

Prefatory Note

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Part 1

August 5, 2004

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Summary and Outlook

August 5, 2004

Summary and Outlook

Domestic Developments

The bulk of the data that we have received since the June Greenbook have been decidedly softer than we had expected. Notably, employment growth slowed substantially in June, manufacturing output contracted slightly, and consumer spending fell sharply. All told, real GDP increased only 3 percent at an annual rate in the second quarter—1½ percentage points less than our projection in the June Greenbook.

In preparing the August forecast, we have interpreted the negative surprise in the second quarter as signaling a temporary dip in the pace of growth rather than a persistent downshift. In particular, we still believe that the economic fundamentals are in place to support a return to above-trend growth. Accordingly, although we have allowed some of the second-quarter weakness to carry over into the current quarter, we have left growth thereafter substantially as it was in the previous Greenbook. An important driver of this return to above-trend growth is an acceleration of business fixed investment, which should benefit from favorable financial conditions, rising profits, and—over the remainder of this year—the partial-expensing tax incentive. Friday's employment report should shed important light on how the current quarter is shaping up.

Next year, real GDP growth should slow somewhat, reflecting a sizable swing in fiscal policy and further steps toward neutrality in the stance of monetary policy. Nonetheless, over the forecast period as a whole, we expect slow but steady progress toward the full utilization of productive resources.

Although the latest reading on the core CPI came in a bit lower than anticipated, spot prices of crude petroleum have recently hit new highs. On net, our outlook for core inflation in the second half of this year is little changed from the June Greenbook. We expect core inflation to edge down next year, as prices of energy and imports give way from rapid increases in the first half of this year to modest declines next year.

Key Background Factors

Market participants have marked down their expected path for the federal funds rate, and long-term interest rates have declined about 25 basis points, on net, since the last Greenbook, largely in response to softer-than-expected economic data. We, too, have reacted to the weaker tone of incoming data by tempering the amount of policy tightening over the forecast period. We now assume that the funds rate reaches 2¾ percent by the fourth quarter of 2005, ¼ percentage point less than forecast in the June Greenbook. As has been true for some time, our assumed path for the funds rate is shallower than that implicit in futures markets. Assuming that market participants gradually come to share our view about the path for policy, long-term rates should edge down a bit through 2005.

Reflecting some concerns about the prospects for corporate earnings and oil prices, broad equity price indexes have dropped about 4 percent since the last Greenbook. We have shifted down our starting level for stock prices by roughly this amount, but we still assume that prices will increase at an annual rate of 6½ percent over the forecast period, a

pace consistent with risk-adjusted parity with the projected yield on long-term Treasury securities.

Our assumptions about fiscal policy are little changed from the June Greenbook: Federal fiscal policy shifts from stimulative this year to slightly restrictive next year, largely reflecting the expiration of the partial-expensing allowances for business equipment purchases. We continue to assume that several of the major changes in the individual income tax enacted in recent years—the child tax credit, marriage penalty relief, the expanded 10 percent bracket, and AMT relief—will be extended for next year and beyond. However, the Congress and the Administration have not yet reached agreement on the length of the extension. On the spending side, the Congress recently passed a \$416 billion defense appropriations bill that included \$25 billion earmarked for the costs of the war in Afghanistan and Iraq. These amounts were about in line with our expectations. The remaining appropriations are likely to be taken up in an omnibus spending bill after the summer recess. For the current fiscal year, we expect the federal budget deficit to be \$429 billion, about the same as we forecast last time; for the 2005 fiscal year, we anticipate a deficit of \$358 billion, a bit larger than in the June Greenbook, because of the slightly weaker level of economic activity.

The foreign exchange value of the dollar has changed little since the June Greenbook. As in the June projection, we assume a small decline in the real exchange value of the dollar going forward that cumulates to less than 1 percent by the end of 2005. Our outlook for foreign GDP for the second half of this year is slightly weaker than in the June Greenbook, reflecting the adverse effects of higher oil prices as well as less-robust U.S. growth. We are now looking for foreign output growth of 3½ percent both in the second half of this year and in 2005.

The spot price of West Texas intermediate (WTI) crude oil has moved up about \$5 per barrel since the June forecast; for the third quarter as a whole, we expect WTI prices to average about \$43 per barrel. Among the key factors pushing up prices are strong global demand, worries about terrorism and political instability in major exporting countries, and the Russian government's crackdown on Yukos. Futures quotes continue to imply a gradual decline in prices over the coming year and a half, to about \$38 per barrel by the end of 2005. Nonetheless, futures prices for the end of next year are up substantially since late June, and we have raised our outlook for crude oil prices accordingly.

Recent Developments and the Near-Term Outlook

Although many of the signals of activity in the late spring were on the weak side, a number of more timely indicators—including unemployment insurance claims, consumer confidence, and nondefense capital goods orders—suggest that activity will expand at a solid pace in the near term. For the current quarter, we expect GDP to increase at an annual rate of about 4 percent.

Summary of the Near-Term Outlook
(Percent change at annual rate except as noted)

| Measure | 2004:Q2 | | 2004:Q3 | |
|------------------------------------------------------|-----------------------------------------------|------------|------------|------------|
| | June GB | Aug. GB | June GB | Aug. GB |
| Real GDP | 4.7 | 3.1 | 5.2 | 3.9 |
| Private domestic final purchases | 5.6 | 2.9 | 5.2 | 4.8 |
| Personal consumption expenditures | 3.4 | 1.0 | 4.6 | 4.1 |
| Residential investment | 18.8 | 16.5 | -2.7 | -1.2 |
| Business fixed investment | 14.2 | 9.4 | 14.1 | 13.4 |
| Government outlays for consumption and investment | 3.0 | 2.6 | 2.0 | 2.5 |
| | Contribution to growth (percentage points) | | | |
| Inventory investment | -0.6 | .3 | .7 | -0.4 |
| Net exports | -0.1 | -0.2 | -0.5 | -0.2 |

Following three months in which job gains averaged 300,000 per month, private nonfarm payroll employment increased only 117,000 in June. But surveys of employers and households suggest that labor demand remains strong. And initial claims for unemployment insurance averaged about 340,000 in July, a level similar to that earlier in the year. As a consequence, we anticipate that private nonfarm payroll growth will move back up in the current quarter, to around 300,000 per month.

Manufacturing-sector IP edged down 0.1 percent in June as production of motor vehicles registered a fourth consecutive monthly decline and, elsewhere, production rose only 0.1 percent after the robust gains in IP of the February-to-May period. However, the June weakness appears to have been temporary: Motor vehicle production increased in July, and the latest Institute of Supply Management survey is consistent with solid gains in production. For the third quarter as a whole, we are forecasting manufacturing IP growth of 6½ percent at an annual rate.

According to the advance estimate from the BEA, real consumer outlays rose at an annual rate of only 1 percent in the second quarter, a pace well below that of the preceding four quarters. Despite the second-quarter weakness, we continue to believe that the fundamentals for consumer spending are strong. In particular, even with the pause in June, 1.3 million private-sector jobs were added in the first six months of 2004; surveys suggest that consumer confidence remains elevated; and real disposable personal income increased 4 percent over the most recent four quarters. We are looking for a rebound in consumer spending growth in the current quarter, to 4 percent at an annual rate. The one solid piece of evidence that we have on third-quarter spending is consistent

with this projection: July motor vehicle sales moved up sharply, to 17.2 million units at an annual rate.

Although we estimate that residential investment spending jumped at an annual rate of 16½ percent in the second quarter, single-family housing starts dropped off sharply in June, to an annual rate of 1.49 million units. But both permit issuance for new construction and new home sales (which were near a record-high level) point to a rebound in starts. For the third quarter, we have penciled in single-family starts at a pace of 1.58 million units. Multifamily starts have been surprisingly resilient despite high vacancy rates, and we are assuming third-quarter starts of 350,000, a pace similar to the one in the first half.

In the second quarter, real business spending on equipment and software increased at an annual rate of 10 percent, up from the 8 percent pace of the first quarter. We are projecting a further pickup in E&S spending growth in the current quarter, to an annual rate of 17 percent. An important factor in the E&S acceleration is outlays by businesses for motor vehicles, especially trucks: Demand for trucking services appears to be very strong, and order backlogs for medium and heavy trucks are mounting. We also anticipate a contribution from an acceleration in domestic deliveries of aircraft in the current quarter, albeit to a still-low level. Finally, orders and shipments of nondefense capital goods other than transportation equipment have moved up strongly in recent months and point to solid gains in third-quarter spending; we believe that some of the strength reflects the influence of the partial-expensing provision.

We currently estimate that real spending on nonresidential structures increased at an annual rate of 7 percent in the second quarter. A number of indicators suggest that growth in nonresidential construction activity will continue: Vacancy rates for most major property types moved down in the second quarter, rents appear to have stabilized, and manufacturing capacity utilization has risen sharply in recent quarters. As a consequence, we are looking for another moderate increase in NRS in the current quarter.

We estimate that nonfarm inventory accumulation was \$45 billion in constant-dollar terms in the second quarter, a pickup from the first quarter. Inventories of motor vehicles, especially light trucks, have risen to a substantial level in recent quarters, and conversations with our industry contacts suggest that much of this accumulation has been unintentional. In our forecast, some of the overhang of vehicle stocks is run off as motor vehicle sales recover in the current quarter. Outside the motor-vehicle sector, the recent increases in stocks appear to be largely intentional, the result of firms bringing inventories into better alignment with sales. We are expecting a further increase in inventory investment outside the motor-vehicle sector in the current quarter. Even so, inventory investment overall subtracts 0.4 percentage point from third-quarter GDP growth.

We are forecasting federal spending to increase at an annual rate of 4¼ percent in the current quarter following a 2¾ percent gain in the second quarter. Although defense spending rose only a little last quarter, data from the Daily Treasury Statement suggest an acceleration in the current quarter. Nondefense spending rose at a 4½ percent annual rate in the second quarter, and we expect another large increase in the current quarter. State and local spending rose at an annual rate of 2½ percent in the second quarter, boosted by construction spending. We anticipate that, in the current quarter, state and local spending will post another small increase—1½ percent at an annual rate.

We estimate that exports increased at a 12½ percent annual rate in the second quarter, boosted by strong growth abroad and continued effects of the net decline in the exchange value of the dollar in recent years. However, imports also posted a strong gain last quarter, and net exports are estimated to have made a negative arithmetic contribution of 0.2 percentage point to GDP growth in the second quarter. In the current quarter, we anticipate both imports and exports will slow a bit from their rapid second-quarter increases and will impose an arithmetic drag on output similar to that in the second quarter.

The core CPI rose just 0.1 percent in June, following a 0.2 percent rise in May. As a result, we now anticipate that the core CPI will increase 2.0 percent at an annual rate in the current quarter, down from an average increase of 2.4 percent at an annual rate in the first half of the year. Energy prices continued to rise rapidly through June and were up more than 25 percent at an annual rate in the first half of the year. Weekly data for July, however, suggest that gasoline prices moved down last month, reflecting the narrowing of refining and marketing margins from elevated levels. On net, we expect little change in energy prices in the current quarter. As a consequence, overall consumer prices should increase at about the same pace as core prices, following considerably faster increases in the first half of the year.

The Longer-Term Outlook for the Economy

We continue to believe that monetary policy will be sufficiently accommodative to keep GDP growing at a pace slightly faster than potential over the next year and a half. Although higher oil prices and a lower stock market in this forecast argue for slightly slower growth going forward, these influences are partly offset by the downward revision to our projection for interest rates. In addition, we believe much of the weakness in consumer and business spending in the spring was transitory, and we have assumed that spending in these areas catches up to levels more consistent with fundamentals over the next year and a half.

Household spending. We are forecasting consumer spending to increase at a pace of about 4 percent, on average, supported by continued strong employment growth and a boost to real incomes from the anticipated decline in energy prices. Gains in employment and real incomes should also encourage new residential construction over the projection period. However, fixed mortgage rates have risen appreciably since the start of the year,

Projections of Real GDP
(Percent change at annual rate from end
of preceding period except as noted)

| Measure | 2004 | | 2005 |
|------------------------|-----------------------------------------------|------------|------------|
| | H1 | H2 | |
| Real GDP | 3.8 | 4.3 | 3.6 |
| Previous | 4.6 | 5.0 | 3.6 |
| Final sales | 3.1 | 4.3 | 3.8 |
| Previous | 4.5 | 4.3 | 3.6 |
| PCE | 2.6 | 4.3 | 3.9 |
| Previous | 3.7 | 4.5 | 3.8 |
| Residential investment | 10.6 | -3.1 | -0 |
| Previous | 11.4 | -4.9 | -1.8 |
| BFI | 6.8 | 15.2 | 9.9 |
| Previous | 10.4 | 15.6 | 9.0 |
| Government purchases | 2.5 | 2.1 | 2.2 |
| Previous | 3.2 | 1.9 | 2.2 |
| Exports | 9.8 | 10.0 | 7.6 |
| Previous | 7.4 | 10.2 | 8.0 |
| Imports | 10.0 | 9.7 | 7.8 |
| Previous | 7.9 | 10.8 | 8.1 |
| | Contribution to growth (percentage points) | | |
| Inventory change | .7 | .1 | -.1 |
| Previous | .1 | .7 | .0 |
| Net exports | -.5 | -.4 | -.4 |
| Previous | -.4 | -.6 | -.4 |

and adjustable mortgage rates should rise going forward. These increases in rates will likely have a damping effect on residential construction activity. On net, our projection is for residential construction to be about flat next year.

Business spending. We continue to anticipate that a strong level of profits and favorable financing conditions will support business outlays for equipment and software over the projection period. With the partial-expensing tax provision slated to expire at the end of this year, firms are expected to pull forward some spending that otherwise would have taken place next year. For inventories, we anticipate that the pace of stock building will have a roughly neutral effect on GDP growth going forward.

By next year, the ongoing expansion in employment and business activity will be putting pressure on existing capacity for a broad range of structures, including office buildings, retail space, and factories. As a consequence, the recovery in nonresidential construction gathers steam, with NRS rising $6\frac{3}{4}$ percent in 2005. In the drilling and mining category, high oil and natural gas prices should support activity.

Government spending. We project that federal spending will decelerate, from an increase of 4 percent this year to one of $1\frac{1}{2}$ percent in 2005. The slowdown is concentrated in defense, as the Iraq-related buildup should be behind us by next year. With the finances of state and local governments continuing to improve, we expect spending in this sector to accelerate from an increase of $1\frac{1}{2}$ percent this year to a rise of $2\frac{1}{2}$ percent next year.

Net exports. Supported by past declines in the real exchange value of the dollar and solid growth abroad, real exports are expected to increase at an annual rate of 10 percent in the second half of this year and a further $7\frac{1}{2}$ percent in 2005. However, real imports are also expected to increase rapidly, boosted by the growth of domestic spending. On balance, net exports are projected to trim, in arithmetic terms, 0.4 percentage point from GDP growth in the second half of this year and in 2005. (*The International Developments section provides more detail on the outlook for the external sector.*)

Aggregate Supply, the Labor Market, and Inflation

The recent annual revision to the national accounts had only small implications for our assessment of the supply side of the economy. We have trimmed slightly our estimates of potential GDP growth over the 2002 to 2005 period, reflecting downward revisions to investment and thus to capital deepening. We have not adjusted our estimates of structural multifactor productivity growth. We now assume potential GDP growth of 3.4 percent both this year and next.

While potential GDP has been revised down slightly, the downward revision to actual GDP growth in the second and third quarters in this projection translates into a notably wider output gap coming out of the current quarter than we had written down in the June Greenbook. That gap narrows somewhat over the course of the next year and a half, and 2005 ends up with slightly more slack than in the previous projection.

Our outlook for core inflation next year is little changed from the June Greenbook. The indirect effects of higher energy prices suggest a bit higher inflation. However, we have assumed a smaller increase in import prices than last time, as we have now taken on board the effects of the expiration at the end of this year of the Multi-Fiber Agreement, which should lower apparel prices.

Productivity and the labor market. We anticipate further strong employment gains over the projection period. However, the improved labor market conditions will

Decomposition of Structural Labor Productivity

(Percent change, Q4 to Q4, except as noted)

| Measure | 1974-95 | 1996-2001 | 2002 | 2003 | 2004 | 2005 |
|--------------------------------------|------------|------------|------------|------------|------------|------------|
| Structural labor productivity | 1.5 | 2.7 | 3.2 | 3.7 | 3.1 | 2.8 |
| Previous | 1.5 | 2.7 | 3.3 | 3.8 | 3.2 | 3.0 |
| <i>Contributions¹</i> | | | | | | |
| Capital deepening | .7 | 1.4 | .6 | .6 | .8 | 1.0 |
| Previous | .7 | 1.4 | .7 | .7 | .9 | 1.1 |
| Multifactor productivity | .5 | 1.1 | 2.4 | 2.8 | 2.0 | 1.6 |
| Previous | .5 | 1.1 | 2.4 | 2.8 | 2.0 | 1.6 |
| Labor composition | .3 | .3 | .3 | .3 | .3 | .3 |
| MEMO | | | | | | |
| Potential GDP | 3.0 | 3.4 | 3.4 | 3.8 | 3.4 | 3.4 |
| Previous | 3.0 | 3.4 | 3.5 | 3.9 | 3.5 | 3.5 |

NOTE. Components may not sum to totals because of rounding. For multiyear periods, the percent change is the annual average from Q4 of the year preceding the first year shown to Q4 of the last shown.

The Outlook for the Labor Market

(Percent change, Q4 to Q4, except as noted)

| Measure | 2002 | 2003 | 2004 | 2005 |
|---------------------------------------------|------|------|------|------|
| Output per hour, nonfarm business | 3.7 | 5.6 | 2.2 | 1.9 |
| Previous | 4.3 | 5.4 | 2.2 | 2.0 |
| Nonfarm private payroll employment | -.9 | -.2 | 2.6 | 2.2 |
| Previous | -.9 | -.2 | 2.8 | 2.0 |
| Household survey employment | .3 | 1.2 | 1.5 | 1.7 |
| Previous | .3 | 1.2 | 1.7 | 1.7 |
| Labor force participation rate ¹ | 66.5 | 66.1 | 66.2 | 66.5 |
| Previous | 66.5 | 66.1 | 66.2 | 66.5 |
| Civilian unemployment rate ¹ | 5.9 | 5.9 | 5.5 | 5.3 |
| Previous | 5.9 | 5.9 | 5.3 | 5.2 |
| MEMO | | | | |
| GDP gap ² | 2.2 | 1.6 | 1.0 | .8 |
| Previous | 2.1 | 1.7 | .5 | .5 |

1. Percent, average for the fourth quarter

2. Percent difference between potential and actual GDP in the fourth quarter of the year indicated. A positive number indicates that the economy is operating below potential.

Inflation Projections
(Percent change, Q4 to Q4, except as noted)

| Measure | 2002 | 2003 | 2004 | 2005 |
|------------------------------------------------------------------|------|------|------|------|
| PCE chain-weighted price index | 1.8 | 1.7 | 2.4 | 1.2 |
| Previous | 1.8 | 1.5 | 2.1 | 1.2 |
| Food and beverages | 1.4 | 2.7 | 2.7 | 1.8 |
| Previous | 1.4 | 2.6 | 2.9 | 2.0 |
| Energy | 7.9 | 7.2 | 10.8 | -4.1 |
| Previous | 7.9 | 7.8 | 7.6 | -4.6 |
| Excluding food and energy | 1.5 | 1.2 | 1.8 | 1.5 |
| Previous | 1.6 | 1.0 | 1.7 | 1.5 |
| Consumer price index | 2.2 | 1.9 | 2.9 | 1.4 |
| Previous | 2.2 | 1.9 | 2.8 | 1.5 |
| Excluding food and energy | 2.0 | 1.2 | 2.2 | 1.9 |
| Previous | 2.0 | 1.2 | 2.3 | 2.0 |
| GDP chain-weighted price index | 1.6 | 1.7 | 2.0 | 1.7 |
| Previous | 1.4 | 1.6 | 1.8 | 1.4 |
| ECI for compensation of private industry workers ¹ | 3.2 | 4.0 | 4.1 | 4.0 |
| Previous | 3.2 | 4.0 | 4.0 | 4.2 |
| NFB compensation per hour | 3.0 | 5.3 | 4.1 | 4.0 |
| Previous | 1.8 | 4.5 | 4.3 | 4.1 |
| Prices of core nonfuel imports | .1 | 1.6 | 3.5 | -.3 |
| Previous | .1 | 1.6 | 4.0 | .5 |

1. December to December.

encourage an increase in labor force participation, limiting the reduction in the unemployment rate. On net, we expect the unemployment rate to move down to 5.3 percent by the end of next year, a level just slightly higher than in the June Greenbook. We project that increases in labor productivity over the next six quarters will average 1.6 percent at an annual rate, below our estimate of its underlying structural pace, as firms relieve some of the pressure on their workers that we believe has built up in recent years.

Prices and labor costs. Core inflation as measured by the index for personal consumption expenditures other than food and energy is expected to ease over the forecast period, from an annual rate of 2 percent in the first half of this year to 1½ percent next year. This outlook depends importantly on our expectations that energy and import prices will decelerate from rapid increases in the first half of this year to absolute declines

in 2005. In addition, slack in resource utilization is expected to persist through 2005, helping to hold down inflation. The declines in energy prices in our projection will keep overall inflation below the core figures. We are projecting overall PCE inflation to drop to 1¼ percent next year from 2½ percent this year.

The latest employment cost index data suggest that increases in wages and salaries remain modest whereas benefit costs—boosted by large employer contributions to pension funds—are rising rapidly. Looking ahead, we anticipate some moderation in benefit cost increases—in particular, as the need to replenish pension funds diminishes—coupled with some pickup in basic wage increases. On balance, we expect the ECI to rise about 4 percent both this year and next, in line with recent increases.

Financial Flows and Conditions

Domestic nonfinancial sector debt is projected to expand 7¾ percent this year—about ½ percentage point less than last year's rate—before slowing to a 7 percent increase in 2005. As in the June Greenbook, we anticipate that a reduced pace of government and household borrowing over the forecast period will more than offset a pickup in business borrowing.

After having risen a bit more than 10 percent in 2003, household debt is expected to decelerate to an increase of 9¼ percent this year and 7½ percent in 2005. The stepdown reflects a marked decline in the pace of home mortgage borrowing, which we expect to be held back by significantly smaller increases in home values and a substantial reduction in the volume of cash-out refinancing. In contrast, we anticipate that increases in consumer credit will trend up from 4¼ percent last year to 5½ percent in 2004 and 6¼ percent in 2005. This pickup is consistent with the projected rise of durable goods expenditures and a reduction in the propensity to use mortgage credit to finance household purchases.

As in the previous Greenbook, borrowing by nonfinancial businesses is projected to move up in the second half of this year and to increase further in 2005. Reflecting ample internal funds and some shift toward shorter-term finance, net bond issuance was near zero in the second quarter and weakened further in July. But we expect businesses to resume borrowing in the bond market, as capital spending is anticipated to rise more quickly than cash flow over the forecast period. In addition, with inventory investment projected to step up, we expect further increases in C&I loans and commercial paper. All told, nonfinancial business debt is projected to expand 4¾ percent this year and 6¼ percent in 2005.

Federal sector debt is expected to increase 10½ percent this year, a pace similar to last year's. In 2005, federal debt growth is projected to drop back to about 7½ percent, as the lapse of the partial-expensing provision raises corporate taxes; personal tax payments also increase. Borrowing by state and local governments is expected to move down over the remainder of this year and to moderate further next year as a result of the brightening

fiscal outlook and the damping effect of higher interest rates on advance-refunding activity.

The effects of tighter monetary policy on opportunity costs and the decline in mortgage refinancing activity projected over the remainder of 2004 are expected to pull down M2 growth to about 4 percent for the year as a whole. In 2005, a continued increase in opportunity costs leads to further deceleration in M2, to a pace well below that of nominal income.

Alternative Simulations

In this section, we evaluate risks to the forecast using simulations of the FRB/US model. The first two scenarios explore the possibility that we have understated the strength of aggregate demand. The third scenario examines the risk that the growth in consumer spending will fall short of the baseline projection. We then consider a scenario in which the outlook for aggregate supply is less favorable than in the baseline. The next simulation explores the risk that inflation may slow markedly if competitive pressures substantially erode the markup of prices over unit labor costs. In all these simulations, the federal funds rate is held at baseline. The final scenario assumes that the funds rate follows a path consistent with current readings from the futures market.

Spending rebound. In the baseline, the level of real activity remains below potential through 2005 despite a real funds rate that stays well below its historical mean of about 2½ percent. One way to characterize this outlook is that the stimulus to spending from monetary policy has been and will continue to be offset by a low equilibrium real rate of interest—a summary measure of the net effect of other forces influencing aggregate demand in the medium term. In the baseline, we assume that these forces recede, but so gradually that, by the end of the forecast period, the equilibrium real funds rate is estimated to be well below its long-run average. In this scenario, we assume that these other forces restrain real activity much less than in the baseline, to a degree consistent with an equilibrium real rate that is close to its long-run average. Thus, the effective stimulus from monetary policy turns out to be much larger, causing real GDP to rebound sharply in the second half of this year and to increase almost 5 percent in 2005. As a result, the unemployment rate falls to 4½ percent by the end of next year. As resource utilization tightens, inflation moderates a bit less than in the baseline in 2005 and is poised to move higher in 2006 unless offset by a significant tightening in monetary policy.

Stronger investment. The Greenbook baseline projects that real expenditures on equipment and software will decelerate 3 percentage points in 2005, largely as a consequence of the expiration of partial expensing. However, gauging the effect of tax incentives on investment is difficult, and the observed increases in E&S spending this year may reflect, to a greater degree, underlying fundamentals rather than partial expensing. In this scenario, we assume that partial expensing has had and will have little effect on equipment investment. We thus all but eliminate the pothole in E&S spending

Alternative Scenarios

(Percent change, annual rate, from end of preceding period, except as noted)

| Measure and scenario | 2003: H2 | 2004 | | 2005 |
|-------------------------------------------------|-------------|------------|------------|------------|
| | | H1 | H2 | |
| <i>Real GDP</i> | | | | |
| Baseline | 5.8 | 3.8 | 4.3 | 3.6 |
| Spending rebound | 5.8 | 3.8 | 5.6 | 4.9 |
| Stronger investment | 5.8 | 3.8 | 4.3 | 4.4 |
| Higher saving rate | 5.8 | 3.8 | 3.9 | 2.5 |
| Less-favorable supply conditions | 5.8 | 3.8 | 4.3 | 2.7 |
| Lower markup | 5.8 | 3.8 | 4.4 | 3.6 |
| Market-based funds rate | 5.8 | 3.8 | 4.3 | 3.4 |
| <i>Civilian unemployment rate¹</i> | | | | |
| Baseline | 5.9 | 5.6 | 5.5 | 5.3 |
| Spending rebound | 5.9 | 5.6 | 5.3 | 4.4 |
| Stronger investment | 5.9 | 5.6 | 5.5 | 5.0 |
| Higher saving rate | 5.9 | 5.6 | 5.6 | 5.9 |
| Less-favorable supply conditions | 5.9 | 5.6 | 5.3 | 5.1 |
| Lower markup | 5.9 | 5.6 | 5.5 | 5.2 |
| Market-based funds rate | 5.9 | 5.6 | 5.5 | 5.4 |
| <i>PCE prices excluding food and energy</i> | | | | |
| Baseline | 1.1 | 2.0 | 1.7 | 1.5 |
| Spending rebound | 1.1 | 2.0 | 1.7 | 1.6 |
| Stronger investment | 1.1 | 2.0 | 1.7 | 1.5 |
| Higher saving rate | 1.1 | 2.0 | 1.7 | 1.4 |
| Less-favorable supply conditions | 1.1 | 2.0 | 2.0 | 2.0 |
| Lower markup | 1.1 | 2.0 | 1.3 | .9 |
| Market-based funds rate | 1.1 | 2.0 | 1.7 | 1.5 |

1. Average for the final quarter of the period.

in early 2005, and E&S outlays advance in 2005 at close to the 19 percent pace expected in the second half of this year. The added impetus from investment boosts the rate of growth of real GDP to 4½ percent next year and pushes the unemployment rate down to 5 percent. Inflation is little changed from the baseline as price pressures from stronger spending are largely offset by a faster pace of capital deepening.

Higher saving rate. The saving rate is currently quite low by historical standards, and we expect that it will rise considerably over the next several years. In the baseline projection, ¾ percentage point of this adjustment occurs by the end of 2005. The recent softness in consumer spending, however, may be a signal that the adjustment during the forecast period will be more rapid. In this scenario, restraint on the propensity to

consume adds 1 percentage point to the baseline increase in the saving rate by the end of 2005. Under these conditions, real GDP increases only 2½ percent next year, and the unemployment rate rises to nearly 6 percent. Inflation is a touch lower in 2005 as a result.

Less-favorable supply conditions. In this scenario, structural productivity is assumed to rise ½ percentage point more slowly than in the baseline this year and next. In addition, we assume that the NAIRU has been and will continue to be 5¾ percent. The lower level and slower growth of potential output, through their effects on permanent income, sales expectations, and the stock market, restrain real GDP substantially. Nonetheless, aggregate demand is held back less than aggregate supply, causing the unemployment rate to be a bit lower than in the baseline. Core inflation remains around 2 percent in this scenario.

Lower markup. Although the annual NIPA revision suggests that the current markup of prices over unit labor costs in the nonfarm business sector is not as high as previously indicated, it nonetheless remains on the high side of historical standards. In the baseline, we anticipate that the economic forces driving prices, wages, and productivity will reduce the excess of the markup relative to its historical average about one-third. There is a risk of a more rapid decline, however, especially if intensified competitive forces emerge and cause firms to be more aggressive in their wage offers while limiting the degree to which firms can pass on cost increases. Such an outcome is portrayed in this scenario. Hourly compensation increases almost ½ percentage point faster than in the baseline. On the price side, heightened competition limits the ability of firms to pass on not only this incremental rise in labor costs but also some of the costs in the baseline. As a result, price inflation is about ½ percentage point less than baseline, and the markup falls about two-thirds of the way back toward its historical average. The associated shift of real income from firms to workers, as reflected in higher real labor income and lower real corporate profits, provides a small stimulus to real activity.

Market-based funds rate. Quotes from futures markets are consistent with a federal funds rate that rises to almost 3¼ percent by late 2005, a path that is only a little steeper than that incorporated in the baseline. As a result, adopting the market-based path for the funds rate has very little effect on real activity or inflation.

**Selected Greenbook Projections and 70 Percent
Confidence Intervals Derived from Historical
Forecast Errors and FRB/US Simulations**

| Measure | 2004 | 2005 |
|----------------------------------------|---------|---------|
| <i>Real GDP</i> | | |
| <i>(percent change, Q4 to Q4)</i> | | |
| Projection | 4.1 | 3.6 |
| Confidence interval | | |
| Greenbook forecast errors ¹ | 3.1–5.0 | 1.6–5.6 |
| FRB/US stochastic simulations | 3.3–4.8 | 2.0–5.3 |
| <i>Civilian unemployment rate</i> | | |
| <i>(percent, Q4)</i> | | |
| Projection | 5.5 | 5.3 |
| Confidence interval | | |
| Greenbook forecast errors ¹ | 5.2–5.8 | 4.5–6.1 |
| FRB/US stochastic simulations | 5.1–5.8 | 4.4–6.1 |
| <i>PCE prices</i> | | |
| <i>excluding food and energy</i> | | |
| <i>(percent change, Q4 to Q4)</i> | | |
| Projection | 1.8 | 1.5 |
| Confidence interval | | |
| Greenbook forecast errors ² | 1.5–2.1 | 0.7–2.3 |
| FRB/US stochastic simulations | 1.5–2.1 | 0.8–2.2 |

NOTE. Shocks underlying stochastic simulations are randomly drawn from the 1978–2003 set of model equation residuals.

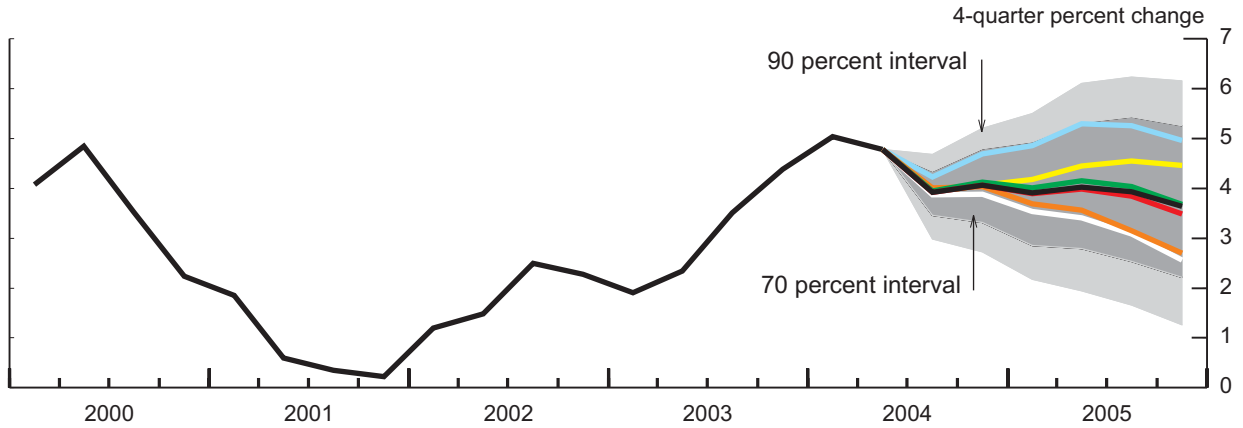
1. 1978–2003.
2. 1981–2003.

Forecast Confidence Intervals and Alternative Scenarios

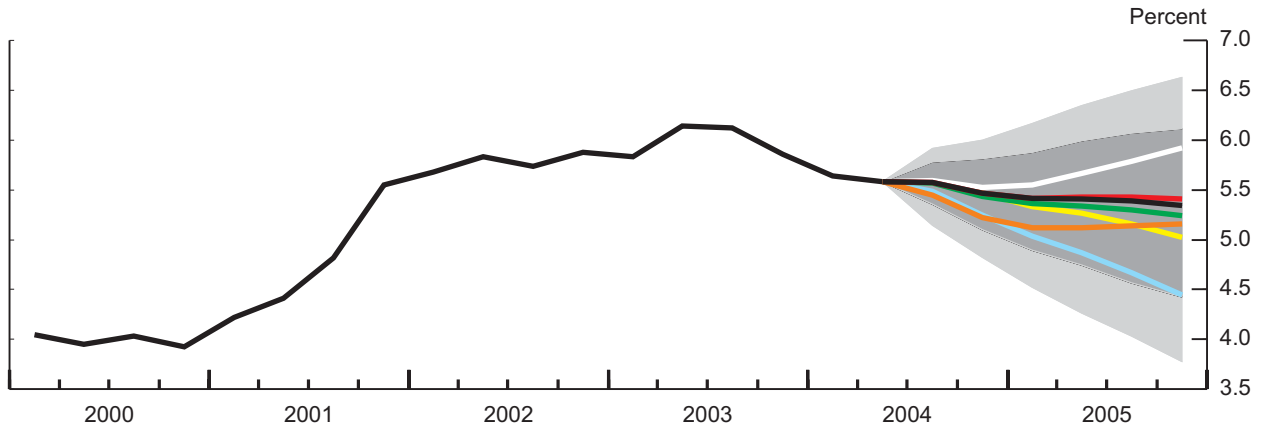
Confidence Intervals Based on FRB/US Stochastic Simulations

- Greenbook baseline
- Spending rebound
- Stronger investment
- Higher saving rate
- Less-favorable supply conditions
- Lower markup
- Market-based funds rate

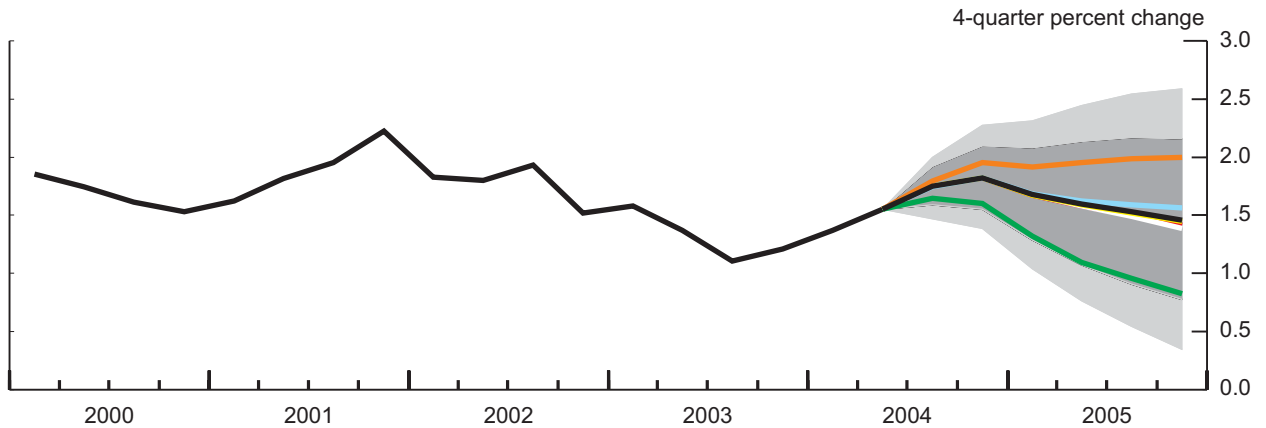
Real GDP



Unemployment Rate



PCE Prices excluding Food and Energy



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STAFF PROJECTIONS OF CHANGES IN GDP, PRICES, AND UNEMPLOYMENT
(Percent, annual rate)

| Interval | Nominal GDP | | Real GDP | | GDP chain-weighted price index | | Consumer price index ¹ | | Unemployment rate ² | | |
|---------------------------------|-------------|----------|----------|----------|--------------------------------|----------|-----------------------------------|----------|--------------------------------|----------|------|
| | 06/23/04 | 08/05/04 | 06/23/04 | 08/05/04 | 06/23/04 | 08/05/04 | 06/23/04 | 08/05/04 | 06/23/04 | 08/05/04 | |
| ANNUAL | | | | | | | | | | | |
| 2001 | 2.9 | 3.2 | 0.5 | 0.8 | 2.4 | 2.4 | 2.8 | 2.8 | 4.7 | 4.7 | |
| 2002 | 3.8 | 3.5 | 2.2 | 1.9 | 1.5 | 1.7 | 1.6 | 1.6 | 5.8 | 5.8 | |
| 2003 | 4.8 | 4.9 | 3.1 | 3.0 | 1.7 | 1.8 | 2.3 | 2.3 | 6.0 | 6.0 | |
| 2004 | 6.9 | 6.5 | 4.9 | 4.4 | 1.9 | 2.0 | 2.5 | 2.6 | 5.5 | 5.6 | |
| 2005 | 5.5 | 5.5 | 4.1 | 3.9 | 1.3 | 1.6 | 1.6 | 1.7 | 5.2 | 5.4 | |
| QUARTERLY | | | | | | | | | | | |
| 2002 | Q1 | 5.4 | 4.5 | 4.7 | 3.4 | 1.1 | 1.4 | 1.4 | 1.4 | 5.7 | 5.7 |
| | Q2 | 3.9 | 4.2 | 1.9 | 2.4 | 1.5 | 1.5 | 3.4 | 3.4 | 5.8 | 5.8 |
| | Q3 | 4.4 | 3.9 | 3.4 | 2.6 | 1.5 | 1.7 | 2.2 | 2.2 | 5.7 | 5.7 |
| | Q4 | 3.1 | 2.7 | 1.3 | 0.7 | 1.7 | 2.0 | 2.0 | 2.0 | 5.9 | 5.9 |
| 2003 | Q1 | 4.3 | 4.9 | 2.0 | 1.9 | 2.3 | 2.7 | 3.8 | 3.8 | 5.8 | 5.8 |
| | Q2 | 4.2 | 5.3 | 3.1 | 4.1 | 1.1 | 1.1 | 0.7 | 0.7 | 6.1 | 6.1 |
| | Q3 | 10.0 | 8.8 | 8.2 | 7.4 | 1.6 | 1.4 | 2.4 | 2.4 | 6.1 | 6.1 |
| | Q4 | 5.7 | 5.7 | 4.1 | 4.2 | 1.5 | 1.6 | 0.7 | 0.7 | 5.9 | 5.9 |
| 2004 | Q1 | 7.2 | 7.4 | 4.4 | 4.5 | 2.7 | 2.8 | 3.5 | 3.5 | 5.6 | 5.6 |
| | Q2 | 7.4 | 6.4 | 4.7 | 3.1 | 2.6 | 3.2 | 4.5 | 4.8 | 5.6 | 5.6 |
| | Q3 | 6.3 | 4.9 | 5.2 | 3.9 | 1.1 | 0.9 | 2.0 | 2.1 | 5.4 | 5.6 |
| | Q4 | 5.7 | 6.0 | 4.9 | 4.7 | 0.8 | 1.2 | 1.0 | 1.3 | 5.3 | 5.5 |
| 2005 | Q1 | 5.3 | 5.9 | 3.7 | 3.9 | 1.5 | 1.9 | 1.3 | 1.2 | 5.2 | 5.4 |
| | Q2 | 4.9 | 5.2 | 3.6 | 3.6 | 1.3 | 1.6 | 1.5 | 1.5 | 5.2 | 5.4 |
| | Q3 | 4.9 | 5.2 | 3.6 | 3.6 | 1.3 | 1.6 | 1.7 | 1.5 | 5.2 | 5.4 |
| | Q4 | 4.8 | 5.1 | 3.5 | 3.6 | 1.3 | 1.5 | 1.7 | 1.6 | 5.2 | 5.3 |
| TWO-QUARTER³ | | | | | | | | | | | |
| 2002 | Q2 | 4.7 | 4.3 | 3.3 | 2.9 | 1.3 | 1.4 | 2.4 | 2.4 | 0.2 | 0.2 |
| | Q4 | 3.8 | 3.3 | 2.3 | 1.7 | 1.6 | 1.8 | 2.1 | 2.1 | 0.1 | 0.1 |
| 2003 | Q2 | 4.2 | 5.1 | 2.5 | 3.0 | 1.7 | 1.9 | 2.2 | 2.2 | 0.2 | 0.2 |
| | Q4 | 7.8 | 7.2 | 6.2 | 5.8 | 1.6 | 1.5 | 1.5 | 1.5 | -0.2 | -0.2 |
| 2004 | Q2 | 7.3 | 6.9 | 4.6 | 3.8 | 2.6 | 3.0 | 4.0 | 4.2 | -0.3 | -0.3 |
| | Q4 | 6.0 | 5.4 | 5.0 | 4.3 | 1.0 | 1.0 | 1.5 | 1.7 | -0.3 | -0.1 |
| 2005 | Q2 | 5.1 | 5.6 | 3.7 | 3.7 | 1.4 | 1.8 | 1.4 | 1.3 | -0.1 | -0.1 |
| | Q4 | 4.9 | 5.2 | 3.5 | 3.6 | 1.3 | 1.5 | 1.7 | 1.6 | 0.0 | -0.1 |
| FOUR-QUARTER⁴ | | | | | | | | | | | |
| 2001 | Q4 | 2.4 | 2.7 | -0.0 | 0.2 | 2.4 | 2.4 | 1.8 | 1.8 | 1.7 | 1.7 |
| 2002 | Q4 | 4.2 | 3.8 | 2.8 | 2.3 | 1.4 | 1.6 | 2.2 | 2.2 | 0.3 | 0.3 |
| 2003 | Q4 | 6.0 | 6.2 | 4.3 | 4.4 | 1.6 | 1.7 | 1.9 | 1.9 | 0.0 | 0.0 |
| 2004 | Q4 | 6.7 | 6.1 | 4.8 | 4.1 | 1.8 | 2.0 | 2.8 | 2.9 | -0.6 | -0.4 |
| 2005 | Q4 | 5.0 | 5.4 | 3.6 | 3.6 | 1.4 | 1.7 | 1.5 | 1.4 | -0.1 | -0.1 |

1. For all urban consumers.

2. Level, except as noted.

3. Percent change from two quarters earlier; for unemployment rate, change in percentage points.

4. Percent change from four quarters earlier; for unemployment rate, change in percentage points.

Strictly Confidential <FR>
Class II FOMCREAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS, ANNUAL VALUES
(Seasonally adjusted annual rate)

August 5, 2004

| Item | Units ¹ | - - Projected - - | | | | | | | | |
|---------------------------------------|--------------------|-------------------|--------|--------|--------|---------|---------|---------|---------|---------|
| | | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
| Expenditures | | | | | | | | | | |
| Nominal GDP | Bill. \$ | 8304.3 | 8747.0 | 9268.4 | 9817.0 | 10128.0 | 10487.0 | 11004.0 | 11719.6 | 12369.1 |
| Real GDP | Bill. Ch. \$ | 8703.5 | 9066.9 | 9470.3 | 9817.0 | 9890.7 | 10074.8 | 10381.3 | 10842.9 | 11263.2 |
| Real GDP | % change | 4.3 | 4.5 | 4.7 | 2.2 | 0.2 | 2.3 | 4.4 | 4.1 | 3.6 |
| Gross domestic purchases | | 5.1 | 5.5 | 5.5 | 3.0 | 0.4 | 3.1 | 4.3 | 4.3 | 3.9 |
| Final sales | | 3.7 | 4.8 | 4.2 | 2.9 | 1.5 | 1.2 | 4.5 | 3.7 | 3.8 |
| Priv. dom. final purchases | | 5.2 | 6.4 | 5.3 | 4.3 | 1.0 | 1.7 | 4.9 | 4.3 | 4.4 |
| Personal cons. expenditures | | 4.3 | 5.4 | 4.9 | 4.1 | 2.8 | 2.5 | 3.8 | 3.4 | 3.9 |
| Durables | | 9.9 | 14.4 | 7.3 | 4.7 | 10.8 | 1.5 | 9.9 | 4.8 | 7.1 |
| Nondurables | | 2.5 | 4.7 | 4.9 | 3.0 | 1.9 | 2.3 | 4.6 | 3.7 | 4.6 |
| Services | | 4.0 | 3.8 | 4.4 | 4.5 | 1.6 | 2.9 | 2.2 | 3.0 | 2.9 |
| Business fixed investment | | 11.4 | 10.9 | 7.7 | 7.8 | -9.6 | -6.0 | 9.4 | 10.9 | 9.9 |
| Equipment & Software | | 13.8 | 13.5 | 10.8 | 7.5 | -9.0 | -2.2 | 12.1 | 13.8 | 10.8 |
| Nonres. structures | | 4.6 | 4.0 | -0.9 | 8.8 | -11.1 | -16.1 | 1.5 | 1.6 | 6.8 |
| Residential structures | | 3.1 | 10.3 | 3.6 | -1.8 | 1.4 | 6.9 | 12.0 | 3.5 | 0.0 |
| Exports | | 8.3 | 2.6 | 5.6 | 6.5 | -11.9 | 3.5 | 6.1 | 9.9 | 7.6 |
| Imports | | 14.3 | 11.0 | 12.1 | 11.2 | -7.6 | 9.7 | 4.9 | 9.9 | 7.8 |
| Gov't. cons. & investment | | 1.2 | 3.3 | 4.2 | 0.4 | 5.0 | 3.8 | 2.2 | 2.3 | 2.2 |
| Federal | | -0.5 | 0.1 | 4.2 | -2.2 | 6.4 | 8.2 | 5.5 | 3.9 | 1.6 |
| Defense | | -1.5 | -1.2 | 4.3 | -3.5 | 6.5 | 8.5 | 8.5 | 4.3 | 1.3 |
| State & local | | 2.2 | 5.1 | 4.2 | 1.7 | 4.2 | 1.6 | 0.4 | 1.4 | 2.5 |
| Change in bus. inventories | Bill. Ch. \$ | 71.2 | 72.6 | 68.9 | 56.5 | -31.7 | 11.7 | -0.8 | 40.3 | 47.3 |
| Nonfarm | | 68.5 | 71.2 | 71.5 | 57.8 | -31.8 | 13.5 | -1.1 | 38.3 | 46.5 |
| Net exports | | -104.6 | -203.8 | -296.2 | -379.5 | -399.1 | -472.1 | -518.5 | -561.6 | -603.8 |
| Nominal GDP | % change | 5.9 | 5.7 | 6.3 | 4.6 | 2.7 | 3.8 | 6.2 | 6.1 | 5.4 |
| GDP Gap ² | % | -0.8 | -1.5 | -2.3 | -2.4 | 0.1 | 1.6 | 2.2 | 1.3 | 0.8 |
| Employment and Production | | | | | | | | | | |
| Nonfarm payroll employment | Millions | 122.8 | 125.9 | 129.0 | 131.8 | 131.8 | 130.3 | 129.9 | 131.6 | 134.6 |
| Unemployment rate | % | 4.9 | 4.5 | 4.2 | 4.0 | 4.7 | 5.8 | 6.0 | 5.6 | 5.4 |
| Industrial prod. index | % change | 8.1 | 4.4 | 4.9 | 2.3 | -5.2 | 1.3 | 1.5 | 6.2 | 4.6 |
| Capacity util. rate - mfg. | % | 82.6 | 82.0 | 81.4 | 81.1 | 75.4 | 73.9 | 73.4 | 76.5 | 79.3 |
| Housing starts | Millions | 1.47 | 1.62 | 1.64 | 1.57 | 1.60 | 1.70 | 1.85 | 1.92 | 1.87 |
| Light motor vehicle sales | | 15.13 | 15.52 | 16.90 | 17.36 | 17.12 | 16.79 | 16.64 | 16.83 | 17.66 |
| North Amer. produced | | 13.19 | 13.48 | 14.41 | 14.48 | 14.04 | 13.50 | 13.33 | 13.43 | 14.15 |
| Other | | 1.95 | 2.03 | 2.49 | 2.87 | 3.08 | 3.30 | 3.31 | 3.39 | 3.51 |
| Income and Saving | | | | | | | | | | |
| Nominal GNP | Bill. \$ | 8337.3 | 8768.3 | 9302.2 | 9855.9 | 10171.6 | 10514.1 | 11059.2 | 11788.8 | 12406.1 |
| Nominal GNP | % change | 5.8 | 5.5 | 6.5 | 4.7 | 2.9 | 3.5 | 6.5 | 5.8 | 5.1 |
| Nominal personal income | | 6.4 | 7.0 | 5.5 | 7.1 | 2.2 | 1.9 | 4.6 | 7.6 | 5.1 |
| Real disposable income | | 4.3 | 5.6 | 2.8 | 4.4 | 1.2 | 2.9 | 3.9 | 5.0 | 3.3 |
| Personal saving rate | % | 3.6 | 4.3 | 2.4 | 2.3 | 1.8 | 2.0 | 1.4 | 1.9 | 2.2 |
| Corp. profits, IVA & CCAdj. | % change | 9.1 | -10.0 | 9.6 | -8.6 | -0.2 | 15.4 | 23.3 | 6.8 | -2.1 |
| Profit share of GNP | % | 10.4 | 9.1 | 9.2 | 8.3 | 7.5 | 8.3 | 9.2 | 10.2 | 9.6 |
| Excluding FR Banks | % | 10.1 | 8.9 | 8.9 | 8.0 | 7.3 | 8.1 | 9.1 | 10.0 | 9.5 |
| Federal surpl./deficit | Bill. \$ | -55.8 | 38.8 | 103.6 | 189.5 | 46.7 | -254.5 | -364.5 | -365.2 | -238.3 |
| State & local surpl./def. | | 39.1 | 52.0 | 50.4 | 50.0 | 4.8 | -25.0 | -3.2 | 8.3 | 12.8 |
| Ex. social ins. funds | | 38.0 | 50.3 | 48.7 | 47.9 | 2.2 | -26.6 | -4.3 | 6.9 | 11.3 |
| Gross natl. saving rate | % | 17.5 | 18.2 | 18.0 | 18.0 | 16.3 | 14.1 | 13.5 | 14.2 | 14.6 |
| Net natl. saving rate | % | 6.6 | 7.4 | 6.9 | 6.7 | 4.2 | 2.0 | 1.4 | 2.9 | 3.3 |
| Prices and Costs | | | | | | | | | | |
| GDP chn.-wt. price index | % change | 1.5 | 1.1 | 1.6 | 2.2 | 2.4 | 1.6 | 1.7 | 2.0 | 1.7 |
| Gross Domestic Purchases | | | | | | | | | | |
| chn.-wt. price index | | 1.0 | 0.7 | 2.0 | 2.4 | 1.6 | 1.8 | 1.8 | 2.4 | 1.3 |
| PCE chn.-wt. price index | | 1.3 | 0.9 | 2.1 | 2.3 | 1.7 | 1.8 | 1.7 | 2.4 | 1.2 |
| Ex. food and energy | | 1.4 | 1.4 | 1.6 | 1.5 | 2.2 | 1.5 | 1.2 | 1.8 | 1.5 |
| CPI | | 1.9 | 1.5 | 2.6 | 3.4 | 1.8 | 2.2 | 1.9 | 2.9 | 1.4 |
| Ex. food and energy | | 2.2 | 2.3 | 2.0 | 2.6 | 2.7 | 2.0 | 1.2 | 2.2 | 1.9 |
| ECI, hourly compensation ³ | | 3.4 | 3.5 | 3.4 | 4.4 | 4.2 | 3.2 | 4.0 | 4.1 | 4.0 |
| Nonfarm business sector | | | | | | | | | | |
| Output per hour | | 2.0 | 2.8 | 3.2 | 2.1 | 3.1 | 3.7 | 5.6 | 2.2 | 1.9 |
| Compensation per Hour | | 4.0 | 5.7 | 4.9 | 6.5 | 3.5 | 3.0 | 5.3 | 4.1 | 4.0 |
| Unit labor cost | | 2.0 | 2.7 | 1.6 | 4.3 | 0.4 | -0.7 | -0.2 | 1.9 | 2.1 |

1. Changes are from fourth quarter to fourth quarter.

2. Percent difference between potential and actual. A positive number indicates that the economy is operating below potential.

3. Private-industry workers.

Strictly Confidential <FR>
Class II FOMC

August 5, 2004

REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS, QUARTERLY VALUES
(Seasonally adjusted, annual rate except as noted)

| Item | Units | 2001 Q1 | 2001 Q2 | 2001 Q3 | 2001 Q4 | 2002 Q1 | 2002 Q2 | 2002 Q3 | 2002 Q4 | 2003 Q1 | 2003 Q2 |
|---------------------------------------|--------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| Expenditures | | | | | | | | | | | |
| Nominal GDP | Bill. \$ | 10021.5 | 10128.9 | 10135.1 | 10226.3 | 10338.2 | 10445.7 | 10546.5 | 10617.5 | 10744.6 | 10884.0 |
| Real GDP | Bill. Ch. \$ | 9875.6 | 9905.9 | 9871.1 | 9910.0 | 9993.5 | 10052.6 | 10117.3 | 10135.9 | 10184.4 | 10287.4 |
| Real GDP | % change | -0.5 | 1.2 | -1.4 | 1.6 | 3.4 | 2.4 | 2.6 | 0.7 | 1.9 | 4.1 |
| Gross domestic purchases | | -0.4 | 0.7 | -0.8 | 2.2 | 4.4 | 2.8 | 2.9 | 2.4 | 1.7 | 4.4 |
| Final sales | | 1.6 | 1.0 | -0.4 | 3.8 | 0.3 | 1.8 | 2.0 | 0.7 | 2.4 | 5.2 |
| Priv. dom. final purchases | | 0.8 | -0.9 | 0.6 | 3.5 | 0.7 | 1.7 | 2.4 | 1.9 | 2.6 | 5.1 |
| Personal cons. expenditures | | 1.7 | 1.0 | 1.8 | 7.0 | 1.8 | 2.8 | 2.9 | 2.5 | 2.7 | 3.9 |
| Durables | | 6.7 | -0.3 | 3.1 | 37.4 | -8.5 | 4.4 | 14.0 | -2.4 | -0.1 | 20.6 |
| Nondurables | | 0.5 | -0.1 | 2.4 | 4.9 | 3.8 | 0.8 | -0.6 | 5.3 | 5.0 | 1.6 |
| Services | | 1.1 | 1.8 | 1.2 | 2.3 | 3.3 | 3.5 | 2.4 | 2.2 | 2.1 | 1.8 |
| Business fixed investment | | -4.3 | -13.6 | -6.8 | -13.3 | -9.7 | -9.6 | -1.1 | -3.2 | -0.2 | 11.8 |
| Equipment & Software | | -2.8 | -16.9 | -11.4 | -4.2 | -6.3 | -4.5 | 4.6 | -2.0 | 4.5 | 11.0 |
| Nonres. structures | | -8.3 | -4.0 | 6.0 | -33.2 | -18.5 | -22.6 | -16.0 | -6.6 | -13.0 | 14.5 |
| Residential structures | | 2.2 | 5.6 | 1.8 | -3.8 | 9.2 | 11.4 | 2.8 | 4.2 | 7.6 | 9.0 |
| Exports | | -5.3 | -12.7 | -18.2 | -10.8 | 4.7 | 11.0 | 3.1 | -4.2 | -1.5 | -1.6 |
| Imports | | -3.7 | -12.6 | -10.3 | -3.4 | 12.5 | 11.4 | 5.4 | 9.6 | -1.9 | 2.5 |
| Gov't. cons. & investment | | 5.3 | 7.9 | -1.5 | 8.5 | 4.7 | 4.4 | 2.1 | 4.0 | 0.2 | 7.2 |
| Federal | | 8.1 | 9.1 | 0.1 | 8.7 | 8.2 | 12.8 | 2.9 | 9.2 | 0.3 | 22.1 |
| Defense | | 7.1 | 4.3 | 2.3 | 12.5 | 5.9 | 11.4 | 3.4 | 13.5 | -2.8 | 38.4 |
| State & local | | 4.0 | 7.3 | -2.3 | 8.4 | 2.9 | 0.3 | 1.7 | 1.4 | 0.1 | -0.5 |
| Change in bus. inventories | Bill. Ch. \$ | -7.8 | -2.5 | -29.9 | -86.7 | -7.4 | 7.9 | 22.7 | 23.8 | 9.6 | -17.6 |
| Nonfarm | | -13.5 | -1.1 | -31.1 | -81.7 | -11.9 | 16.1 | 24.6 | 25.3 | 9.6 | -15.7 |
| Net exports | | -398.2 | -385.2 | -398.4 | -414.5 | -444.9 | -458.1 | -469.8 | -515.4 | -511.7 | -525.2 |
| Nominal GDP | % change | 2.8 | 4.4 | 0.2 | 3.6 | 4.5 | 4.2 | 3.9 | 2.7 | 4.9 | 5.3 |
| GDP Gap ¹ | % | -0.9 | -0.4 | 0.7 | 1.1 | 1.1 | 1.4 | 1.6 | 2.2 | 2.6 | 2.6 |
| Employment and Production | | | | | | | | | | | |
| Nonfarm payroll employment | Millions | 132.5 | 132.2 | 131.8 | 130.9 | 130.4 | 130.4 | 130.3 | 130.2 | 130.0 | 129.9 |
| Unemployment rate | % | 4.2 | 4.4 | 4.8 | 5.6 | 5.7 | 5.8 | 5.7 | 5.9 | 5.8 | 6.1 |
| Industrial prod. index | % change | -6.3 | -5.0 | -5.2 | -4.5 | 1.9 | 4.2 | 1.2 | -1.9 | 0.9 | -4.0 |
| Capacity util. rate - mfg. | % | 77.5 | 76.0 | 74.6 | 73.5 | 73.7 | 74.1 | 74.2 | 73.5 | 73.5 | 72.7 |
| Housing starts | Millions | 1.61 | 1.63 | 1.60 | 1.57 | 1.72 | 1.68 | 1.70 | 1.74 | 1.74 | 1.75 |
| Light motor vehicle sales | | 17.11 | 16.68 | 16.14 | 18.56 | 16.51 | 16.50 | 17.52 | 16.64 | 15.99 | 16.34 |
| North Amer. produced | | 14.19 | 13.65 | 13.17 | 15.16 | 13.19 | 13.25 | 14.19 | 13.36 | 12.61 | 13.06 |
| Other | | 2.91 | 3.03 | 2.98 | 3.40 | 3.32 | 3.25 | 3.33 | 3.28 | 3.38 | 3.28 |
| Income and Saving | | | | | | | | | | | |
| Nominal GNP | Bill. \$ | 10060.2 | 10173.5 | 10151.8 | 10300.9 | 10361.7 | 10461.6 | 10571.7 | 10661.2 | 10781.3 | 10929.0 |
| Nominal GNP | % change | 2.1 | 4.6 | -0.8 | 6.0 | 2.4 | 3.9 | 4.3 | 3.4 | 4.6 | 5.6 |
| Nominal personal income | | 5.9 | 1.4 | 0.6 | 1.0 | 2.2 | 4.3 | -0.1 | 1.1 | 3.8 | 4.7 |
| Real disposable income | | 1.3 | -1.7 | 11.5 | -5.6 | 10.8 | 2.7 | -1.7 | 0.2 | 1.8 | 4.3 |
| Personal saving rate | % | 1.9 | 1.2 | 3.4 | 0.5 | 2.7 | 2.7 | 1.6 | 1.2 | 1.0 | 1.1 |
| Corp. profits, IVA & CCAdj. | % change | -7.6 | 2.3 | -30.7 | 51.7 | 24.8 | 15.2 | 3.6 | 19.1 | -1.5 | 36.7 |
| Profit share of GNP | % | 7.7 | 7.7 | 7.0 | 7.7 | 8.1 | 8.3 | 8.3 | 8.6 | 8.5 | 9.0 |
| Excluding FR Banks | % | 7.4 | 7.4 | 6.8 | 7.5 | 7.9 | 8.1 | 8.1 | 8.4 | 8.3 | 8.8 |
| Federal surpl./deficit | Bill. \$ | 156.6 | 123.6 | -88.6 | -4.7 | -208.5 | -251.6 | -255.1 | -302.7 | -281.6 | -364.4 |
| State & local surpl./def. | | 32.5 | 25.8 | -8.6 | -30.6 | -28.8 | -23.6 | -21.3 | -26.3 | -49.0 | -5.7 |
| Ex. social ins. funds | | 29.9 | 23.1 | -11.2 | -33.0 | -30.8 | -25.3 | -22.8 | -27.6 | -50.1 | -6.7 |
| Gross natl. saving rate | % | 17.3 | 16.7 | 16.2 | 14.9 | 15.0 | 14.6 | 13.7 | 13.2 | 12.8 | 13.1 |
| Net natl. saving rate | | 5.7 | 4.9 | 3.6 | 2.8 | 2.9 | 2.5 | 1.5 | 0.9 | 0.4 | 0.9 |
| Prices and Costs | | | | | | | | | | | |
| GDP chn.-wt. price index | % change | 3.3 | 3.1 | 1.6 | 1.7 | 1.4 | 1.5 | 1.7 | 2.0 | 2.7 | 1.1 |
| Gross Domestic Purchases | | | | | | | | | | | |
| chn.-wt. price index | | 2.7 | 2.3 | 1.0 | 0.6 | 1.2 | 2.5 | 1.8 | 1.9 | 3.7 | 0.4 |
| PCE chn.-wt. price index | | 3.3 | 2.6 | 0.6 | 0.6 | 0.9 | 2.9 | 2.0 | 1.4 | 3.2 | 0.7 |
| Ex. food and energy | | 2.8 | 2.1 | 1.4 | 2.6 | 1.2 | 2.0 | 2.0 | 0.9 | 1.5 | 1.1 |
| CPI | | 3.7 | 3.2 | 1.1 | -0.7 | 1.4 | 3.4 | 2.2 | 2.0 | 3.8 | 0.7 |
| Ex. food and energy | | 2.9 | 2.6 | 2.8 | 2.4 | 2.1 | 2.3 | 2.1 | 1.7 | 1.3 | 1.0 |
| ECI, hourly compensation ² | | 4.3 | 4.0 | 3.9 | 4.4 | 3.6 | 4.4 | 2.5 | 3.3 | 5.5 | 3.4 |
| Nonfarm business sector | | | | | | | | | | | |
| Output per hour | | -0.5 | 5.3 | 1.4 | 6.4 | 7.3 | 1.3 | 4.3 | 2.1 | 3.4 | 7.9 |
| Compensation per hour | | 6.6 | 2.1 | 2.1 | 3.4 | 5.1 | 3.6 | 1.3 | 2.0 | 4.6 | 6.4 |
| Unit labor cost | | 7.1 | -3.0 | 0.7 | -2.9 | -2.0 | 2.2 | -2.9 | -0.1 | 1.1 | -1.3 |

1. Percent difference between potential and actual. A positive number indicates that the economy is operating below potential.
2. Private-industry workers.

Strictly Confidential <FR>
Class II FOMC

August 5, 2004

REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS, QUARTERLY VALUES
(Seasonally adjusted, annual rate except as noted)

| Item | Units | - - - - - Projected - - - - - | | | | | | | | | |
|---------------------------------------|--------------|-------------------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| | | 2003 Q3 | 2003 Q4 | 2004 Q1 | 2004 Q2 | 2004 Q3 | 2004 Q4 | 2005 Q1 | 2005 Q2 | 2005 Q3 | 2005 Q4 |
| EXPENDITURES | | | | | | | | | | | |
| Nominal GDP | Bill. \$ | 11116.7 | 11270.9 | 11472.6 | 11651.5 | 11791.3 | 11963.2 | 12134.7 | 12290.9 | 12447.1 | 12603.8 |
| Real GDP | Bill. Ch. \$ | 10472.8 | 10580.7 | 10697.5 | 10779.6 | 10884.1 | 11010.6 | 11115.7 | 11213.5 | 11312.1 | 11411.4 |
| Real GDP | % change | 7.4 | 4.2 | 4.5 | 3.1 | 3.9 | 4.7 | 3.9 | 3.6 | 3.6 | 3.6 |
| Gross domestic purchases | | 6.4 | 4.7 | 5.0 | 3.1 | 3.9 | 5.2 | 4.0 | 3.5 | 3.9 | 4.1 |
| Final sales | | 6.8 | 3.7 | 3.3 | 2.8 | 4.4 | 4.1 | 2.9 | 4.5 | 3.9 | 3.7 |
| Priv. dom. final purchases | | 7.2 | 4.8 | 4.2 | 2.9 | 4.8 | 5.2 | 3.3 | 4.9 | 4.6 | 4.7 |
| Personal cons. expenditures | | 5.0 | 3.6 | 4.1 | 1.0 | 4.1 | 4.4 | 4.1 | 4.0 | 3.8 | 3.8 |
| Durables | | 16.5 | 3.9 | 2.2 | -2.5 | 11.9 | 8.1 | 7.7 | 7.2 | 6.4 | 7.2 |
| Nondurables | | 6.9 | 5.1 | 6.7 | -0.1 | 3.5 | 4.9 | 4.6 | 4.6 | 4.6 | 4.5 |
| Services | | 1.9 | 2.8 | 3.3 | 2.3 | 2.9 | 3.5 | 3.1 | 3.0 | 2.9 | 2.7 |
| Business fixed investment | | 15.7 | 11.0 | 4.2 | 9.4 | 13.4 | 17.0 | 1.0 | 13.2 | 12.7 | 13.2 |
| Equipment & Software | | 21.7 | 12.0 | 8.0 | 10.2 | 16.6 | 20.9 | -0.3 | 15.2 | 14.4 | 14.8 |
| Nonres. structures | | -1.3 | 7.9 | -7.6 | 7.1 | 3.1 | 4.5 | 5.6 | 6.7 | 7.1 | 8.0 |
| Residential structures | | 22.5 | 9.6 | 5.0 | 16.5 | -1.2 | -4.9 | -2.0 | 1.4 | 0.6 | 0.0 |
| Exports | | 11.3 | 17.5 | 7.3 | 12.4 | 9.4 | 10.6 | 5.7 | 8.0 | 7.7 | 8.8 |
| Imports | | 2.9 | 17.1 | 10.6 | 9.5 | 7.6 | 11.7 | 6.0 | 5.9 | 8.4 | 11.1 |
| Gov't. cons. & investment | | 0.1 | 1.6 | 2.5 | 2.6 | 2.5 | 1.8 | 2.0 | 2.1 | 2.2 | 2.3 |
| Federal | | -3.3 | 4.8 | 7.1 | 2.7 | 4.2 | 1.8 | 1.5 | 1.7 | 1.6 | 1.7 |
| Defense | | -7.7 | 11.6 | 10.6 | 1.9 | 3.7 | 1.1 | 1.2 | 1.4 | 1.2 | 1.4 |
| State & local | | 2.2 | -0.1 | -0.0 | 2.5 | 1.5 | 1.7 | 2.2 | 2.4 | 2.5 | 2.7 |
| Change in bus. inventories | Bill. Ch. \$ | -3.5 | 8.6 | 40.0 | 47.4 | 28.9 | 44.8 | 72.5 | 46.5 | 37.2 | 32.9 |
| Nonfarm | | -2.7 | 4.6 | 34.5 | 44.9 | 29.2 | 44.5 | 72.1 | 45.7 | 36.2 | 31.8 |
| Net exports | | -508.7 | -528.3 | -550.1 | -555.3 | -561.0 | -579.9 | -589.2 | -591.7 | -605.9 | -628.5 |
| Nominal GDP | % change | 8.8 | 5.7 | 7.4 | 6.4 | 4.9 | 6.0 | 5.9 | 5.2 | 5.2 | 5.1 |
| GDP Gap ¹ | % | 1.7 | 1.6 | 1.4 | 1.5 | 1.3 | 1.0 | 0.9 | 0.8 | 0.8 | 0.8 |
| EMPLOYMENT AND PRODUCTION | | | | | | | | | | | |
| Nonfarm payroll employment | Millions | 129.8 | 130.0 | 130.4 | 131.1 | 131.9 | 132.9 | 133.7 | 134.3 | 134.9 | 135.4 |
| Unemployment rate | % | 6.1 | 5.9 | 5.6 | 5.6 | 5.6 | 5.5 | 5.4 | 5.4 | 5.4 | 5.3 |
| Industrial prod. index | % change | 3.8 | 5.6 | 6.6 | 6.0 | 5.1 | 7.1 | 5.4 | 4.5 | 4.3 | 4.3 |
| Capacity util. rate - mfg. | % | 73.2 | 74.1 | 75.1 | 76.1 | 76.9 | 77.8 | 78.5 | 79.0 | 79.5 | 80.0 |
| Housing starts | Millions | 1.88 | 2.04 | 1.94 | 1.91 | 1.93 | 1.89 | 1.88 | 1.88 | 1.87 | 1.87 |
| Light motor vehicle sales | | 17.36 | 16.85 | 16.39 | 16.49 | 17.14 | 17.28 | 17.38 | 17.61 | 17.75 | 17.91 |
| North Amer. produced | | 14.02 | 13.63 | 13.13 | 13.10 | 13.72 | 13.78 | 13.89 | 14.11 | 14.23 | 14.37 |
| Other | | 3.35 | 3.22 | 3.26 | 3.39 | 3.43 | 3.50 | 3.49 | 3.50 | 3.52 | 3.54 |
| INCOME AND SAVING | | | | | | | | | | | |
| Nominal GNP | Bill. \$ | 11168.3 | 11358.1 | 11546.1 | 11731.2 | 11862.2 | 12015.7 | 12186.5 | 12332.8 | 12480.9 | 12624.3 |
| Nominal GNP | % change | 9.0 | 7.0 | 6.8 | 6.6 | 4.5 | 5.3 | 5.8 | 4.9 | 4.9 | 4.7 |
| Nominal personal income | | 4.6 | 5.3 | 5.9 | 6.5 | 6.4 | 11.6 | 2.1 | 6.2 | 6.2 | 6.2 |
| Real disposable income | | 8.2 | 1.4 | 3.2 | 2.9 | 4.3 | 9.8 | -0.3 | 4.5 | 4.5 | 4.6 |
| Personal saving rate | % | 1.9 | 1.3 | 1.2 | 1.7 | 1.7 | 3.0 | 1.9 | 2.1 | 2.3 | 2.5 |
| Corp. profits, IVA & CCA ² | % change | 32.0 | 30.2 | 13.6 | 13.2 | 3.9 | -2.5 | 1.1 | -3.3 | -1.8 | -4.1 |
| Profit share of GNP | % | 9.5 | 9.9 | 10.1 | 10.2 | 10.2 | 10.0 | 9.9 | 9.7 | 9.6 | 9.4 |
| Excluding FR Banks | | 9.3 | 9.8 | 9.9 | 10.1 | 10.1 | 9.9 | 9.8 | 9.6 | 9.4 | 9.2 |
| Federal surpl./deficit | Bill. \$ | -433.0 | -379.2 | -384.3 | -389.2 | -352.0 | -335.3 | -257.6 | -234.8 | -224.2 | -236.6 |
| State & local surpl./def. | | 6.5 | 35.3 | 11.8 | 10.9 | -0.5 | 10.8 | 12.8 | 10.2 | 12.6 | 15.6 |
| Ex. social ins. funds | | 5.4 | 34.1 | 10.6 | 9.5 | -1.9 | 9.3 | 11.3 | 8.7 | 11.1 | 14.1 |
| Gross natl. saving rate | % | 13.6 | 14.3 | 13.8 | 14.3 | 14.4 | 14.5 | 14.5 | 14.6 | 14.6 | 14.6 |
| Net natl. saving rate | | 1.6 | 2.5 | 2.3 | 3.0 | 3.1 | 3.2 | 3.2 | 3.3 | 3.3 | 3.3 |
| PRICES AND COSTS | | | | | | | | | | | |
| GDP chn.-wt. price index | % change | 1.4 | 1.6 | 2.8 | 3.2 | 0.9 | 1.2 | 1.9 | 1.6 | 1.6 | 1.5 |
| Gross Domestic Purchases | | 1.7 | 1.4 | 3.4 | 3.4 | 1.5 | 1.4 | 1.5 | 1.3 | 1.3 | 1.3 |
| chn.-wt. price index | | 1.6 | 1.2 | 3.3 | 3.3 | 1.7 | 1.2 | 1.1 | 1.3 | 1.3 | 1.3 |
| PCE chn.-wt. price index | | 0.9 | 1.3 | 2.1 | 1.8 | 1.7 | 1.6 | 1.5 | 1.5 | 1.4 | 1.4 |
| Ex. food and energy | | 2.4 | 0.7 | 3.5 | 4.8 | 2.1 | 1.3 | 1.2 | 1.5 | 1.5 | 1.6 |
| CPI | | 1.5 | 0.8 | 1.9 | 2.9 | 2.0 | 2.0 | 1.9 | 1.9 | 1.8 | 1.8 |
| Ex. food and energy | | 4.4 | 3.1 | 4.3 | 4.0 | 3.9 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| ECI, hourly compensation ² | | 8.2 | 2.8 | 4.1 | 3.0 | -0.2 | 2.1 | 1.4 | 1.6 | 2.2 | 2.2 |
| Nonfarm business sector | | 5.6 | 4.6 | 4.2 | 4.4 | 3.9 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| Output per hour | | -2.4 | 1.7 | 0.1 | 1.4 | 4.1 | 1.9 | 2.5 | 2.3 | 1.7 | 1.8 |
| Compensation per hour | | | | | | | | | | | |
| Unit labor cost | | | | | | | | | | | |

1. Percent difference between potential and actual. A positive number indicates that the economy is operating below potential.
2. Private-industry workers.

CONTRIBUTIONS TO GROWTH IN REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS

| Item | 2001 Q3 | 2001 Q4 | 2002 Q1 | 2002 Q2 | 2002 Q3 | 2002 Q4 | 2003 Q1 | 2003 Q2 | 2003 Q3 | 01Q4/ 00Q4 | 02Q4/ 01Q4 | 03Q4/ 02Q4 |
|-----------------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|---------------|---------------|---------------|
| Real GDP | -1.4 | 1.6 | 3.4 | 2.4 | 2.6 | 0.7 | 1.9 | 4.1 | 7.4 | 0.2 | 2.3 | 4.4 |
| Gross dom. purchases | -0.8 | 2.2 | 4.5 | 2.8 | 3.0 | 2.4 | 1.8 | 4.6 | 6.8 | 0.4 | 3.2 | 4.5 |
| Final sales | -0.4 | 3.7 | 0.4 | 1.8 | 2.0 | 0.7 | 2.4 | 5.1 | 6.8 | 1.5 | 1.2 | 4.5 |
| Priv. dom. final purchases | 0.5 | 2.9 | 0.6 | 1.4 | 2.1 | 1.6 | 2.2 | 4.3 | 6.2 | 0.8 | 1.4 | 4.2 |
| Personal cons. expenditures | 1.2 | 4.7 | 1.3 | 2.0 | 2.0 | 1.7 | 1.8 | 2.7 | 3.6 | 1.9 | 1.8 | 2.7 |
| Durables | 0.3 | 2.8 | -0.8 | 0.4 | 1.2 | -0.2 | -0.0 | 1.6 | 1.4 | 0.9 | 0.1 | 0.8 |
| Nondurables | 0.5 | 1.0 | 0.8 | 0.2 | -0.1 | 1.0 | 1.0 | 0.3 | 1.4 | 0.4 | 0.5 | 0.9 |
| Services | 0.5 | 1.0 | 1.4 | 1.5 | 1.0 | 0.9 | 0.9 | 0.8 | 0.8 | 0.7 | 1.2 | 0.9 |
| Business fixed investment | -0.8 | -1.6 | -1.1 | -1.1 | -0.1 | -0.3 | -0.0 | 1.1 | 1.5 | -1.2 | -0.6 | 0.9 |
| Equipment & Software | -1.0 | -0.4 | -0.5 | -0.4 | 0.3 | -0.2 | 0.3 | 0.8 | 1.5 | -0.8 | -0.2 | 0.9 |
| Nonres. structures | 0.2 | -1.3 | -0.6 | -0.7 | -0.5 | -0.2 | -0.3 | 0.3 | -0.0 | -0.4 | -0.5 | 0.0 |
| Residential structures | 0.1 | -0.2 | 0.4 | 0.5 | 0.1 | 0.2 | 0.4 | 0.4 | 1.1 | 0.1 | 0.3 | 0.6 |
| Net exports | -0.6 | -0.7 | -1.1 | -0.5 | -0.4 | -1.7 | 0.1 | -0.5 | 0.6 | -0.2 | -0.9 | -0.1 |
| Exports | -2.0 | -1.1 | 0.4 | 1.0 | 0.3 | -0.4 | -0.2 | -0.2 | 1.0 | -1.3 | 0.3 | 0.6 |
| Imports | 1.5 | 0.5 | -1.5 | -1.5 | -0.7 | -1.3 | 0.3 | -0.3 | -0.4 | 1.1 | -1.3 | -0.7 |
| Government cons. & invest. | -0.3 | 1.5 | 0.9 | 0.8 | 0.4 | 0.8 | 0.1 | 1.4 | 0.0 | 0.9 | 0.7 | 0.4 |
| Federal | 0.0 | 0.5 | 0.5 | 0.8 | 0.2 | 0.6 | 0.0 | 1.4 | -0.2 | 0.4 | 0.5 | 0.4 |
| Defense | 0.1 | 0.5 | 0.2 | 0.5 | 0.1 | 0.5 | -0.1 | 1.5 | -0.4 | 0.2 | 0.3 | 0.4 |
| Nondefense | -0.1 | 0.1 | 0.3 | 0.3 | 0.1 | 0.0 | 0.2 | -0.1 | 0.1 | 0.1 | 0.2 | -0.0 |
| State and local | -0.3 | 1.0 | 0.4 | 0.0 | 0.2 | 0.2 | 0.0 | -0.1 | 0.3 | 0.5 | 0.2 | 0.1 |
| Change in bus. inventories | -1.0 | -2.1 | 3.1 | 0.6 | 0.6 | 0.1 | -0.5 | -1.0 | 0.6 | -1.3 | 1.1 | -0.1 |
| Nonfarm | -1.1 | -1.9 | 2.7 | 1.1 | 0.4 | 0.1 | -0.5 | -0.9 | 0.5 | -1.2 | 1.0 | -0.2 |
| Farm | 0.1 | -0.2 | 0.4 | -0.5 | 0.2 | 0.0 | 0.1 | -0.1 | 0.1 | -0.1 | 0.0 | 0.1 |

Note: Components may not sum to totals because of rounding.

August 5, 2004

Strictly Confidential <FR>
 Class II FOMC
 CONTRIBUTIONS TO GROWTH IN REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS

| Item | Projected | | | | | | | | | | | | Projected | |
|-----------------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|---------------|---------------|---------------|---------------|---------------|
| | 2003 Q4 | 2004 Q1 | 2004 Q2 | 2004 Q3 | 2004 Q4 | 2005 Q1 | 2005 Q2 | 2005 Q3 | 2005 Q4 | 2004/ 02Q4 | 2004/ 03Q4 | 2004/ 04Q4 | 2004/ 05Q4 | 2004/ 06Q4 |
| Real GDP | 4.2 | 4.5 | 3.1 | 3.9 | 4.7 | 3.9 | 3.6 | 3.6 | 3.6 | 4.4 | 4.1 | 4.1 | 3.6 | 3.6 |
| Gross dom. purchases | 4.9 | 5.3 | 3.3 | 4.1 | 5.4 | 4.2 | 3.7 | 4.0 | 4.3 | 4.5 | 4.5 | 4.5 | 4.1 | 4.1 |
| Final sales | 3.7 | 3.3 | 2.8 | 4.4 | 4.1 | 2.9 | 4.5 | 3.9 | 3.7 | 4.5 | 3.7 | 3.7 | 3.7 | 3.7 |
| Priv. dom. final purchases | 4.1 | 3.6 | 2.5 | 4.1 | 4.5 | 2.9 | 4.2 | 4.0 | 4.0 | 4.2 | 3.7 | 3.7 | 3.8 | 3.8 |
| Personal cons. expenditures | 2.5 | 2.9 | 0.7 | 2.9 | 3.1 | 2.8 | 2.8 | 2.6 | 2.6 | 2.7 | 2.4 | 2.4 | 2.7 | 2.7 |
| Durables | 0.3 | 0.2 | -0.2 | 1.0 | 0.7 | 0.6 | 0.6 | 0.5 | 0.6 | 0.8 | 0.4 | 0.4 | 0.6 | 0.6 |
| Nondurables | 1.0 | 1.3 | -0.0 | 0.7 | 1.0 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 | 0.7 | 0.7 | 0.9 | 0.9 |
| Services | 1.2 | 1.4 | 1.0 | 1.2 | 1.4 | 1.3 | 1.3 | 1.2 | 1.1 | 0.9 | 1.2 | 1.2 | 1.2 | 1.2 |
| Business fixed investment | 1.1 | 0.4 | 0.9 | 1.3 | 1.7 | 0.1 | 1.3 | 1.3 | 1.4 | 0.9 | 1.1 | 1.1 | 1.0 | 1.0 |
| Equipment & Software | 0.9 | 0.6 | 0.8 | 1.2 | 1.6 | -0.0 | 1.2 | 1.1 | 1.2 | 0.9 | 1.1 | 1.1 | 0.9 | 0.9 |
| Nonres. structures | 0.2 | -0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 | 0.0 | 0.0 | 0.0 | 0.2 | 0.2 |
| Residential structures | 0.5 | 0.3 | 0.9 | -0.1 | -0.3 | -0.1 | 0.1 | 0.0 | 0.0 | 0.6 | 0.2 | 0.2 | 0.0 | 0.0 |
| Net exports | -0.7 | -0.8 | -0.2 | -0.2 | -0.7 | -0.3 | -0.1 | -0.5 | -0.7 | -0.1 | -0.5 | -0.5 | -0.4 | -0.4 |
| Exports | 1.6 | 0.7 | 1.2 | 0.9 | 1.1 | 0.6 | 0.8 | 0.8 | 0.9 | 0.6 | 1.0 | 1.0 | 0.8 | 0.8 |
| Imports | -2.2 | -1.5 | -1.4 | -1.1 | -1.7 | -0.9 | -0.9 | -1.3 | -1.7 | -0.7 | -1.4 | -1.4 | -1.2 | -1.2 |
| Government cons. & invest. | 0.3 | 0.5 | 0.5 | 0.5 | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| Federal | 0.3 | 0.5 | 0.2 | 0.3 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.4 | 0.3 | 0.3 | 0.1 | 0.1 |
| Defense | 0.5 | 0.5 | 0.1 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.4 | 0.2 | 0.2 | 0.1 | 0.1 |
| Nondefense | -0.2 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | -0.0 | 0.1 | 0.1 | 0.1 | 0.1 |
| State and local | -0.0 | 0.0 | 0.3 | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 | 0.1 | 0.2 | 0.2 | 0.3 | 0.3 |
| Change in bus. inventories | 0.5 | 1.2 | 0.3 | -0.4 | 0.6 | 1.0 | -0.9 | -0.3 | -0.1 | -0.1 | 0.4 | 0.4 | -0.1 | -0.1 |
| Nonfarm | 0.3 | 1.1 | 0.4 | -0.6 | 0.5 | 1.0 | -0.9 | -0.3 | -0.1 | -0.2 | 0.4 | 0.4 | -0.1 | -0.1 |
| Farm | 0.2 | 0.1 | -0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |

Note: Components may not sum to totals because of rounding.

Staff Projections of Federal Sector Accounts and Related Items
(Billions of dollars except as noted)

August 5, 2004

| Item | Fiscal year | | | | 2003 | | | | 2004 | | | | 2005 | | | |
|-------------------------------------------------|-------------------------|-------------------|------|------|-----------------|-----------------|-----------------|-----------------|-----------------|------|------|------|------|------|------|------|
| | 2002 ^a | 2003 ^a | 2004 | 2005 | Q1 ^a | Q2 ^a | Q3 ^a | Q4 ^a | Q1 ^a | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| | Not seasonally adjusted | | | | | | | | | | | | | | | |
| Unified budget | | | | | | | | | | | | | | | | |
| Receipts ¹ | 1853 | 1782 | 1863 | 2060 | 398 | 528 | 429 | 441 | 410 | 550 | 462 | 468 | 443 | 638 | 511 | 513 |
| Outlays ¹ | 2011 | 2156 | 2291 | 2417 | 543 | 544 | 534 | 571 | 580 | 576 | 565 | 607 | 607 | 600 | 603 | 625 |
| Surplus/deficit ¹ | -158 | -374 | -429 | -358 | -145 | -17 | -105 | -130 | -171 | -26 | -102 | -139 | -165 | 38 | -93 | -112 |
| On-budget | -317 | -535 | -587 | -537 | -169 | -91 | -113 | -180 | -193 | -99 | -116 | -183 | -202 | -43 | -109 | -159 |
| Off-budget | 160 | 161 | 159 | 179 | 24 | 75 | 9 | 50 | 23 | 73 | 13 | 44 | 38 | 81 | 17 | 47 |
| Means of financing | | | | | | | | | | | | | | | | |
| Borrowing | 221 | 374 | 404 | 389 | 64 | 106 | 108 | 119 | 136 | 41 | 109 | 142 | 151 | 1 | 95 | 92 |
| Cash decrease | -17 | 26 | -0 | -10 | 20 | -17 | -5 | 2 | 12 | -23 | 9 | -1 | 6 | -30 | 15 | 15 |
| Other ² | -46 | -25 | 25 | -22 | 62 | -73 | 2 | 10 | 23 | 8 | -16 | -3 | 7 | -9 | -17 | 5 |
| Cash operating balance, end of period | 61 | 35 | 35 | 45 | 13 | 30 | 35 | 33 | 21 | 45 | 35 | 36 | 30 | 60 | 45 | 30 |
| NIPA federal sector | | | | | | | | | | | | | | | | |
| Receipts | 1886 | 1863 | 1939 | 2161 | 1889 | 1903 | 1816 | 1901 | 1922 | 1946 | 1987 | 2032 | 2163 | 2203 | 2246 | 2270 |
| Expenditures | 2066 | 2209 | 2315 | 2424 | 2170 | 2267 | 2249 | 2280 | 2306 | 2335 | 2339 | 2368 | 2421 | 2438 | 2470 | 2507 |
| Consumption expenditures | 575 | 646 | 690 | 719 | 634 | 666 | 663 | 671 | 691 | 700 | 699 | 704 | 719 | 724 | 728 | 733 |
| Defense | 369 | 425 | 464 | 479 | 410 | 447 | 437 | 450 | 465 | 474 | 467 | 470 | 479 | 482 | 485 | 488 |
| Nondefense | 205 | 221 | 226 | 240 | 224 | 219 | 226 | 221 | 226 | 226 | 231 | 234 | 240 | 242 | 243 | 245 |
| Other spending | 1491 | 1563 | 1625 | 1705 | 1536 | 1601 | 1586 | 1609 | 1615 | 1635 | 1640 | 1664 | 1702 | 1714 | 1742 | 1774 |
| Current account surplus | -180 | -345 | -376 | -263 | -282 | -364 | -433 | -379 | -384 | -389 | -352 | -335 | -258 | -235 | -224 | -237 |
| Gross investment | 87 | 92 | 102 | 106 | 89 | 95 | 94 | 96 | 102 | 104 | 105 | 105 | 106 | 106 | 107 | 108 |
| Gross saving less gross investment ³ | -178 | -347 | -386 | -275 | -281 | -370 | -436 | -385 | -395 | -401 | -364 | -347 | -269 | -246 | -236 | -249 |
| Fiscal indicators⁴ | | | | | | | | | | | | | | | | |
| High-employment (HEB) surplus/deficit | -134 | -272 | -336 | -244 | -200 | -284 | -371 | -322 | -348 | -355 | -320 | -312 | -238 | -218 | -209 | -223 |
| Change in HEB, percent of potential GDP | 2.0 | 1.2 | 0.4 | -0.9 | -0.3 | 0.7 | 0.7 | -0.5 | 0.2 | 0.0 | -0.3 | -0.1 | -0.6 | -0.2 | -0.1 | 0.1 |
| Fiscal impetus (FI) percent of GDP | 1.0 | 1.0 | 1.0 | -0.2 | 0.1 | 0.4 | 0.3 | 0.3 | 0.3 | 0.1 | 0.1 | 0.1 | -0.4 | 0.0 | 0.0 | 0.0 |

1. OMB's July 2004 baseline surplus estimates are -\$444 billion in FY 2004 and -\$292 billion in FY 2005 and surplus estimates under enactment of its proposed policies are -\$445 billion and -\$331 billion, respectively. CBO's March 2004 baseline surplus estimates are -\$477 billion in FY 2004 and -\$363 billion in FY 2005. Budget receipts, outlays, and surplus/deficit include corresponding social security (OASDI) categories. The OASDI surplus and the Postal Service surplus are excluded from the on-budget surplus and shown separately as off-budget, as classified under current law.

2. Other means of financing are checks issued less checks paid, accrued items, and changes in other financial assets and liabilities.

3. Gross saving is the current account surplus plus consumption of fixed capital of the general government as well as government enterprises.

4. HEB is gross saving less gross investment (NIPA) of the federal government in current dollars, with cyclically sensitive receipts and outlays adjusted to the staff's measure of potential output and the NAIRU. Quarterly figures for change in HEB and FI are not at annual rates. The sign on Change in HEB, as a percent of nominal potential GDP, is reversed. FI is the weighted difference of discretionary changes in federal spending and taxes in chained (2000) dollars, scaled by real GDP. The annual FI estimates are on a calendar year basis. Also, for FI and the change in HEB, positive values indicate aggregate demand stimulus.

a--Actual

Strictly Confidential (FR) **Change in Debt of the Domestic Nonfinancial Sectors** **August 5, 2004**
Class II FOMC **(Percent)**

| Period ¹ | Total | Federal government | Nonfederal | | | | | Memo: Nominal GDP | |
|---------------------|-------|--------------------|------------|------------|----------------|----------|-----------------------------|-------------------|-----------------|
| | | | Total | Households | | Business | State and local governments | | |
| | | | | Total | Home mortgages | | | | Consumer credit |
| <i>Year</i> | | | | | | | | | |
| 1998 | 6.9 | -1.4 | 9.6 | 8.0 | 8.2 | 7.7 | 12.2 | 6.3 | 5.7 |
| 1999 | 6.3 | -1.9 | 8.8 | 8.1 | 9.1 | 7.4 | 10.6 | 3.4 | 6.3 |
| 2000 | 4.9 | -8.0 | 8.4 | 8.7 | 8.4 | 10.7 | 9.4 | 1.3 | 4.6 |
| 2001 | 6.2 | -0.2 | 7.7 | 9.0 | 9.9 | 8.0 | 6.1 | 8.9 | 2.7 |
| 2002 | 6.9 | 7.6 | 6.8 | 9.6 | 12.0 | 4.1 | 2.9 | 11.1 | 3.8 |
| 2003 | 8.1 | 10.9 | 7.5 | 10.2 | 12.7 | 4.3 | 4.3 | 8.2 | 6.2 |
| 2004 | 7.7 | 10.6 | 7.1 | 9.2 | 10.6 | 5.6 | 4.7 | 6.0 | 6.1 |
| 2005 | 6.9 | 7.6 | 6.8 | 7.6 | 8.2 | 6.3 | 6.3 | 3.9 | 5.4 |
| <i>Quarter</i> | | | | | | | | | |
| 2003:1 | 6.9 | 4.5 | 7.4 | 10.8 | 13.4 | 4.1 | 3.8 | 5.7 | 4.9 |
| 2 | 11.2 | 20.4 | 9.2 | 11.4 | 13.6 | 5.2 | 5.9 | 12.4 | 5.3 |
| 3 | 7.1 | 8.2 | 6.9 | 10.0 | 12.0 | 5.3 | 3.2 | 6.1 | 8.8 |
| 4 | 6.4 | 9.0 | 5.8 | 7.1 | 9.5 | 2.2 | 3.9 | 7.6 | 5.7 |
| 2004:1 | 8.6 | 11.6 | 8.0 | 10.9 | 12.5 | 6.1 | 4.1 | 9.6 | 7.4 |
| 2 | 7.4 | 11.2 | 6.5 | 8.8 | 10.5 | 3.9 | 3.9 | 5.6 | 6.4 |
| 3 | 6.8 | 7.3 | 6.6 | 8.4 | 9.5 | 5.7 | 4.9 | 4.1 | 4.9 |
| 4 | 7.3 | 10.6 | 6.5 | 7.6 | 8.3 | 6.1 | 5.6 | 4.3 | 6.0 |
| 2005:1 | 7.6 | 11.8 | 6.7 | 7.5 | 8.0 | 6.3 | 6.1 | 4.3 | 5.9 |
| 2 | 6.5 | 6.7 | 6.5 | 7.4 | 8.0 | 6.1 | 5.9 | 3.8 | 5.2 |
| 3 | 6.4 | 5.6 | 6.6 | 7.4 | 8.0 | 6.1 | 6.2 | 3.7 | 5.2 |
| 4 | 6.4 | 5.5 | 6.6 | 7.4 | 8.0 | 6.0 | 6.3 | 3.5 | 5.1 |

Note. Quarterly data are at seasonally adjusted annual rates.

1. Data after 2004:Q1 are staff projections. Changes are measured from end of the preceding period to end of period indicated except for annual nominal GDP growth, which is calculated from Q4 to Q4.

2.6.3 FOF

Strictly Confidential (FR) **Flow of Funds Projections: Highlights** **August 5, 2004**
Class II FOMIC **(Billions of dollars at seasonally adjusted annual rates except as noted)**

| Category | 2002 | | | | 2003 | | | | 2004 | | | | 2005 | | | |
|----------------------------------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--|--|
| | 2002 | 2003 | 2004 | 2005 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | |
| <i>Net funds raised by domestic nonfinancial sectors</i> | | | | | | | | | | | | | | | | |
| 1 Total | 1293.9 | 1616.2 | 1598.2 | 1561.8 | 1486.1 | 1334.0 | 1824.2 | 1560.4 | 1457.3 | 1550.8 | 1673.0 | 1513.7 | 1515.6 | 1544.9 | | |
| 2 Net equity issuance | -41.6 | -57.3 | -126.9 | -101.0 | -44.9 | -67.0 | -104.0 | -123.7 | -114.0 | -166.0 | -156.0 | -86.0 | -81.0 | -81.0 | | |
| 3 Net debt issuance | 1335.5 | 1673.5 | 1725.1 | 1662.8 | 1531.0 | 1401.0 | 1928.2 | 1684.1 | 1571.3 | 1716.8 | 1829.0 | 1599.7 | 1596.6 | 1625.9 | | |
| <i>Borrowing sectors</i> | | | | | | | | | | | | | | | | |
| Nonfinancial business | | | | | | | | | | | | | | | | |
| 4 Financing gap ¹ | 35.1 | -17.0 | 28.3 | 171.2 | -50.0 | -30.9 | -10.6 | -26.5 | -19.1 | 169.3 | 136.4 | 150.7 | 184.7 | 212.9 | | |
| 5 Net equity issuance | -41.6 | -57.3 | -126.9 | -101.0 | -44.9 | -67.0 | -104.0 | -123.7 | -114.0 | -166.0 | -156.0 | -86.0 | -81.0 | -81.0 | | |
| 6 Credit market borrowing | 197.8 | 302.2 | 349.5 | 488.0 | 231.1 | 282.9 | 303.3 | 294.5 | 372.8 | 427.1 | 474.5 | 465.8 | 496.5 | 515.1 | | |
| Households | | | | | | | | | | | | | | | | |
| 7 Net borrowing ² | 736.3 | 857.6 | 854.7 | 771.6 | 890.7 | 648.4 | 1009.1 | 833.8 | 818.3 | 757.7 | 755.5 | 763.4 | 777.7 | 789.8 | | |
| 8 Home mortgages | 638.4 | 756.1 | 711.6 | 611.5 | 765.6 | 625.6 | 840.2 | 729.6 | 673.5 | 603.3 | 594.0 | 605.2 | 617.3 | 629.5 | | |
| 9 Consumer credit | 77.4 | 83.0 | 113.4 | 134.9 | 104.4 | 45.1 | 124.3 | 81.1 | 119.1 | 129.2 | 135.5 | 133.3 | 135.4 | 135.3 | | |
| 10 Debt/DPI (percent) ³ | 102.5 | 108.3 | 111.8 | 114.8 | 108.6 | 110.3 | 111.2 | 112.2 | 112.9 | 112.1 | 114.0 | 114.5 | 115.0 | 115.4 | | |
| State and local governments | | | | | | | | | | | | | | | | |
| 11 Net borrowing | 143.9 | 117.6 | 94.1 | 63.8 | 91.6 | 116.2 | 149.7 | 89.3 | 66.8 | 70.8 | 70.8 | 62.8 | 62.8 | 58.8 | | |
| 12 Current surplus ⁴ | 148.9 | 176.6 | 162.7 | 172.8 | 193.2 | 215.8 | 162.9 | 165.2 | 155.1 | 167.5 | 170.8 | 169.5 | 173.3 | 177.6 | | |
| Federal government | | | | | | | | | | | | | | | | |
| 13 Net borrowing | 257.5 | 396.0 | 426.8 | 339.5 | 317.5 | 353.4 | 466.0 | 466.5 | 313.4 | 461.2 | 528.3 | 307.8 | 259.6 | 262.2 | | |
| 14 Net borrowing (n.s.a.) | 257.5 | 396.0 | 426.8 | 339.5 | 107.6 | 118.6 | 135.9 | 40.7 | 108.6 | 141.7 | 151.4 | 1.0 | 95.1 | 92.0 | | |
| 15 Unified deficit (n.s.a.) | 230.7 | 396.1 | 437.1 | 331.2 | 104.5 | 130.2 | 170.8 | 25.7 | 102.1 | 138.5 | 164.6 | -38.0 | 92.6 | 111.9 | | |
| <i>Depository institutions</i> | | | | | | | | | | | | | | | | |
| 16 Funds supplied | 482.5 | 477.1 | 558.6 | 547.8 | 147.4 | 385.3 | 1096.2 | 375.2 | 298.2 | 464.7 | 621.0 | 480.2 | 585.6 | 504.5 | | |
| Memo (percentage of GDP) | | | | | | | | | | | | | | | | |
| 17 Domestic nonfinancial debt ⁵ | 189.8 | 194.8 | 197.6 | 200.9 | 195.2 | 196.0 | 196.4 | 197.3 | 198.4 | 199.0 | 199.8 | 200.7 | 201.4 | 202.1 | | |
| 18 Domestic nonfinancial borrowing | 12.7 | 15.2 | 14.7 | 13.4 | 13.8 | 12.4 | 16.8 | 14.5 | 13.3 | 14.4 | 15.1 | 13.0 | 12.8 | 12.9 | | |
| 19 Federal government ⁶ | 2.5 | 3.6 | 3.6 | 2.7 | 2.9 | 3.1 | 4.1 | 4.0 | 2.7 | 3.9 | 4.4 | 2.5 | 2.1 | 2.1 | | |
| 20 Nonfederal | 10.3 | 11.6 | 11.1 | 10.7 | 10.9 | 9.3 | 12.7 | 10.5 | 10.7 | 10.5 | 10.7 | 10.5 | 10.7 | 10.8 | | |

Note. Data after 2004:Q1 are staff projections.

1. For corporations: Excess of capital expenditures over U.S. internal funds.

2. Includes change in liabilities not shown in lines 8 and 9.

3. Average debt levels in the period (computed as the average of period-end debt positions)

divided by disposable personal income.

2.6.4 FOF

4. NIPA state and local government saving plus consumption of fixed capital and net capital transfers.

5. Average debt levels in the period (computed as the average of period-end debt positions) divided by nominal GDP.

6. Excludes government-insured mortgage pool securities.

n.s.a. Not seasonally adjusted.

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International Developments

Oil prices have risen significantly since the June FOMC meeting, because of concerns about supply, particularly in Russia and Iraq, as well as persistently strong global demand. Economic growth in the foreign economies appears to have remained brisk on average during the second quarter. We project that the pace of expansion will moderate during the second half of this year and expect it to continue at 3½ percent in 2005. Headline inflation jumped in the second quarter, mainly as a result of higher energy prices. Non-energy commodity prices peaked in the second quarter and recently some, particularly agricultural commodity prices, have reversed part of their previous steep rises. So far, we have seen only a limited pickup in core inflation rates in most countries, and wage growth generally has remained subdued. We expect inflation to settle back down in coming quarters as oil and other commodity prices decline somewhat and excess capacity persists in many countries.

Summary of Staff Projections
(Percent change from end of previous period, s.a.a.r.)

| Indicator | 2003 | 2004: Q1 | Projection | | |
|--------------------|------------|-------------|------------|------------|------------|
| | | | 2004 | | 2005 |
| | | | Q2 | H2 | |
| Foreign output | 2.8 | 4.3 | 4.0 | 3.5 | 3.5 |
| <i>Previous GB</i> | <i>2.7</i> | <i>4.3</i> | <i>4.0</i> | <i>3.6</i> | <i>3.5</i> |
| Foreign CPI | 2.1 | 2.5 | 3.1 | 2.6 | 2.1 |
| <i>Previous GB</i> | <i>2.1</i> | <i>2.5</i> | <i>2.9</i> | <i>2.3</i> | <i>2.1</i> |

NOTE. Changes for years are measured as Q4/Q4; for half-years, Q2/Q4 or Q4/Q2.

Our projections for foreign growth are just a touch weaker than those in the June Greenbook, because we believe that changes in underlying fundamentals have had roughly offsetting effects on the outlook. On the one hand, the staff forecast for U.S. growth this year is less robust than in the previous forecast, and the projected path of oil prices is higher than in our last forecast. On the other hand, data have been coming in on the upper end of our expectations for the euro area, the United Kingdom, and several emerging market economies. Growth in China fell sharply in the second quarter in response to the Chinese government's measures aimed at curtailing investment, but we expect a rebound in activity once some of these measures are eased.

The exchange value of the dollar fell against most major foreign currencies early in the period in response to weaker-than-expected U.S. employment and core CPI data for June.

The dollar reversed its decline after the Chairman's congressional testimony in July, which gave market participants a more upbeat assessment of U.S. economic prospects, and some subsequent U.S. data releases. On balance since the June FOMC meeting, the dollar has changed little in terms of the staff's major currencies index. Our forecast for the broad real dollar is little changed from that in the previous Greenbook. We continue to expect that the burden of financing our large and growing external deficit will result in some dollar depreciation over the forecast period.

After subtracting nearly $\frac{1}{2}$ percentage point from U.S. GDP growth in the first half of this year, net exports are projected to deduct slightly less from growth in the second half of this year and in 2005. Buoyant growth abroad should help support exports while the moderation in U.S. demand slows imports somewhat during the forecast period. The U.S. current account deficit is expected to expand from about \$590 billion (annual rate) in the second quarter of 2004 to \$725 billion in the fourth quarter of 2005, nearly 6 percent of GDP.

Oil Prices

Oil prices have been volatile and have increased markedly over the intermeeting period, with the spot price of West Texas intermediate (WTI) rising from an average of \$38 per barrel in June to more than \$44 per barrel late in the period, before closing at \$42.83 per barrel on August 4. Prices for oil futures contracts have also moved up appreciably, leading us to mark up our oil price projection throughout the forecast period.

The major development in the world oil market since the June FOMC meeting has been the Russian government's intensified crackdown on Yukos, Russia's largest oil company. In late July, Russian authorities seized Yukos's main production subsidiary, which produces about 1 million barrels of oil per day. The government reportedly plans to sell it along with other Yukos assets, and possibly reinstitute some state control. Whether these developments will disrupt Russian oil production in the near term is still unclear.

Concerns during the intermeeting period about oil supply have not been limited to Russia; Iraq, Nigeria, and Venezuela also remain sources of considerable uncertainty. Because Saudi Arabia and several other members of OPEC have ramped up oil production over the past few months, relatively little spare production capacity remains to compensate for a potential supply disruption. Continued strong world demand for oil has also contributed to the recent run-up in oil prices. In early July, the International Energy Agency considerably revised up its estimate of world oil consumption for the first half of

2004. With world economic growth projected to remain robust, oil demand should continue to be strong over the forecast period.

The projected path of oil prices, in line with recent quotes from futures markets, calls for the spot price of WTI to decline to \$38.40 per barrel by the fourth quarter of 2005. Compared with the previous Greenbook, this projection is about \$5 per barrel higher in the near term and about \$4 per barrel higher at the end of the forecast period. With current estimates suggesting that world oil production is running ahead of consumption so that oil inventories may well be rising, expectations for a decline in oil prices seem sensible. Nonetheless, the recent upward revision to global oil consumption highlights the possibility that consumption may prove stronger--and inventories leaner--than analysts currently anticipate. In addition, market-based measures of uncertainty about oil prices have increased significantly in recent weeks. For this reason, the alternative simulation in this section of the Greenbook considers the effects of a sustained increase in oil prices to \$50 per barrel.

International Financial Markets

Over the first half of the intermeeting period, the major currencies index of the exchange value of the dollar declined more than 2 percent, as interest rate differentials moved against the dollar in reaction to the weaker-than-expected U.S. data releases. The dollar reversed these losses during the latter part of July, in part in response to the Chairman's presentation of the semi-annual monetary policy report to the Congress. On balance, the dollar's major currencies index was little changed over the intermeeting period. The dollar depreciated 2¼ percent on net against the Canadian dollar and registered small changes against the major European currencies, but it appreciated 3 percent against the yen. The yen weakened as Japanese officials reiterated their intention to maintain the easy stance of monetary policy and amid concerns that Japan's economic expansion could be particularly hard hit by slower growth in China.

The dollar's trade-weighted exchange value against the currencies of our other important trading partners was also little changed on balance over the intermeeting period, as net depreciations against the Mexican peso and Brazilian *real* were offset by appreciations against the Argentine peso, Korean won, and Taiwanese dollar. Brazilian and Mexican EMBI+ spreads narrowed on net over the intermeeting period.

The broad real dollar in the current quarter is projected to be a touch below the level we wrote down in the June Greenbook and to decline less than 1 percent over the rest of the

forecast period. The projected path for the broad real dollar tilts down slightly more than in the previous Greenbook, reflecting the lower path for U.S. interest rates assumed in this forecast.

In the major foreign industrial countries, long-term interest rates fell 10 to 30 basis points over the intermeeting period, following U.S. long-term rates down. Share price indexes in most of these countries slipped, registering declines of up to 7 percent. The Bank of England's Monetary Policy Committee (MPC) raised official interest rates 25 basis points on August 5; this hike was the fifth since November.

. The Desk did not intervene over the period for the accounts of the System or the Treasury.

Foreign Industrial Countries

We estimate that growth in the foreign industrial countries picked up to an annual rate of 3½ percent in the second quarter, as faster growth in Canada and the United Kingdom outweighed a moderation in Japan. We expect growth to settle down to a rate around 2¾ percent over the remainder of the forecast period. After rising further in the third quarter, largely because of higher oil prices, twelve-month headline inflation rates should inch down in most foreign industrial countries next year, except in Japan.

Data suggest Japanese real GDP grew strongly in the second quarter, but growth moderated from the rapid pace of previous quarters. Continued strength in consumption should diminish as saving rates begin to reverse their previous declines, while slower growth in emerging Asia tempers export growth. As a result, we project that GDP will continue to decelerate over the forecast period. Twelve-month CPI inflation is projected to become positive later this year for the first time since 1999. Nonetheless, inflationary pressures should remain weak over the forecast period, and we expect the Bank of Japan to maintain its quantitative easing policy through the end of 2005.

In the euro area, recent data suggest that real GDP growth edged down to an annual rate of 2 percent in the second quarter following a first-quarter pace of 2¼ percent. Growth is expected to taper off to slightly below 2 percent in the second half of 2004, as domestic demand remains sluggish, particularly in Germany, and as export growth slows from its recent strong pace. Growth is then expected to pick up slightly in 2005 as domestic demand firms. We project that twelve-month inflation, boosted by higher oil and

administered prices, will remain above the ECB's 2 percent target through early next year. However, we assume that the ECB will hold off tightening policy until economic activity gains some momentum.

In the United Kingdom, real GDP grew 3.8 percent in the second quarter, as consumer spending again advanced strongly. We continue to expect that consumption will slow, partly in response to rising interest rates and an assumed deceleration of house prices (though this has yet to materialize). In consequence, real GDP growth is projected to step down in the second half of this year and slow to just above 2½ percent by the end of 2005. We assume that the Bank of England will continue its gradual tightening of monetary policy and that this tightening will be sufficient to keep inflation from moving above the 2 percent target rate.

Indicators suggest that Canadian real GDP grew around 4¼ percent in the second quarter, led by strong exports and a spurt in business fixed investment. We expect growth to slow to around 3¼ percent in the second half, as export growth moderates from the blistering pace of the first half and domestic demand remains steady. The Bank of Canada is assumed to begin tightening monetary policy by the end of the year, consistent with keeping core inflation around the 2 percent midpoint of the Bank's inflation target range. Headline inflation is expected to peak around 2½ percent in the fourth quarter.

Other Countries

We estimate that output growth in emerging Asia, on average, slowed from 7½ percent in the first quarter to about 5 percent in the second quarter. The slowdown largely resulted from the sharp deceleration in Chinese activity, following policy measures taken to temper the very fast pace of investment. Chinese authorities have stated that they will partially unwind the quantitative controls that were imposed earlier this year, so we project a bounceback in Chinese growth in the second half. This is expected to offset some slowing in several other Asian economies, and thus we predict that output growth in the region will remain around 5 percent over the forecast period. Notwithstanding the downward revision to the U.S. growth forecast and higher oil prices, we expect activity in the region to continue to benefit from strong high-tech demand.

Real GDP growth in China slowed to 2¾ percent at an annual rate (according to staff estimates) in the second quarter, considerably lower than the double-digit pace the economy had maintained since the end of the SARS epidemic last year. The measures that the Chinese authorities took to tighten credit and slow investment seem to have been

effective. Personal consumption, in contrast, appears to have picked up, and growth of both exports and imports has continued to be strong. Taken together, developments have been consistent with a “soft” landing scenario for China. We project that growth will average about 7½ percent for the remainder of the forecast period, as we expect some controls to be loosened. Activity in Taiwan and Hong Kong has remained robust, supported by both Chinese activity and global high-tech demand. For Korea, although external demand has remained strong, we have marked down projected growth in the second half of 2004, as domestic demand has been weak and is expected to continue to be constrained by high consumer debt burdens.

In Latin America, real GDP grew an estimated 4¾ percent in the second quarter. We estimate that Mexican GDP growth slowed slightly in the second quarter to about 5 percent, consistent with recent data that suggested that industrial production and retail sales remained strong, on balance. We expect Mexican growth to moderate to 4¼ percent next year, in line with U.S. growth. In Brazil, rising industrial production, falling unemployment, and strong trade surpluses suggest continued expansion.

Driven largely by increases in food and fuel prices, consumer price inflation in emerging-market economies rose in the second quarter. We expect average inflation in emerging Asian economies to peak at a four-quarter pace of 4 percent in the current quarter and then to fall to about 2¼ percent by the end of 2005, as food and fuel prices are expected to recede. In part because of lagged effects of higher oil prices, inflation is expected to move above 4½ percent later this year in Latin America and then ebb to 4 percent by the end of 2005.

Prices of Internationally Traded Goods

In the second quarter, prices of imported core goods increased at an annual rate of 3½ percent, markedly less than in the first quarter. In part, the deceleration in import prices stems from the dollar’s appreciation earlier this year and the lessening of the effects of its previous depreciation. The rise in core import prices so far this year has been driven largely by higher primary commodity prices, which have shown through to elevated import prices of non-oil industrial supplies and foods. Prices for other categories of imports have registered smaller increases. In the second half of this year, prices of imported core goods are expected to slow a bit to a rate of about 2¾ percent, as a result of the turndown in non-energy commodity prices. Next year, prices of imported core goods are projected to decelerate further and show little change for the year as commodity prices continue to reverse some of their previous rises. This projection is

nearly 1 percentage point lower than in the June Greenbook and results from weaker commodity prices and an adjustment for the January 1, 2005, phase-out of the Multi-Fiber Agreement. The elimination of this quota system is expected to reduce import prices of apparel products.

Staff Projections of Selected Trade Prices

(Percent change from end of previous period
except as noted, s.a.a.r.)

| Trade category | 2003 | 2004: Q1 | Projection | | |
|--------------------------|-------|-------------|------------|-------|-------|
| | | | 2004 | | 2005 |
| | | | Q2 | H2 | |
| <i>Exports</i> | | | | | |
| Core goods | 3.4 | 7.9 | 6.0 | 2.8 | 1.4 |
| <i>Imports</i> | | | | | |
| Non-oil core goods | 1.8 | 6.4 | 3.5 | 2.7 | -0.0 |
| Oil (dollars per barrel) | 27.74 | 30.91 | 34.59 | 39.42 | 35.53 |

NOTE. Prices for core exports and non-oil core imports, which exclude computers and semiconductors, are on a NIPA chain-weighted basis.

The price of imported oil for multi-quarter periods is the price for the final quarter of the period.

After rising strongly in the first quarter, prices of exported core goods went up at a slightly slower pace in the second quarter, partly because price increases for foods (especially soybeans) and industrial supplies moderated. Over the forecast period, prices of exported core goods are projected to decelerate, consistent with a moderation in domestic inflation.

Trade in Goods and Services

In the first quarter, real imports of goods and services grew at an annual rate of 10½ percent, marginally higher than the rate projected in the June Greenbook. We estimate that real imports of goods and services grew in the second quarter at a rate of 9½ percent, nearly 4 percentage points higher than projected at the time of the June Greenbook. May nominal imports came in stronger than we had expected, and previously published data for April were revised up. Core imports registered an increase of 15 percent, and imports of semiconductors, computers, and services also registered considerable gains. Offsetting these increases, oil imports plummeted, in part because of the effects of new seasonal adjustment factors.

Staff Projections for Trade in Goods and Services
(Percent change from end of previous period, s.a.a.r.)

| Measure | 2003 | 2004: Q1 | Projection | | |
|--------------------|------|-------------|------------|------|------|
| | | | 2004 | | 2005 |
| | | | Q2 | H2 | |
| Real exports | 6.1 | 7.3 | 12.4 | 10.0 | 7.6 |
| <i>Previous GB</i> | 6.4 | 7.4 | 7.4 | 10.2 | 8.0 |
| Real imports | 4.9 | 10.6 | 9.5 | 9.7 | 7.8 |
| <i>Previous GB</i> | 4.5 | 10.2 | 5.6 | 10.8 | 8.1 |

NOTE. Changes for years are measured as Q4/Q4; for half-years, Q2/Q4 or Q4/Q2.

In the second half of this year, import growth should remain at about its second-quarter pace. Core import growth should return to a more-sustainable rate, but anticipation of the expiration of partial-expensing provisions will likely boost imports of capital goods, including computers and semiconductors. We expect total real import growth to slow in 2005 as the removal of the investment incentive slows imports of computers, semiconductors, and other capital goods. U.S. GDP growth provides less impetus to core imports next year than in 2004, though this is offset by a boost coming from lower import price inflation. Over the next one and a half years, total import growth is somewhat below that projected in the June Greenbook, primarily because of slower U.S. GDP growth and somewhat more drag (in early 2005) from the expiration of partial expensing than assumed in the previous forecast.

Real exports of goods and services grew at a solid annual rate of 7¼ percent in the first quarter of this year, a pace marginally lower than we projected in the June Greenbook. For the second quarter, we estimate that real exports of goods and services grew at a pace of around 12½ percent, 5 percentage points more than the June Greenbook forecast. This upward revision reflects stronger-than-expected nominal export data for May as well as upwardly revised data for April. Core exports likely registered double-digit growth for the third straight quarter, partly from the effects of past dollar depreciation, and exported services grew rapidly as well. Conversely, exports of computers and semiconductors (which surged in the second half of last year) extended their first-quarter weakness into the second quarter.

We project that real exports of goods and services will grow at an annual rate of 10 percent in the second half of this year. Growth of core exports is projected to slow to

a pace that is more consistent with foreign growth and relative prices, but exports of computers and semiconductors are expected to rebound. In 2005, the growth of total real exports steps down to a pace of 7½ percent. This slowing reflects in part a lessening of the boost to core exports and services resulting from the previous depreciation of the dollar.

The expiration of the partial-expensing incentive mainly affects imports of capital goods, but it also influences U.S. exports of intermediate inputs used to produce those goods. Hence, we have built in a small boost to real export growth this year, followed by a drag in early 2005. As we have assumed a bit more drag on exports than in the previous Greenbook, our projection for total real export growth in 2005 is a touch lower.

Alternative Simulation

Our Greenbook forecast calls for oil prices to begin to decline in late 2004. However, destabilizing events in oil-producing regions may induce oil prices to rise significantly higher than in the baseline projection. Accordingly, in our alternative scenario, we used the perfect foresight version of the FRB/US model to consider the effects of a sustained rise to \$50 per barrel in the price of WTI crude oil. The shock begins in 2004:Q3, and we assume households and firms believe that the shock is permanent. Higher oil prices weaken consumer spending by depressing household disposable income, and they lower investment demand by reducing productive efficiency. Real GDP growth is nearly ½ percentage point lower in the second half of this year and in the first half of 2005, and slightly less in 2005:H2. The oil price shock also puts upward pressure on production costs and prices, causing the core PCE inflation rate to rise about 0.2 percentage point above baseline in 2005.

Alternative Simulation:
Oil Price Rises to \$50 per Barrel
 (Percent change from previous period, annual rate)

| Indicator and simulation | 2004: H2 | 2005 | |
|-----------------------------------------------------|-------------|------|-----|
| | | H1 | H2 |
| <i>U.S. real GDP</i> | | | |
| Baseline | 4.3 | 3.7 | 3.6 |
| Higher oil price | 3.9 | 3.3 | 3.3 |
| <i>U.S. PCE price excluding food and energy</i> | | | |
| Baseline | 1.7 | 1.5 | 1.4 |
| Higher oil price | 1.8 | 1.6 | 1.6 |

NOTE. H1 is Q2/Q4; H2 is Q4/Q2. In these simulations, the real federal funds rate remains unchanged from baseline.

August 5, 2004

Strictly Confidential (FR)
Class II FOMCOUTLOOK FOR FOREIGN REAL GDP AND CONSUMER PRICES: SELECTED COUNTRIES
(Percent, Q4 to Q4)

| Measure and country | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | Projected 2004 | Projected 2005 |
|----------------------|------|------|------|------|------|------|------|-------------------|-------------------|
| REAL GDP (1) | | | | | | | | | |
| ----- | | | | | | | | | |
| Total foreign | 4.2 | 1.5 | 5.0 | 4.3 | 0.3 | 3.0 | 2.8 | 3.8 | 3.5 |
| Industrial Countries | 3.4 | 2.7 | 4.4 | 3.6 | 0.7 | 2.7 | 1.9 | 3.0 | 2.8 |
| Of which: | | | | | | | | | |
| Canada | 4.4 | 4.4 | 5.9 | 4.1 | 1.4 | 3.8 | 1.7 | 3.3 | 3.4 |
| Japan | 0.4 | -1.2 | 0.4 | 3.9 | -2.2 | 1.8 | 3.5 | 3.7 | 2.1 |
| United Kingdom | 3.2 | 2.8 | 3.3 | 3.0 | 2.2 | 1.9 | 2.9 | 3.3 | 2.7 |
| Euro Area (2) | 3.2 | 2.0 | 3.9 | 2.7 | 0.7 | 1.1 | 0.7 | 2.0 | 2.0 |
| Germany | 1.7 | 0.7 | 3.4 | 1.9 | 0.5 | 0.5 | 0.1 | 1.5 | 1.5 |
| Developing Countries | 5.4 | -0.3 | 6.1 | 5.3 | -0.3 | 3.4 | 4.1 | 5.1 | 4.5 |
| Asia | 5.0 | -2.2 | 8.6 | 5.9 | 0.9 | 5.8 | 6.0 | 5.7 | 5.1 |
| Korea | 3.1 | -5.4 | 11.4 | 4.5 | 4.7 | 7.7 | 4.1 | 3.8 | 4.7 |
| China | 9.1 | 9.8 | 7.0 | 7.6 | 6.9 | 8.3 | 10.0 | 7.9 | 7.4 |
| Latin America | 6.2 | 1.2 | 4.2 | 4.4 | -1.3 | 1.4 | 2.2 | 4.7 | 4.0 |
| Mexico | 6.8 | 2.9 | 5.4 | 4.8 | -1.2 | 1.9 | 2.0 | 4.9 | 4.2 |
| Brazil | 2.5 | -1.6 | 3.4 | 3.8 | -0.8 | 3.8 | -0.1 | 3.8 | 3.0 |
| CONSUMER PRICES (3) | | | | | | | | | |
| ----- | | | | | | | | | |
| Industrial Countries | 1.5 | 0.9 | 1.1 | 1.7 | 0.9 | 2.1 | 1.3 | 1.7 | 1.4 |
| of which: | | | | | | | | | |
| Canada | 1.0 | 1.1 | 2.4 | 3.1 | 1.1 | 3.8 | 1.7 | 2.5 | 1.8 |
| Japan | 2.1 | 0.7 | -1.1 | -1.2 | -1.3 | -0.5 | -0.4 | 0.1 | 0.3 |
| United Kingdom (4) | 1.7 | 1.4 | 1.2 | 1.0 | 1.0 | 1.6 | 1.3 | 1.6 | 1.8 |
| Euro Area (2) | 1.5 | 0.8 | 1.5 | 2.5 | 2.1 | 2.3 | 2.0 | 2.1 | 1.8 |
| Germany | 1.5 | 0.3 | 1.1 | 1.7 | 1.5 | 1.2 | 1.2 | 1.6 | 1.3 |
| Developing Countries | 6.8 | 9.0 | 4.6 | 4.1 | 2.8 | 2.9 | 3.0 | 3.9 | 3.0 |
| Asia | 2.7 | 4.4 | 0.1 | 1.8 | 1.1 | 0.7 | 2.1 | 3.6 | 2.3 |
| Korea | 5.0 | 5.8 | 1.2 | 2.6 | 3.4 | 3.4 | 3.5 | 4.3 | 3.9 |
| China | 0.8 | -1.2 | -1.0 | 0.9 | -0.1 | -0.6 | 2.6 | 4.0 | 1.6 |
| Latin America | 15.5 | 15.4 | 12.5 | 8.4 | 5.3 | 6.4 | 4.9 | 4.6 | 4.1 |
| Mexico | 17.0 | 17.3 | 13.5 | 8.7 | 5.1 | 5.3 | 3.9 | 4.1 | 3.8 |
| Brazil | 4.6 | 2.0 | 8.4 | 6.4 | 7.5 | 10.7 | 11.5 | 6.9 | 5.2 |

1. Foreign GDP aggregates calculated using shares of U.S. exports.
2. Harmonized data for euro area from Eurostat.
3. Foreign CPI aggregates calculated using shares of U.S. non-oil imports.
4. CPI excluding mortgage interest payments, which is the targeted inflation rate.

OUTLOOK FOR FOREIGN REAL GDP AND CONSUMER PRICES: SELECTED COUNTRIES
(Percent changes)

| Measure and country | 2003 | | | | 2004 | | | | Projected | | | |
|-----------------------------------|-------------------------------------------------|------|------|------|------|------|-----|-----|-----------|-----|-----|-----|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| REAL GDP (1) | ----- Quarterly changes at an annual rate ----- | | | | | | | | | | | |
| Total foreign | 0.9 | 1.1 | 3.9 | 5.3 | 4.3 | 4.0 | 3.5 | 3.4 | 3.6 | 3.5 | 3.4 | 3.4 |
| Industrial Countries of which: | ----- | | | | | | | | | | | |
| Canada | 2.8 | -0.7 | 1.4 | 3.3 | 2.4 | 4.3 | 3.3 | 3.3 | 3.4 | 3.4 | 3.4 | 3.4 |
| Japan | 0.2 | 3.8 | 2.7 | 7.3 | 6.1 | 4.0 | 2.6 | 2.2 | 2.1 | 2.1 | 2.0 | 2.2 |
| United Kingdom | 0.8 | 2.7 | 3.8 | 4.2 | 2.9 | 3.8 | 3.2 | 3.1 | 2.9 | 2.7 | 2.6 | 2.6 |
| Euro Area (2) | -0.0 | -0.3 | 1.7 | 1.5 | 2.3 | 2.1 | 1.8 | 1.9 | 1.9 | 1.9 | 2.0 | 2.0 |
| Germany | -1.0 | -0.7 | 0.8 | 1.1 | 1.8 | 1.6 | 1.1 | 1.4 | 1.3 | 1.4 | 1.7 | 1.7 |
| Developing Countries | ----- | | | | | | | | | | | |
| Asia | 0.3 | 2.3 | 7.1 | 7.1 | 6.3 | 4.8 | 4.7 | 4.5 | 4.7 | 4.5 | 4.4 | 4.4 |
| Korea | 3.5 | -1.7 | 13.9 | 8.9 | 7.6 | 5.1 | 5.2 | 5.0 | 5.2 | 5.1 | 5.0 | 5.0 |
| China | -1.1 | -0.2 | 6.7 | 11.3 | 3.2 | 4.5 | 3.8 | 3.8 | 4.7 | 4.8 | 4.7 | 4.8 |
| Latin America | 15.5 | 2.9 | 12.4 | 9.4 | 14.4 | 2.8 | 7.3 | 7.3 | 7.3 | 7.3 | 7.5 | 7.5 |
| Mexico | -3.5 | 5.8 | 0.9 | 6.0 | 5.5 | 4.8 | 4.4 | 4.1 | 4.3 | 4.0 | 3.8 | 3.8 |
| Brazil | -1.7 | 4.6 | -0.4 | 5.6 | 5.4 | 5.1 | 4.7 | 4.3 | 4.6 | 4.2 | 4.0 | 4.0 |
| | -4.6 | -3.5 | 2.1 | 5.9 | 6.8 | 3.5 | 2.5 | 2.5 | 3.0 | 3.0 | 3.0 | 3.0 |
| CONSUMER PRICES (3) | ----- Four-quarter changes ----- | | | | | | | | | | | |
| Industrial Countries | 2.4 | 1.7 | 1.4 | 1.3 | 0.8 | 1.5 | 1.7 | 1.7 | 1.6 | 1.5 | 1.4 | 1.4 |
| of which: | ----- | | | | | | | | | | | |
| Canada | 4.5 | 2.8 | 2.1 | 1.7 | 0.9 | 2.2 | 2.5 | 2.5 | 2.4 | 2.1 | 1.9 | 1.8 |
| Japan | -0.3 | -0.2 | -0.5 | -0.4 | -0.3 | -0.2 | 0.0 | 0.1 | 0.1 | 0.2 | 0.2 | 0.3 |
| United Kingdom (4) | 1.5 | 1.3 | 1.4 | 1.3 | 1.2 | 1.4 | 1.7 | 1.6 | 1.6 | 2.0 | 1.8 | 1.8 |
| Euro Area (2) | 2.3 | 1.9 | 2.1 | 2.0 | 1.7 | 2.3 | 2.2 | 2.1 | 2.1 | 1.9 | 1.8 | 1.8 |
| Germany | 1.1 | 0.9 | 1.0 | 1.2 | 1.0 | 1.9 | 1.8 | 1.6 | 1.7 | 1.4 | 1.4 | 1.3 |
| Developing Countries | ----- | | | | | | | | | | | |
| Asia | 3.4 | 3.1 | 2.6 | 3.0 | 3.0 | 3.6 | 4.1 | 3.9 | 3.8 | 3.4 | 3.2 | 3.0 |
| Korea | 1.2 | 1.1 | 1.1 | 2.1 | 2.2 | 3.3 | 4.0 | 3.6 | 3.5 | 2.9 | 2.4 | 2.3 |
| China | 4.1 | 3.3 | 3.2 | 3.5 | 3.3 | 3.4 | 4.5 | 4.3 | 4.6 | 5.1 | 4.3 | 3.9 |
| Latin America | 0.4 | 0.7 | 0.9 | 2.6 | 2.8 | 4.4 | 4.9 | 4.0 | 3.8 | 2.4 | 1.8 | 1.6 |
| Mexico | 7.1 | 6.4 | 5.4 | 4.9 | 4.7 | 4.5 | 4.6 | 4.6 | 4.4 | 4.4 | 4.4 | 4.1 |
| Brazil | 5.5 | 4.8 | 4.0 | 3.9 | 4.3 | 4.3 | 4.2 | 4.1 | 3.9 | 4.0 | 4.0 | 3.8 |
| | 15.7 | 17.0 | 15.3 | 11.5 | 6.8 | 5.5 | 6.8 | 6.9 | 6.4 | 6.2 | 5.4 | 5.2 |

1. Foreign GDP aggregates calculated using shares of U.S. exports.
2. Harmonized data for euro area from Eurostat.
3. Foreign CPI aggregates calculated using shares of U.S. non-oil imports.
4. CPI excluding mortgage interest payments, which is the targeted inflation rate.

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | Projected 2004 | Projected 2005 |
|----------------------------------------------------|--------|--------|--------|--------|--------|--------|--------|-------------------|-------------------|
| NIPA REAL EXPORTS and IMPORTS | | | | | | | | | |
| Percentage point contribution to GDP growth, Q4/Q4 | | | | | | | | | |
| Net Goods & Services | -0.8 | -1.1 | -1.0 | -0.9 | -0.2 | -0.9 | -0.1 | -0.5 | -0.4 |
| Exports of G&S | 0.9 | 0.3 | 0.6 | 0.7 | -1.3 | 0.3 | 0.6 | 1.0 | 0.8 |
| Imports of G&S | -1.7 | -1.4 | -1.6 | -1.6 | 1.1 | -1.3 | -0.7 | -1.4 | -1.2 |
| Percentage change, Q4/Q4 | | | | | | | | | |
| Exports of G&S | 8.3 | 2.6 | 5.6 | 6.5 | -11.9 | 3.5 | 6.1 | 9.9 | 7.6 |
| Services | 0.4 | 4.4 | 5.3 | 1.8 | -8.9 | 9.8 | 3.8 | 6.9 | 6.0 |
| Computers | 26.7 | 7.3 | 13.4 | 22.7 | -23.5 | -1.0 | 11.2 | 9.2 | 19.5 |
| Semiconductors | 21.1 | 9.5 | 34.6 | 27.6 | -34.6 | 9.9 | 38.8 | 26.4 | 38.9 |
| Other Goods 1/ | 9.8 | 1.2 | 3.3 | 5.9 | -10.2 | 0.4 | 5.0 | 10.4 | 5.7 |
| Imports of G&S | 14.3 | 11.0 | 12.1 | 11.2 | -7.6 | 9.7 | 4.9 | 9.9 | 7.8 |
| Services | 11.9 | 10.4 | 6.5 | 10.7 | -5.9 | 8.9 | 3.7 | 6.2 | 4.9 |
| Oil | 4.2 | 4.2 | -3.4 | 13.3 | 3.7 | 4.2 | 1.8 | 1.5 | 1.5 |
| Computers | 32.6 | 26.4 | 26.0 | 13.9 | -13.6 | 13.4 | 16.9 | 27.2 | 19.5 |
| Semiconductors | 32.5 | -7.7 | 34.2 | 22.8 | -51.1 | 10.0 | 0.3 | 39.5 | 36.3 |
| Other Goods 2/ | 13.1 | 11.2 | 12.9 | 10.5 | -6.5 | 9.9 | 4.9 | 10.2 | 8.0 |
| Billions of Chained 2000 Dollars | | | | | | | | | |
| Net Goods & Services | -104.6 | -203.8 | -296.2 | -379.5 | -399.1 | -472.1 | -518.5 | -561.6 | -603.8 |
| Exports of G&S | 943.7 | 966.5 | 1008.2 | 1096.3 | 1036.7 | 1012.4 | 1031.8 | 1139.9 | 1235.0 |
| Imports of G&S | 1048.3 | 1170.3 | 1304.5 | 1475.8 | 1435.8 | 1484.4 | 1550.2 | 1701.4 | 1838.8 |
| Billions of dollars | | | | | | | | | |
| US CURRENT ACCOUNT BALANCE | -136.0 | -209.6 | -296.8 | -413.5 | -385.7 | -473.9 | -530.7 | -617.3 | -694.2 |
| Current Acct as Percent of GDP | -1.6 | -2.4 | -3.2 | -4.2 | -3.8 | -4.5 | -4.8 | -5.3 | -5.6 |
| Net Goods & Services (BOP) | -108.2 | -164.9 | -263.3 | -378.4 | -362.7 | -421.7 | -496.5 | -584.0 | -626.6 |
| Investment Income, Net | 17.0 | 8.3 | 18.4 | 25.3 | 28.7 | 12.6 | 38.8 | 52.1 | 19.9 |
| Direct, Net | 72.4 | 65.5 | 78.2 | 94.9 | 115.9 | 100.8 | 118.9 | 155.6 | 163.9 |
| Portfolio, Net | -55.4 | -57.2 | -59.8 | -69.7 | -87.2 | -88.2 | -80.1 | -103.5 | -144.0 |
| Other Income & Transfers, Net | -44.8 | -53.0 | -52.0 | -60.4 | -51.7 | -64.8 | -72.9 | -85.4 | -87.5 |

1. Merchandise exports excluding computers and semiconductors.
2. Merchandise imports excluding oil, computers, and semiconductors.

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

| | 2000 | | | | 2001 | | | | 2002 | | | |
|-------------------------------|--------------------------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| NIPA REAL EXPORTS and IMPORTS | | | | | | | | | | | | |
| | Percentage point contribution to GDP growth | | | | | | | | | | | |
| Net Goods & Services | -1.5 | -1.0 | -0.9 | -0.1 | -0.0 | 0.5 | -0.6 | -0.7 | -1.1 | -0.5 | -0.4 | -1.7 |
| Exports of G&S | 0.7 | 1.3 | 1.1 | -0.3 | -0.6 | -1.4 | -2.0 | -1.1 | 0.4 | 1.0 | 0.3 | -0.4 |
| Imports of G&S | -2.2 | -2.3 | -2.0 | 0.2 | 0.6 | 1.9 | 1.5 | 0.5 | -1.5 | -1.5 | -0.7 | -1.3 |
| | Percentage change from previous period, s.a.a.r. | | | | | | | | | | | |
| Exports of G&S | 6.6 | 12.3 | 10.7 | -2.7 | -5.3 | -12.7 | -18.2 | -10.8 | 4.7 | 11.0 | 3.1 | -4.2 |
| Services | 1.4 | 8.4 | -6.6 | 4.5 | -5.0 | -0.6 | -13.7 | -15.3 | 21.7 | 4.5 | 3.5 | 10.5 |
| Computers | 32.7 | 47.0 | 30.1 | -10.7 | -9.8 | -35.7 | -24.9 | -21.3 | -20.4 | 11.9 | -3.8 | 12.3 |
| Semiconductors | 24.2 | 73.7 | 35.0 | -8.9 | -30.0 | -54.0 | -45.3 | 3.7 | 24.9 | 38.8 | 11.4 | -24.4 |
| Other Goods 1/ | 5.9 | 7.5 | 16.0 | -4.5 | -2.5 | -11.5 | -17.6 | -8.6 | -2.1 | 12.6 | 2.7 | -10.3 |
| Imports of G&S | 16.7 | 16.5 | 14.1 | -1.6 | -3.7 | -12.6 | -10.3 | -3.4 | 12.5 | 11.4 | 5.4 | 9.6 |
| Services | 20.9 | 10.6 | 14.3 | -1.8 | -5.1 | 12.9 | -18.3 | -10.4 | 24.6 | -5.7 | 2.8 | 16.5 |
| Oil | 28.5 | 40.6 | -2.6 | -6.4 | 63.5 | -33.8 | -28.2 | 49.1 | -5.6 | -17.5 | -10.8 | 69.9 |
| Computers | -2.2 | 44.9 | 35.4 | -12.3 | -22.6 | -23.3 | -13.4 | 8.4 | 50.2 | 7.2 | 2.6 | 0.2 |
| Semiconductors | 25.0 | 45.4 | 71.1 | -26.9 | -43.9 | -70.1 | -55.4 | -23.7 | 42.3 | 33.9 | -6.7 | -17.6 |
| Other Goods 2/ | 16.4 | 12.2 | 12.2 | 1.8 | -5.5 | -10.6 | -3.7 | -5.9 | 8.3 | 19.4 | 8.5 | 4.1 |
| | Billions of Chained 2000 Dollars, s.a.a.r. | | | | | | | | | | | |
| Net Goods & Services | -350.6 | -374.5 | -395.6 | -397.2 | -398.2 | -385.2 | -398.4 | -414.5 | -444.9 | -458.1 | -469.8 | -515.4 |
| Exports of G&S | 1060.9 | 1092.0 | 1120.0 | 1112.3 | 1097.2 | 1060.6 | 1008.7 | 980.3 | 991.6 | 1017.8 | 1025.5 | 1014.5 |
| Imports of G&S | 1411.5 | 1466.5 | 1515.6 | 1509.5 | 1495.4 | 1445.8 | 1407.1 | 1394.9 | 1436.5 | 1475.9 | 1495.3 | 1529.8 |
| | Billions of dollars, s.a.a.r. | | | | | | | | | | | |
| US CURRENT ACCOUNT BALANCE | -391.5 | -394.3 | -428.8 | -439.2 | -426.8 | -390.2 | -367.6 | -358.3 | -440.8 | -471.6 | -476.0 | -507.4 |
| Current Account as % of GDP | -4.1 | -4.0 | -4.3 | -4.4 | -4.3 | -3.9 | -3.6 | -3.5 | -4.3 | -4.5 | -4.5 | -4.8 |
| Net Goods & Services (BOP) | -358.4 | -361.8 | -387.5 | -405.7 | -389.3 | -356.1 | -357.1 | -348.3 | -375.0 | -413.5 | -427.7 | -470.7 |
| Investment Income, Net | 20.1 | 22.8 | 17.1 | 41.1 | 23.9 | 29.8 | 1.5 | 59.7 | 9.2 | 1.8 | 10.6 | 28.8 |
| Direct, Net | 84.5 | 88.9 | 91.9 | 114.5 | 106.2 | 116.1 | 95.0 | 146.2 | 100.6 | 95.1 | 94.9 | 112.8 |
| Portfolio, Net | -64.4 | -66.1 | -74.8 | -73.4 | -82.3 | -86.3 | -93.5 | -86.6 | -91.4 | -93.2 | -84.3 | -84.0 |
| Other Inc. & Transfers, Net | -53.1 | -55.3 | -58.4 | -74.6 | -61.3 | -63.9 | -12.0 | -69.7 | -75.0 | -59.9 | -59.0 | -65.4 |

1. Merchandise exports excluding computers and semiconductors.
2. Merchandise imports excluding oil, computers, and semiconductors.

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

| | 2003 | | | | 2004 | | | | Projected | | | |
|-------------------------------|--------------------------------------------------|--------|--------|--------|--------|--------|--------|--------|-----------|--------|--------|--------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| NIPA REAL EXPORTS and IMPORTS | | | | | | | | | | | | |
| | Percentage point contribution to GDP growth | | | | | | | | | | | |
| Net Goods & Services | 0.1 | -0.5 | 0.6 | -0.7 | -0.8 | -0.2 | 9.4 | 10.6 | -0.3 | -0.1 | -0.5 | -0.7 |
| Exports of G&S | -0.2 | -0.2 | 1.0 | 1.6 | 0.7 | 0.9 | 7.6 | 6.8 | 0.6 | 0.8 | 0.8 | 0.9 |
| Imports of G&S | 0.3 | -0.3 | -0.4 | -2.2 | -1.5 | -1.1 | 1.8 | 1.1 | -0.9 | -0.9 | -1.3 | -1.7 |
| | Percentage change from previous period, s.a.a.r. | | | | | | | | | | | |
| Exports of G&S | -1.5 | -1.6 | 11.3 | 17.5 | 7.3 | 12.4 | 9.4 | 10.6 | 5.7 | 8.0 | 7.7 | 8.8 |
| Services | -12.7 | -3.5 | 14.1 | 20.6 | 3.4 | 10.0 | 7.6 | 6.8 | 6.5 | 6.0 | 5.8 | 5.6 |
| Computers | -4.5 | -3.4 | 38.2 | 19.8 | -8.3 | 3.3 | 22.1 | 22.9 | 14.3 | 20.9 | 21.4 | 21.4 |
| Semiconductors | 40.9 | 28.0 | 40.8 | 45.9 | 12.5 | 6.4 | 44.9 | 46.9 | 27.3 | 42.4 | 43.3 | 43.5 |
| Other Goods 1/ | 2.4 | -2.4 | 6.6 | 13.9 | 10.1 | 14.6 | 7.5 | 9.5 | 3.6 | 6.1 | 5.6 | 7.5 |
| Imports of G&S | -1.9 | 2.5 | 2.9 | 17.1 | 10.6 | 9.5 | 7.6 | 11.7 | 6.0 | 5.9 | 8.4 | 11.1 |
| Services | -2.4 | -9.4 | 17.9 | 11.0 | 1.1 | 12.9 | 4.7 | 6.4 | 5.0 | 4.9 | 4.9 | 4.8 |
| Oil | -6.0 | -2.8 | 0.6 | 16.6 | 39.0 | -35.7 | -2.1 | 21.2 | 13.7 | -20.8 | -3.6 | 22.4 |
| Computers | 7.0 | 15.9 | 12.0 | 34.2 | 12.8 | 39.1 | 27.8 | 30.5 | 3.8 | 24.3 | 25.6 | 25.9 |
| Semiconductors | -4.0 | 2.4 | -1.5 | 4.4 | 42.2 | 23.3 | 45.5 | 48.5 | 18.9 | 41.7 | 43.1 | 43.3 |
| Other Goods 2/ | -1.8 | 5.5 | -0.9 | 17.9 | 8.9 | 14.7 | 7.7 | 9.6 | 5.0 | 8.6 | 9.1 | 9.5 |
| | Billions of Chained 2000 Dollars, s.a.a.r. | | | | | | | | | | | |
| Net Goods & Services | -511.7 | -525.2 | -508.7 | -528.3 | -550.1 | -555.3 | -561.0 | -579.9 | -589.2 | -591.7 | -605.9 | -628.5 |
| Exports of G&S | 1010.6 | 1006.5 | 1033.8 | 1076.2 | 1095.4 | 1127.8 | 1153.4 | 1182.8 | 1199.5 | 1222.7 | 1245.5 | 1272.2 |
| Imports of G&S | 1522.3 | 1531.7 | 1542.5 | 1604.5 | 1645.5 | 1683.1 | 1714.4 | 1762.7 | 1788.7 | 1814.4 | 1851.4 | 1900.6 |
| | Billions of dollars, s.a.a.r. | | | | | | | | | | | |
| US CURRENT ACCOUNT BALANCE | -552.8 | -535.5 | -526.5 | -507.8 | -579.5 | -591.2 | -626.4 | -672.0 | -682.3 | -676.5 | -693.2 | -725.0 |
| Current Account as % of GDP | -5.1 | -4.9 | -4.7 | -4.5 | -5.1 | -5.1 | -5.3 | -5.6 | -5.6 | -5.5 | -5.6 | -5.8 |
| Net Goods & Services (BOP) | -501.6 | -493.5 | -489.0 | -502.0 | -547.7 | -569.7 | -595.8 | -622.6 | -622.3 | -616.6 | -624.9 | -642.8 |
| Investment Income, Net | 21.5 | 29.1 | 34.5 | 70.1 | 56.3 | 62.7 | 53.8 | 35.5 | 34.6 | 24.8 | 16.7 | 3.3 |
| Direct, Net | 101.3 | 105.4 | 114.6 | 154.2 | 142.0 | 157.3 | 157.6 | 165.5 | 161.5 | 162.7 | 166.0 | 165.3 |
| Portfolio, Net | -79.8 | -76.3 | -80.1 | -84.1 | -85.7 | -94.6 | -103.8 | -130.0 | -126.8 | -137.9 | -149.3 | -162.0 |
| Other Inc. & Transfers, Net | -72.8 | -71.0 | -72.0 | -76.0 | -88.1 | -84.1 | -84.4 | -84.9 | -94.6 | -84.7 | -85.1 | -85.5 |

1. Merchandise exports excluding computers and semiconductors.
2. Merchandise imports excluding oil, computers, and semiconductors.