hurricanes (which destroyed houses and, therefore, rental income). Also, while new orders have dipped and turned with huge swings in the defense component, the underlying trend appears strong. For nondefense durable goods, new orders in the three months ending in October are up at an annual rate of 15 percent from the previous three month period. Over this same period manufacturers' shipments of durables are up at an 11 percent annual rate.

For each area of the economy that appears to be booming another can be found that appears to be busting. Structural changes make underlying trends difficult to decipher. However, positive trends do exist. After a slowdown in money growth in 1984, the economy grew 1 to 2 percentage points below its long-term path. This year, following a more expansive monetary policy, the economy should grow 1 to 2 percent faster than its long-term average.



(1) Includes inventory valuation and capital consumption adjustments.

All data expressed as seasonally adjusted annual rates.

Source: U.S. Department of Commerce.

HARRIS BANK

A Further Slowdown in Money Growth

In recent years, as the M1 money supply numbers became distorted by shifts among deposit categories, the monetary base has provided a somewhat more reliable guide to the thrust of monetary policy. For the first half of this year the base rose at an annual rate of 9 1/2 percent. Since June its growth has slowed to a 5 1/2 percent rate. The recent slowdown in the money numbers increases the chances of a stable, less inflationary recovery in 1986.

Interest Rates--Back to the Fundamentals

With monetary growth on a slower track, the outlook for lower interest rates has improved. Both short and long-term rates appear relatively high once reasonable tax, inflation and real after-tax components are considered. For short-term rates, applying a marginal tax rate of 33 percent to a 0 to 2 percent real rate plus a 3 to 4 percent inflation premium produces a range of 4 1/2 to 9 percent. With six-month commercial paper rates at 8 percent, they are on the high side of this range. For long-term rates a similar analysis (with a 4 to 6 percent inflation premium) produces a range for Treasury bonds of 7 1/2 to 10 1/2 percent compared with the present rate of close to 10 percent.

Ways and Means to Ruin Tax Reform

The details of the Ways and Means tax proposal are out and the news is not encouraging. The committee went along with most major deductions and offset the potential revenue loss by raising the tax rates faced by all but the lowest income category. For example, under current law the 25 percent marginal tax rate is reached by individuals with taxable income of $26,540. Under the Ways and Means proposal a 25 percent marginal tax rate is reached with taxable income of only $22,500. Currently, you need taxable income of $38,000-$49,000 before paying a 33 percent marginal tax rate, with the Ways and Means Proposal you get to pay a 35 percent marginal tax rate with taxable income of $43,000.

Although an increase in the personal exemption lowers taxable income figures under Ways and Means calculations, other factors work in the opposite direction. Hence, the Ways and Means proposal ends up with little, if any, change in marginal tax rates for all but a relatively small group with either very high or very low incomes. Since changing effective marginal tax rates to promote growth is the economic rationale for tax reform, Ways and Means has effectively emasculated the entire effort.

To understand the Ways and Means tax proposal, it should be viewed from a political as opposed to economic perspective. The major objective of the measure is to take the issue of tax reform away from the President and the Republicans. In this respect, it appears to be successful.

Summary

Prospects improved in several areas over the past month. A further moderation in money growth, growing strength in new orders and a boom in operating profits all point to a healthy business environment for 1986. However, on the tax front prospects have taken a bad turn. In effect, the Ways and Means proposal eliminates the potential economic benefit of tax reform.

Robert J. Genetski
Senior Vice President and Chief Economist

11/26/85

ECONOMIC OUTLOOK

	ACTUAL	FORECAST									YEARS			
	85 III	85 IV	86 I	86 II	86 III	86 IV	87 I	87 II	87 III	87 IV	1984	1985	1986	1987
GROSS NATL PRODUCT	3915.9	4001.8	4095.1	4189.0	4275.4	4363.4	4446.2	4527.3	4604.5	4683.0	3662.8	3895.3	4230.7	4565.2
%ch	6.7	9.1	9.7	9.5	8.5	8.5	7.8	7.5	7.0	7.0	10.8	6.3	8.6	7.9
REAL GNP	1688.9	1711.3	1734.4	1756.3	1774.4	1792.6	1807.2	1819.4	1828.6	1838.4	1639.3	1683.7	1764.5	1823.4
%ch	4.3	5.4	5.5	5.2	4.2	4.2	3.3	2.7	2.0	2.2	6.8	2.7	4.8	3.3
PRICE DEFLATOR	2.3186	2.3385	2.3611	2.3851	2.4094	2.4341	2.4602	2.4883	2.5181	2.5473	2.2341	2.3133	2.3974	2.5035
%ch	2.3	3.5	3.9	4.1	4.2	4.2	4.4	4.7	4.9	4.7	3.8	3.5	3.6	4.4
CPI-ALL URBAN	3.230	3.252	3.283	3.316	3.349	3.383	3.419	3.458	3.499	3.539	3.111	3.218	3.333	3.479
%ch	2.4	2.8	3.9	4.1	4.2	4.2	4.4	4.7	4.9	4.7	4.3	3.4	3.6	4.4
PRETAX PROFITS	232.8	251.2	274.2	290.0	300.8	311.8	323.1	331.9	338.3	344.2	235.7	231.8	294.2	334.4
%ch	23.1	35.6	41.9	25.2	15.8	15.3	15.4	11.4	7.9	7.2	16.0	-1.7	26.9	13.7
PRETAX PROFITS ADJ 1)	321.4	334.5	351.8	367.4	379.2	391.4	401.0	408.4	413.5	418.7	285.7	311.7	372.4	410.4
%ch	34.4	17.4	22.2	19.0	13.5	13.5	10.2	7.5	5.1	5.1	26.9	9.1	19.5	10.2
AFTER TAX PROFITS	144.7	153.7	167.5	176.6	182.6	188.6	195.5	200.8	204.7	208.3	145.9	143.2	178.8	202.3
%ch	23.0	27.4	41.0	23.5	14.3	13.8	15.4	11.4	7.9	7.2	14.5	-1.8	24.9	13.1
AFTER TAX PROFITS ADJ 1)	233.2	237.1	245.1	254.0	261.0	268.3	273.4	277.3	279.9	282.7	195.9	223.0	257.1	278.3
%ch	38.7	6.8	14.3	15.3	11.5	11.6	7.9	5.7	3.8	4.1	31.1	13.8	15.3	8.3
INDUSTRIAL PRODUCTION	1.247	1.254	1.281	1.306	1.325	1.344	1.357	1.367	1.372	1.377	1.218	1.245	1.314	1.368
%ch	1.6	2.3	8.9	8.0	5.9	5.9	3.9	3.0	1.5	1.5	11.6	2.2	5.5	4.1
PRODUCTIVITY	1.067	1.076	1.084	1.092	1.099	1.106	1.111	1.115	1.118	1.122	1.063	1.066	1.095	1.117
%ch	1.5	3.6	3.3	3.2	2.7	2.6	2.1	1.8	1.4	1.5	2.7	.3	2.7	1.9
EMPLOYMENT 2)	107.19	108.20	108.95	109.70	110.33	110.82	111.23	111.59	111.93	112.26	105.00	107.22	109.95	111.75
%ch	1.6	3.8	2.8	2.8	2.3	1.8	1.5	1.3	1.2	1.2	4.1	2.1	2.5	1.6
UNEMPLOYMENT RATE (%)	7.1	7.0	6.7	6.5	6.3	6.3	6.3	6.4	6.4	6.5	7.5	7.2	6.4	6.4
AUTO SALES 3)	12.43	10.90	11.28	11.49	11.60	11.70	11.77	11.81	11.65	11.62	10.39	11.28	11.52	11.71
DOMESTIC	9.44	7.80	8.10	8.30	8.40	8.50	8.55	8.58	8.45	8.42	7.95	8.49	8.33	8.50
IMPORTS	3.00	3.10	3.18	3.19	3.20	3.20	3.22	3.23	3.20	3.20	2.44	2.79	3.19	3.21
HOUSING STARTS 3)	1.664	1.748	1.830	1.860	1.870	1.890	1.900	1.910	1.880	1.870	1.766	1.745	1.863	1.890

1)PROFITS ADJUSTED TO EXCLUDE INVENTORY PROFITS AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST.
2)CIVILIAN EMPLOYMENT AND UNEMPLOYMENT SERIES.
3)IN MILLIONS OF UNITS- SEASONALLY ADJUSTED ANNUAL RATE.

11/26/85

FINANCIAL MARKETS

	ACTUAL	FORECAST									YEARS			
	85 III	85 IV	86 I	86 II	86 III	86 IV	87 I	87 II	87 III	87 IV	1984	1985	1986	1987
MONEY SUPPLY-(M1)	604.6	614.8	625.3	635.9	646.8	657.8	669.0	680.4	692.1	703.9	545.0	592.5	641.4	686.3
%ch	16.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	6.9	8.7	8.3	7.0
NEW ISSUE AA INDUS BONDS	11.4	10.9	10.8	10.8	10.2	10.2	9.5	9.6	9.4	9.5	13.2	11.6	10.5	9.5
NEW ISSUE AA UTIL BONDS	11.6	11.3	11.2	11.2	10.6	10.6	9.9	10.0	9.8	9.9	13.6	11.9	10.9	9.9
30-YR GOVT SECURITIES	10.6	10.2	10.1	10.1	9.5	9.5	8.8	8.9	8.7	8.8	12.4	10.8	9.8	8.8
10-YR GOVT SECURITIES	10.3	10.1	10.0	10.0	9.4	9.4	8.7	8.8	8.6	8.7	12.4	10.7	9.7	8.7
PRIME RATE	9.5	9.5	9.0	9.3	9.8	10.0	10.0	10.3	10.3	10.5	12.0	9.9	9.5	10.3
90-DAY CDS	7.8	7.8	7.6	7.8	8.3	8.6	8.6	8.8	8.8	8.9	10.4	8.0	8.1	8.8
6-MONTH COMMERCIAL PAPR	7.7	7.6	7.4	7.6	8.1	8.4	8.4	8.6	8.6	8.7	10.2	8.0	7.9	8.6
3-MONTH T-BILL	7.1	7.0	6.6	6.8	7.3	7.6	7.6	7.8	7.8	7.9	9.5	7.4	7.1	7.8

Alternative Oil Prices for the '87 Budget

Calendar Year	Mid-Session GNP Deflator Updated	Adjusted Mid-Session Review*	Eickhoff Budget Assumptions*	Sprinkel-Johnson
1984				
Q1	220.58	28.89	28.89	28.89
Q2	222.40	29.19	29.19	29.19
Q3	224.57	28.87	28.87	28.87
Q4	226.10	28.52	28.52	28.52
1985				
Q1	229.10	27.26	27.26	27.26
Q2	230.60	27.50	27.50	27.50
Q3	231.90	26.56	26.56	26.56
Q4	233.60	26.25	26.25	26.25
1986				
Q1	235.60	25.60	25.60	25.60
Q2	237.80	25.00	25.00	25.00
Q3	240.30	25.00	24.50	24.50
Q4	242.80	25.26	24.50	24.50
1987				
Q1	245.20	25.51	24.00	24.00
Q2	247.70	25.77	24.00	24.00
Q3	250.20	26.03	24.00	24.00
Q4	252.70	26.29	24.00	24.00
1988				
Q1	255.10	26.54	23.50	23.50
Q2	257.50	26.79	23.50	23.50
Q3	259.90	27.04	23.50	23.50
Q4	262.30	27.29	23.50	23.65
1989				
Q1	264.60	27.53	23.79	23.86
Q2	266.90	27.77	24.00	24.06
Q3	269.20	28.01	24.21	24.27
Q4	271.50	28.25	24.42	24.47
1990				
Q1	273.60	28.46	24.60	24.63
Q2	275.80	28.69	24.80	24.76
Q3	278.00	28.92	25.00	24.85
Q4	280.20	29.15	25.20	24.91
1991				
Q1	282.20	29.36	25.38	24.95
Q2	284.20	29.57	25.56	24.96
Q3	286.20	29.78	25.74	24.96
Q4	288.30	29.99	25.93	24.96

*Dollars per barrel

	Defense (Real) Full Inflation Adjustment			Defense (Nominal) Automatic Adjustments Only	
	Sprinkel/ Johnson	Eickhoff	Passback 12/9	Sprinkel/ Johnson	Eickhoff
Receipts					
1985	734.0	734.0	734.0	734.0	734.0
86	771.5	771.5	776.0	771.5	771.5
87	841.1	839.3	848.8	841.1	839.3
88	926.9	920.9	936.3	926.9	920.9
89	994.7	993.1	1,015.0	994.7	993.1
90	1,045.8	1,065.7	1,091.7	1,045.8	1,065.7
Expenditures					
1985	946.1	946.1	946.1	946.1	946.1
86	978.7	978.7	981.6	980.0	980.0
87	983.0	983.1	990.8	985.5	985.6
88	1,016.7	1,019.5	1,028.5	1,020.3	1,022.8
89	1,045.2	1,058.0	1,062.4	1,052.1	1,061.8
90	1,068.3	1,101.5	1,104.3	1,083.2	1,105.6
Deficit					
1985	-212.1	-212.1	-212.1	-212.1	-212.1
86	-207.2	-207.2	-205.6	-208.6	-208.6
87	-141.9	-143.8	-142.0	-144.4	-146.4
88	-89.9	-98.7	-92.2	-93.5	-102.0
89	-50.5	-64.9	-47.4	-57.4	-68.7
90	-22.5	-35.8	-12.6	-37.4	-39.9